

AccessFinance

A Newsletter Published by the Financial & Private Sector Development Vice Presidency

Leasing in Developing Countries: IFC Experience and Lessons Learned

IFC has been involved in the development of the Leasing industry in emerging markets for more than 30 years, through a combination of investment and advisory programs aiming at fostering access to financing for SMEs. This effort has been conducted with a wide range of partners including government bodies, commercial banks, specialized leasing companies, capital markets players. This article draws on IFC experience and lessons learned in leasing development.

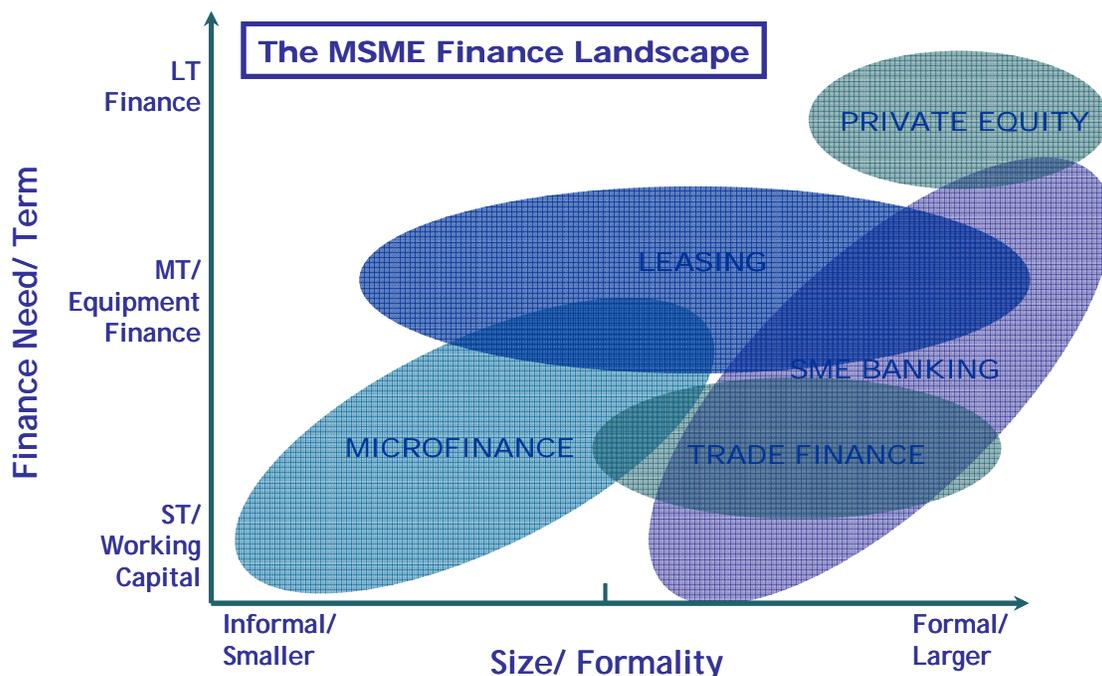
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Role of Leasing for SME Access to Finance

It is widely recognized that Small and Medium Enterprises (SMEs) in emerging markets generally lack access to financing, as commercial banks typically tend to focus on top-tier commercial and retail clients, leaving a wide-open “SME Finance gap”. Traditional banks in developing countries have little appetite and incentive to outreach to SMEs, which they consider riskier and costly to serve due to small transaction sizes.

In middle-income countries, with assistance from development finance institutions, commercial banks have started seeing SMEs as an opportunity and have been developing specific SME banking skills (e.g. product standardization, innovative marketing approaches, low-cost delivery channel, quantitative risk-management, information systems, etc.). Yet most of these banks mainly provide SME clients with fully-secured short term working-capital financing. Only the largest SMEs can access to term financing and invest in equipment to enhance growth, productivity and overall competitiveness.

The graph below is an attempt to schematize how different financing products can target various types of SMEs from micro/ informal to large and formal, and address various financing needs from short-term to long-term.



Lease financing bridges a significant gap in the MSME access to finance arena. Leasing is an asset-backed, term financing product. As such it is particularly relevant to address the key issues that hinder SME access to financing, as leasing institutions (specialized, bank-owned, or captive of equipment manufacturers) develop three critical skills that give them a strong comparative advantage on the SME client segment, including smaller and informal SMEs:

- (1) *Unsecured financing* – Leasing companies develop better capabilities than commercial banks in physical asset management, repossession, evaluation and remarketing. In countries where contract enforcement and ownership rights are properly set, lease financing does not require real-estate nor cash collateral.
- (2) *Cash-flow financing* – Leasing companies develop a strong understanding of the use of the financed assets, and are better able than banks to assess the adequacy of purchased equipments against client needs; they understand better the cash-flows generated by the financed asset, and are able to take these into account in their credit underwriting methodology.
- (3) *SME Business Development* – Helped by a strong product and client segment focus, leasing companies outreach to SMEs directly and through point-of-sale financing (“vendor programs”), in a much more proactive way than traditional banks, that tend to cater mainly to the walk-in customer.

Speed and ease of processing are an important selling argument for small firms. Because leasing generally does not require additional collateral, and because leasing companies and bank leasing subsidiaries are more focused and specialized, lease financing is made available to SMEs more effectively and with lower internal processing costs than term loans.

Developing the leasing industry also creates a broader impact on the capital markets in a developing country. Leasing companies book medium term assets that provide banks, pension funds and insurance companies with a diversification of investment opportunities. As local capital markets develop, lessors are often the first issuers of commercial paper, notes and bonds. These issues present mitigated risk as they can be enhanced by the existence of a flow of lease receivables and the possibility of a pledge on the physical leased assets. At the next level of sophistication, lessors can securitize their lease receivables, creating another marketable security, tapping a larger pool of funding, and thus increasing both depth and breadth of the local capital markets.

IFC’s Track Record in Leasing

In 2007, leasing companies currently in IFC’s investment portfolio have extended leases to 150,000 micro, small and medium firms for a total disbursed amount of US\$3.5 billion.

IFC’s first investment in a leasing company was made in Korea in 1977, with the set-up of Korea Development Leasing Corporation. Since then, and until June 2007, IFC has approved investments in 126 leasing projects for US\$ 1,300 million, in 58 countries. In 27 countries, IFC participated in the set-up of the first leasing company. Over time, these investments have generally had a strong catalytic effect on the sector, attracting attention from local and international players to the market opportunities and fostering competition, leading to the development of new products and financial services, increasing access to financing for small and medium businesses, developing the local capital markets through bond issuing, and portfolio securitizations.

IFC’s investment commitments, July 1977- June 2007, per Region

Region	IFC Investment		
	Number of Transactions	US\$m	%
Africa	26	60.2	4.7%
Asia	66	376.9	29.2%
Europe, ME, North Africa, CA	101	672.2	52.1%
South America	24	170.7	13.2%
World	1	10.0	0.8%
Cumulative Total	218	1290.0	100.0%

IFC has quickly realized that creating a sustainable leasing industry in developing countries requires not only investment, but also targeted advisory services. To address this specific need, IFC operates Technical Assistance Programs that are co-financed by multilateral and bi-lateral donors, and that typically address four advisory

components: legal and regulatory advisory services to address issues that hamper the development of the sector, public awareness raising on the product and its advantages, capacity-building for new entrants and existing players on the leasing market, and finally facilitation of domestic and foreign investment in the sector.

Examples of these programs include Russia, Serbia, Turkey, and Uzbekistan where IFC's advisory work is widely recognized as having been instrumental for the development of the industry, today vibrant in those markets. With an increased focus in frontier countries, IFC has more recently been at the forefront of the creation of the concept of leasing in countries such as Yemen and Afghanistan.

From a financial standpoint, IFC's experience with leasing has generally been good, yet not as remarkable as with other business lines in the financial sector: IFC leasing investments, especially equity investments, have been on average more risky and less profitable in terms of internal rate of return. This mainly reflects the focus that IFC has historically put on development impact through leasing, in particular with a number of small investments in start-up companies in frontier countries, or at very early stages of the development of the industry, locally. This has led to the identification of various lessons that may benefit the industry as a whole, and that the rest of this article highlights.

Legal, fiscal, regulatory aspects: key take-aways for governments and regulators

It has long been debated whether there was a need for a specific leasing law for the product to develop. There is no leasing law in the US nor in Canada, countries in which leasing penetration is at the highest. However, because contract enforcement and property rights are generally weaker in most developing countries, IFC has generally found it necessary to advocate for the establishment of a specific leasing law. The following objectives should be achieved by a leasing law:

- (1) Create the conditions of the lessor's effective ownership and repossession rights.
- (2) Recognize the lessee's responsibility as the custodian of the leased equipment
- (3) Recognize financial leasing as a financial service equivalent to a term loan

Indeed, leasing can only develop and achieve its development role on the SME finance landscape as an unsecured term financing product if leasing companies can easily repossess and sell the leased equipment when the lessee defaults on his repayments. This often advocates for a proper legal definition of leasing and of the minimum terms of a leasing contract, and for the creation of fast-track judicial procedures for the repossession and sale of leased assets. It is also critical for the development of the industry that leasing companies cannot be sued for a misuse of the leased equipment by the lessee who should be legally recognized as the custodian of the leased equipment. Finally, although leasing does not require any fiscal advantage to develop, financial leasing generally needs a legally/ fiscally recognized specific accounting treatment, to be on a level-playing field with bank loans, so that VAT accounting mechanisms apply equally and fairly for both financing products. If specific tax advantages apply to investment in fixed assets (e.g. preferred custom tariffs, amortization advantage, etc.), then they should equally apply to financial leasing.

A well-functioning judicial system overall is as critical for the development of the leasing industry as a leasing law per se, and directly impacts lease portfolios quality and profitability. The World Bank "Doing Business Report", published annually and available on the World Bank website, ranks 180 countries in terms of "business-friendliness" on the basis of a wide range of surveyed indicators, including contract enforcement and property rights. It is a very effective tool to assess how conducive to leasing different environments can be.

Regulation of leasing companies generally includes licensing requirements, minimum capital requirements, and supervision requirements. Financial leasing companies should typically be subject to the same regulatory requirements as any financial service provider, whether they are deposit-taking or non deposit-taking institutions. While this may hinder the development of the leasing sector at the early stages, IFC has found that it generally ensures better long-term sustainability and effectiveness of the industry as a whole. Operating lease companies are generally seen as commercial companies and are often less or not regulated, while financial leasing companies are seen as financial players and are fully regulated and supervised.

Key success factors for leasing players – Banks versus specialized finance companies

IFC's experience as an investor in the leasing industry in emerging markets has led to the identification of several critical success factors for leasing players, mainly:

- (1) Excellent financial management skills. Leasing companies need to develop state-of-the-art risk management skills, including thorough cash-flow analysis, asset-liability management, and economic capital calculation.
- (2) Access to diversified sources of local currency financing ranging from customer deposits and savings to bank loans, bond issuing, and securitizations. The single largest obstacle to the growth of IFC's leasing companies has been the access to term local currency funding.
- (3) Excellent governance and performance management framework. While good governance enhances the ability to access low-cost funding, excellent performance management is key to strengthen business development skills and cost-efficiency that are critical to serve the SME segment.
- (4) A sustainable competitive niche. As financial leasing is becoming a commodity across the globe, retail banks and their subsidiaries compete with stand-alone leasing companies, including in the SME segment. Banks can leverage on access to low-cost funds, better counterparty-risk appraisal skills, and on larger point-of-sale networks. Specialized leasing companies leverage on their focus on a single product and on their better knowledge, and management of the physical leased assets. However bank-owned leasing subsidiaries are generally able to combine the best of both worlds. In this context, stand-alone financial leasing companies are globally losing market share against subsidiaries of banking groups and captives of equipment manufacturers. Possible niche strategies include the development of operating lease products, industry-sector specialization, or focus on a specific underserved market segment.

The way forward – IFC role and contribution

After 30 years of development of the leasing industry in emerging markets, IFC still sees a bigger role and more opportunities for its operations which aim to increase access to financing for small and medium enterprises through lease financing. Initially focused on regulatory and policy-level work, IFC's technical assistance activities in leasing are currently being given a stronger focus on institution-building work, including:

- (1) Assisting emerging market banks in the set-up of leasing operations. IFC and other development finance institutions engage heavily in helping banks downscale their client base from corporate to micro, small and medium enterprises. Leasing is certainly the best product for banks to safely engage in term financing to SMEs, but developing efficient leasing operations in banks requires a major cultural shift and technical skills that need to be imported from technical partners or consultants.
- (2) Helping stand-alone emerging leasing companies create a competitive niche by developing new products and skills. Operating leasing is still in its embryonic stage in most emerging markets, and is complex to develop and manage. As spreads go down with increased competition, financial leasing companies need to develop fee-based products and not only rely on interest income. Downscaling to micro and small businesses requires new risk management tools and improved lending technology.
- (3) Encouraging investors and technical partners from developed economies to invest in leasing operations in emerging markets. IFC provides these partners with its local presence and knowledge of emerging markets, its convening power, its role as an "honest broker" between local and international entities, and its ability to leverage its advisory and investment operations.
- (4) Continuing to enhance access to local funding for leasing players. IFC has structured the first securitization of a leasing portfolio in several countries such as Turkey. It provides guarantees and credit enhancement facilities to help leasing companies access bank loans, issue bonds and/or securitize portfolios of lease receivables.
- (5) Exploring new frontiers for leasing. One of the most promising frontiers is sustainability finance, as leasing is a particularly appropriate tool for the financing of investments in energy efficiency, renewable energy equipment, and cleaner production equipment. Micro leasing is an area which deserves a specific attention, as medium term microfinance products are still very scarce across the globe. Finally, rural finance, so critical to emerging markets, is yet to be developed further. IFC is committed to achieve its development mission by pioneering such products across the emerging markets.

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