INNOVATIONS IN RURAL AND AGRICULTURE FINANCE

2020 VISION FOR FOOD, AGRICULTURE, AND THE ENVIRONMENT

Rural Leasing: An Alternative to Loans in Financing Income-Producing Assets

AJAI NAIR

FOCUS 18 • BRIEF 6 • JULY 2010

Credit for investments that pay back in the medium to long term (three to five years or longer) is in short supply in rural areas. Credit unions and microfinance institutions (MFIs), which generally have better outreach than commercial banks in rural areas, typically provide only short-term credit. Credit available from informal sources (such as moneylenders, family, and friends) is usually both short term and too costly for investment financing. For rural enterprises seeking to acquire equipment—a typical investment need—to modernize production and thereby increase productivity, one solution may be financial leasing.

Leasing offers several advantages. For traditional credit, farmers and rural enterprises are particularly constrained by a lack of assets that can be used as collateral. Leasing overcomes this constraint because it requires no collateral or less collateral than typically required by loans. Because leases also often require lower down payments than the equity required for loans, they are more affordable for rural enterprises that have limited funds and little access to borrowed funds.

From the lessor's perspective, not having to obtain collateral is particularly advantageous in a rural context. Although the difficulties involved in creating, perfecting, and enforcing security are applicable in both urban and rural contexts in most developing countries, they are more severe in rural areas where enterprises are less likely to hold titles to their assets, asset registries are less likely to be functional, and judicial processes are likely to be slower. Lessors are also likely to benefit from not being restricted by interest rate ceilings and sector-specific credit allocations—factors that have traditionally constrained rural lenders. Boxes 1 and 2 explain key features of a leasing contract, and Figure 1 shows a typical tripartite financial lease transaction involving an equipment supplier, a lessor, and lessee.

Box 1—What is a financial lease?

Leasing is a contract between two parties, where the party that owns an asset (the lessor) lets the other party (the lessee) use the asset for a predetermined time in exchange for periodic payments. Leasing separates use of an asset from ownership of that asset. There are two main categories of leasing: financial leases and operating leases.

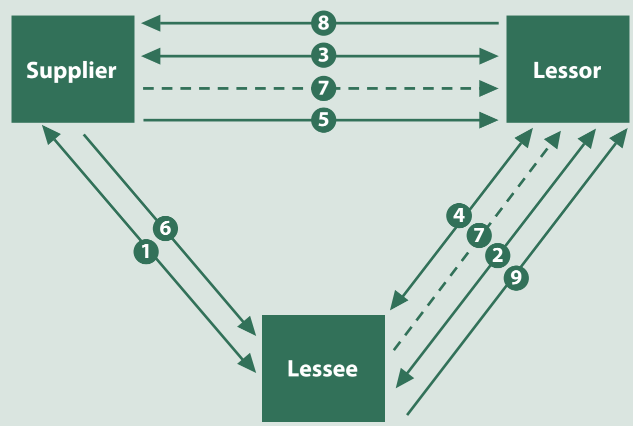
In a financial lease, lease payments amortize the price of the asset. At the end of the lease period, the lessee can purchase the asset for a token price. The lessee is responsible for maintenance and risk of obsolescence of the asset. Because of the option to purchase the asset and the risks transferred to the lessee, a financial lease is a close substitute for a loan. Nearly all rural leases are financial leases.

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.

Box 2—Key features of a financial lease contract

- Security: The primary security is the leased equipment. In some cases a small amount of cash or other asset owned by the lessee may be taken as additional security.
- Insurance: The lessor insures leased assets with commercial insurance and includes the cost in the lease price.
- Lease term: Lease terms range from two to five years.
- Lease cost: It includes cost of insurance, operating cost, loss provision, and profit.
- Lease payment schedule: The payment schedule can be monthly, quarterly, half-yearly, or annual.
- Option to purchase: On completion of the lease payments, lessees have the option to purchase the leased assets at a certain percentage of the lease cost.

Figure 1—Financial lease transaction



1. Initial negotiations about model, specification, price, discounts, warranty, delivery, etc. At this time the method of payment for the asset may not have been discussed.
2. Request for a leasing quotation (the supplier may also provide quotations on behalf of lessors).
3. Purchase contract agreement signed between lessor and supplier based on information supplied by the lessee to include those issues in (1) and also payment terms.
4. Lease contract signed and downpayment paid by lessee.
5. Invoice created by supplier giving title in asset to lessor (assuming full payment received by supplier).
6. Asset delivered to lessee.
7. Delivery and acceptance notice (protocol) signed by supplier and lessee.
8. Supplier's invoice paid by lessor.
9. Regular lease repayments paid.

Source: IFC (International Finance Corporation), *Leasing in Development: Guidelines for Emerging Economies* (Washington, DC, 2009).

Rural leasing initiatives

A 2006 World Bank case study of three profitable providers of leasing in rural areas showed that in all three cases the rural portfolios were as profitable as their urban portfolios. Arrendadora John Deere, the largest provider of farm machinery leases in Mexico, had nearly US$63 million in farm equipment leases. DFCU Leasing, the largest provider of leases in Uganda, had a US$5 million lease portfolio in rural areas. Network Leasing Corporation Limited, a leading micro-leasing provider in Pakistan, had a lease portfolio of more than US$2.4 million in rural areas. Low lease losses, strong client demand for asset financing, and a favorable legal and policy environment made rural leasing a profitable business for these companies. For clients, access to finance at a reasonable cost, low or no collateral requirements, quick processing, and easy access to the provider appear to be significant benefits.

Drawing on the experiences of the providers studied, the World Bank study identified the following lessons on managing financial leasing in rural areas.

- **Rural leasing is a means to acquire productive assets.** All rural leases provided by the three leasing companies are financial 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 the skills and capacities required to effectively serve enterprises of varying sizes.
- **Nonfarm enterprises account for a significant proportion of rural leases.**
- **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-only 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.

The challenge: Supporting increased availability of leasing in rural areas

Leasing is a viable tool to finance rural assets. The nature and capacity of existing financial institutions, the level of potential demand for investment finance in rural areas, and the level of development of the leasing industry should determine the mechanisms for supporting 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.

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 for third-party losses arising out of the operation of leased assets; (3) stipulation of the priority of a lessor's claim over a leased asset; and (4) a framework for easy and fast repossession of leased assets. The use of internationally accepted accounting standards and an unbiased tax code enhance the development of the leasing sector. The existence of a well-functioning asset registry, the availability of insurance and maintenance services for equipment at a reasonable cost, and the existence of a good market for used assets are also necessary for the development of the financial leasing industry.

Targeted institutional support may also be needed to help develop the rural leasing sector. As shown in Boxes 1 and 2 and Figure 1, financial leasing is a relatively complex transaction. To successfully undertake financial leasing operations, organizations need not only well-trained staff, but also high-quality lease origination processes, accounting and internal control systems, and overall portfolio risk management. Types of institutional-level support that can help include (1) subsidies for startup costs of leasing operations to help offset the higher transaction cost and risk of operating in rural areas; (2) funding to establish links between commercial providers and community-based or nonprofit organizations to increase scale; (3) technical support to leasing companies; and (4) provision of equity, loans, or guarantees to expand rural outreach.

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. ■

For further reading: IFC (International Finance Corporation), *Leasing in Development: Guidelines for Emerging Economies* (Washington, DC, 2009), available at www.IFC.org; A. Nair and R. Kloeppinger-Todd, "Buffalo, Bakeries, and Tractors: Cases in Rural Leasing from Pakistan, Uganda, and Mexico" (Washington, DC: World Bank, 2006), available at www.worldbank.org/rural; A. Nair, R. Kloeppinger-Todd, and A. Mulder, "Leasing: An Underutilized Tool in Rural Finance," World Bank Agricultural and Rural Development Discussion Paper No. 7 (Washington, DC: World Bank, 2004), available at www.worldbank.org/rural; G. D. Westley, *Equipment Leasing and Lending: A Guide for Micro-Finance*, Best Practice Series (Washington, DC: Inter-American Development Bank, Sustainable Development Department, 2003).

***Ajai Nair** (anair@worldbank.org) is program coordinator of the Agriculture Finance Support Facility in the Agriculture and Rural Development Department of the World Bank. Azeb Fissha, consultant, provided research and editorial support.*

INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE
Supported by the CGIAR
IFPRI® www.ifpri.org

THE WORLD BANK
www.worldbank.org