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Microleasing: The Unexplored Financing Instrument

Glenn Westley

In microfinance, leasing is an unexplored instrument. A few Latin American microfinance institutions (MFIs) have indeed given it a try, but they can be counted on one hand.

Lease financing is used to support equipment purchases, which in turn allows the entrepreneur to expand production, improve product quality and increase revenues. So, if lease financing is an attractive way to provide medium-term financing for equipment purchases, why isn't it more commonly used among MFIs? Is the lack of leasing in microfinance due to a lack of knowledge among MFIs (and thus a great unexplored opportunity), or are there in fact some features that make it less than an obvious proposition in the context of microfinance?[1]

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In This Issue

Cooperate to Compete

Pablo Angelelli, Maria Ariano, and Carlos Guaipatín

Interest in developing and strengthening business groupings, or *clusters*, has grown significantly in Latin America and the Caribbean during the last decade. Clustering is an effective mechanism for improving the competitiveness of small and micro enterprises, in terms of productivity as well as quality, by promoting learning processes, technology transfers and specialization. Successful experiences in these business groupings, however, have until now been found primarily in industrialized countries.

What is this process of clustering, and how much do business groupings in the region approximate the model that has served as an instrument of economic policy in Europe and North America?

The examples of Córdoba in Argentina and Otavalo in Ecuador, which are described below, illustrate the challenges and opportunities of the nascent process of clustering in the region. These cases show how clusters

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To answer these questions, and provide some recommendations for interested MFIs, the concept of leasing must first be sorted out.

Financial vs. Operational Leases

On its most basic level, a leasing arrangement involves one party using an asset owned by another in exchange for specified periodic payments. While all leases are based on this basic principle, two distinct types of leases have emerged — financial and operational — that are characterized by different risks and potential uses. One is very relevant to microfinance, the other probably isn't.

Of the two, only financial leases are a true alternative to loans for microenterprise equipment acquisition. In this type of lease, the entrepreneur (lessee) specifies the desired equipment, as well as the preferred dealer, and the MFI (lessor) purchases it. Rigorously defined, financial leasing must have three key characteristics: full payout, non-cancellation, and the right to buy the equipment for a nominal amount (see box).

In contrast, operational leases are not necessarily a means to acquire equipment. In many cases, the lessee contracts for shorter-term use of equipment 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 examples of operational leases.

Operational leasing entails three major risks or uncertainties not found in financial leasing. The risks include damage to the equipment; the difficulty in determining an appropriate residual value for calculating monthly payments and the price of any final purchase; and the nonexistence of secondhand markets in which to sell used equipment after it is no longer profitable or possible to lease it.

In contrast, risk in financial leasing is more or less restricted to situations where clients default on their payments, in which case the equipment may be seized. But while financial leasing is definitely relevant to MFIs interested in providing equipment financing to microentrepreneurs, this does not necessarily mean that it is always the right thing to do. Straight lending, as simple as it is, has its advantages too.

The Three Defining Characteristics of Financial 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.
- Give the lessee the right to buy the equipment at the end of the lease term for a predetermined sum, typically the remaining balance or a token sum such as $1.
- Cannot be cancelled without the consent of the MFI or other lessor. (Otherwise clients could simply return the equipment early and stop making payments.)

Pros and Cons of Financial Leasing vs. Lending

The primary advantage financial leasing has over lending is that it offers a stronger legal position for equipment seizure and sale if the borrower defaults. A possible additional advantage for the MFI is the exemption of leasing from the usury ceiling by some countries. A third advantage often mentioned in favor of leasing is its favorable tax treatment; however, as will be shown below, this commonly accepted wisdom is not usually true in the case of microfinance.

The benefits 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 down payments, fewer outside collateral requirements, or longer terms — thus giving back or sharing with

Advantages of Financial Leasing	Disadvantages of Financial Leasing
• *Legal considerations:* stronger position for equipment seizure and sale in the event of client payment default	• *Legal considerations:* greater potential for legal disputes, difficulties, and misunderstandings; greater potential for legal liability problems
• *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)	• *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 informal)
• *Banking regulations:* possibly escape usury ceiling	• *Banking regulations:* financial leasing may be prohibited or permitted only through a subsidiary
	• Greater setup and operating costs

[1] A survey of 25 leading microfinance institutions (MFIs) in Bolivia, Chile, Colombia, Ecuador, El Salvador, Honduras, Mexico, and Peru found that equipment loans and leases account for roughly 20 percent of their overall portfolios. Of the 25 MFI surveyed, 23 offer equipment loan or lease products with at least 2-year terms. While most of these transactions are loans, there is a small but growing movement toward leasing. ANED in Bolivia, INDES in Chile, and Finamérica in Colombia all offer equipment leases. Several other MFIs are planning or seriously considering a leasing program.
For a more complete description of this survey as well as a more detailed analysis of microleasing as an alternative to lending, please consult the working paper *Equipment Leasing and Lending: A Guide for Microfinance* (2003) by Glenn Westley at www. iadb.org/sds/mic/ This article is based on said paper.

clients one of the MFI's primary benefits of leasing.

In the case of larger size operations, leasing may also permit faster approval of financing and may also reduce transaction costs for the client and the MFI. 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.

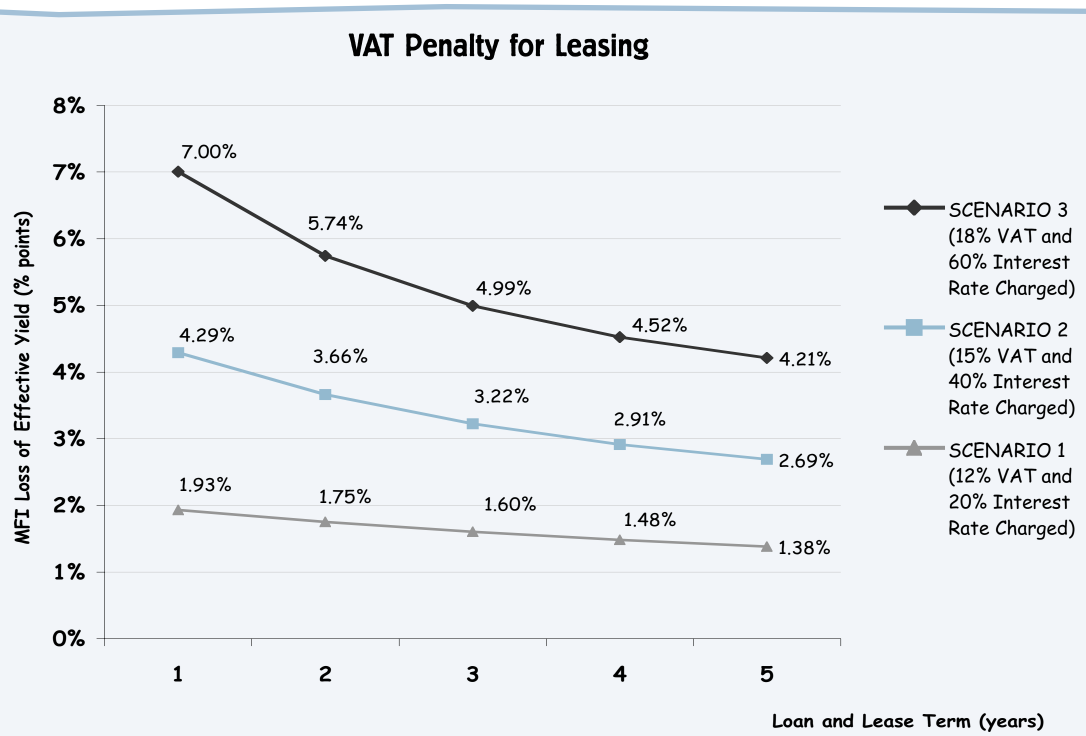
Finally, if leasing is exempted from a country's usury ceiling while lending is not, then clients may be able to obtain equipment financing with a lease far more readily than with a loan, albeit at higher interest rates.[2]

But that is where the advantages of leasing end.

To begin with, tax codes usually favor lending over leasing in the case of informal clients, i.e., clients who do not remit value added tax (VAT) or profit tax on the products they sell. The extent of leasing's disadvantage varies, but it commonly entails a loss of about 2-4 percentage points in the MFI's effective yield. For example, if a loan yields 30% to the MFI, a similar lease would yield roughly 26-28%. Since most MFI clients are informal, tax considerations generally favor lending.

These findings contradict simplistic claims in some of the leasing literature that leasing is tax advantaged. True, lessors can at times take a tax deduction for leased equipment depreciation. However, a complete analysis of the impact of the profit tax on loan/lease choice often reverses the result, particularly as the value added tax frequently favors lending over leasing.

In addition to an unfavorable tax treatment (compared to straightforward lending), financial leasing generally costs more to set up and operate.



Many countries levy value added tax (VAT) on lease payments but not on loan payments. Not surprisingly, this unequal treatment of the two financing instruments affects the relative desirability of loans versus financial leases, making leases relatively less attractive than loans.

As the graph above shows, the loss in effective yield to the financial institution ranges from 1.38% to 7.0%, depending on the VAT, the interest rate and the term of the financing. For example, to take a middle-of-the-road scenario, a financial lease with a 3-year term, a 15% VAT, and a 40% interest rate generates a loss of 3.22% in the effective yield of the financial institution, as compared to a loan.

Clearly, this magnitude of losses in the effective yield is significant and can deter MFIs from offering lease financing to microentrepreneurs. But in addition to making this potentially interesting financial instrument less available to small business in Latin America, a tax that distorts the choice between two close substitutes, as in the case of loan and lease financing, will also produce economic losses for the financial system as a whole.

[2] However, while this type of exemption is said to exist in various countries, no advantage from such an exemption was found in the countries surveyed: Bolivia, Chile, Colombia, Ecuador, El Salvador, Honduras, Mexico or Peru.

It is a somewhat more complex instrument than lending and, moreover, banking regulations in many countries require it be done through a leasing subsidiary, which can add significantly to costs without returning any additional benefits.

Finally, in spite of its stronger legal position compared to lending, financial leasing has a greater potential for legal disputes and misunderstandings because the MFI's ownership of the equipment sometimes comes into conflict with the lessee's possession and use of it. There is also greater potential for legal liability problems with third parties. However, these legal risks are generally deemed to be fairly minor.

In the end, the choice could come down to this: the stronger legal position for equipment seizure and sale inherent in leasing, versus the tax and possible regulatory advantages offered by lending. In cases where there are no regulatory restrictions on leasing, MFIs must decide whether leasing's stronger legal position would more than compensate for the tax-induced losses of approximately 2-4 percentage points in effective yield.

While this rule succinctly summarizes the basic calculation in deciding whether or not to offer lease financing to microentrepreneurs, it doesn't address the question of how to actually succeed at it. A badly designed and executed leasing program will fail regardless of how advantageous its legal position is.

The choice could come down to this: the stronger legal position for equipment seizure and sale inherent in leasing, versus the tax and possible regulatory advantages offered by lending.

Suggestions for MFIs Interested in Microleasing

There are a couple key issues that MFIs should keep in mind when starting up a microleasing program — some of the issues concern potential trouble spots, others simply reflect lessons learned from the few MFIs that already have implemented this type of program.

1. 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 asset-liability problems associated with shorter-term operations (see point 5 below).

2. Risk and cost considerations suggest that interest rates on equipment finance (leases and loans) should be set lower than working capital finance. Working capital and equipment finance appear to carry similar risks in many MFIs; however, the significantly longer equipment finance terms allow their costs to be spread over much more time.[3]

3. Contrary to recommendations found in some of the leasing literature, MFIs making equipment loans or leases should generally insist that clients put up a significant down payment toward the purchase of the equipment and/or pledge collateral aside from the equipment.

4. MFIs may not need to limit themselves to only financing equipment that has good second-hand market value and that their leasing officers know well (as typically suggested in the leasing literature). Since the value of an equipment lease to a microentrepreneur is not likely to be very large, the MFI can easily cover itself through additional non-traditional collateral, such as household goods or other business items, which can be seized in case the client defaults.

5. MFIs that offer medium-term financing, regardless of whether it is in the form of loans or leases, need to be concerned with asset-liability management, a tool financial institutions use to control risks related to interest rates, liquidity, and foreign exchange. 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 exchange 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.

It should also be noted that equipment finance to microenterprises — whether it be in the form of lending or leasing — does not necessarily have to be done according to the conventional microfinance lending methodology, which relies on progressively larger and longer-term loans. Several leading MFIs in Latin America are today providing medium-term equipment financing safely and profitably to completely new clients. The secret behind this type of financing, which deserves a more complete explanation than what is possible in this article, is in the proper application of four key underwriting criteria and the use of the relationship-banking paradigm.[4]

Suggestions for Policymakers

For policymakers interested in promoting the availability of lease financing for microentrepreneurs, there are a couple of recommendations worth pointing out.

[3] It is interesting to note that the survey of MFIs mentioned in footnote 1 uncovered that virtually all of the 25 respondents were setting identical interest rates for their working capital and equipment finance. They could thus improve their operations by differentiating the interest rates of these two types of finance.

[4] See *Equipment Leasing and Lending: A Guide for Microfinance* for a more complete treatment of this topic.

To begin with, bank superintendencies should adopt a rigorous definition of financial leasing (such as the one given earlier) but not restrict any financial institution from engaging in financial leasing. They should avoid restrictions that prohibit financial institutions from offering financial leases or require that financial leasing occur only through a subsidiary. Flexibility in this regard would allow many MFIs and other financial institutions to offer equipment finance by means of a lease. This action is justified because, on balance, financial leasing rarely poses more risk than lending and often it poses significantly less.

Tax authorities also need to do their part by adopting the same rigorous definition of financial leasing and then give identical treatment in the tax code to loans and financial leases. Experience tells us that large economic losses often occur when tax systems distort choices between close substitutes, such as loans and financial leases.

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Cooperate to Compete

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offer possibilities for improving the competitive capacity of productive sectors and for designing public policies that can accelerate economic growth and strengthen employment opportunities.

Are we Far from the "Ideal" Model?

A mature cluster is characterized by a high concentration of businesses in an area with easy access to inputs, services, and specialized labor, where technological innovations are spread quickly, and where there is also a public and private institutional presence that provides a favorable business climate.[1] Businesses and the surrounding entities collaborate to find joint solutions to collective problems. In this ideal scenario, the external pressure to compete and the possible benefits from cooperation provide strong incentives for establishing collaborative arrangements.

In Latin America and the Caribbean, industrial conglomerates are generally very heterogeneous and do not easily fit into the cluster model described here. Still, there are several promising cases where firms could achieve higher levels of competitiveness from cooperation, especially if the policy environment from the local authorities is also well implemented. In Córdoba and Otavalo, for example, there are economic subsectors that show signs of a nascent clustering process, although the business sectors in general are characterized by a low level of specialization, little pre-existing cooperation and by a high level of disarticulation with other local entities.

> In clusters…businesses and the surrounding entities collaborate to find joint solutions to collective problems . . . the external pressure to compete and the possible benefits from cooperation provide strong incentives for establishing collaborative arrangements.

In these cases of incipient clustering, one can see a desire to cooperate in a critical number of businesses, which in turn can translate into effective collaboration among certain producers, as well as between producers and agents of innovation (research centers, universities, service providers, etc.). The desire to cooperate is fundamentally based on the economic benefits that the businesses expect as a result of collaboration. However, the glue that brings and holds the parties together is trust, which may exist from historical or cultural factors or simply as a result of repeated interactions over a period of time.

In other words, firms cooperate because they perceive that the benefits associated with this type of strategy are greater than its costs, the latter including expenses and risks of coordinating actions with competitors and other businesses in the productive chain. A pre-existing trust among the local firms, whether it be due to history, culture or other factors, significantly lowers these costs and risks.

The Partial Gains of Córdoba

Keeping in mind the model of the "ideal" cluster, a first glance at the productive sector in the Córdoba province of Argentina would indicate that there is no great potential there for promoting business clusters. For one, companies of the productive sector do not show high levels of cooperation or of productive specialization. In addition, the relationship to scien-

[1] Including, for example, universities, research centers, business associations and guilds, workers' organizations, consulting businesses, regulatory bodies, and public groups.

tific institutions and technological service providers is weak, particularly in the case of smaller businesses.

Nevertheless, if one considers the formation of a cluster as an evolutionary process, there are subsectors — especially in the fields of information and communication technologies, furniture and wood products, and caprinoculture (or goat farming) — where there are opportunities to advance towards more cooperative and competitive business arrangements.

The case of the information and communications sector in Córdoba, where approximately 160 relatively small and young companies are concentrated, is an example of a potentially successful cluster. The basic condition for a successful business cluster — the desire to cooperate — is manifested here principally through two initiatives: the Córdoba Technology Cluster (CCT), a new organization that brings together the 25 most important businesses, and the Chamber of Commerce, another institution where 50 other businesses participate.

The Chamber of Commerce and the Córdoba Technology Cluster have been working hand in hand with six universities in the region to improve the quality of their human resources and create new infrastructure for research and development for the sector, which in turn can speed up innovation and facilitate technology transfer in the area.

The furniture and wood products sector, which comprises 230 mostly smaller businesses, is another sector with promise. Here, some of the larger enterprises are showing a certain level of upstream integration in the productive chain, though the level of specialization is still reduced. And there is also a desire to cooperate, though it is less developed than in the information and communications sector.

As an example of incipient cooperation, one group of furniture producers and service providers in interior design are engaged in joint marketing. Another group of six companies in the province has come together around marketing to improve their access specifically to international markets. Much of the collaboration is encouraged by and channeled through the Chamber of Woodworkers and Producers, an institution that performs an important role in defining the cooperative relationships with the architecture and industrial design departments of the city of Córdoba.

Even though the benefits generated from the cooperative activities cannot be easily quantified in this case, at least two positive aspects should be mentioned: a nascent process of productive specialization and integration among the businesses, and a dialogue that has produced a shared analysis of the problems and initial discussions of joint solutions.

Finally, the colorful example of 3000 to 4000 Córdoba goat farmers and their 150,000 goats must be mentioned. Here is a sector whose economic significance in the province is modest, given the characteristics of the sector and its participants. It is basically made up of poor farmers who have primitive production methods and precarious installations. Just like the previous cases, however, this population could significantly benefit from increased cooperation.

Indeed, a few promising signs of increased cooperation have already been noticed. In 1997, some 250 livestock producing families joined with a group of professionals to constitute a producers association to jointly purchase inputs, develop training programs, improve animal health, and carry out market research for new products.. This association has also forged alliances with other support organizations and technological services institutions like the Córdoba Science Agency and the National Institute of Agriculture and Livestock Technology. Cooperation has translated into important benefits in the form of lower prices for inputs, higher quality of outputs and an improvement in the living conditions of the families.

The Untapped Potential of Otavalo Craftsmanship

Located 110 kilometers north of the city of Quito in the Ecuadoran mountains is the village of Otavalo, famous in Latin America for its woven textiles. Of its 90,000 some inhabitants, approximately 56% are indigenous, and many of them design, produce, and market woven articles of clothing. The busy and colorful Saturday market attracts thousands of people who are looking for artisan products of various kinds.

In the case of Otavalo, the textile production chain is dominated by micro and small enterprises, generally organized around the family unit. There are currently some 6,000 indigenous micro and small textile producers in the village, with strong differences between one business and another in terms of type of activity and production processes.

> Many of the cooperative efforts begun in Otavalo have not lasted due to institutional weakness and a lack of financial resources.

Although there are successful small and micro-enterprise producers, most of the textile artisans engage in their business activities amid difficult economic conditions in the periphery of town. They are informal enterprises with few resources, low productivity and small production quantities. Frequently they do not know who the final customer is and they lack alternatives to sell their products through other distribution channels.

As in the Córdoba cases, the textile sector of Otavalo shows little exploitation of the economic advantages associated with clusters. For example, access to quality raw materials is deficient and the only local enterprise that makes refined wool is partially disconnected with the local productive sector because it exports its entire output. Furthermore, there is little specialized labor in the area, nor any training centers.

Many of the cooperative efforts undertaken in Otavalo in the past have not lasted due to institutional weakness and a lack of financial resources. In spite of the difficult context of Otavalo textile craftsmanship, however, there are some positive elements that offer opportunities to improve the sector's competitiveness.

First, in Otavalo momentum is building towards collaborative practices among the enterprises; one can sense it is a time of change and enthusiasm. A unified cultural identity and the common problems facing the various competitors already imply a high potential for cooperation. In fact, several business owners with vision and leadership have attempted to develop an associative culture in the trade in order to identify common problems and build the necessary organizations to address the obstacles faced by the sector.

Another favorable element in this incipient process of collaboration has been the support of the local government, which for the first time is headed by an indigenous mayor sensitive to the problems of Otavalo enterprises. In order to support the productive processes of the community and satisfy the needs of the micro-business owners, the mayor has looked for institutional support from the central government, from donors, and from international organizations. The support of an external agent could help to break the vicious cycle in which Otavalo is trapped and which restricts its competitiveness.

When are Public Policies Worthwhile?

The cases presented here exemplify the potential and limitations of increased cooperation and competitiveness in various business clusters of the region. These examples also illustrate the basic conditions that need to be pre-

Characteristics, Limitations, and Challenges of Business Clusters

	Characteristics	Limitations	Areas for Cooperation
		Córdoba	
Information and Communication Technologies	• 160 primarily small and medium scale businesses • Exports to Europe, United States and Latin America	• Reduced internal market • Insufficient training • Lack of compliance with quality standards	• Access to international markets • Training for human resources • Quality certification
Furniture and other wood products	• 230 small and medium scale businesses • Strong orientation to local markets	• Difficulties in sustaining mechanisms for cooperation • Low productive specialization • Design and quality problems in products	• International insertion • Strengthening of sales capacity • Creation of stable mechanisms for institutional cooperation
Caprinoculture	• 3.000-4.000 families who raise goats • Strong orientation to local markets	• Primitive production methods • Inadequate infrastructure • Lack of marketing	• Infrastructure improvement • Joint purchase of supplies • Training • Exploitation of derivative products • Genetics
		Otavalo	
Textile Craftsmanship	• 6.000 micro y small indigenous weavers • Local market and exports	• Low product quality • Low quality inputs • Low-skilled labor	• Trust building • Development of providers • Training • Access to markets

sent in order for policies that support clustering to have a positive impact on the economic activity of the area.

- First, there needs to be a critical mass of businesses concentrated in a region and in a subsector with a clear competitive advantage. In other words, there needs to be a business base or a productive tradition in the population.

- Second, there needs to exist a commercial opportunity for the products of the subsector, that is, a potential for marketing and selling the products in regional, national or international markets.

- Third, there needs to exist a dynamic "embryo" of cooperation among businesses in the area/ subsector, which can be built upon to support greater cooperation and fundamentally improve competitiveness

The existence of these conditions is crucial for the successful introduction of public policies designed to strengthen cooperation and competitiveness in business clusters. Once these conditions are met, policies of local and regional governments can have a real impact, though it will always be important to adapt policy design to the particular situation of each business cluster in order to take advantage of the culture, traditions, and competitive advantages of each productive system.

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