FINANCE for the POOR
Equipment Leasing and Lending: A Guide for Microfinance[1]

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As microfinance has evolved toward greater levels of commercialization, the range of products offered has expanded, starting from the simple beginnings in which short-term working capital loans were the only product available from many microfinance institutions (MFIs). While this is still true today of some MFIs, it is now widely recognized that the acquisition of equipment is often a key channel through which microentrepreneurs expand their businesses, improve their products, and raise their incomes—underscoring the importance of equipment finance.

Equipment finance is a significant part of microfinance. Based on a survey of 25 MFIs in Latin America, many of them considered leaders in the field, equipment loans and leases account for an average of 21% of the MFIs' overall portfolios. Of these 25 MFIs, 23 offer equipment loan or lease products with at least 2-year terms. While most of this equipment finance consists of loans, there is a small, but growing movement toward leasing among Latin American MFIs, reflecting the superiority of leasing over lending in certain circumstances (discussed below). For example, Associación Nacional Ecuménica de Desarrollo (ANED) in Bolivia, Inversiones para el Desarrollo (INDES) in Chile, and Finamérica in Colombia offer equipment leases. Several other MFIs are planning to initiate a leasing program or are seriously considering it.

Surprisingly little has been written on how to do equipment finance for mainstream microentrepreneurs, that is, for those microentrepreneurs needing approximately $50 - $2,500 to purchase equipment. This article examines the pros and cons of the two major equipment financing alternatives—leases and loans—from both the MFI and client perspectives. It also provides best practice recommendations for MFIs to use in their equipment leasing and ending programs. Many of the practices one would use for equipment finance for mainstream microenterprises turn out to be very different from those suggested for small, medium-scale, and large enterprises. In addition, an assessment of the relative merits of leasing versus lending is quite different for MFIs and their microenterprise clients than for banks and their typically much larger clients. Thus, this article attempts to fill a clear need for information on how MFIs should finance equipment for their mainstream microenterprise clients. The article concludes with policy recommendations for governments and donors.

Financial vs. Operational Leases

In a leasing arrangement, one party uses an asset owned by another party in exchange for specified periodic payments. The lessee uses the asset and pays a rental to the lessor, who owns it. There are two major types of leases: financial leases and operational leases.

Financial leases are an alternative to loans for equipment acquisition. In a financial lease, the microentrepreneur (or other lessee) specifies to the MFI (or other lessor) the desired equipment and the dealer from whom the equipment should be purchased. The MFI purchases this equipment, which the lessee uses. Rigorously defined, financial leasing must have three key

[1] http://www.adb.org/documents/periodicals/microfinanceFourth Anniversary Issue

characteristics: full payout, right to buy the equipment for a nominal amount, and non-cancellation (see box below).

Operational leases do not have one or more of these three financial lease characteristics, and are not necessarily a means to acquire equipment. In many operational leases, the lessee contracts for shorter-term use equipment available from the lessor and may or may not have the option to buy. Operational lessors typically recover equipment acquisition costs plus interest through multiple serial leases and final sale of the equipment. Leasing a car for a week or for three years are both examples of operational leases.

Because operational leases do not require the lessee to amortize the full cost or nearly full cost of the leased good or because the lessee is not given the option to buy, the MFI bears three major risks that are avoided with financial leasing. These risks are (i) damage, (ii) residual value, and (iii) second-hand market risks. For example, if a lessee is not required to amortize all or virtually all of the cost of leased equipment, the lessor must be prepared either to sell the equipment after the initial lease period has ended or to lease the equipment again. This forces the lessor to be concerned with (i) damage risk, that is whether the equipment will sustain damage during the lease period; (ii) residual value risk, that is whether an appropriate residual value has been estimated for purposes of calculating the monthly lease payments and the cost of any final purchase option; and (iii) second-hand market risk, that is whether adequate second-hand markets will exist in which to sell used equipment after it is no longer profitable or possible to lease the equipment. MFIs that are doing financial leasing can be much less concerned about these three risks than if they were doing operational leasing. In fact, financial lessors need be no more concerned about these risks than lenders. Only in the case when clients default on their payments and the equipment is seized need the financial lessor or lender be concerned about whether the equipment is damaged, worth less than expected, or completely unsaleable.

Because of the substantial additional risks of operational leasing, it is likely that most MFIs will be interested largely in financial leasing. Therefore, this article focuses on financial leasing and lending as alternative techniques for financing equipment acquisition.

Pros and Cons of Financial Leasing vs. Lending: The MFI's Perspective

Many of the discussions of the pros and cons of financial leasing found in the leasing literature are confusing. This confusion arises because much of this literature fails to rigorously distinguish financial from operational leasing and identify the additional risks inherent in operational leasing, beyond those of financial leasing. As a result, the additional risks of operational leasing are not always excluded when discussing financial leasing and comparing it to lending.

The key advantage that financial leasing has over lending is that financial leasing offers a stronger legal position to the MFI for equipment seizure and sale in the event of client payment default. The MFI has this advantage in the case of financial leasing because it owns the equipment. A possible, additional advantage of financial leasing for the MFI is the exemption of leasing from the usury ceiling by some countries. However, we did not find any advantage from such an exemption in any of eight countries we examined, which are all Latin American countries with major microfinance markets (Bolivia, Chile, Colombia, Ecuador, El Salvador, Honduras, Mexico, and Peru). Although tax codes may give some advantage to financial leasing over lending, more often the reverse holds. In the same eight countries, we find that the tax codes usually favor lending in the case of informal clients, by which we mean, clients who do not remit value added tax (VAT) or profit tax on the products they sell. The amount of leasing's disadvantage depends on the country and situation, but is commonly equivalent to the loss of approximately 2–4%.

The Three Defining Characteristics of Financial Leases

• Financial leases, sometimes called full payout leases, require the lessee to amortize all or virtually all (typically 95–100%) of the lessor's original acquisition costs and also to pay interest.
• Financial leases give the lessee the right to buy the equipment at the end of the lease term for a prespecified sum, called the residual value, which for financial leases is set at a nominal amount, typically the remaining balance or a token price such as $1.
• Financial leases are non-cancelable; that is, the lease cannot be cancelled without the consent of the MFI or other lessor. If financial leases were cancelable, the full-payout feature could be defeated by clients who simply return the equipment early and stop making payments.

Financial Leasing: Pros and Cons from the MFI Perspective Advantages of Financial Leasing

Disadvantages of Financial Leasing

- Stronger legal position for equipment seizure and sale in the event of client payment default
- Banking regulations: possibly escape usury ceiling
- Taxes: may be advantageous to financial leasing in the case of MFI clients who pay profit tax and VAT on the products they sell (formal clients) percentage points in the MFI's effective yield. For example, if a loan yields 30% to the MFI, a similar lease would yield approximately 26–28%. For formal clients (who do remit these taxes on the products they sell), the situation is mixed. Some countries and situations favor financial leasing and other countries and situations favor lending. Since most MFI clients are informal, tax considerations generally favor lending. These results are very different from the simplistic claims found in some of the leasing literature that leasing is tax advantaged. These claims are made on the basis, for example, that lessors can take a tax deduction for leased equipment depreciation (since lessors own the equipment). Although lessors sometimes can take this deduction, this is far from a complete analysis of the impact of the profit tax on loan/lease choice. A complete analysis often reverses the result. Moreover, the simplistic claims normally also ignore the value added tax, which often favors lending over leasing.

Financial leasing also faces several other disadvantages.

- First, banking regulations in many countries either prohibit some financial institutions from doing financial leasing at all, or else require that financial leasing be done through a leasing subsidiary. In the case of microfinance, financial leasing subsidiaries add to costs without returning significant benefits. Therefore, the requirement that leasing subsidiaries be used is a disadvantage for financial leasing.
- Second, financial leasing has a greater potential for legal disputes and misunderstandings because of the separation of the MFI's ownership of the equipment from the lessee's possession and use of the equipment.
- Third, financial leasing has greater potential for the MFI to have legal liability problems with third parties because the MFI owns the equipment that the lessee is using. However, in our survey of eight countries, these two legal risks were generally considered fairly minor.

- Finally, financial leasing has somewhat greater setup and operating costs than lending. Reducing these pros and cons down to the most essential points, an MFI might find that the choice between financial leasing and lending could often come down to a:
  - Greater potential for legal disputes, difficulties, and misunderstandings
  - Greater potential for legal liability problems
  - Greater setup costs
  - Greater operating costs
- Banking regulations: financial leasing may be prohibited or permitted only through a subsidiary
- Taxes: generally disadvantageous to financial leasing in the case of MFI clients who do not pay profit tax or VAT on the products they sell (most MFI clients are from the informal sector) choice between the following: the stronger legal position for equipment seizure and sale inherent in financial leasing versus the tax and possible regulatory advantages offered by lending. Hence, in cases where there are no regulatory restrictions on leasing, an MFI would basically have to decide whether leasing's stronger legal position would more than compensate for the tax-induced losses, often of approximately 2–4 percentage points in effective yield. If so, leasing would be the equipment finance modality of choice; if not, lending would be.

Pros and Cons of Financial Leasing vs. Lending: The Client's Perspective

In choosing whether to finance equipment through a lease or loan, the client would first consider the interest rate charged for each (which reflect all the MFI pros and cons just discussed), and any difference in taxes the client is required to pay. The other important factors include the following two advantages of leasing.

The benefits to the client of the lessor's stronger legal position for equipment seizure and sale in the event of payment default are widely discussed in the leasing literature. Because of this stronger legal position, lessors frequently offer financing with lower downpayments, less outside collateral requirements, or longer terms—thus giving back or sharing with clients one of the MFI's primary benefits of leasing. In the case of larger size operations, leasing may permit faster approval of financing and may also reduce transactions costs for the client and MFI; these advantages arise because with leasing it is not necessary to register a lien on the leased good (since the MFI owns it), whereas this registration process is often undertaken with loan collateral in larger size operations.

Finally, if leasing is exempted from a country's usury ceiling while lending is not, then clients may be able to obtain equipment financing with a lease far more readily than with a loan, albeit at higher interest rates.

MFI Best Practice Recommendations

Best practice recommendations for MFI equipment loan and lease programs include the following major points:

- MFIs that offer medium-term loans or leases—with maturities, for example, of 2–5 years—need to be concerned with asset-liability management (ALM), a tool used by financial institutions to control three risks: interest rate risk, liquidity risk, and foreign currency risk.
- To control interest rate and liquidity risks, MFIs should match the amount of assets and liabilities maturing in each of a number of designated time intervals. To control foreign

currency risk, MFIs should lend or lease in local currency to clients producing non-traded outputs and lend or lease in foreign currency to clients producing traded outputs. The currency of the MFI's liabilities should then be matched to the resulting loan/lease portfolio.

- Many leading MFIs in Latin America are making medium-term equipment loans and leases safely and profitably to completely new clients. Such a practice stands in contrast to the use of the progressive loan scheme, which has a long tradition in microfinance. The longer paper, from which this article is taken, discusses how lending and leasing to completely new clients can prudently be done through the proper application of four key underwriting criteria and the use of the relationship banking paradigm.
- Contrary to some literature on leasing, MFIs making equipment loans or leases should generally insist that clients put up a significant downpayment toward the purchase of the equipment and/or pledge collateral aside from the equipment.
- The term of an equipment loan or lease should be set by trading off the advantage of greater affordability to clients of longer-term operations versus the advantage to MFIs of the reduced credit risks and diminished ALM problems that are associated with shorter-term operations.
- While virtually all of the 25 MFIs surveyed set the same interest rates for their working capital and equipment loans, risk and cost considerations suggest that interest rates on equipment loans (and leases) should be set lower. Working capital and equipment loans appear to carry similar risks in many MFIs; however, the significantly longer equipment loan terms allow their costs to be spread over much more time.
- The literature on leasing often suggests that lessors limit themselves to financing equipment with good second-hand market value and that their leasing officers know well. However, these limitations may not be very important for MFIs offering equipment loans or financial leases to mainstream microentrepreneurs. For these clients, many MFIs can finance virtually any equipment the client demands, including used equipment, through the use of non-traditional collateral.

Policy Recommendations

Two key policy recommendations are in the regulatory and tax areas.

- Prudential regulations. Superintendencies should adopt the rigorous definition of financial leasing given above and should not restrict any financial institution allowed to do lending from engaging in financial leasing. The removal of financial leasing restrictions – restrictions that either prohibit financial institutions from offering financial leases or else require financial leasing to be done through a subsidiary—would allow many MFIs and other financial institutions to offer equipment finance by means of a lease. The removal of these leasing restrictions is justified because, on balance, financial leasing rarely poses more risk than lending and often poses significantly less risk.

- Taxation. Likewise, tax authorities should adopt the rigorous definition of financial leasing given above and should give identical treatment in the tax code to loans and financial leases. The recommendation that loans and financial leases be treated alike in the tax code is based on the fact that: a) financial leases and loans are close substitutes for one another, and b) large economic losses often occur when tax systems distort choices between two close substitutes. Those who want to learn more about equipment leasing and lending may refer to an expanded version of this article, by the same author and with the same title. It can be found at the IDB website, www.iadb.org/sds/mic, by selecting Publications or What's New.

Interest rate and foreign currency risks are the risks that the MFI will suffer losses when interest rates and foreign exchange rates change. Liquidity risk refers to the risk that the MFI will not have enough short-term assets to cover its short-term liabilities at any given moment in time.

The reason that financial leasing is normally less risky is that financial institutions have a stronger legal position for equipment seizure and sale in the event of client payment default. This advantage is normally much more important than leasing's two generally minor additional risks, namely, those related to (i) legal disputes, difficulties, and misunderstandings; and (ii) liability.