microNOTE #23

Leasing: A Potential Solution for SME Expansion and Rural Financial Sector Deepening

A Case Study of Russia

An animal fodder production company leases equipment (photo above) outside Krasnodar, Russia.

Definition of Leasing: In Russia, the term "leasing" refers to financial leasing, in which the lease term is set close to the expected economic life of the equipment and lease payments are set so that their

A. Introduction

This microNOTE explores how the development of leasing markets can effectively expand access to medium and long-term financing[1] for rural small and medium enterprises (SMEs) and agribusinesses. Drawing upon recent field work in Russia and IFC publications[2], this microNOTE highlights the experiences of leasing companies that received technical assistance and/or investment from International Finance Corporation (IFC).

Throughout Eastern Europe and Central Asia, rural and agricultural SMEs face the problem of replacing obsolete machinery and equipment while having limited access to commercial financing. In Russia, estimates suggest that 75% of fixed assets in many enterprises are obsolete, generating a high demand among SMEs for capital asset financing. After the 1998 economic crisis, many large enterprises were broken apart and divided into SMEs; many of these enterprises are now crippled by old equipment which stifles enterprise productivity and profitability.

Twenty-seven percent of Russia's population lives in rural areas and two-thirds of the country's rural population is dependent on agriculture for their livelihood.

[1] In this microNOTE, medium and long-term financing refers to a period of approximately three to five years. While longer- term financing (ten years plus) is common for the leasing of real estate in some countries, the typical lease term offered by the companies examined in this field research was three years.
[2] International Finance Corporation. *Financial Leasing in Russia, Market Survey, 2001-2002.*

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This publication was produced for review by the U.S. Agency for International Development. It was prepared by Anna Bantug-Herrera and Sherry Sposeep of Chemonics International Inc.

Agricultural SMEs are an important source of employment, but their ability to produce, process, and market agricultural products is hindered by limited access to modern machinery and equipment.

Agricultural SMEs face a series of constraints that reduce their ability to access financing, including idiosyncratic, weather-related risks, mixed product quality, weak or undeveloped marketing infrastructure, and pricing risks. In addition, weak regulation and enforcement of the land code discourages creditors from accepting land as collateral, further reducing the ability of agribusinesses to obtain commercial financing.

Some SMEs can obtain short-term working capital loans, but most struggle with inadequate access to the medium and long-term financing needed to invest in newer, better technologies and improved equipment. The absence of this financing prevents them from undertaking investments that could enhance the scale or productivity of operations.

B. Russia's Leasing Industry

In this challenging environment, the development of leasing markets in Russia holds much potential to increase the growth and competitiveness of the SME and agriculture sector.

Leasing can complement bank loans by providing SMEs an alternative source of financing for major capital investments such as machinery and equipment. Since the late 1990s, the enabling environment for leasing has greatly improved and leasing markets specifically targeting SMEs have expanded rapidly. The main constraint now facing Russian leasing companies is their inability to access adequate domestic debt and equity finance to capitalize leasing portfolios, and as a result, some leasing companies have begun to explore foreign finance options.

The Russian leasing industry is characterized by different types of lessors, both private and government-owned. Russian banks created many leasing companies at the onset of industry development, and these companies have since expanded their client base and financing sources with some becoming wholly independent leasing companies. Foreign banks set up some leasing companies, but their growth has been slower because the banks want to limit their exposure to the uncertainties of Russian financial markets. Large, financial industrial groups also played a role in establishing leasing companies, specifically to supply equipment to companies within the group. These types of "closed" leasing companies will likely decline as Russian leasing markets improve and expand.

In the private sector, captive leasing companies or supplier-owned leasing companies, both Russian and foreign, are becoming more common. Foreign equipment suppliers, such as Caterpillar, John Deere, and Klauss, will likely play an increasing role in the Russian market. The captive leasing company model is effective because the manufacturers and dealer networks have specialized knowledge of the client base which allows for more efficient risk analysis. The suppliers of rural leases are often geographically positioned closer to the lessees than in other leasing models allowing for closer monitoring.

Leasing companies established by private individuals do not constitute a large share of the current leasing landscape, but they are key regional players that meet the financial services needs of underserved pockets of SMEs.

There are also government-owned leasing companies serving rural areas that operate on either a commercial or non-commercial basis. The government-owned Rosagroleasing dominates agricultural leasing in Russia and distorts leasing markets through its use of subsidized, below market interest rates.

Secondary markets for leased equipment are scarce except for movable assets, such as cars, tractors and combines. The underdeveloped secondary market for equipment poses a challenge for leasing companies forced to recover and resell leased assets; but arrears and write-offs have been smaller in Russia's leasing industry than those of traditional lenders for several reasons. First, leasing companies hold title to the equipment during the lease period and productive equipment is too important to client operations to risk losing it by defaulting on lease payments. Second, leasing companies employ a range of risk-mitigation techniques to protect against default. These practices include portfolio diversification, tailored repayment schedules, rigorous risk analysis, buy-back and remarketing agreements, and insurance. Higher than usual down payments for leases are common in Russia, putting additional pressure on the client to repay. Leasing services can be viable and profitable if risks are well-analyzed and deals are properly secured.

C. Enabling Environment for Leasing in Russia

Today the policy, legal and regulatory framework for leasing is relatively developed and leasing companies rarely cite legal and regulatory issues as a major hindrance to operations. This is due to the efforts of multiple stakeholders, including the private sector, government and donors in advocating for a transparent enabling environment to ensure the industry's long-term stability and growth.

The IFC's Russia Leasing Development Group project in coordination with other key leasing stakeholders drafted amendments and framework agreements to resolve both internal contradictory provisions and contradictions that existed among the various legal acts. When the 2002 Federal Law "On Amendments and Addenda to the Federal Law on Leasing" passed, it substantially reduced the investment risks created from legal and tax uncertainties and established a stronger legislative base for the leasing industry to develop.

In Russia, the main tax advantages to leasing are (a) the flexibility to record an asset on either the balance sheet of the lessor or lessee, (b) accelerated depreciation of the asset up to a factor of 3, (c) lowering profit and property taxes, and (d) the ability of lessees to fully expense leasing payments, lowering the taxable profit base.

D. Lessons Learned and Recommendations

Overall, leasing has significant potential as a tool to expand finance to SMEs and to deepen the rural financial markets. A solid policy, legislative and regulatory framework coupled with donor initiatives on both the investment and technical assistance side can nurture and stimulate this industry formation.

Based upon a literature review of IFC-facilitated leasing interventions, as well as field work in Russia, the following recommendations can be made for work with the enabling environment, technical assistance, and investments to develop leasing markets.

1. Encourage an appropriate legal and regulatory environment conducive for potential players to enter and exit the leasing market. A poorly designed licensing regime can be a bureaucratic barrier that actually prevents or delays the entry of leasing companies rather than protects the market from corrupt or weak companies seeking to enter. A level playing field for leasing companies to profitably operate and compete is necessary particularly with regards to receiving the same VAT and customs duty treatment as provided to other financial institutions. Sound, transparent, and consistent legislation on leasing can reduce investment risks and uncertainties that impede leasing industry development.

2. Support a clear tax policy that has advantages to the leasing industry to provoke the demand and supply side of the leasing market. While the leasing industry in some developed countries has expanded without the presence of advantageous tax treatment on leasing, beneficial tax treatment is often needed to spur industry growth. Identify and coordinate closely with a policy champion to push through a policy reform agenda. A policy champion can contribute political insight and an effective approach to tackling institutional change. Champion(s) who are responsive and open to working with key stakeholders are also crucial to generating a participatory process that includes opportunities for discussing, drafting, and finalizing policy reform.

Once tax policy is reformed, engage local governments, especially tax authorities, to explain how leasing operates and the benefits it can have on the local economy. Education helps to lessen the uncertainties surrounding leasing and creates a more positive and transparent environment.

3. Socially responsible investors and financial institutions can demonstrate the viability of leasing as a financing option by investing in start-up leasing companies within specific economic sectors. In Russia, IFC has been instrumental in developing and promoting the leasing industry through equity and debt investment. IFC provided equity financing of $3 million to establish AFC to enhance leasing to the agricultural sector. The AFC has two other shareholders-Rabobank and Netherlands Development Finance Company (FMO). The AFC has $1.5 million in equity and $15 million in loan capital shared among these three shareholders wherein the IFC assumes the syndicated risk.

4. Credit enhancements such as the guarantees issued by USAID's Development Credit Authority (DCA) can be used to generate greater access to medium and longer term financing for leasing companies, as well as to encourage those companies to provide leases to specific segments of the economy. "Money is the raw material of the finance industry," one leasing company president in Russia said. A guarantee facility could support a commercial bank's extension of long-term loans to viable leasing company partners, and access to such financing is key to success.

Similarly, risk sharing with leasing companies can be an effective tool to encourage extension of leases to farmers and other rural enterprises not currently served.

5. Finance alone is not enough! Donor interventions should entail a combination of investment and technical assistance. A leasing initiative that involves both investment in select leasing companies and wide-reaching technical assistance is a best practice strategy learned by IFC management. Donor technical assistance to multiple leasing companies rather than to one leasing company may also be a more effective approach to stimulate SME development.

6. Establish leasing support interventions close to the rural and agricultural businesses they serve. Donor interventions that promote leasing industry development often begin in urban locations where it is easier to identify and resolve legal and regulatory issues.

Successful rural leasing, however, requires closer coordination and collaboration with regional and local players that serve rural and agricultural SMEs.

Leasing interventions must include a focus on public outreach to explain the benefits and the risks of agricultural leasing, and the delivery of hands-on technical assistance to leasing companies in risk analysis, monitoring and marketing.

7. Facilitate public education initiatives about leasing and its benefits and risks to effectively impact market supply and demand. In the rural areas of Russia, a lack of understanding about leasing persists. Workshops, seminars and other information distribution channels can be used to disseminate information about leasing as a viable financing option for productive asset investment and how leasing deals are structured. Facilitating linkages among potential lessees, leasing companies and equipment suppliers through seminars, workshops, and trade shows are integral strategy to promoting leasing industry development.

8. Integrate leasing into other financial services and rural finance development projects and nurturing closer donor and stakeholder collaboration and coordination and increased research on leasing models. Proactive donor and stakeholder coordination is needed on legal and policy reform initiatives to ensure legislative and policy reform consistency across sectors.

Often times, scarce information exists on the demand and supply of leasing services in rural areas; and further research and analysis of successful leasing models is needed to effectively integrate leasing into rural finance and development programming. Making existing studies by donors and leasing associations more widely available through better dissemination is useful.

9. Advocate portfolio diversification as an effective risk mitigation tool for leasing companies to safeguard against defaults. Rather than exclusively targeting agricultural or rural oriented SMEs, successful leasing institutions can better manage risk and portfolio quality by diversifying their client base geographically by sector and by lease size.

In Russia, default rates accounted for less than one percent of the leasing portfolio for several IFC-assisted leasing companies. The low arrears and write-offs among rural SMEs is attributed to the fact that productive equipment is too important to client operations to risk losing it by defaulting on lease payments.

10. Assist in developing strong leasing associations. Strengthening the industry by supporting a national or regional leasing association is an effective exit strategy for donors if the industry is large enough to sustain such an association via member dues or other fee-based services. Association sustainability is a common and difficult problem to resolve. Associations can evolve from a leasing advocacy working group as was the case of the NW Leasing Association, which now functions an advocate on leasing policy and legislation as well as provides training services to industry players in northwestern Russia.

Donor assistance in association building often requires a long-term commitment because it is difficult to develop income generating services that can sustain the association over the long term.