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# RAFI notes Rural Leasing

## Issue 11

*With limited access to traditional loan financing, where can collateral-poor rural enterprises turn to finance needed equipment? Leasing—already a popular financing tool for businesses in urban areas—has the potential to shore up this gap in rural and agricultural finance.*

### INTRODUCTION

Enterprises in developing countries depend on financing to acquire the equipment needed to increase productivity. In rural areas, however, enterprises' access to long-term finance is often limited by a lack of acceptable collateral.

Leasing as a financing tool has the potential to address this market failure in rural credit. While traditionally more common in urban centers, leasing overcomes many of the constraints to accessing medium and longer-term financing in rural areas. Leasing can allow businesses with limited collateral, cash and credit history to acquire productivity-enhancing equipment, while providing lessors with the comfort they need to take on rural and agricultural clients.

This RAFI note explores the benefits that developing leasing markets can bring to farmers and rural businesses. It also addresses the constraints that often must be overcome in developing a viable leasing industry, and interventions that can help overcome those constraints, drawing on the leasing literature as well as recent donor experience in the leasing sector. The note concludes by highlighting the implications for USAID programming in rural and agricultural finance.

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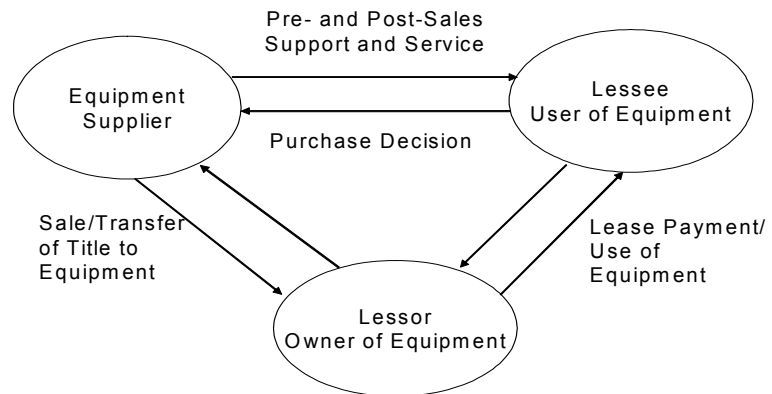
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## THE NUTS AND BOLTS OF LEASING

Leasing, like lending, is a method of financing the acquisition of fixed assets. In contrast to loan financing, however, leasing assumes that the value of an asset is in its use, rather than in its ownership. Formally defined, a lease is a contractual arrangement between two parties, where the provider (the *lessor*) owns the asset and lets the client (the *lessee*) use the equipment asset in exchange for periodic payments. In practical terms, leasing allows enterprises that cannot purchase equipment (because they do not have the required funds or lack access to bank finance) the opportunity to use equipment without having to own it, while giving lessors the security they need to extend longer-term financing in rural markets.

Leasing comes in two main forms: finance leases and operating leases. In a finance lease, the lease period typically extends for most or all of the equipment's useful life, and the lessor recovers the equipment costs plus interest through a regular stream of lease payments. The lessee bears all the costs of maintenance, damage and insurance and the lease usually cannot be canceled. Furthermore, at the end of the lease, the lessee usually has the option to purchase the asset for a nominal price. Although the

**FIGURE 1: A TYPICAL FINANCE LEASE**



Source: Adapted from Nair et al 2004.

mechanics are somewhat different, finance leases are seen as close substitute for term loans for financing asset acquisition.

In contrast, an operating lease is more akin to a simple rental. In an operating lease, the lessor recoups his investment through multiple, usually shorter-term leases and the final sale of the asset, sometimes for substantial value. Unlike finance leases, operating leases can usually be canceled, and the lessor, not the lessee, bears all the costs of maintenance, insurance and damage. Because of the substantial additional risks that operating leases pose to lessors—not least of which is the uncertainty of finding a second-hand market for used equipment—most leasing companies offer only finance leases in emerging markets. In this note, therefore, we focus on the finance lease, unless otherwise specified.

The typical finance lease is a three-party deal (see Figure 1). The equipment user first chooses the equipment and the dealer after comparing models, price, maintenance and other factors. With the supplier's quote in hand, the equipment user chooses a lessor after comparing lease terms (down payment required, interest rate, option to purchase at the end of the lease term, etc.). The lessor then purchases and delivers this equipment to the user (now the lessee), which the lessee uses for the term of the lease in exchange for fixed regular payments.

## BENEFITS OF LEASING

There are considerable benefits to developing leasing as a financing tool in rural areas of developing economies. From the user's perspective, the benefits include:

**Accessibility.** Collateral requirements are frequently the main constraint to accessing credit in rural areas. Many farmers and rural businesses lack clear title to their

land, have land of low market value, or otherwise face legal hurdles to pledging movable property as collateral for loans. Because the leased asset itself is usually all that is needed to secure the transaction, leasing can allow enterprises with no credit history and limited or no collateral to acquire assets to expand operations and boost production potential.

**Duration.** Rural enterprises seldom have access to term funding (i.e., loans with terms over one year). Leases typically run for most or all of the useful economic life of the asset being leased, often with terms from two to five years or longer.

**Flexibility.** Lease terms may vary substantially to meet the needs of both the lessee and lessor. One variation on a finance lease is the “lease-back”, in which the client sells his equipment to the lessor, who in turn leases the equipment back to the client. In effect, the lease-back unties the cash invested in one asset for investment in others while retaining the asset, which is still needed in order to operate.

**Processing time.** The “collateral” in a lease is the asset itself, eliminating the need for complex credit analysis, loan documentation and other transaction costs.

**Taxes.** In most countries, the lessee can offset lease payments against taxable in-

come, while borrowers can only deduct the interest paid on bank loans. Furthermore, the lessor as owner of the asset can claim depreciation benefits, which the lessor may or may not pass on to the lessee through reduced financing costs.

From the provider’s perspective, the primary benefits of leasing include:

**Ownership.** Since the lessor owns the leased asset, the asset is easier to reclaim than when a lender has to chase after the client’s collateral, often through poorly developed court systems where liens are difficult to enforce.

**Regulation.** Leasing is typically less regulated than is lending. Many countries impose ceilings on loan interest rates, particularly for small or rural loans, but they do not regulate lease rates. Leasing companies also face less stringent requirements on measures such as capitalization, debt-equity ratios, and credit allocations. Lesser regulation allows leasing operations more leverage in raising funds and flexibility to charge market interest rates that let them extend their reach to client segments that lenders might consider too high risk.

## ENABLING ENVIRONMENT ISSUES

For leasing to develop and benefit both equipment providers and users, an appropriate

“enabling environment” must be in place. Experience around the world demonstrates that a supportive leasing environment begins with sound, transparent, and consistent leasing legislation and effective but modest regulation.

At a minimum the legal framework—whether codified in a specific leasing law or integrated into the general civil code—should include: (1) clear definitions of leasing concepts and rights and responsibilities of lessor and lessee; (2) clarity in assigning liability for third-party losses arising from use of leased assets; (3) priority of lessor’s claims over leased assets; and (4) clear ground rules for repossession of leased assets.<sup>1</sup> The easier it is to reclaim an asset and claim payments and damages due, the more likely leasing companies will be to take on riskier clients and offer leases with lower risk premiums, making financing available more cheaply to a broader customer base.

Prudential regulation is also important but, to the extent leasing companies do not take public deposits, regulation should be kept to a minimum. Furthermore, since finance leases, which form the large majority of leases in developing countries, are usually no more risky than term loans, it can even be argued that banks and other deposit-taking institutions be permitted to offer finance leases, either directly or through subsidiaries.

Sound accounting and tax regimes can also enhance the development of a nascent leasing sector. Ac-

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<sup>1</sup> Nair, Kloepfinger-Todd and Mulder (2004), p. 13.

counting rules affect how leases (and the underlying assets) are reflected in the accounts of the lessor and lessee, as well as the treatment of leases for tax purposes. Use of internationally accepted accounting standards for leasing can help ensure that abuse of leasing instruments, and in turn regulation of the industry, stays at a minimum.

In addition, the tax system can either benefit or impede the growth of leasing markets, depending on the extent to which tax rules reflect an adequate understanding of leasing. As a general rule, tax laws should treat leasing as a viable alternative to outright purchase and should not discriminate between leasing and other forms of financing. In practice, however, this rarely happens, and tax laws can end up working against the leasing sector (see text box). Aligning tax incentives with efforts to promote capital investment and SME growth can also be very complicated, especially in the rural context. Although many governments allow lessees to deduct lease amounts from before-tax income, rural businesses and farmers often fall below the taxable income threshold or are otherwise granted tax-exempt status by law, and thus those tax benefits are lost to a segment of the population that needs them most.

## PARTICULAR ISSUES FOR RURAL LEASING

Even if a strong enabling environment is in place, there are a number of micro, or firm-level challenges that can affect the market for leasing in rural areas. These include: (1) costs of recovery, (2) costs of monitoring, (3) equipment maintenance, and (4) availability of insurance services.

First, the costs of seizing assets can be considerably higher than in more developed areas, especially given the geographical dispersion of rural enterprises. With farm equipment leasing, repossession problems are compounded by weather-related setbacks and fluctuations in agricultural commodity prices, which in many cases lead to contract renegotiation rather than repossession. Because of the higher costs of recovery, the down payment required by lessors may be higher than that required of urban clients, making leasing more costly for rural enterprises.

Second, monitoring costs—the costs related to ensuring timely payment and verifying the proper use of leased assets—can be high because of the greater distances to and between lessee locations. These costs can be mitigated with the development of local networks of partners to help monitor the leases, but fostering these relationships takes considerable time and effort.

Misperceptions about leasing can often fuel policies that put leasing at a disadvantage compared to other financing options. Until recently, for example, value added tax (VAT) rules in Armenia provided VAT exemptions for certain equipment when imported for use, but not when imported for lease. After considerable lobbying from the USAID-supported ACBA Leasing Company, the Government of Armenia in 2005 extended the exemption to include the same equipment when imported for lease.

Third, equipment maintenance, while nominally the responsibility of the lessee, poses additional challenges for lessors who need to ensure adequate local maintenance service to reduce the possibility of default due to equipment failure. Maintenance is especially important in the case of used equipment leasing, which is likely to be more affordable for the majority of rural clients, but which typically comes with shorter terms and higher down payments.

Fourth, access to insurance services is often limited in rural areas, which may discourage leasing companies from extending their services to rural clients. Liability insurance is especially important in the case of vehicle leases, to protect the lessor from liability arising out of accidents.

These challenges aside, leasing companies come in various shapes and sizes, and rural leasing may not be appropriate for all of them. Consider the most common types of

lessors in emerging markets: state-owned leasing companies, private leasing companies, commercial banks, microfinance institutions, and equipment manufacturers.

State-owned leasing companies, still common in many transitioning economies, have significant outreach and institutional infrastructure, but are enmeshed in a culture of subsidies that can undermine their long-term financial stability. Private leasing companies have the advantage of independence and usually have more specialized knowledge of the equipment they lease, but private leasing companies are generally urban-based and may find it uneconomical to provide services in rural areas. In contrast, commercial banks, while generally more regulated than other financial institutions, have access to cheaper funds through deposits and benefit from branch networks that give them greater geographical reach and the ability to provide other financial services to rural lessees. Microfinance institutions, meanwhile, may reach the smallest rural businesses, but access to long-term funds (to finance equipment purchases) is usually limited, and given limited operational resources, the costs of setting up leasing subsidiaries in rural areas may be beyond their means. Finally, equipment manufacturers often provide leasing services through captive leasing

operations, effectively integrating equipment purchase and financing; but such services are generally only available in stronger emerging markets.

There is no conclusive evidence that one type of lessor is more likely to succeed in rural markets than others, but experience shows that success in rural leasing depends on two key elements: (1) local presence, whether through branch offices or through close links to organizations that can provide leasing support services in rural areas, and (2) access to competitive local currency term funds.

## STRATEGIC INTERVENTIONS

In addition to support for enabling environment reforms, a combination of sector and firm-level interventions can help leasing companies expand operations and enhance the development of rural leasing. These include: (1) subsidizing startup costs, (2) providing credit enhancements, (3) lending technical support to nascent leasing operations, and (4) strengthening leasing industry linkages.

Subsidizing startup costs can help leasing companies offset the higher costs and risks of setting up in rural areas. Several international donor organizations, including USAID, are already doing this through existing projects. In 2004, USAID provided seed capital to help launch Armenia's first pri-

vately financed commercial leasing company, ACBA Leasing, a subsidiary of the Agricultural Cooperative Bank of Armenia. In Uganda, too, USAID provided capital to help Development Finance Company Uganda (DFCU) establish rural leasing branches.

Credit enhancements, such as the guarantees issued by USAID's Development Credit Authority (DCA), can encourage commercial banks to extend long-term financing to leasing company partners. A guarantee facility can be designed to support strategic objectives, including expansion of leasing services to rural SMEs and agribusinesses.

Leasing companies can also benefit from technical assistance to support product development, staff training, and improvements in management and service delivery. Credit officers with little leasing experience will need education not only on the intricacies of leasing, risk analysis and monitoring, but also on the equipment needs and risk profiles of rural and agricultural clients. In addition, public education efforts are critical to build local understanding of leasing and its benefits. With support from USAID's Agribusiness SME Development (ASME) Project, ACBA Leasing has made presentations at industry seminars and workshops, participated in trade shows, and developed and provided materials to potential lessees, equipment distributors and importers to educate them on leasing and how leasing deals are structured.

Finally, strengthening industry linkages can enhance the development of the rural leasing sector. Donors can assist in the creation of links

between urban-based leasing companies and rural organizations that can provide monitoring, equipment maintenance and other support services. Support can also be provided in developing regional or national leasing associations to provide legislative advocacy and training for leasing companies, filling a critical industry support and advocacy role long after donors have left.

## CONCLUSIONS

Leasing can be a viable tool for financing rural assets and deepening the rural financial sector. For lessors, it provides a financing mechanism with the potential to reduce transaction costs and manage risk, while providing them with opportunities to reach customers in new markets. For rural SMEs and agribusinesses, it enables capital investment and productivity enhancement even when financial resources are scarce, and thus it addresses an important unsatisfied demand for financing. Furthermore, from the perspective of financial sector development, leasing also broadens the product range and competition in financial services, leading ultimately to lower cost financing for all businesses.

When considering integrating leasing into rural finance development projects, USAID Missions should consider the following:

- Determining how to support increased access to leasing in rural areas depends on the composition and capacity of existing financial institutions, the level of leasing industry development, and the rural demand for leasing. An initial market study may be a good way to gauge the market for leasing services and potential weaknesses therein.
- Policy-level support may be required if the enabling environment for leasing is weak. Support in this regard can range from legal and regulatory framework development to accounting and tax policy reform assistance.
- Institutional support should entail a combination of targeted investment and technical assistance. Support to multiple leasing companies can stimulate competition and innovation and increase access to leasing services for rural enterprises.
- Leasing services can be more effectively targeted when located in the areas where rural and agricultural businesses operate. Project interventions that promote leasing industry development may be based in urban areas during the early stages to concentrate on enabling environment issues, but activities should increasingly be implemented in rural areas so that projects can coordinate more closely with regional and local players.
- Rather than exclusively target agribusiness or rural areas, successful leasing can better manage portfolio risk by diversifying their client base geographically and by sector and size of leases. Donor interventions should, therefore, consider the development of leasing economy-wide, not just in the rural and agricultural sectors.
- Access to term funding is one of the most critical issues for leasing companies in emerging economies. Leasing is often pursued as an alternative to term loans, simply because commercial banks do not have the liability structure to make loans of more than one or two years, as deposits are typically all short term. Many leasing companies will initially fund leases with capital, or may have loans or lines of credit from donors. Eventually, however, volume will necessitate sourcing leases with funding from inside the country, and term funds may still not be available from domestic banks. DFCU Leasing in Uganda has been dealing with this issue, and has looked at bond issuance as well as factoring or securitizing its leases (i.e., selling or borrowing against leases to generate cash that can be used to fund more leases). Donor projects can provide critical assistance in developing and refining these and other innovative solutions; but until then, access to term funding is likely to remain a major constraint to leasing as the solution to financing fixed assets.

- Donor and stakeholder collaboration and coordination are critical for ensuring that donor initiatives are well aligned, and that successful leasing models are integrated into financial sector and rural finance development projects.

## Recommended

“Leasing: An Underutilized Tool in Rural Finance,” World Bank Agricultural and Rural Development Department Discussion Paper No. 7, by Ajai Nair, Renate Kloppinger-Todd and Annabel Mulder 2004. Available at <http://www.worldbank.org/rural>

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