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"International Development & U.S. Business Partnerships:
The Role of A.I.D. in Lease Financing"

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The Role of AID in Lease Financing*

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(AAEL - please include the following disclaimer)
* The views expressed in this article are those of the author and not necessarily those of the U.S. Agency for International Development.

I. INTRODUCTION

Faced with increasing competition and specialization in a maturing domestic market, U.S. leasing companies continue to look to foreign markets as a potential area of expansion. The highest growth markets for leasing today are in developing countries. However, such an undertaking is often daunting for U.S. companies contemplating such an expansion, given the complex and varying tax, accounting, and legal systems overseas. The resulting caution is exacerbated by the political and credit risks associated with developing markets. The U.S. Agency for International Development has developed an integrated program of loans, loan/lease guarantees, training and related services to meet the need of U.S. as well as indigenous leasing companies for risk management, financial assistance, and expertise in entering developing country markets.

II. AID AND THE PARTNERSHIP FOR BUSINESS AND DEVELOPMENT

The U.S. Agency for International Development was established by Congress in 1961 with the aim of promoting broad-based, sustainable economic growth around the world. It is headquartered at the U.S. State Department in Washington, D.C., where for 30 years it has served USAID economic missions in more than 80 developing countries in Asia, Latin America and the Caribbean, and Africa and the Near East. Today, the Agency is also serving Eastern Europe.

In 1981, the Agency established the **Bureau for Private Enterprise** to implement its Private Sector Initiative. The principal goal of the Bureau is *to generate economic growth through the private sector*. In helping the Agency find the most effective means of fostering market-based economic growth, the Bureau serves as a laboratory for private sector economic development strategies. To support the private sector in developing countries, the Bureau provides technical and financial assistance, and helps host countries foster a business climate more conducive to economic development through support of policy reform and institutional change.

A key focus of AID's Private Sector Initiative, and one that is relevant for lease financing, is financial market development. Effective financial markets are critical for development because they serve to mobilize resources for productive investment. Additionally, efficient financial markets promote more widespread ownership of assets in a country. Dispersing economic power is essential for broad-based economic growth, in that it affords more people the opportunity to participate and compete in the economy.

AID has played an active role in supporting developing countries' efforts to make their financial markets more efficient. In particular, it promotes financial markets that are integrated and relatively undistorted, through initiatives that support policy reform and institutional change. The kind of system AID seeks to develop relies heavily on financial liberalization and competition in the market place. The result is a system that can channel private savings toward the most productive, high yield investments. Such a system maximizes participation in the private sector by increasing financing alternatives and making them accessible to more people.

Indeed, inaccessibility to credit is a significant problem affecting entrepreneurs in many developing nations, especially those engaged in small and medium-sized businesses. In many cases financial markets are constrained by legal and regulatory frameworks that inhibit capital mobilization and the creation of alternative financing mechanisms. For example, developing countries often impose ceilings on deposit and lending interest rates instead of letting the market determine those rates. These policies limit the growth of financial markets, and discourage financial institutions from innovation and lending except to large, firmly established companies.

AID's mission for the 1990s is "to administer economic assistance programs that combine the American tradition of international concern and generosity with the active promotion of America's national interest." An outgrowth of this mission is a new initiative, the **Partnership for Business and Development.** This initiative formally renews AID's commitment to strengthen its ties with the U.S. and the international business communities and, by extension, its commitment to assisting U.S. businesses overseas. In other words, it seeks to engage the American private sector in development through promoting U.S. exports and businesses which contribute to economic growth in A.I.D-assisted countries.

An important financial vehicle of AID for private sector development is the Private Sector Investment Program. This program is an investment pool with a cumulative portfolio of $127 million which has mobilized over $300 million in credit for businesses in developing countries. The Investment Program (formerly the Private Sector Revolving Fund) was created by Congress in 1983 to promote private sector development in developing countries primarily through the strengthening of small private sector enterprises. It was enacted under Section 108 of the Foreign Assistance Act (FAA) of 1961, as amended. Under the Omnibus Trade and Competitiveness Act of 1988 loan guarantee authority was added to the dollar lending authority of this program.

The Investment Program aims to facilitate development that is sustainable over the long-term and does not require continuous reliance on outside assistance. For this reason, the Private Sector Investment Program is designed to: 1) stimulate growth and expansion of private enterprises in developing countries by facilitating access to credit; 2) create innovative financing mechanisms to serve as models for the private sector development efforts of local USAID Missions; 3) strengthen local, private financial institutions by helping them develop new markets and learn new lending techniques; and 4) involve the United States private sector in Third World development.

There are two primary financial mechanisms utilized in the Private Sector Investment Program: loan guarantees and, on a limited basis, direct project loans. AID will either issue a non-subsidized loan to a project or will provide guarantee coverage for a project loan or for a portfolio of loans through an intermediary financial institution. These loans and loan guarantees are tailored to the needs of the client and come in a variety of packages, including U.S. export guarantees, small business guarantees, capital equipment lease transactions, subordinated bank bond guarantees, privatization support facilities, U.S. franchise expansion, and direct project loans, etc.

The active portfolio, as of March 30, 1991, consisted of $110 million in guarantee facilities with 68 intermediary financial institutions and 6 Direct Project Loans totalling $10 million. These 80 projects cover 22 individual countries in all AID assisted regions, with 5 regional and world-wide projects. Together, these cover in excess of 12,000 loans to small businesses.

III. LEASING PROMOTION IN AID'S STRATEGY

Lease financing is a new and growing facility within the Investment Program. During 1989, AID developed this new program to extend its risk-sharing coverage to transactions involving the leasing of capital equipment by small and medium-sized businesses. Leasing plays an important role in development because it affords entrepreneurs and small growing businesses an alternative means of financing in an environment with limited financing options. For this reason, in some developing countries leasing may be the only means of medium to long-term financing for capital equipment.

The growth of the leasing industry in developing countries has been aggressively promoted and encouraged not only by AID, but also by the International Finance Corporation of the World Bank and other multilateral donor groups. Leasing provides a business owner with necessary equipment while preserving bank lines of credit for the many other needs of a growing business.

According to recent statistics, while high income developed countries dominate the leasing market in terms of total leasing levels and market penetration, leasing volume is quickly growing in developing countries. Most leases in developing countries are "finance leases" as opposed to "operating leases". [Under a finance lease the lessee acquires the use of the asset for most of its useful life in return for a series of payments to the lessor over the lease period, and is responsible for taxes, maintenance, and insurance. The leased property is reflected as an asset on the lessee's balance sheet. The lessor recovers the full full capital cost of the asset, associated financing costs, and an element of profit. Under an operating lease the lessee acquires use of an asset for a fraction of its useful life. The capital cost of an asset is not paid back during the period of the lease, and is not shown on the balance sheet of the lessee. As the holder of the asset, the lessor assumes all responsibility for maintenance, personal property taxes and insurance.] Lease financing is suitable for developing countries where there is not a well developed secondary market for equipment. Under this arrangement leasing companies are able to provide lessees with long-term financing, while avoiding problems related to operation, maintenance, and selling or releasing used assets.

As is illustrated by *Chart 1* (statistics provided by the London Financial Group), wealthier countries use leasing to finance capital formation to a relatively greater extent than poorer countries. High income countries accounted for 95% of total leasing volume in 1988. Lower per capita income countries tend to have a lower percentage of market penetration (defined as leasing volume to total business investment in equipment). However, as indicated by *Chart 2*, the highest levels of leasing growth are in the lower middle income countries. These countries are the principal targets of AID assistance. Thus, there appears to be significant opportunities for the expansion of leasing in these countries. Some of the developing countries with the fastest growing leasing industries (% growth 1987-1988) are:

Turkey	1400.0	Argentina	50.0
Korea	34.4	Taiwan	37.5
Mexico	342.4	Singapore	35.8
Brazil	227.6	Indonesia	28.1
Chile	100.0	Morocco	27.0
Thailand	98.6	Nigeria	23.0
Malaysia	70.0	Philippines	18.6
Venezuela	64.0		

Chart 1

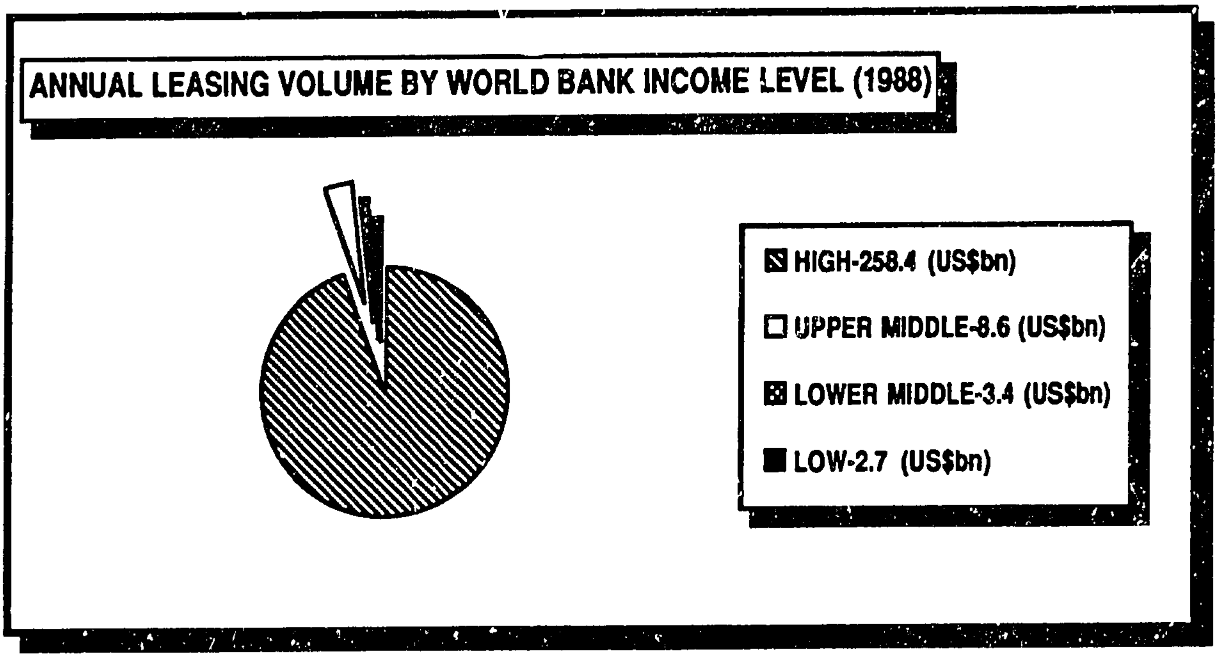
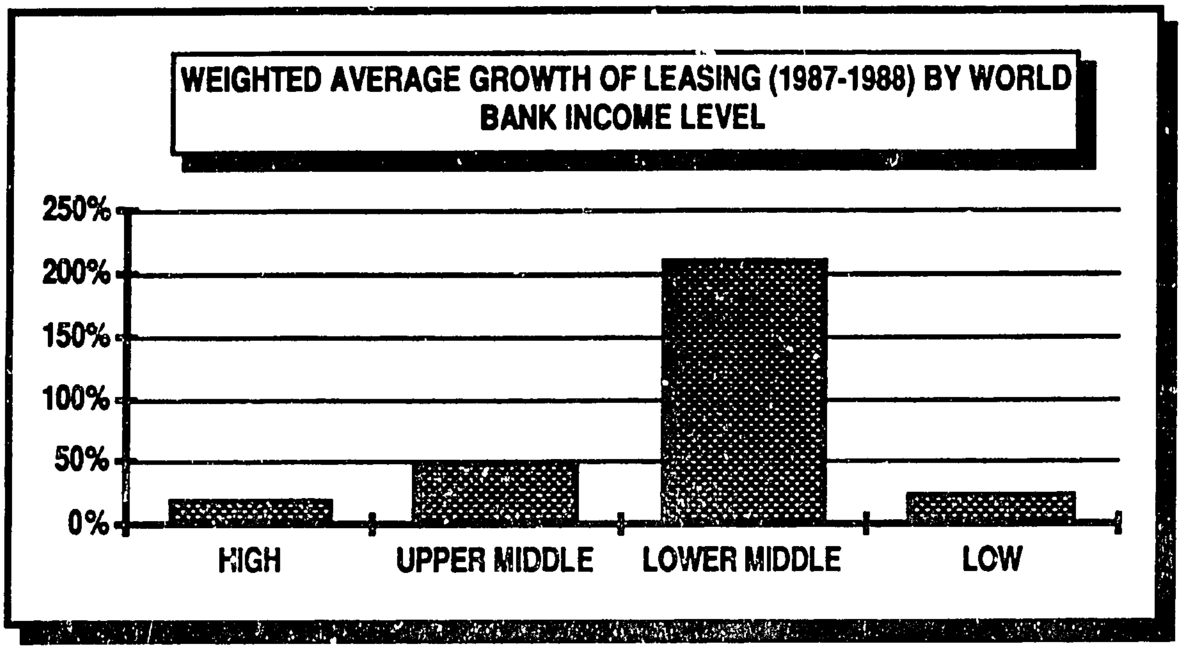


Chart 2



IV. AID's Programs and Leasing: Structuring a Leasing Guarantee

AID has the financial and technical resources to encourage the expansion of leasing as an important and innovative financial mechanism to assist in economic development. AID's lease guarantee program, now one year old, has already provided $7 million in guarantees for eight leasing companies in Pakistan, Sri Lanka, Bangladesh, the Philippines, Morocco, and the Dominican Republic, and is looking to greatly expand this program. These companies lease a wide range of equipment, including heavy industrial machinery, trucks, refrigeration equipment, computers, agricultural equipment, telephone systems, ships, and aircraft. In addition to these AID-assisted countries, AID is looking to expand to Eastern Europe and other regions.

Under its loan guarantee authority, AID extends its risk-sharing coverage by guaranteeing up to 50% of the principal of eligible loans to both small and medium enterprises and to leasing companies. Guarantees are backed by the full faith and credit of the United States Government, and are available for up to US$3 million equivalent on loan portfolios of US$6 million equivalent. The initial guarantee period is for three years, and is renewable for a total of up to nine years.

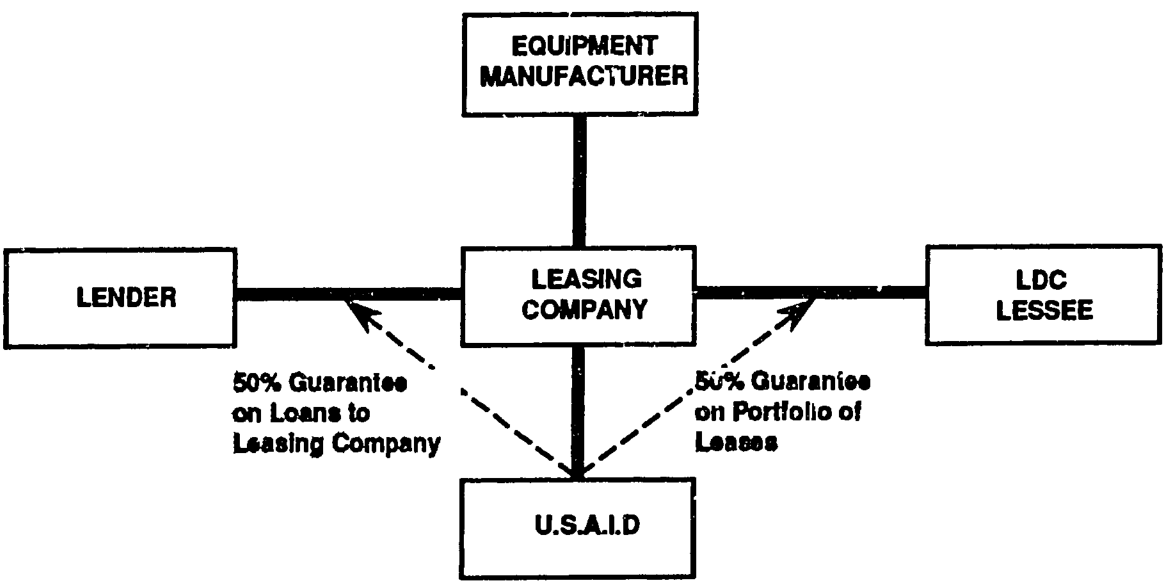
Guarantees cover small business leases made to finance any productive or commercial activity, subject only to limited restrictions. Maximum lease size to a qualifying small business is typically US$150,000.

AID charges a low front-end facility (commitment) fee of one-half percent (0.5%) of maximum U.S. Government contingent liability (i.e., its own risk exposure, or 50% of covered portfolio). Competitive annual utilization fees are based on the level of guarantee coverage actually used. Rates are at or near those for comparable letter of credit facilities. Fees may be payable in local currency.

A leasing company can benefit from a 50% guarantee in two ways. First, it can reduce its risk of lending to small and medium enterprises. Second, it can use the guarantee to back its own loan from an in-country financial institution. In this second case the leasing company can use an AID guarantee to obtain credit for expanding its inventory. These options are illustrated in Figure 1.

Figure 1

A.I.D. LEASING GUARANTEE DIAGRAM



Guarantee facilities can help a leasing company expand its capital base or share the risk involved with leasing capital equipment to small businesses. A typical transaction of a lessor using an AID guarantee to share the risk of making loans to small business lessees is as follows:

Lease Finance Company X in the Philippines learns of AID's Leasing Guarantee facility. It has been approached by a large number of small and medium companies that want to lease capital equipment. Company X wants to lease its equipment to these companies and add them to its portfolio, but is reluctant without some means of sharing its risk. It submits an application to AID for a 50% guarantee coverage of a US$6 million portfolio of equipment leases. If the application is approved, the project facility is authorized, and a letter of commitment is sent to Company X. At this point AID assumes contingent liability for 50% of a $6 million portfolio. Company X concludes individual lease transactions with the companies of its choice. It notifies AID of the transactions, the amounts utilized out of the overall $6 million facility, and remits a utilization fee for each transaction, as well as a modest front-end commitment fee.

V. Benefits to U.S. Financial Institutions, Manufacturers, and Equipment Vendors

AID's program offers two direct benefits to U.S. financial institutions desiring to expand their lending internationally (cross-border or in developing countries), manufacturers, and equipment vendors. First, it reduces the participating firms' risk exposure. By utilizing an AID guarantee a leasing company reduces its risk exposure by 50% on the portfolio of leases covered by the guarantee. This allows the leasing company to lend to small and medium enterprises which otherwise might be seen as too risky. The guarantee facility also reduces the risk of the financial institution extending credit to the leasing company. This not only benefits the lender and lessor, but, by extension, benefits the manufacturers from whom the lessor purchases more equipment.

Secondly, participating leasing companies benefit from AID's extensive experience and knowledge of the markets in developing countries around the world. AID offers a versatile package of trade and investment promotion services ranging from broad assessments of trade and investment climates and industry-specific opportunities, to more specialized services to develop free trade zones. Its Private Sector Support Services include: a broad range of technical advisory, research, training, and financial support services to improve the performance and efficiency of financial markets; a program of training, technical assistance, and credit alternatives to enhance the ability of emerging enterprises to adapt to rapid economic changes; and a flexible package of trade and investment promotion services to increase the competitiveness of enterprises in the global market place. An example of this is the current development of AID's Business and Development Network, a one-stop business service to match U.S. and developing entrepreneurs in ventures that are profitable to both. This will entail close cooperation with USAID Missions overseas and other economic arms of the U.S. government (e.g. Department of Commerce).

VI. The Future

Leasing is a quickly growing and well established industry. According to the *World Leasing Yearbook 1990*, leasing has grown rapidly in over 60 countries to the point it exceeds the Eurobond market, the medium-term note, Euro commercial paper and international equities markets. The London Financial Group Global Leasing Report estimated that the annual volume of leasing in 1988 totalled some $274 billion. As noted earlier, the highest levels of leasing growth are in the lower middle income countries, AID's principal target countries. The International Finance Corporation estimates that leasing could account for 10% of all fixed capital formation in developing countries, depending on new product development and the emergence of a strong secondary market for used equipment.

These are important considerations for U.S. leasing companies. As the U.S. market has matured, an increasing number of U.S. leasing companies are exploring the option of expanding their operations overseas. In ten years, from 1978 to 1988, leasing volume in the United States jumped from US$ 27 billion to US$ 133 billion. Development agencies like AID have anticipated this growth and are poised to assist U.S. companies in their international expansion.

In the future, AID seeks to diversify the services it offers to support leasing. Increased support for research and data gathering is envisioned because so little has been done in those areas in most countries. One area of research that is very important is looking at the critical growth factors in the leasing industry. In other words, examining what laws and regulations create the economic climate most favorable to the growth of leasing and how AID can participate in supporting needed changes. AID is also particularly interested in exploring the opportunities for expanding the use of operating-style leases. Operating leases are inherently riskier but offer certain advantages, such as flexibility and a short term commitment. There is a great need for this service in developing nations and correspondingly a great potential for expanding the use of this type of lease in middle income countries. On a more limited basis, AID also plans to support leasing through technical training, regional conferences, and various means of financial support.

Close collaboration and partnership between the U.S. Agency for International Development and U.S. industries such as leasing has the dual benefit of promoting U.S. firms' competitive position internationally, while facilitating AID's development objectives in the most efficient manner.

For more information on AID's Leasing Guarantee Program, or to obtain an application for guarantee coverage, contact:

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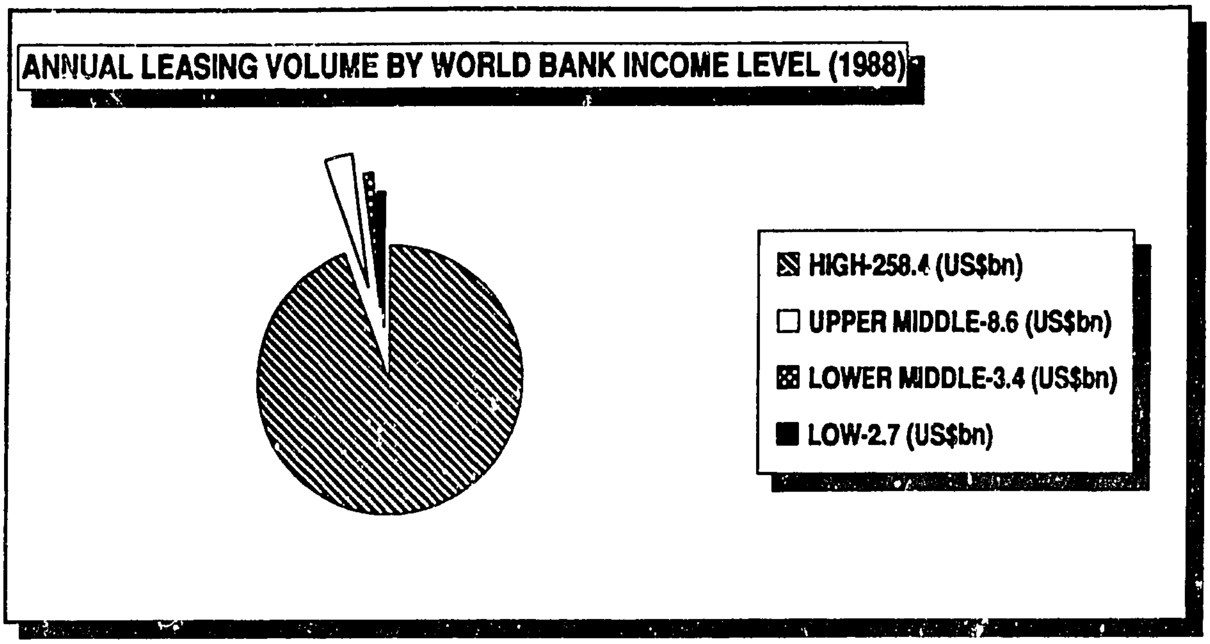
Telex: 248379 AID UR


ANNUAL LEASING VOLUME BY WORLD BANK INCOME LEVEL (1988)
HIGH-258.4 (US$bn)
UPPER MIDDLE-8.6 (US$bn)
LOWER MIDDLE-3.4 (US$bn)
LOW-2.7 (US$bn)

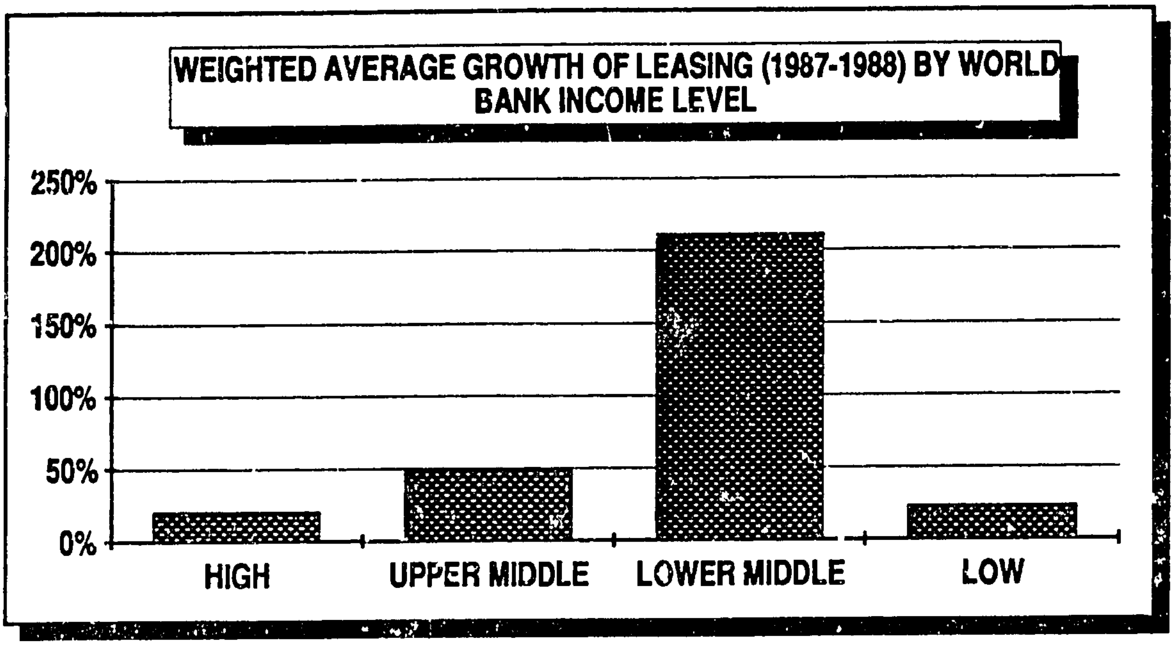
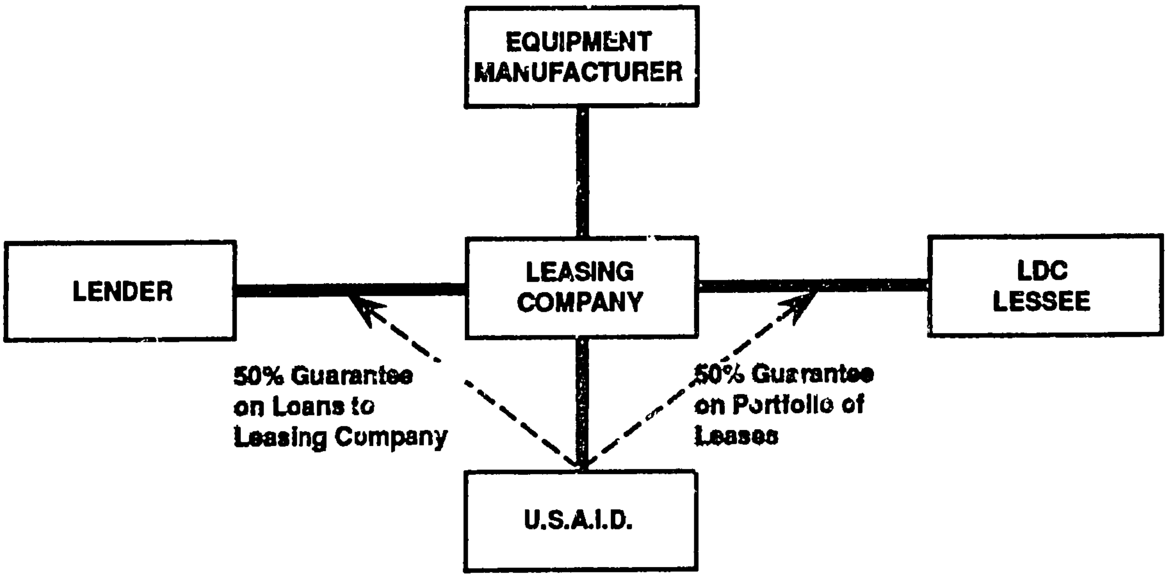

WEIGHTED AVERAGE GROWTH OF LEASING (1987-1988) BY WORLD BANK INCOME LEVEL
250%
200%
150%
100%
50%
0%
HIGH
UPPER MIDDLE
LOWER MIDDLE
LOW

Figure 1

A.I.D. LEASING GUARANTEE DIAGRAM



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