Microleasing
Overcoming Equipment Financing Barriers

Mike Goldberg

As their businesses grow, many microbusiness owners would like to purchase new machinery from a microfinance institution (MFI), since such equipment can hold the key to increasing production. However, MFIs are often not able or willing to lend for longer periods of time, with grace periods that long term lending for machinery requires. Long term financing from other sources is usually not feasible, since banks and leasing companies require collateral, a well-documented credit history and financial statements. For many microbusinesses, leasing could provide an effective alternative to taking on more debt. This note reviews financial and operational leasing, describes two microleasing experiences in Latin America, identifies risks, and provides recommendations for launching a micro-leasing program. It is based on a distance learning dialogue with South American microfinance networks and presentations by Glenn Westley of the Inter American Development Bank (IADB) and Eduardo Gutiérrez, Executive Director of the National Ecumenical Development Association (Asociación Nacional Ecuménica de Desarrollo; ANED). The authors included additional research.

The Basics of Leasing

There are two types of equipment leasing arrangements: the financial lease and the operational lease. In a financial lease, the client pays the full price of the equipment, plus interest, through the lease period. At the end of the lease period, the client may purchase the equipment outright for a nominal amount (usually the depreciated asset value). A financial lease can only be cancelled by mutual agreement. In an operational lease, the client rents the equipment for a specified period, at the end of which the client returns the equipment, buys it outright, or renews the agreement. The client may cancel the agreement and return the equipment before the end of the lease period.

Both leasing types have some risks for the MFI and the client. The most important is the possibility that the client will fail to make the regularly scheduled payments. In that case, the MFI, as the equipment owner, can more easily seize the equipment than under the terms of a defaulted loan. Indeed, this stronger legal position is the best argument for leasing. For the client, this requirement means that even in an economic downturn, the business must continue making the monthly payment.

Under the operational lease, the residual value of the asset after the end of the lease period may be difficult to predict. If the asset’s resale value at the end of the lease period was lower than expected,
period is less than what is owed, the MFI loses the difference. Another risk for operational leases is damage to the leased equipment. Damages will reduce the residual value and increase maintenance costs. Because the operational lease has no lease-to-buy provision, the client has fewer incentives to maintain the equipment or to avoid damaging it during the life of the lease. The MFI also faces the risk of warehousing expenses for storage of repossessed equipment, as well as security costs and equipment removal costs.

To reduce damage risks and costs, the MFI may charge a damage deposit at the beginning of the lease period, but this is not a perfect solution. The amount may not be sufficient to cover the costs of maintaining the equipment or fixing the damage. Moreover, the client may not be able or willing to pay to fix the equipment at the end of the lease period. Some MFIs address damage risk by making arrangements to maintain the equipment during the lease period, and billing the client for the service. They also make regular visits to confirm that the client is using the equipment properly. Some MFIs also turn to insurance policies to cover related risks, such as theft, injuries to workers, and life insurance for deaths related to the use of leased equipment. Finally, the MFI may offer to sell the equipment to the client at a low price at the end of the lease period. This last option assumes that the lease has covered the initial cost of the equipment, plus interest.

On balance, the financial lease is the better product for an MFI, because it serves as an alternative for an equipment loan—and the MFI can avoid the added responsibility of entering the secondary market when the original lease contract ends. Table 1 below describes the advantages and disadvantages of financial leasing. If a client fails to make the regular payment (for whatever reason), financial leasing gives the MFI a stronger legal position than a loan for repossession of the asset. The equipment serves as the collateral, and can easily be repossessed. This is a routine legal process; it takes less than two months in Ecuador and Colombia, compared to one or two years for a defaulted loan. It is fairly inexpensive—between one and two percent of the lease cost. In Chile, Colombia, El Salvador, Honduras, and Mexico, the laws and procedures are similar for the recovery of leased equipment. Leasing companies often limit their exposure to standardized goods that can easily be resold locally.

Assessing the tax advantages of financial leasing is complicated by a country’s tax codes. Examples of taxes include a stamp tax on equipment over US$27,000 (Colombia), an asset tax (Mexico), and a tax on imported equipment (Rumania). For informal businesses, tax considerations favor loan financing of new equipment. For formal clients (who pay taxes), the local tax code determines whether leasing makes sense. Often, the MFI can reduce its tax burden by deducting the depreci-

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<td>Legal enforcement</td>
<td>Firm legal position to reposess and sell equipment if the client does not pay the lease.</td>
<td>Greater potential for misunderstanding and legal disputes</td>
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<td>Product design</td>
<td>The MFI can offer financing with smaller initial payments, fewer external guarantees, and longer terms Easy for clients to plan cash flow</td>
<td>May not create a credit history for the client</td>
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<td>Costs</td>
<td>Lower enforcement costs</td>
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<td>Tax issues</td>
<td>Taxes could be advantageous for formal businesses that pay the value-added tax (VAT) and utilities taxes.</td>
<td>No tax advantage from leasing for informal firms</td>
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Table 1: Financial leasing advantages and disadvantages
ated value of the rented equipment. Sometimes taxes are charged on principal and interest, and in other cases the client can deduct principal and interest from taxable income. The value-added tax (VAT) is sometimes applied against the lease charge, but not a loan.

**Advantages of Leasing for Microbusinesses and MFIs**

Leasing provides a number of advantages for the client, both in financial and operational terms. In financial terms, collateral is far less of a constraint, since the title of the equipment remains with the lender until the end of the lease contract. In that way, collateral is built into the arrangement. It offers fixed rate financing, making leasing “inflation friendly.” As other costs go up, the client pays the same amount each month through the lease period. There is also less upfront cash outlay. In other words, the client does not need to make a large cash payment to acquire the equipment, since the lease usually covers 100 percent of the asset purchase cost. This means that the business can use its own funds for working capital needs. Leasing payments can be structured to match a business’s cashflow—whether through balloon payments, step-up or step-down payments, deferred payments or even seasonal payments. Leasing does not affect the solvency of the firm, since it is not reflected in the liabilities of the balance sheet. Finally, depending on the country’s tax code, leasing can also represent a significant tax saving for a formally registered firm, especially if accelerated depreciation is permitted for the equipment.

The client also benefits in operational ways. The client can choose the supplier and the equipment without intervention or limitations placed on the choice by the MFI. In addition, leasing is efficient, because the client acquires the equipment only for the time it is needed. The client can also upgrade more easily, as new technology or improvements become available, by leasing more modern, more productive equipment. Finally, leasing also offers easy to understand lending terms and does not require a large amount of documentation. Since the lease covers

to qualify potential clients. Leasing offers a secure form of lending to clients who have already shown an ability to manage short term working capital loans. It also helps to diversify the loan portfolio. In some countries, equipment leasing is exempted from the interest rate ceilings imposed on lending. In addition, as discussed below, there are cost-effective means of limiting the risks of damage to the equipment and the costs of recovering the asset in the event of non-payment.

Two Latin American experiences: ANED and Finarca

The International Finance Corporation (IFC) has been instrumental in promoting leasing in Latin America. The IFC has worked with a number of financial institutions in Peru, Bolivia, and Nicaragua, among others. Despite this support, leasing has remained fairly small, compared to the loan portfolios of the region’s MFIs. Some institutions considered equipment leasing programs, but government policies discouraged them from moving forward. In Bolivia, a new law required the creation of a subsidiary for leasing programs. As a result, Banco Procredit Los Andes, for example, discontinued its leasing program—and two other MFIs, FADES and Pro Mujer, never advanced beyond expressions of interest. As General Manager Hugo Paguaga Baca of Finarca put it, “it is always good to have a regulatory framework in place, but it shouldn’t be a noose that is going to strangle the industry.”

That said, the experiences of ANED (www.aned.org), in Bolivia and Finarca (www.finarca.com) in Nicaragua, show how leasing programs can respond to demand by their microbusiness clients for better ways to acquire productive assets. Both institutions began their programs in 1997. In 2004, ANED’s program was redesigned with support from the Inter-American Development Bank. Finarca was the first leasing company licensed by the Superintendency of Banks and Other Financial Institutions. In 2000, the Superintendency permitted it to offer a broader range of financial services—working capital loans, consumer loans, housing finance, and letters of credit. The company evolved quickly and, three years later, was acquired by Scotia Bank of Canada.
ANED’s leasing program is dedicated to meeting the needs of the micro business sector by improving the conditions for access to medium and long-term financing. Equipment and machinery include farm implements, machinery for carpentry shops, bottling plants, energy and small industry, among other things. Based on its experiences to date, ANED is expanding leasing to include livestock.

Finarca has grown in two directions: expanding the range of leases and finding new clients in the country-side. Finarca recently launched a new program to lease equipment to at least 300 micro and small enterprises. Eligible projects and products for leasing include industrial machinery, warehouse equipment, vehicles, hotel and restaurant equipment, agricultural machinery, and office equipment, among others. As of June, 2008, Finarca had a portfolio of US$18.8 million, representing 85 percent of its total assets.

ANED’s and Finarca’s leasing programs resolve the problem of inadequate or no guarantees. They incorporate productive technology and support and strengthen the credit products already offered. They also strengthen the relationship between the small producers and the farmers. The leasing programs have improved the supply of machinery and equipment and have led to the establishment of strategic alliances among providers.

Recommendations for Establishing a Microleasing Program

Microfinance institutions considering long term lending for equipment should consider leasing as an alternative to credit. Given the right market and legal and regulatory conditions, MFIs will benefit by adding leasing to the list of financial products they offer their clients. As the experiences of ANED and Finarca demonstrate, the rewards of a leasing program for the institution and its clients can outweigh the initial costs of design and set-up.

To that end, MFIs and government authorities should seek to create the appropriate environment for a successful leasing program. They should begin with a standard definition of financial leasing to replace the various definitions currently found in the tax laws. Adopting a clear legal definition of financial leasing and treating leasing and lending equally under the tax codes will avoid the market distortions of a tax system that distinguishes between the two arrangements. MFIs should also understand and implement effective risk mitigation strategies to limit their exposure and provide incentives for prompt repayment by clients holding leases.

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Graphics from FINARCA and ANED websites

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