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Innovations in Microfinance

This series showcases innovative microfinance programs from the February 2000 "Advancing Microfinance in Rural West Africa" conference held in Bamako, Mali. The programs emphasize reaching new frontiers in rural areas, particularly in West Africa. These notes are an investigation of innovative practices working in specific environments, not a general endorsement of financial products. We recommend institutions utilize these technical notes as introductory information. To learn more about this topic and its applicability to your program, please consult the bibliography at the end of the piece.

Leasing: A New Option for Microfinance Institutions

I. Introduction

Leasing is a dynamic type of business financing that is well suited to the microfinance industry. Many microfinance institutions (MFIs) are adding this new product to their financial services menu and using it to raise funds to finance capital equipment purchases. With leasing, an MFI can develop longer term financing mechanisms for its clients and increase their borrowing capacity. Microentrepreneurs gain access to short- and medium-term capital for fixed assets—an option not readily available at most MFIs. Because the lease is granted based on an enterprise's cash flow rather than on its credit history, assets—or capital base—leasing gives entrepreneurs with scarce financial resources the opportunity to start a business on a limited budget or increase an operation's productivity through new capital investments.

Leasing can be structured as a transaction that also reaps profits for the leasing company. MFIs can reduce transaction costs by accurately projecting cash flow during the lease period, with the assumption that microenterprises will meet lease payments. The risk involved also is reduced because property ownership is not transferred to the enterprise until the lease term is completed; this provides the lessor with collateral—the leased item—that can be repossessed in the event of loan default.

This technical note provides a snapshot of leasing's benefits.

II. A Short History of Leasing

Leasing is not a new concept; it follows the basic premise that *business profits arise from equipment use, not equipment ownership*. Leasing can be traced back 5,000 years to ancient Greece and the Middle East, where it was used in agricultural transactions. The mechanization of agriculture and the Industrial Age brought further specialization to leasing. Today, thousands of businesses that are long on ideas and short on cash are using leasing as a simple and flexible financing solution to increase productivity and generate profits.

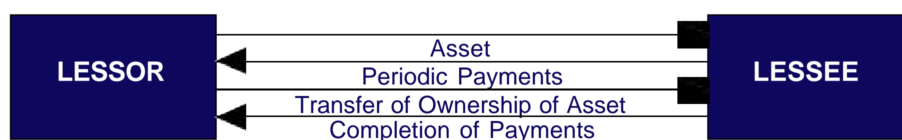
III. The Nuts and Bolts of Leasing

THE BASIC PRINCIPLES OF A LEASE AGREEMENT

The lease agreement documents the transaction between the equipment owner (lessor) and the business that wants to lease the equipment (lessee/client). Through leasing, the client acquires the right to use the equipment for a fee over time. The client agrees to make payments to the leasing company over the life of the agreement and can purchase the equipment, return it to the lessor, or negotiate a lease extension, when the original agreement expires.

Most lease contracts run from 3 to 7 years; however, irrigation and other agricultural equipment leases often run a bit longer, to about 10 years. Leasing contracts usually include these terms:

- The leasing company remains the equipment owner. The client acquires the right of temporary possession and use.
- The client must pay one or more lease payments when the lease is signed and the client obtains possession of the equipment; subsequent payments are usually made at periodic intervals.
- The leasing company may or may not recognize a salvage value in calculating leasing payments.
- Often the lease cannot be canceled, and if canceled, a substantial penalty may be imposed.
- Typically, the client is responsible for property taxes, insurance, and repairs not covered by the warranty.
- When the lease period ends, the client has the option to purchase the equipment, renew the lease, or return the equipment to the lessor



Leasing is not simply a form of passive lending; it also is a proactive commercial discipline. Lease financing is an asset management-based business that requires specialized expertise. Given the use of lower grade technology in the informal sector, lessors targeting this market must be able to accurately estimate the equipment's residual value and participate actively in re-leasing and selling the equipment on the secondary market. Given this situation, MFIs seeking to offer leasing services to their clients should think about specializing in a limited range of equipment and targeting the most appropriate market channels.

TYPES OF LEASES

A lease can be tailored to the client's specific needs and structured in a number of ways. Payment schedules, for instance, can be used to accommodate a business' cash flow needs. To complicate matters, different companies call the same type of lease by different names.

As a general rule, there are three basic types of leases:

1. A **capital or finance lease** combines some of the benefits of leasing with those of ownership. Payments are spread over several years and often represent the equipment's full value. Typically, a finance lease is structured as a noncancelable agreement, where the leasing company buys the equipment that the client has chosen and the client uses the equipment for a significant period of its useful life. Financial leases also are called full-payout leases because payments during the lease term amortize the lessor's total purchase costs with a residual value of up to 5 percent of the original acquisition price. These leases establish either a bargain purchase price or fixed price for the equipment when the lease term ends.

   - **Typical clients:** Used with clients that are planning to acquire the equipment at the end of the lease agreement; they assume the risk of equipment obsolescence, maintenance, and insurance.

   - **How it works:** The full purchase price plus interest charges are spread over the length of the lease term.

2. A **hire-purchase lease** is an alternative to a lending transaction for the equipment purchase. It is usually employed for retail or individual financing of smaller ticket items, such as motorcycles, sewing machines, refrigerators, and the like. The client assumes a higher down payment, sometimes up to 30 percent of the purchase price, and with each lease payment retains a higher percentage of equipment ownership, thus building equity.

   - **Typical clients:** Clients that have an established credit history with the institution can manage the down payment and assume a stake in the leasing agreement. This reduces the possibility of default.

   - **How it works:** The asset price and risk involved in the financial transaction are spread over the lease term.

3. An **operational lease** entails the client renting an asset over a time period that is substantially less than the asset's economic life. Operating leases are generally short term, typically three years or less, and are often used with equipment, such as cars or tractors. Leasing agencies usually finance one type of equipment or serve a specific industry. The agencies assume a share of the risks and rewards inherent in the transaction and anticipate the asset's resale value at the lease term's end.

   - **Typical clients:** Used with equipment that rapidly depreciates or becomes obsolete in a short time.

   - **How it works:** The leasing agency retains ownership of the equipment during the lease and recovers its capital costs through multiple rentals and the equipment's final sale.

LEASING AND LENDING: TWO APPROACHES TO FINANCING FIXED ASSETS

Leasing and lending are different financing activities, the primary difference being how asset ownership is funded. With a lease, the leasing company gains asset ownership, takes depreciation benefits, and may pass the benefits along to the client through lower rental payments. The business has the option to purchase or re-lease the asset at the fair market value at the lease's end. With a loan, the business owns the asset, retains the depreciation, and provides the lender with a legal claim.

The benefits of lending versus leasing are listed below:

Leasing

- The leased equipment is usually all that is needed to secure a lease transaction.
- The end user transfers all the risk of obsolescence to the lessor.
- A lease requires a small or no down payment and finances only the equipment's value. The value is expected to be depleted over the lease term. The client usually has an option to buy the equipment for its remaining value at lease end.

Lending

- A loan requires the borrower to pledge assets for collateral.
- The end user bears all risk of equipment devaluation.
- Upon signing for a loan, the end user must pay a down payment. The loan finances the remaining amount.

Leasing can complement microfinance lending services. Leasing usually works well for businesses with low taxable income such as microenterprises, which tend to operate in the informal sector and are unable to take full advantage of depreciation benefits.

It is important, however, to keep in mind that microcredit and leasing are different products, each with an important role to play in offering alternative forms of financing to microenterprises. Leasing does not represent the right solution for every situation. MFIs should consider several issues before adding leasing to their mix of financial services:

Ownership: An institution must weigh the attractiveness of owning the leased asset at the end of the term versus giving such rights to the lessor.

Terms: Leasing terms may be longer than loan terms because leasing is tailored to the life of the asset and a business' cash flow. Staff must manage the lease contract through the lease term.

Total expenses can be comparable to or higher than a loan. Lease payments include an implied interest rate, but the legal cost to set up the lease should be less. A method is needed to measure the leased equipment's performance and capabilities and identify cost savings, improved efficiency, and other results of a leasing strategy. This will help justify the leasing program and strengthen the MFI's financial position.

Liquidity: Leasing's initial capital costs are high because the leasing company has to purchase the equipment up-front. This investment will affect the institution's overall cash flow. MFIs need to build their expertise in setting values and pricing them accurately to make leasing profitable.

Lease Management: Lease arrangements are usually more liberal than loans. Leasing companies evaluate credit history on shorter terms. MFIs need to allocate substantial resources to track the equipment's life cycle along with the financial plan for the lease payments. MFIs may be in a good position to find new users for old equipment.

Tax advantages are a primary motivator for leasing. Lease contracts allow the transfer of a valuable tax shield from the client to the leasing company. MFIs need to carefully assess local tax rules to identify whether these provide additional opportunities that justify investing in leasing.

COMPARATIVE ADVANTAGES AND DISADVANTAGES OF LEASING

According to the International Finance Corporation, the World Bank's private sector arm, asset-based financing and leasing are particularly attractive to small and medium-sized businesses because the leasing company retains legal ownership of the leased asset over the lease term, and a client or microentrepreneur can qualify for the leased equipment based on generated cash flow rather than credit history, assets, or capital base.

Currently, microentrepreneurs rely on microcredit, informal financing, supplier credit, internal cash generation, and other financing sources. Most MFIs supply micro-entrepreneurs with working capital through short- to medium-term loans. Using leasing, MFIs can finance fixed assets for a broad range of microenterprises through innovative products, services, and delivery channels.

Some of the benefits offered by leasing include:

- **Availability and demand:** In most developing countries, leasing may be the only form of medium- to long-term financing available to microenterprises for fixed assets. It provides MFIs with an opportunity to reach new borrowers and expand existing markets.

- **Efficient capital use:** Leasing provides efficient and effective use of available capital. Since the leasing company purchases the equipment directly from the supplier, the client cannot use borrowed funds for other purposes. In some cases, leasing creates an opportunity for lower equipment prices because of higher sales volume.

- **Collateralized financing:** The leasing company retains ownership of the leased asset, which is generally used as collateral for the transaction, contributing toward simpler legal security arrangements and providing a tax deduction for asset depreciation. As the asset's legal owner, the leasing company is in a stronger position if the client stops payments.

- **Lower transaction costs:** Lease transactions can be arranged quickly and simply. As a result, the lessor can more accurately project cash flow during the equipment lease term, assuming that the client meets lease payments. Knowing the cash flow associated with the lease facilitates planning and mitigates risk. Lenient requirements mean that clients can more easily access financing.

- **Fixed rate financing:** Leasing typically offers medium- to long-term financing at a fixed rate over the term of the lease. The leasing company can then easily quantify the margins between funding and transaction costs on the lease contract.

Leasing also has some disadvantages that MFIs should be aware of. These include:

- **Ownership over assets:** Asset ownership remains with the lessor, which sustains the cost related to obsolescence or depreciation. In most cases, the lease term is usually shorter than the asset's useful life. MFIs should consider the asset's life span and potential for resale because these influence the terms and costs of the lease.

- **Fixed costs:** Many costs are fixed and independent of the characteristics of the leasing company, client, or asset. Therefore, for leases on lower priced assets, transaction costs will be a more significant payment component.

- **Cost of funds and liquidity:** The revenue generated through leasing must exceed the lessor's cost of funds to be profitable. An MFI's cost of funds tends to be higher than prevailing market rates. Given the nature of leasing and its substantial up-front

capital costs, this can have a negative impact on the MFI's liquidity and decreases its profitability.

- **A measure of residual value analysis:** A major difference between leasing and lending is the residual value of leasing; this is the book value that the leasing company uses to depreciate an asset during the lease term. This is the wild card of leasing because huge profits or losses are occasioned on realization of the salvage value. Measurement of the future value of assets includes both the potential gain and possible loss and is extremely important to the profitability of leasing.

IV. Target Market

LEASING CLIENTS

Informal sector clients vary widely from small-scale sole proprietorships to more established medium-scale businesses. A leasing product is targeted to clients that can repay a larger loan over a longer term, not necessarily first- or second-time clients that need access to credit for working capital. Leasing is most appropriate for clients that have outgrown typical microfinance credit products and have the potential to increase business output and product quality by using more sophisticated equipment.

A typical leasing client:

- Is a repeat loan client on at least the third loan cycle;
- Has experience using and managing the leased item;
- Is able to store and care for the item; and
- Has additional income or appropriate savings to cover the loan payment.

Leasing is attractive to microenterprise clients because they can:

- Use the equipment without paying its full cost;
- Benefit from ownership without depleting cash or increasing debt;
- Conserve capital for other business expenditures;
- Simplify budgets by using a fixed payment plan; and
- Protect against inflation and obsolescence.

V. Evaluating Leasing Costs

Lease payments are determined by several factors:

1. **Cost of funds:** Lease payments must be sufficiently high to cover the leasing company's cost of funds, which are not stable over time or across lessors. The cost of funds differs from one leasing company to another. For example, a bank holding company's leasing office is likely to have a lower cost of funds than an independent leasing company or an MFI leasing program. As prevailing interest rates change over time and an MFI's costs of funds tend to be higher, the MFI's leasing program needs to incorporate these costs.

2. **Client risk of default:** The client's financial condition is an important determination in setting lease payments. MFIs considering leasing need to develop several ways to measure risk default to get an approximation of a client's financial position. Lease payments for microfinance clientele are likely to be higher because of the additional risk involved with this market segment. MFIs may require

prepayments on the lease contract or a security deposit to cover the higher risk and to protect against potential losses resulting from default.

3. **Service and processing costs:** In a lease contract, transaction costs are per-unit costs. These include writing the contract, specifying the security agreement, identifying the asset, negotiating the lease terms, and covering legal fees. Many are fixed costs and independent of the lessor or asset. Therefore, transaction costs are expected to decline proportionately as the asset cost increases.

4. **Type of asset and residual value risk:** The type of leased asset, its economic depreciation, and obsolescence risk are factored into the lease payment. By specializing, MFIs can reduce the risk associated with the residual value of assets.

5. **Tax benefits for the leasing company:** Although tax laws vary from country to country, in a true lease arrangement only the leasing company is allowed tax deductions for depreciation. Some leasing companies will adjust the lease payments to reflect the tax benefits. Given the informal nature of the microfinance market, the tax benefits of leasing may provide MFIs with an incentive to enter the market.

6. **Contract options:** Lease contracts offer a variety of options, such as asset purchase, lease renewal, and lease cancelation. Naturally, the options included affect the lease payment. Another option concerns the frequency of the lease payments. Using these options, MFIs can tailor each contract to the client's cash flow. For example, a microentrepreneur may want lower fixed payments early in the contract and higher payments toward the end of the contract.

7. **Maintenance and service provisions:** Operating leases may provide for maintenance and service of the leased asset. MFIs can offer a lease maintenance service as an additional cost that is then factored into each lease payment.

8. **Market competition:** Competition plays an important role in determining lease payments. Entry into the leasing market is relatively easy for independent leasing firms and financial institutions such as MFIs. However, independent leasing firms face the threat that a bank, which supplies the leasing company with funds, will, in turn, enter the market as a competitor. MFIs need to consider the likelihood of this situation as a risk in entering a target market and determine how it will affect their competitiveness.

Lease payments constitute payments for both capital and services, so they cannot be directly compared to loans. The evaluation of the attractiveness of financial leases requires the computation of the after-tax cash flows associated with the various financing alternatives and the calculation of the present values of financing costs.

VI. Promoting a Supportive Legal and Regulatory Leasing Environment

Leasing requires a stable macroeconomic environment with a clear legal and regulatory framework. Experience from Kenya to Bangladesh demonstrates that a supportive leasing environment begins with sound financial leasing laws, prudential supervision, and tax regulations that govern leasing transactions. This structured environment is needed to foster the leasing industry's continued growth and encourage leasing companies to enter the microfinance market.

At a minimum, the legal framework should include:

- Accepted leasing definitions and terminology that recognize leasing;
- Sufficient freedom of contractual relations with a clear legal framework that recognizes lessor ownership and client rights;
- Recognition of the three-party leasing structure;
- Accelerated depreciation of leased property;
- Lease expenditures in the production cost;
- Recommendations to reduce some taxes on leasing activities; and
- Default remedies, including the right to accelerate remaining lease payments and expedite repossession and recovery.

Without these legal definitions and clarifications, the economic advantages of leasing will be hard to realize. It is imperative that MFIs carefully analyze and assess the legal and regulatory environment for leasing activities.

VII. Illustrative Cases

KENYA: PROMOTING PRIVATE RURAL DEVELOPMENT THROUGH LEASED PHOTOVOLTAIC SYSTEMS

Several multilateral and bilateral donors have supported innovative leasing programs that promote simple and innovative technologies. In Kenya, for example, a hire-purchase methodology has become the primary means of financing the acquisition of solar power-based energy systems or household photovoltaic systems to small and micro businesses. Although a heavily subsidized government program to disperse the photovoltaic systems was in place, it had an extremely poor performance record. This provided an opportunity for a private company that was determined to compete and capture the photovoltaic market; they began by leasing solar power-based energy systems throughout Kenya. This company has been able to capture the photovoltaic system market in Kenya. It has sold more than 60,000 units since 1987 and surpassed the total number of rural consumers connected under the national power utility's Rural Electrification Program. In light of this experience, the Kenyan government adopted a hands-off attitude toward the distribution of solar energy systems through the private sector. In capturing an under-served market, the company proved that leasing can be a profitable venture for all parties involved.

CECAM, MADAGASCAR: LEASING ARRANGEMENTS FOR THE RURAL MARKET

With the FERT Association's support, Caisses d'Epargne et de Crédit Agricole Mutuel (CECAM) developed a leasing product to help farmers in Madagascar obtain capital assets. CECAM is a network with more than 25,000 members that has made a strong commitment to provide financial services for agricultural production in rural Madagascar.

In 1992, CECAM began providing a hire-lease product for agricultural equipment. Because of its popularity, CECAM expanded the product line to include the lease of livestock, equipment for rural craftspeople, and domestic equipment such as sewing machines and solar lighting units.

The CECAM leasing product is unique because it is targeted specifically to rural businesses. To obtain a lease on a specific piece of equipment, the client must be a network member and have the capacity to pay a down payment that is equal to 25 percent of the equipment's total value. The lease term can be from 4 to 36 months and requires the client to pay the remaining 75 percent of the price, plus annual interest of 30 percent.

To meet client needs, the payment schedule is adapted to fit the client's production cycle. For some agricultural businesses, payments have been structured to meet the business cash flow, with as little as four payments due over the course of a year. Because there are few secondary income sources in rural areas, CECAM does not use this as a lease qualification. Instead, the lease is secured by the equipment rental and through a verbal commitment of the member's solidarity group.

During the payment term, CECAM retains ownership of the equipment. After the final payment, ownership is legally transferred to the client; this process builds capital assets and strengthens the business.

GRAMEEN BANK: DIVERSIFYING PRODUCTS AND LOWERING TRANSACTION COSTS THROUGH LEASING

The Grameen Bank's leasing program began in 1992 and now operates in all 14 zones of Bangladesh. Through this lease-hire program, Grameen's clients have gained immediate use of products from power-looms to livestock to help build capital assets and increase their enterprises' productivity.

Grameen's lease-hire product is designed to meet client needs, while keeping transaction costs low. For the client, there is no limit to the items that can be leased; each lease is specific to the client. The maximum loan term is three years, although the lease can be paid off in full at any time. The client must make weekly payments, but after consultation with the branch manager, the client can make smaller payments during the off-peak period and larger payments during the peak period. This flexibility has helped move the product into agricultural areas where incomes are tied to the harvest cycle.

By choosing to integrate its leasing program into its existing institutional structure, Grameen was able to keep lease transaction costs low. Branch staff manage the product. Second-time borrowers that are already involved in the bank's microfinance program qualify for longer term financing for fixed assets through the leasing program. Branch and zone offices provide transaction security because they have prior knowledge of the client's ability to generate sufficient cash flow to make weekly payments. The leasing program's cost structure is the cost of the leased item, plus a 25-percent leasing fee. Lease payments are then calculated over a payback period of up to three years, using an average balance method. Payments are collected during the client's regularly scheduled weekly group meetings. The loan officer can offer the group traditional microfinance products and the leasing product, without an extra burden or additional time commitment from clients.

The Grameen Bank has achieved remarkable results with its leasing product. By December 1997, leasing made up 4 percent of the bank's total portfolio, with an outstanding portfolio of US$5.29 million in leasing products and an average lease size of US$623. The average repayment rate was 98 percent, with 14.5 percent of the lease contracts moving into ownership of the item financed.

VIII. Recommendations

Before entering the leasing market, an institution should consider these practical issues:

1. **Do your homework:** Verify that your institution understands its legal authority to enter into a lease transaction. Determine the types of fees and charges that the institution is allowed to collect. Identify any legal issues before entering the leasing market.
2. **Understand residual values** to accurately determine the property's expected worth at the end of the lease. This valuation can make or break a leasing program. Leasing experts say, "If you don't do a good job estimating what the property is going to be worth at the end of the lease, you can look really good on paper for two or three years, but once the property starts coming back and you have to sell it on the market—that's when you start losing money. Consider having an in-house expert who is experienced in setting values and pricing accurately."
3. **Consult with counsel:** Leasing transactions involve more than just regulatory compliance. There are many other laws that may apply at the federal, state, or local level. As a result, be ready to obtain the advice of legal counsel on all statutes or regulations that could affect a lease program. Legal counsel should be involved throughout the leasing process.

IX. Conclusions

It is clear that leasing offers viable bottom-line benefits to both parties—lessor and client—and, with a supportive legal and regulatory environment, provides MFIs with an attractive product to finance fixed assets. For the lessor, leasing represents an attractive product. For MFIs that are interested in extending loans for fixed assets to established clients, it provides a financing mechanism with the potential to reduce transaction costs and manage risk. Through leasing, microenterprises can allocate scarce financial resources to new capital investments in an expeditious process that will directly contribute to revenue production.

MFIs are uniquely positioned to play an active role in the expansion of the leasing market for second-tier equipment, particularly because microenterprises comprise the largest segment of manufacturing, commerce, and industry in the developing world. Leasing provides MFIs with new opportunities to reach borrowers and expand into existing markets. The rapid growth of leasing in a number of developing countries indicates that leasing is addressing an important unsatisfied demand for financing. Leasing has the potential to develop into an effective financing technique that MFIs can use to reach those enterprises with financial needs that cannot be satisfied by traditional microfinance approaches.

X. Glossary

Acquisition price: An asset's purchase price, with the ownership rights passing to the new owner.

Amortization: A breakdown of periodic loan payments into principal and interest portions.

Bargain purchase option: An option to purchase the equipment at a price significantly below market value at the end of the lease.

Depreciation: Allocating the asset's purchase cost over its useful economic life.
Estimated useful life: The period during which an asset is expected to be useful in trade or business.

Fair market value lease: A lease with a predetermined ceiling to limit fair market exposure at the lease term's end.

Full-payout lease: A lease in which the total of the lease payments pays back to the lessor the entire cost of the equipment, including financing, overhead, and a reasonable rate of return.

Client: The party to a lease agreement that is obligated to pay the rentals to the lessor and is entitled to use and possess the leased equipment during the lease term.

Lessor: The party to a lease agreement that has legal or tax title to the equipment and grants the client the right to use the equipment for the lease term and is entitled to receive rental payments.

Obsolescence: A loss in value caused by internal or external changes.

Present value: The discounted value of a payment to be received in the future, taking into consideration a specific interest or discount rate.

Residual value: The book value that the lessor uses to depreciate a piece of equipment to during the lease term, typically based on an estimate of the future value, less a safety margin.

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