

Conceptual Review of Lease Financing in India

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Abstract: Procurement of the essential finance has always been a challenging task for developing country like India due to insufficient capital and scarce resources. The core objective of each business entity is to attain growth with stability. In order to achieve such objectives all the business entities are forced to look for different source of financing. Due to apparent reasons, leasing has emerged as a new source of financing. This study at a glance presents the growth and development of Lease Financing in Indian Scenario. It also throws light on the concept of lease financing and its evolution in India. It also discuss the pros and cons of lease financing. The study is purely based on the secondary data. Last of all, based on the conclusion of the study, appropriate suggestions are made for sustainable and sturdy expansion of the leasing industry in India.

Keywords: Leasing, India, NBFC's, Lessee, Lessor.

I. INTRODUCTION

Financial services basically means where all kinds of services are provided in financial terms and money play as an essential commodity. Various entities which provides these services are: Non-Banking Finance Company, Commercial banks and Merchant banks. In India, major financial services is provided by NBFC's which is registered with Reserve Bank of India which mainly provide fund based services to customers like Leasing and Hire-Purchase. Since the inception of liberalization much has been talked about the lease financing as an alternative source of financing. Earlier the hire purchase was the only financial services provided but now a days almost every financing company has added the leasing function in the Object clause. The growth of leasing business emerges from the fact that asset can be gainfully employed without having the ownership [1]. As per the Global Leasing Report, presented by the London Financial group it reveals that there is a significant growth in Leasing Industry worldwide. In the year 1978 leasing business was of \$ 40.8 billion. Then the Volume of the Business increased tremendously to \$273.8 billion in 1988. Within a decade i.e., in the year 1998 it reached to \$432.5 billion. The leasing volume in 2011 was \$616.83 billion showing a tremendous growth in leasing industry. Throughout the period there was a significant growth found in this industry. Remarkable growth is found due to contribution from the U.S based companies their contribution is \$193.9 billion as highest of all countries in the world. Whereas other developed countries like China contribution \$63.72 billion, next Germany \$52.49 billion. Whereas India's contribution is insignificant and negligible at \$1.05 billion. In India, the leasing business is progressing slowly, in terms of volume and also in terms of varieties of transactions. Hence there is need to conduct a study to identify the areas in which it can be developed. There is a tremendous potential for leasing in India. Hence the Government of India and State Governments have to encourage the companies, financial institutions and banks to develop the industry. They should also liberalize the rules, terms and conditions by Reserve Bank of India.

II. REVIEW OF LITERATURE

The paper by Kurfi (2009) on "Corporate Capital structure and Lease financing Practices of selected manufacturing Firms in Nigeria" studies lease financing practices and corporate capital structure of selected Nigerian manufacturing firms for period 1993 – 2002. The main purpose behind this survey was to analyze the extent to which firms engaged in lease financing for capital assets acquisitions and its impact on corporate capital structure. Out of 106 manufacturing companies listed in the Nigerians Stock Exchange as at December 2002, only 19 firms were reported for finance lease during the study period [2]. Lim et al. (2003) in their paper " Market evaluation of Off- balance sheet Financing: You can run but you can't hide" compare the impact of operating leases on debt ratings and the yield of new debt issues to that of balance sheet debt. Their findings are focused on firstly, operating leases are significantly less important than balance sheet debt for firm debt ratings. Secondly, operating leases have the same impact as balance sheet debt on the yields of new bond issues [3].

Damodaran (2010) in his paper entitled “Dealing with Operating Leases in Valuation” state that most firm valuation models start with the after tax operating income, as a measure of the operating income. In using this measure of earnings we assume that operating expenses include only those expenses designed to create revenue in the current period, and that they do not include any financing expenses and show them after operating income. He emphasized whether these expenses are really financing expenses and that ignoring this misclassification can create significant problems in measuring and comparing profitability [4].

Lasfer (2005) in his paper entitles “Why do companies Lease their Real Estate Assets” explains the costs and benefits of leasing, than owning real estate assets. Companies lease their real assets to avoid debt financing, to lower down their tax liability, to obtain lower cost of financing and to conserve liquidity [5]. “Legal and Regulatory Framework for Leasing in Russia During year 2000” by Bloom (2005) studies that The International Monetary Fund is projecting that the gross domestic product of Russia will increase by two percent during the year 2000. Reports in the fall of 1999 indicate that the Russian economy may have grown by two percent during 1999 as compared to 1998. The "correction" in the value of the Russian Ruble, and the cessation of speculative investments in high-yield securities in the fall of 1998, coupled with higher oil prices, and stable government policies have, notwithstanding several changes in the head of the Russian government during 1999, quite possibly, laid the foundation for economic growth in Russia during the year 2000 and beyond [6].

Shah (2007) in her article “The leasing sector in Pakistan and its role in capital investment” says that the cost of leasing for a Pakistani lessee averages around 20-25% per annum. The effective cost for a tax-paying lessee may be 16-20%. Assuming an 18% cost of capital (weighted average) for the lessee, the asset can only generate a net income for the lessee, if the lessee in turn earns at least 19-21% per annum from the asset. This would only be possible in high growth sectors of the economy. In her experience, it is rare to see a gross profit margin of 20%, especially in the manufacturing sectors who are the prime clients for leasing Plant and Machinery. In such condition the product is being used as a source of working capital and quite often as a competing product with short term loans from commercial banks. Her study conveys that In Pakistan, the net profit margin of the lessor ranges between 3% and 5%. The cost of lease to the lessee is 18-20%. [7]. “Depreciation dichotomy between Accounting Standard and Tax Laws on Financial Lease Transaction” by Jain (2012) states that over a few years, the instrument of lease fell out of popularity largely because of the tax issues. Among other tax issues, the major issue is depreciation allowance. When Accounting Standard (AS) 19 on “Leases” was introduced, it was expected that the requirement of capitalization of the leased asset by the lessee in case of financial lease transaction would be accepted by the income tax laws as well [8].

Meier and Ryan (2015) explain whether the new clause in oil and gas lease should be enforceable or not. Under the existing law when the landowners are approached by the companies offering for oil and gas lease, landowners make an assumptions that they have prevent their unwanted transfers of lease interest, however it is still unclear under existing laws[9]. Naaz (2015) examines the financial performance of Sundaram Finance Ltd. By evaluating the liquidity, profitability and solvency ratios. Simple Regression test was used to analyse the financial performance of SFL [10].

Brendon (2018) explains the strength and growth of global leasing report in his paper entitled “Global leasing Report”. He studied that the top 50 countries in 2016 reported growth in new business volume of 9.40%, rising from US\$1,005.30bn in 2015 to US\$1,099.77bn in 2016. Three regions, North America, Europe and Asia, account for more than 95% of world volume. New business volume exceeded the previous year’s global total by US\$94.47bn. The Asian region experienced impressive growth of 30% and demonstrated by far the largest percentage increase among all the global regions [11]. Brendon (2019) explains the remarkable growth highlights in leasing’s innovation and resilience. The Asian region experienced truly exceptional growth of 58.9% largely bolstered by an uplift in new business of US\$59bn in China. Europe recorded a growth rate of 32.7% and North America experienced 9.3% growth over the previous year. Australia/New Zealand was up 1% and South America up 23.2%. By contrast, Africa recorded a fall from last year’s figure of 15.8% [12].

Objectives of the study: the study specifically aims at:

- To study the conceptual framework of lease financing in India.
- To study the problems and prospects of lease financing in India.
- To study why the concept of lease financing evolve in India.

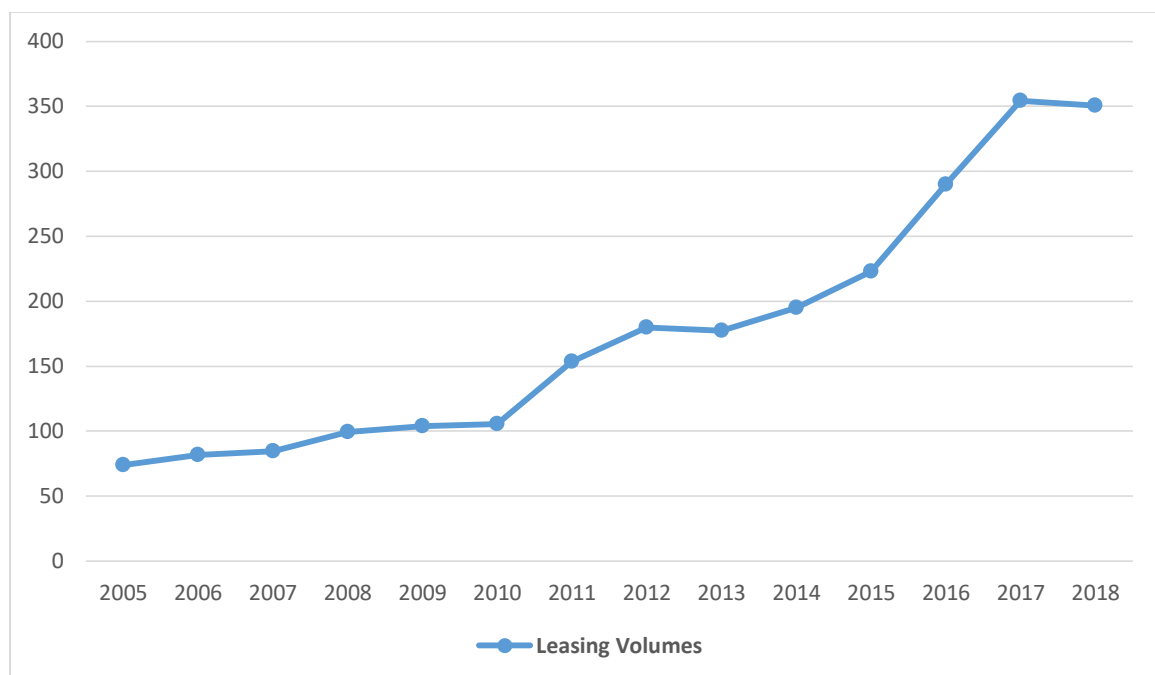
- To study the growth of lease volume in Asia including India.
- Finally to come out with conclusions and suggestions for the development of leasing business in India.

Methodology of the study: The study is purely based on secondary sources of data. Altogether the relevant books, magazines, journals, periodicals, thesis, websites are consulted by the author for the better referencing.

III. CONCEPTUAL REVIEW OF LEASE FINANCING

Concept of leasing: The International Accounting Standards No.17 defines lease as “an arrangement whereby the lessor conveys to the lessee in return for rent the right to use the asset for an agreed period of time” [13]. Leasing as financing concept is simple an arrangement between two parties, the leasing company or the lessor who owns and finances the purchases of asset and the user or the lessee, to whom the assets is rented. The rent is payable in advance at regular interval of time agreed by the lessor and the lessee but in this regard much is dependent upon the type of the equipment [14]. The propensity to lease also varies as per the size and growth of the industries. The industries which are likely to have high growth rates and are huge in size lease their property.

This proves that leasing also allows the companies to grow faster [15]. The most important forms of leasing are financial leases and operating leases. Treatment of tax and accounting transactions differ among different types of leasing [16]. Currently, leasing becomes prevalent among the customers and industries as they gaze for substitutes to finance the attainment of fixed assets.



Source: White Clarke Group Global Leasing Report 2020 [17]

Fig. 1: Growth of Leasing Volume in Asia (US\$ billion)

The above Fig. shows the tremendous positive growth of annual lease volume in Asian region from the year 2005 to 2018. The major players in the Asian leasing markets are China, Japan, Korea, Taiwan, Hong Kong, Malaysia and India

Evolution of leasing in India: Leasing is not a new concept in India, as it took place around 2000 BC, when Sumerian farmers leased tools from temple priests. Till late 18th century leasing were mainly used for agricultural purposes but in early 19th century leasing was mainly used for growth of cities in industrialized countries [18]. The first leasing corporation of India was set up by Farouk Irani with industrialist A.C Muthia in 1973 in Madras which was named as “First Leasing Company of India” promoted by Chitambaram Group. Initially the growth of leasing company was slothful up to 1980. But again in 1980 “The Twentieth Century Leasing Company” was established which was followed by four other leasing companies in the same year such as Sundaram finance, Motor and General Finance, Nagarjuna Finance, Mazda Industries, Pressman Leasing, H.B leasing and so on [19]. Reserve bank of India also allows the commercial banks

to endeavor into leasing activity. Today most of the business that is long on ideas and short in cash are using leasing as one of the most flexible financing solution to increase production and to generate maximum profits. Major leasing players in the Indian market are Non-Banking Financial Companies (NBFC's), Non-Banking Non-Financial Companies (NBNFC's) and other entities which include Rental Operators, Cab Aggregators, Indian Railway Finance Corporation and car finance companies. [20]. The Indian leasing market is mostly consist of operating leases and financial leases is died away years before as it suffers from additional tax burden. Indian banks are also not offering any kind of leasing as they are permitted by RBI several years back because financial leases was the main product to be offered by the banks but they don't have enough demand in the Indian market [21].

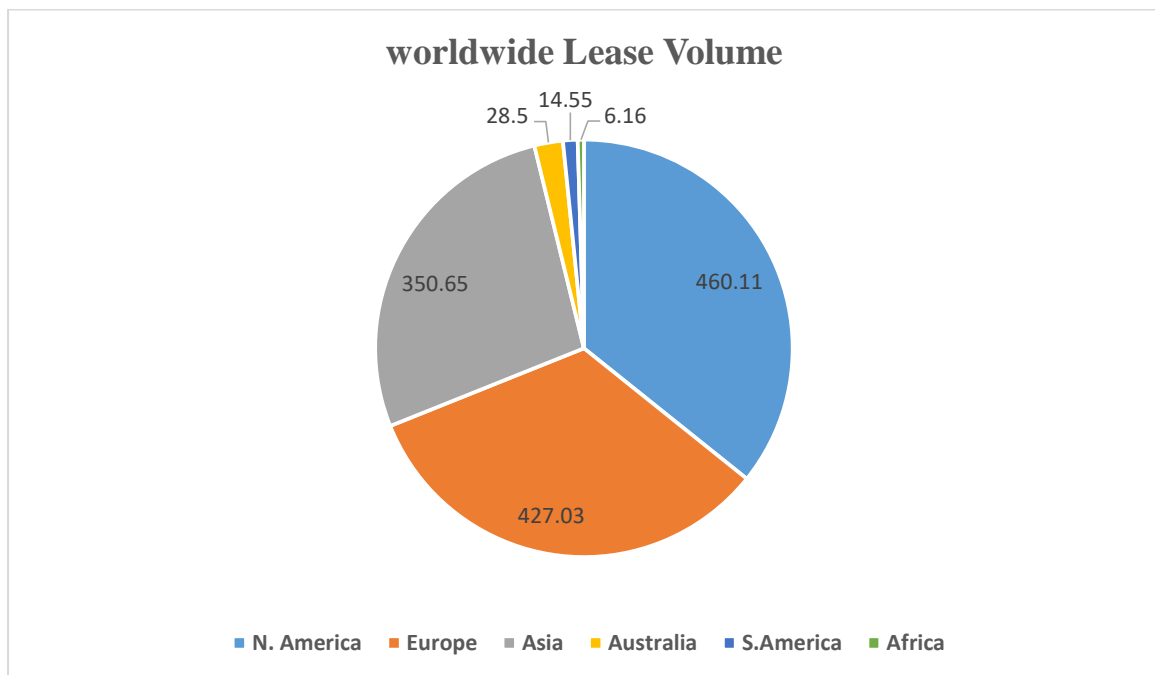
Table 1: Annual lease volume in India (US \$billion)

Years	Annual Volume
2014-2015	0.19
2015-2016	0.40
2016-2017	1.08
2017-2018	1.58

Source: Compiled by the author from the various reports of White Clarke group Global Leasing Report for the financial year 2017,2018,2019,2020.

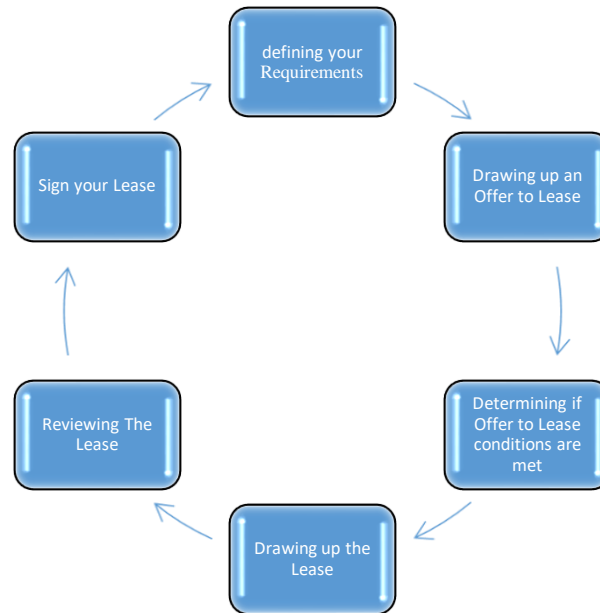
The above table shows that Indian market has a considerable scope for the expansion in the leasing market ahead even though it is still at the development stage.

If we will talk about the different region for annual lease volume, North America is at the top position with annual lease volume of US\$ 460.11 billion. Second dominant region is Europe followed by Asia with the annual lease volume of US\$ 350.65 billion. Australia (US\$ 28.55 billion), South America (US\$ 14.55 billion) and Africa (US\$ 6.16 billion) stands at third, fourth and Fifth position for the financial year of 2017-2018. The above data is also shown in the form of pie chart below.



Source: London financial group global leasing report 2018 [22]

Fig. 2: Worldwide Lease volume for 2017-2018 (US\$ billion)



Source: Authors compilation

Fig. 3: Process of Leasing

As we can see from the above figure that first step in the process of lease financing is to determine the requirement list then the lessee search for the lessor who can fulfil such terms and conditions. Further an agreement of “Offer to Lease” is drawn and if the condition mentioned in the document is not satisfied by both party, then the “Offer to Lease” agreement becomes null and void and the parties don’t have a further legal obligations against each other. However if they are satisfied with all the conditions, the lessor draws up the lease at his expense and presents it to the lessee to review the lease. Finally, the lease is signed by the lessor and lessee after reviewing the lease agreement multiple times. Once signed, both the parties establishes the terms and conditions and binds themselves for a specified period of time.

Types of Leasing:

The most common types of leasing are capital or finance leases and operating leases. Categorisation is based on whether all the risks of ownership and benefits are transferred to the lessee or not.

Capital or Finance lease: A finance lease is a long term lease that transfers significantly all the risks and rewards related to ownership of an asset. Title may or may not be eventually transferred [23]. Financial lease is non-cancellable lease and is also known as full pay-out leases as lessor is able to amortize full payment of purchase cost through lease rentals. Further lessee has to bear all cost of repairs and maintenance. Ownership remains with the lessor [24]. Financial lease is very much popular in economies like U.S.A, U.K, and India etc. International Accounting Standard 17 governs the international lease accounting.

Operating Lease: Operating lease is a short term lease which can be limited for a month, half yearly, annually or for three years. Lessor is not able to amortize full cost of an asset on the basis of lease rentals. This type of lease can be terminated any time by giving a stipulated notice by any of the either party. Lessee is also not entitled for any kind of risks and rewards associated with lease [25]. Operating lease is also known as “Off- balance sheet” financing as asset and debt is not recorded in the company’s balance sheet. It is also known as service lease.

Table 2: Financial leases Vs Operating leases

Particulars	Financial leases	Operating leases
Period of leasing	Covers full economic life of an asset	Ranges from short to intermediate
Maintenance responsibility	Lessee	Lessor
Amortization	Fully amortized	Not fully amortized
Risk of obsolescence	Lessee is liable	Lessor is liable

Cancellation	Non -cancellable	Cancellable by either of the party
Accounting	Liability to be recorded in the books of lessee	Off balance sheet financing
Types of asset leased	Land and machineries, buildings, aircraft, railcars etc.	Computers, automobiles, trucks, office equipment's etc.

Source: Author compilation

Problems of lease financing in India: India has a great potential for leasing but it also faces severe handicaps which are discussed below [26]:

- It is highly beneficial for the lessee to take the equipment on operating lease where the risk of the obsolescence is borne by the leasing company. Hence it is a great trouble for leasing company since it has to bear the capital loss in case of obsolescence.
- The problem of delayed payment of rents and bad debts add to the cost of lease.
- The market of leasing has not grown with the same pace as the number of lessor. Hence, there is over supply of lessor leading to competitors. The margin of profit for the lessor has dropped down.
- Due to cut throat competition, leasing companies experienced a considerable fall in the rental given by the lessee. Consequently, their profitability had bounced back.
- Leasing business required expertise for dealings in the procedure like appraisal, accounting and finance areas. Due to lack of such expertise, the operations of the leasing business are bound to suffer.

Benefits of lease financing: Following are the factors which are responsible for the growth of leasing in India:

- Leasing helps the acquisition of fixed assets without any initial investment on the part of lessee. Since a lease does not require a down payment, it is equivalent to 100% financing [27].
- With an operating lease, the lessee can treat their lease rentals as an expense. Therefore lessee is able to have tax benefits without the full lease obligation affecting the balance sheet. Lessee is also able to claim depreciation on the leased asset each year and therefore can deduct interest expense of the lease payments.
- Unmatched flexibility is involved in the leasing, as there is option of purchase, upgrade and return or extend an equipment lease at the end of the agreement.
- A wide variety of leasing products is available, allowing you to tailor a program to fit your month to month or year to year cash flow needs. Some leases even allow even to miss one or more payment that too without any penalty.
- With leasing problem of capital vs. equipment is solved. Business entities get use of the asset while capital stays where it belongs i.e. working for the company.

IV. CONCLUSION

The mode of lease financing as a source of business finance complement the activities of banks in the fields of deposit mobilization and advancing. As per the Global report of leasing prepared by the London Financial group the leasing business is progressing very slowly which is insignificant and negligible if compared to any other countries. Hence, Leasing companies are capable of playing a dynamic role in the development of the country provided that there is a continuous support from the government. The government, on its part, in order to safeguard the money of the public should provide certain regulatory framework. At the same time, it should also provide supportive policy to the leasing industry so that it can grow on healthy lines. Leasing industry should also ensure the safety of depositor's money.

Suggestions: In order to support and expand the leasing Industry it is required that government should provide uniform lease related laws and practices for all the states in India. Micro leasing should also be promoted in order to ease poverty which is the major problem of the developing country like India. Cross border leasing can also be expanded if the RBI provide relaxation to the current norms related to import of capital goods.

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