



Subsidizing Capital Equipment: Leasing

“The key benefit of leasing is the access it provides to those that do not have a significant asset base already by enabling small enterprises to leverage off an initial cash deposit, with the inherent value of the asset being purchased acting as collateral.”

-Leasing in Development Guidelines for Emerging Economies
IFC Report

Programs that subsidize physical capital generally work through leasing agreements. There is a growing amount of literature on this subject and on the appropriateness of leasing versus credit schemes. Many of the development examples in the literature are for rural markets. Leasing is a valuable tool for MSMEs to use physical capital without collateral or credit history. This allows smaller businesses more access to finance leading to the acquisition of capital equipment. Leasing can also provide an alternative to credit in countries with weak business environments. These agreements can help to allocate risks to the party most suitable to bear the risk.

Types of leasing agreements:

- **Finance Lease:** In this type of agreement, the lessor purchases the capital and leases it to the lessee for a monthly fee. For the duration of the arrangement the lessor owns the capital, thus providing a useful alternative to collateral if the lessee defaults. At the end of the arrangement, the lessee has the option of purchasing the capital. Usually the terms of the lease are for the entire economically productive life of the asset. Financial leases are useful for clients that do not have collateral to back up a loan.
- **Operational Lease:** These agreements do not have an implication of final ownership. The terms of the lease are for substantially less than the economically productive life of the asset. The lessee would return the capital before the economic viability of the equipment was obsolete. These leases are often used for capital with a high depreciation value.
- **Hire Purchase Lease:** This type of agreement is similar to the finance lease. The client puts down a substantial down payment on the capital and throughout the term of the lease the lessee owns a growing percentage of the capital until eventually she owns the equipment in its entirety. This serves the dual purpose of gaining access to productive capital and building equity. Hire purchase leases are often used for smaller purchases (i.e. a sewing machine).

Drawbacks to leasing:

There are a number of disadvantages leasing has as compared to lending. Possible problems include:

- Local banking regulations could pose problems in financial leasing.
- There are more opportunities for legal disputes because the leasing institution owns the equipment.

- The leasing institution may face increased liabilities due to their ownership of the equipment.
- Financial leasing tends to have higher operating costs
- There is often a lack of knowledge about leasing operations among the lessees.

Because of the drawbacks listed above, before initiating a project to promote leasing of capital equipment to MSMEs, there needs to be a strong legal and regulatory framework in place. Without this environment as a backdrop, a leasing project is not a viable development program. Many studies cite the necessity of the following institutions:

- Clear *rights and responsibilities* of all parties to a lease
- No contradictions within the *existing legislation*
- Clear, swift and easy *repossession mechanisms*
- There exists only the necessary level of leasing industry *supervision and licensing*
- An appropriate *taxation* framework surrounding the lease, including income and value-added taxes
- An appropriate *accounting* framework

Development Impacts:

According to the World Bank study, *Leasing: An Underutilized Tool in Rural Finance*, the substantial development impacts of leasing are:

- Access to finance and increase in capital investment
- Increase in capital base and capital market development
- Competition in the financial market

Sources:

Studies and toolkits

Leasing: An Underutilized Tool in Rural Finance

World Bank

[http://lnweb18.worldbank.org/ESSD/ardext.nsf/11ByDocName/Leasing-AnUnderutilizedToolinRuralFinance/\\$FILE/LeasingDP7_Final.pdf](http://lnweb18.worldbank.org/ESSD/ardext.nsf/11ByDocName/Leasing-AnUnderutilizedToolinRuralFinance/$FILE/LeasingDP7_Final.pdf)

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

USAID

http://www.microlinks.org/file_download.php/mN+23+Leasing++A+Potential+Solution+Russia.pdf?URL_ID=1040&filename=11515964821mN_23_Leasing_A_Potential_Solution_Russia.pdf&filetype=application%2Fpdf&filesize=208569&name=mN+23+Leasing++A+Potential+Solution+Russia.pdf&location=user-S/

Leasing: A New Option for Microfinance Institutions

USAID

http://pdf.usaid.gov/pdf_docs/PNACQ698.pdf

Leasing in Development Guidelines for Emerging Economies

IFC – World Bank Group

http://rru.worldbank.org/Documents/Toolkits/Leasing/Leasing_in_Development_Full.pdf

Equipment Leasing and Lending: A Guide for Microfinance

Asian Development Bank

<http://www.adb.org/Documents/Periodicals/Microfinance/finance-200452.pdf>

Country Experiences

Approaches to SME Lending in Eastern Europe and Eurasia

USAID

http://pdf.usaid.gov/pdf_docs/PNADE050.pdf

Buffalo, Bakeries, and Tractors: Cases in Rural Leasing From Pakistan, Uganda, and Mexico

World Bank

http://www.ruralfinance.org/servlet/BinaryDownloaderServlet/38812_Document.pdf?filename=1151392905359_Buffalo_Bakeries_and_Tractors_Cases_in_R-1552321165.pdf&refID=38812

Recommendations to ABAD for Facilitation of Leasing Services - Financial Institutions and Leasing Companies: What is the potential to increase access to leasing services in Azerbaijan?

USAID

http://pdf.usaid.gov/pdf_docs/PNADE726.pdf

Coping with the “Unexpected”—The Experience of ACBA Leasing in Armenia

USAID

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