

CREDIT ALTERNATIVES IN RURAL FINANCE: FINANCIAL LEASING

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Enterprises use credit to acquire productivity-enhancing assets. Rural enterprises in developing economies, however, often lack access to the credit they need. Key reasons for this lack of access include the low level and scattered nature of economic activity in rural areas, the enterprises' lack of collateral, inadequate capacity among the country's lenders to lend in rural areas, and legal and policy environments that discourage lending to rural enterprises. Traditionally, leasing has served as an alternative to credit for urban enterprises, but generally it has not been a feasible option for rural enterprises. This note argues that rural leasing can be viable and highlights the key factors to facilitate successful rural leasing.

TYPES OF LEASES: FINANCIAL AND OPERATING

To better understand the merits of leasing, it is important to first define its two main categories: financial leases and operating leases. In a *financial lease*, lease payments amortize the price of the asset (amortization may be run for the full price or for most of the price). At the end of the lease period, the lessee can purchase

the asset for a token price. The lessee is responsible for maintenance and risk of obsolescence of the asset, and the leasing contract is usually noncancelable. In contrast, *operating leases* do not include the option to purchase the asset. Maintenance costs and risk of obsolescence are borne by the lessor, and leases are cancelable. The lessor recoups the investment through multiple leases and final sale of the asset. Because of the option to purchase the asset and the risks transferred to the lessee, a financial lease is a close substitute for a loan. Nearly all rural leases are financial leases.

ADVANTAGES OF LEASING

Leasing can be an attractive alternative to loans because of the advantages it presents to both providers and users. From the provider's perspective, the major advantage is the ownership of the leased asset, and the related rights in cases of default. In a secured-credit transaction, the borrower has ownership of the financed asset, while the lender has a lien on the asset. If the borrower defaults, the lender often has to obtain a court order to collect the collateral. In contrast, in a leasing transaction, the lessor owns the leased asset. In case of default of lease payments, the company can repossess the asset after giving the lessee a legal notice. A court intervention is needed only if the lessee obstructs the repossession. Usually, court decisions are favorable to the lessor, because lessor rights are stronger than creditor rights. Stronger lessor rights also reduce the incentive for the lessee to default.

Two other advantages are generally available to leasing: (1) the freedom to set lease interest rates and (2) fewer costs to adhere to regulations. Many countries impose interest rate ceilings on loan interest rates, particularly for small loans and rural loans, but they do not regulate lease rates. Leasing companies often are exempt from prudential regulation¹ or are subject to less stringent regulatory requirements than that required by banks. Financial leasing is less risky than operational leasing because maintenance and risks of obsolescence are borne by the lessee.

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From the client's perspective, the primary advantage of leasing is the potential to acquire assets without any additional collateral. In addition, leasing is usually available to clients with little or no credit history, offers more flexible payment terms, and has fewer transaction costs. Most, but not all, of these advantages are available to lessors and lessees in the rural context.

ENABLING ENVIRONMENT

For a leasing sector to develop and benefit rural enterprises, the necessary enabling environment needs to be in place. This enabling environment should include two key elements: a clear legal basis and minimal regulation. A good legal framework for leasing, includes (1) clear definitions of a lease contract, leased assets, and responsibilities and rights of the parties to a lease contract; (2) clarity in allocating responsibility for liability of third-party losses arising out of the operation of leased assets; (3) priority of lessor's claim over a leased asset; and (4) a framework for easy and fast repossession of leased assets. Minimal regulation is appropriate, because prudential regulation is only required if leasing companies take public deposits, which they rarely do. Furthermore, because these leases are not significantly riskier than loans, banks should be permitted to provide finance leases. Additionally, use of internationally accepted accounting standards and an unbiased tax code enhances the development of the leasing sector.

INSTITUTIONAL SUPPORT

In addition to a strong enabling environment, institutional support can help develop the rural leasing sector. There are four such types of institutional-level support: (1) subsidizing startup costs for commercial leasing operations; (2) funding establishment of links between commercial providers and community-based or nonprofit organizations; (3) lending technical support to leasing companies; and (4) providing equity, loans, or guarantees.

First, subsidizing startup costs helps organizations offset the higher transaction costs and risks of operating in rural areas. These costs and risks tend to be higher for the initial period in which operations are established. The U.S. Agency for International Development provided startup capital to Development Finance Company Uganda (DFCU), a leasing company, to help it establish rural branches.

Second, funding the creation of links between commercial providers operating in urban areas and community-

based or nonprofit organizations in rural areas demonstrates the mutual benefits of such arrangements and encourages sustainable links on a fee, commission, or profit-sharing basis.² CECAM (Caisses d'Épargne et de Crédit Agricole Mutuels), a cooperative agricultural financial institution providing credit and leases in Madagascar, uses solidarity group guarantees to monitor the physical status of assets and to decrease incentives for defaulting on lease payments.

Third, leasing companies benefit from technical assistance such as training, advisory services, and management support. Technical assistance grants can support product development or improve service delivery. For example, the Central Asian Leasing Project, supported by the International Finance Corporation (IFC), provided technical assistance to governments and leasing companies in the region.

Fourth, nonavailability of medium and long-term financing is a limiting constraint for financial institutions in many countries. Access to capital can be critical if leasing companies and other lessors are expected to start or expand rural operations. To meet this need, donor organizations are providing capital to rural enterprises. The U.K. Department for International Development provided capital to Development Finance Company Uganda (DFCU) to expand its operations to rural areas. And, the World Bank's Rural Finance Project in Romania has a Rural Credit and Leasing Facility that provides financing to private banks and leasing companies to be used exclusively in rural areas.

LESSONS LEARNED FROM CASE STUDIES

Three case studies reinforce the need to support the development of leasing services in rural areas and provide concrete examples of viable areas of support at the institutional level.

The first of these three cases, the Network Leasing Corporation Limited (NLCL) in Pakistan, focuses on micro and small entrepreneurs. It pioneered microleasing in Pakistan in the mid-1990s and is presently one of the leading providers. Its lease portfolio in 2004 was US\$11.6 million, of which around 20 percent is estimated to be in rural areas. The second case, DFCU Leasing Company Limited in Uganda, is estimated to have a market share of nearly 80 percent in Uganda and focuses on small and medium enterprises. The company's



lease portfolio in 2004 was US\$25.7 million and around 20 percent of this is estimated to be in rural areas. The third case, Arrendadora John Deere in Mexico, a subsidiary of John Deere Capital Corporation, USA, is the largest provider of farm machinery leases in Mexico. The company's core clientele includes medium and large farming enterprises. Its lease portfolio in 2004 was US\$74 million, 85 percent of which is invested in farm equipment leases.

These case studies demonstrate that rural leasing can be profitable. In fact, all three companies not only were profitable, but also reported their rural portfolios to be as profitable as their urban portfolios. Portfolio quality was generally good, repossessions were relatively few, and only one firm reported write-offs in the past four years.

No legal or regulatory constraints to repossession were reported by these companies. The taxation and regulatory frameworks in the countries differed. For example, leasing companies are subject to prudential regulation in Pakistan and Mexico but not in Uganda, and only Pakistan has a taxation framework with a positive bias toward leasing. These differences, however, did not appear to critically affect the ability of the leasing companies to operate profitably.

Access to asset-finance was the most significant benefit for clients. For several clients, their first lease was also their first access to formal finance and they could also obtain subsequent leases. Other benefits cited by clients included the absence of or reduced need for additional collateral, less time for processing, and approachability of the provider.

Five general lessons were drawn from the case studies

- *Rural leasing is a means to acquire productive assets.* All rural leases provided by the three leasing companies are finance leases and were used to finance the acquisition of assets (in contrast to renting of assets).
- *Rural enterprises of different sizes benefit from leasing, but a provider may not be able to equally serve all enterprises.* Providers are limited because of differences in skills and capacities required to effectively serve enterprises of varying sizes.
- *Non-farm enterprises account for a significant proportion of rural leases.* In the case of NLCL and DFCU, leases to non-farm rural enterprises accounted for a larger proportion than leases to farming enterprises.

- *Rural leasing can be profitable, but jump-starting rural leasing will require government and donor support.* All three firms studied benefited from access to government or donor funds, particularly in expanding their rural operations.
- *A rural leasing company may not be viable.* Because leasing is a specialized financial activity, economies of scale, cost, and risk factors may require that, in most economies, leasing companies have larger urban operations.



POTENTIAL WORLD BANK SUPPORT

World Bank projects can support the development of rural leasing in several ways and a small number of projects are already doing so. For example, the Rural Finance Project in Romania has a major component that benefits rural leasing. Although the Poverty Alleviation Fund Project in Pakistan does not specifically target leasing, credit under the project is available to leasing companies offering microleases and operating in rural areas. The Micro, Small and Medium Enterprise Project in Nigeria supports the creation of a legal and regulatory framework for leasing and provides startup grants for financial institutions, some of which are expected to benefit enterprises operating in rural towns.

The World Bank can build on these experiences to further support the development of rural leasing markets.

As in the case of all rural finance, an enabling environment is necessary but not sufficient. Although rural leasing overcomes some of the key constraints faced by rural credit, it is still subject to several similar constraints. These constraints include the low intensity of economic activity in rural areas, poor infrastructure, the high cost of developing financial technologies that can be used in rural areas, poor quality of client information, and covariant income risks of large segments of the population. All these factors may discourage leasing companies with successful urban operations from expanding to rural areas and justify institutional-level initiatives to encourage rural leasing.

CONCLUSION

Leasing is a viable tool to finance rural assets. The nature and capacity of existing financial institutions, the level of potential demand for leasing in rural areas, and the level of development of the leasing industry should determine the mechanisms to support increased access to leasing for rural enterprises. Policy-level support will be required in countries that do not have a clear legal and regulatory framework for leasing. Such support must be sectorwide and not restricted to rural leasing.

Institutional-level support, however, can be more targeted to rural leasing. A wide range of organizations—leasing companies, banks, financial cooperatives, microfinance organizations, and equipment selling companies—could benefit from such support. Institutional-level support can

include capital support when access to long-term funds is a critical constraint. Capital support combined with technical assistance can help leasing firms develop access to sustainable sources of capital. Although grants may be the best means to support technical assistance, soft credits also can be used to provide technical assistance to governments as well as leasing firms.

Rural finance projects should ensure that its services are available to not only credit providers but also leasing providers. These projects should also explore partnerships or possibilities of working in tandem with international and national institutions that provide long-term project finance for leasing companies.

FURTHER READINGS

Nair, Ajai and Renate Kloeppinger-Todd. 2006. "Buffalo, Bakeries, and Tractors: Cases in Rural Leasing from Pakistan, Uganda, and Mexico." World Bank Agricultural and Rural Development Discussion Paper No. 28. World Bank, Washington, DC. Available at <http://www.worldbank.org/rural>.

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¹ Prudential regulation involves enforcing requirements such as a minimum level of capitalization, debt-equity ratios, and liquidity requirements on deposit-taking financial institutions to reduce the risk of failure of such institutions, which would result in depositors losing their deposits and risk bank runs.

² The rural organization could provide one or more of the following services: initial appraisal, referencing, guaranteeing, lease payment collection, and supervision. The leasing firm could complete the final appraisal and negotiate favorable terms with suppliers on asset price, maintenance support, and insurance.

This note summarizes the findings of two recent publications on rural leasing. "Leasing: An Underutilized Tool in Rural Finance" provides an overview of leasing, analyzes its relevance for rural finance, and makes policy recommendations to support rural leasing. The 10 lessors surveyed for this paper together provided more than US\$125 million in leases to rural enterprises in 2002–03. Seventy-five percent of these leases were for agriculture or agricultural processing equipment. The lessors included three microfinance organizations, six private companies, and one state-owned company.

"Buffalo, Bakeries, and Tractors: Cases in Rural Leasing from Pakistan, Uganda, and Mexico" presents case studies of three companies from among the 10 lessors surveyed. These are profitable companies serving different market niches.

