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Evaluation of Leasing in India

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WORLD BANK GROUP
Creating Markets, Creating Opportunities

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ACKNOWLEDGMENT

Pratibha Chhabra, Sagar Siva Shankar (WBG)

Peer Reviews:
Ashutosh Tandon (IFC), Simon Bell (WBG), Swati Sawhney (WBG), Murat Sultanov (WBG)

Vinod Kothari, Nidhi Bothra, Abhirup Ghosh
(Vinod Kothari Consultants Private Limited)

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Abbreviations

AFC	:	Asset Finance Companies
AS	:	Accounting Standards
ATM	:	Automated Teller Machine
BPO	:	Business Process Outsourcing
CAGR	:	Compound Annual Growth Rate
CBDT	:	Central Board of Direct Taxes
CGST	:	Central Goods and Service Tax
CRR	:	Cash Reserve Ratio
CST	:	Central Sales-tax Act
ECB	:	External Commercial Borrowings
FAS	:	Financial Accounting Standards (US accounting standards)
FASB	:	Financial Accounting Standards Board
FDI	:	Foreign Direct investment
FY	:	Financial Year
GDP	:	Gross domestic Product
GST	:	Goods and Services Tax
IAS	:	International Accounting Standards
IASB	:	International Accounting Standards Board
ICAI	:	Institute of Chartered Accountants of India
ICDS	:	Income Computation and Disclosure Standards
IFC	:	International Finance Corporation
IFRS	:	International Financial Reporting Standards
IGST	:	Inter Goods and Service Tax
INR	:	Indian currency (Rupee)
IPOs	:	Initial Public Offers
IRFC	:	Indian Railways Finance Corporation
IRR	:	Internal Rate of Return
IT	:	Information Technology
ITC	:	Input Tax Credit
KPO	:	Knowledge Process Outsourcing
LST	:	Local VAT Law (local sales-tax)
MFI		Micro Finance Institutions
MNC	:	Multinational Corporation
MSME	:	Micro Small and Medium Enterprise
MW	:	Mega Watt
NBFCs	:	Non- Banking Financial Companies
NBNC	:	Non-Banking Non-Financial Company
NIC	:	National Industrial Classification
NPA	:	Non-Performing Assets
OEM	:	Original Equipment Manufacturer
OTP	:	Obligation to Pay (in context of IFRS 16)
PSL	:	Priority Sector Lending
RBI	:	Reserve Bank of India
RoU	:	Right of Use (in context of IFRS 16)
SARFAESI	:	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
SGST	:	State Goods and Service Tax
SIDBI	:	Small Industries Development Bank of India
SLR	:	Statutory Liquidity Ratio
SMEs	:	Small and Medium Enterprises
UK	:	United Kingdom
USA	:	United States of America
USD	:	United States Dollars
VAT	:	Value Added Tax
VKC Analysis	:	VKC Analysis represents the facts and findings of the study carried out by the Consultant during the course of the assignment
WDV	:	Written-Down Value

Executive Summary

Leasing: An introduction

There are two basic types of leasing structures in use:

- An **operating lease** is a contract that allows the lessor, as owner, to retain legal ownership of an asset but allows the lessee to enjoy the economic use of the asset for a predetermined period before returning the asset to the lessor. At the end of the lease period, the asset continues to be owned by the lessor.
- In a **finance lease**, the lessor is the owner of the asset; however, at the end of the lease period ownership is typically transferred to the lessee on the payment of a residual value price[1] of the asset which is usually pegged at 10% of the original asset cost, or less. Thus, a finance lease is essentially a finance transaction dressed up as a lease.

There is no separate legal regime for leasing in India; instead leasing transactions are governed by the common law of contracts. Lease transactions are regarded as contracts of hire. Over the years a series of court rulings have upheld the lessor's overarching rights over the asset as the legal owner of it.

[1] The expected value of the asset at the end of the lease is called residual value. Any uncertainty in the amount of residual value, estimated at the inception of the lease, is called residual value risk. In case of financial leases, since the residual value is typically prefixed, the residual value risk is negligible. In case of hire-purchase transactions, given the nominal purchase option, the residual value itself is negligible.

Since the lessor remains the owner of the asset, in the event of default, the lessor can simply take back his/her asset. On the other hand, in a loan transaction, in the event of default the lender must take over possession of the asset which is actually in the name of the borrower. Hence typically, loans come with higher credit risk, and therefore, higher risk premium, resulting into higher cost of funding. Lease transactions are expected to increase the ease of financing, reduce the cost of funding, as also save the equity of the lessee that would have otherwise gone into meeting the borrower's contribution in case of a loan.

Leasing companies may be non-banking finance companies, or non-banking non-financial companies. Financial leasing is regarded as a financial activity; operating leasing is not. Hence, if an entity is principally engaged in either financial leasing or other lending activities, it will need to register itself as a Non-Banking Financial Company (NBFC) with the RBI. Companies principally engaged in operating leases are non-banking non-financial entities, and do not come under regulatory purview of the RBI. If a leasing entity is an NBFC, it will need to adhere to several prudential guidelines of the RBI.

The tax nuances of leasing are with regard to applicable direct tax provisions, the tax issues are seemingly addressed with regard to indirect tax with GST coming into effect.

In terms of direct taxation, the income from leasing business is taxable after granting depreciation deduction. While the law does not specifically lay down distinction between financial and operating leases, from the point of income tax incidence, it is generally believed that it is only in case of operating leases that the depreciation is claimed by the lessor. In case of a financial lease, it is the Lessee who claims the depreciation. Depreciation rates for most common-use assets in India ranges between 15%-20% on declining balances method; as a result, most lease transactions do not result into a significant tax advantage to the lessor.

As the country has moved to a comprehensive GST regime, the problem of duplicity of taxes, and the loss of benefits due to non-fungibility of goods and services, is addressed. Currently, from indirect tax perspective, there is no difference between financial leases and operating leases and the rentals are subject to GST. However, considering the fact that financial leases in substance are similar to loans, the tax treatment should also be the same.

Development and State of Leasing in India

While leasing had several phases of rapid development and gradual/rapid decline, the state of the leasing industry is a product of the regulatory and tax environment.

Past instances of misuse of depreciation benefits in several lease transaction have made tax officers generally apprehensive of leasing. Hence, even genuine lease transactions face difficulties in getting their depreciation claims allowed. As for financial leases, there is no income-tax motivation; on the contrary, there was a double hit of indirect taxes owing to VAT as well as service tax. Thus, financial leases have lost attraction over time.

Owing to such factors, India presents an unusual picture compared to many other countries where the volume of operating leases is far higher than finance leases. Of course, the Indian Railway Finance Corporation (IRFC), a dedicated leasing entity for the Indian Railways, does financial leases, but being exclusively dedicated to the railways, these volumes may not be relevant for industry data. Operating leases are mostly offered by some NBFCs, and some Non-Banking Non-financial Companies (NBNCs). Banks are currently not offering leasing services in India. A substantial part of the leasing market, consists of lease options provided by vendors and OEMs to their customers - this is the case in sectors such as automobiles, healthcare, IT equipment and so on.

Leasing looks set to undergo a revival in India - this is not because of newer and more transparent regulatory regime or because of any tax arbitrage - but simply because of the phase the Indian economy finds itself in. New-age businesses and start-ups believe in lighter balance sheets, focusing on their core operations rather than asset build-up. Leasing may play a significant role particularly in light of the looming NPA crisis. Lessors retain ownership of the asset, hence repossession of the asset is easier. Secondly, in case the lessee defaults and has to go undergo corporate debt restructuring, operating lease rentals are classified as operating expenses and hence receive priority in any payout settlement.

Notably, the Insolvency and Bankruptcy Code recognizes leased assets as excluded from the bankruptcy estate for liquidation purposes, thereby granting the lessor the uppermost right to stay out of liquidation proceedings. Amendments to the SARFAESI Act permit lessors under a financial lease to make use of the SARFAESI process for recovery; it is felt that this does not rule out common law procedures.

Additionally, certain sectors have emerged as new thrust areas for leasing - this includes the solar sector. A solar lease has several attractions: high depreciation rates allowed on solar equipment, and the ability to tie the payments by the user to the savings energy costs.

Leasing worldwide

Globally, leasing has grown at a CAGR of 10.35% between 1983 and 2000 and at a CAGR of 5.04% between 2000 and 2014. The leasing volumes rose from USD 93.5 billion in 1983 to USD 944.3 billion as at the end of 2014. Region-wise, North America has always been the market leader, capturing the maximum share of the global leasing volumes, followed by Europe and Asia.

In terms of leasing penetration, India is placed much lower in the ranks among the developed and developing countries around the world. As at the end of 2014, Australia, Canada and UK had the best the penetration rates with 40%, 31% and 28.6% respectively.

In terms of regulatory developments globally, introduction of IFRS 16 to replace FAS 13 (in USA) and IAS 17 (internationally) is one of the most notable changes. The new standard, which will come into effect from 1st January, 2019, attempts to change the lessee's way of lease accounting substantially. This standard removes the distinction between operating leases and financial leases. Except for short-term leases or small-value leases, the assets will be capitalised in the books of the lessee at a discounted value of the lease rentals. The new standard, however, does not change anything for the lessors. Further, this standard will not apply to SMEs. The new standard may usher a new era of shorter-term, higher residual value leases, as, in that case, the value of the asset that goes on the balance sheet of the lessee is much lesser than the actual fair value of the asset.

Leasing to MSME sector

One of the key aims of this report has been to understand the needs of the MSME segment and understand why leasing has so far not been able to play a bigger role in meeting the financial needs of this segment. Towards this, we carried out a primary survey with various MSMEs, consultants to MSMEs and NBFCs.

It emerged that one of the main reasons why MSMEs avail of finance options instead of lease options is the relative simplicity of the loan product. It is easy to understand, there are no residual value issues. Moreover even consultants to MSMEs recommend them to avail of traditional debt as opposed to leases - this is owing to the fear of the complications of the taxation regime - both direct and indirect. Lack of awareness of leasing option emerged as a substantial contributor to the present state of leasing industry. Vendors of standard equipment also confirmed that most of the NBFCs they deal with find it easier to sell a loan rather than a lease.

Leasing can provide several advantages to both lessor and lessee in the MSME segment- repossession of asset by the lessor is easy as the lessor remains the owner of the asset; SARFAESI Act and its long drawn repossession process need not be invoked. Should the lessor and lessee be able to agree on a high residual value of the asset, the monthly rent of the lessor would come down. Upfront capital expenditure in the leasing case tends to be minimal.

An important advantage is that leasing allows one to write off the cost of the asset in the form of lease rentals in 3-4 years. As opposed to this, in the case of ownership of the asset, even if it is on loan, the depreciation one can claim is only 15% annually on plant and machinery. It would take nearly 15 years or more to write off the full cost of asset. Thus, if one includes taxes in the cost of a loan versus that of a lease; leasing does often work out cheaper.

Leasing also works well in the informal sector where financial statements are either absent or unaudited, and hence non-standardized. This is because in case of leasing, the legal ownership of the asset remains with the lessor which puts the lessor in a better position in terms of security. In case of default, instead of initiating enforcement of security interest as in case of secured loans, the lessor can easily repossess the asset. Thus, the leasing option, after eliminating the tax inefficiency, should make access to finance easier for the informal and sector.

Conclusions and recommendations for action:

It is clear that the penetration of leasing in India is very low, especially so for financial leases. Therefore, there is a need for the government to create a more enabling environment for carrying out lease transactions and also to encourage usage of this product through removing existing disincentives. Following are the recommendations that would enable in creation of an ideal environment of the leasing entities to operate in India:

1. **Changes required in the taxation environment:**

    a. Financial leases, which are akin to financial transactions, must be taxed as a financial transaction, instead of GST being levied on the rentals in case of financial leases; the GST rules should create a tax parity between financial leases and loans.

    b. The Income Computation and Disclosure Standard on Leases, issued by the Central Board of Direct Taxes, which is yet to be notified, attempts to remove the anomalies with respect to lease classification for the purpose of direct tax purposes, may be put to effect.

    c. Currently stamp duty is levied on lease of certain assets which are affixed to the ground for usage and stamp duty happens to be a sunk cost. This acts a deterrent for the leasing entities to engage into such transactions, therefore, there is a need for a clarification from the government in this regard that would affirm that a property will not be rendered as an immovable property just by virtue of annexation with any immovable property for the purpose of its ultimate usage.

2. **Changes required in the regulatory environment:**

   a. Currently certain concessions and exemptions that are available in case of imported assets are not available in case of leases. These exemptions were denied; it is important that the benefits be restored.

   b. Cross border financial leases are considered as External Commercial Borrowings, however, there is a lack of clarity with respect to cross border operating lease transactions. A clarification from the appropriate authority on the treatment of cross border operating leases is required.

   c. Currently micro-finance institutions (MFIs) are not permitted to primarily engage in leasing, MFIs may be allowed to extend leasing arrangements as well.

   d. The financial sector in India is mainly driven by the priority sector lending requirements for the banks. Priority sector includes MSMEs; however, leasing exposures to MSMEs do not qualify for the purpose of priority sector lending requirements. Therefore, the requirements must be adequately modified to include leasing as well.

3. **Promotion of leasing in India:**

   a. The MSME industry bodies must arrange for platforms to promote leasing as an alternative source of financing for the MSMEs.

   b. Currently there is a no ready residual value risk absorber in the country. There is a need identification of suitable ways of residual value risk mitigation, which may include – setting up of platforms for sale of off-lease assets, permitting insurance companies to offer residual value insurance products.

CHAPTER 1

BACKGROUND ON LEASING

In its simplest form, leasing is a means of providing access to a fixed asset and may be defined as a contract between two parties wherein one party (the lessor) provides an asset for use to another party (the lessee) for a specified period of time (lease term) in return for specified payments (rentals).

The ability to acquire assets by way of lease rather than owning them has several benefits for the lessee, including allowing them to keep a lighter balance sheet and free up resources for working capital, among others.

Among several other benefits of leasing is also its potential for bringing down the cost of credit. The lessor, with title over the asset, has better recovery rights, and therefore, has lower risk. This allows the lessor to impose lower risk premiums while extending his financing. Reduced cost of funding benefits the economy as a whole.

1.1 Leasing Products

Globally, there are two basic types of leases – financial and operating leases. While this distinction emanates from accounting standards on leasing, the distinction delves into the essential structure of the lease as well.

A **finance lease** is a contract that allows the lessor, as owner, to retain legal ownership of an asset while transferring substantially all the risks and rewards of economic ownership to the lessee. A finance lease may also be termed a full payout lease, as the leasing payments made during the term of the lease will repay all of the original cost of the asset plus the interest charge by the lessor. Typically, at the end of the lease tenure, the asset is transferred to the lessee on the payment of a pre-agreed residual value, usually upto 10% of the original cost. Thus, a finance lease is essentially a finance transaction dressed up as a lease.

An **operating lease** is a contract that allows the lessor, as owner, to retain legal ownership of an asset but allows the lessee to enjoy the economic use of the asset for a predetermined period before returning the asset to the lessor.

Table 1 below helps to compare financial leases and operating leases, from an Indian perspective. Many of the points in the table are discussed later herein. Also see Annexure 1.2 for detailed comparison.

Table 1: Financial lease versus Operating lease

Comparison of Financial lease and Operating lease		
Feature	**Financial lease**	**Operating lease**
Legal ownership	Lessor	Lessor
Right to economic usage	Lessee	Lessee
Responsibility for insuring asset	Lessor or lessee depending on contract	Lessor or lessee depending on contract
Responsibility for maintenance of asset	Lessee	Generally lessee; some leases may offer bundled contracts with maintenance by lessor or lessor-appointed agency
Transfer of ownership at end of lease	Lease agreement will typically offer a renewal or purchase at a price considerably lower than the fair market rental/ price of the asset	The asset is returnable to the lessor; lease contract may offer a purchase option at a price usually based on expected fair value of the asset
Choice of vendor	Lessee	Lessee, but subject to greater involvement of the lessor

Financial Leasing vs Loans

The critical difference between these two popular methods of asset financing is in the ownership of the asset that is the subject of the financing contract. Under the terms of a finance lease, the lessor (leasing company) is the legal owner of the asset. This ownership is normally achieved by the supplier of the asset invoicing the lessor, and the lessor paying the supplier directly. Under the terms of a loan agreement, the borrower is the legal owner of the asset. The supplier of the asset for which the loan has been created invoices the borrower directly, and the borrower uses the money that has been provided by the lender to pay the supplier. The treatment of the GST also varies between a finance lease and a loan. This issue is addressed later in this chapter. The similarities between a loan and a financial lease include the following:

- The lessee (providing the terms of the lease are met) and the borrower are able to retain the asset once payments are complete.
- Over the period of both a lease and a loan, interest and capital (equipment cost) are repaid.
- Should there be a default on either the lease or the loan, both the lessor and the lender have the legal right to reclaim/repossess the asset, provided the loan is secured.
- The risks and costs of ownership, including maintenance and obsolescence, remain with the lessee and the borrower. Also, under both a financial lease and a loan, if the asset appreciates, neither the lessor nor the lender benefit.
- The agreements are non-cancellable until either the lessor or the lender has recovered its outlay.

Hire Purchase: A traditional form of financing

In a hire purchase transaction, the hirer (user) has, at the end of the fixed term of the hire, the option to buy the asset at a token value. This is called, in some countries, a conditional sale or deferred purchase. In view of the certainty of title transfer at the end of the term, hire purchase is viewed as a device of title retention for the purpose of securing funding, and therefore, akin to a secured loan.

1.2 Evolution of Leasing in India

- Leasing in India originated in 1973. It grew in popularity as a financial product quickly, and by 1986, as per RBI's records, there were 339 equipment leasing companies with leased assets aggregated to USD 36.85 million.[2]
- From 1986 till 1996 was a period of a significant boom in the industry. The factors that worked to fuel the boom included tax incentives due to first year depreciation and investment allowance, positive response to leasing IPOs by the capital markets, strong performance by early starting companies, etc. There were two more factors, discussed below, that fueled an unsustainable growth – the lure of public deposits, and lack of accounting standards (see Box).

[2] The number of leasing entities surged from mere 2 in 1980 to 339 in 6 years. – Lease Financing and Hire Purchase by Vinod Kothari, Fourth Edition

Deposits and Depreciation – the twin factors that led to bursting of the leasing boom

Financial companies in India had traditionally been allowed to accept deposits from the public. While the limit up to which non-financial companies have been allowed to accept deposits has been only 25%, for financial companies, the limit was 1000% of net owned funds. Most of the leasing entities took advantage of largely unregulated deposit market, and started accepting deposits mostly for tenures of 1 year. While the leasing companies continued to accept deposits, these short term deposits were deployed for long term slowly leading the companies to a growing build-up of severe asset-liability mismatches.

In early years of leasing, India had no accounting standard dealing with lease transactions. Hence, a lessor could treat all lease rentals as income, and thereby, report substantially higher leasing incomes than the actual interest embedded in lease rentals. A lessee could keep all leases off-the-balance sheet. This led to higher-than-real profits in initial years booked by leasing entities, which would reverse in later years, thereby creating unsustainable financial statements.

Around the same time, tax assessments of several leasing companies revealed the use of leasing as a mechanism for tax shelter. Several sham transactions came to the fore, where assets for which a lease was undertaken were either non-existent or could not be identified. In an effort to capture the high depreciation available on some of the asset classes, several sale and lease back transactions were undertaken with artificial inflation in asset values, leading to tax officers disallowing depreciation to the lessors in such transactions and remaining conspicuously cautious of sale and lease back transactions.

- To make matters worse, most states in India introduced sales-tax on lease transactions around the same time. The applicability of sales-tax on lease transactions served as an extra cost to be borne by the lessee, severely affecting the economics of the transaction. This tax was an incremental tax; that is, with no offset available for the lessee to absorb the additional tax burden.
- New accounting standard AS 18, largely emulating IAS 17, was issued by ICAI in 2001, treating a financial lease at par with a secured lending transaction. While there was a confirmation by the Central Board of direct Taxes (CBDT) that despite lessee capitalisation in case of financial leases for accounting purposes, the eligibility of depreciation to leasing entities will continue to be driven by tax rules, the past history with dubious leasing transactions engineered solely for tax motive, led tax authorities to continue to deny tax benefits particularly for financial leases.
- In the absence of any tax benefits and the added burden of VAT, there remained little incentive for lessors to push leasing as a product and gradually, by late 1990s, leasing entities shifted to the traditional loan format.
- Volumes of lease transactions continued to come down from 1996 to 2004. In 2004, most states in the country adopted value-added taxation (VAT), which allowed the lessors to offset their output VAT liability on the sales tax charged on

lease rentals against the VAT paid by them at the time of purchase of the asset. This brought down the tax burden in the lease transactions removing some of the disincentives in leasing. However, the VAT system also meant significant compliance costs, as every leasing transaction would have to be reported for VAT purposes. There was also a question of loss of present value, as the VAT suffered on the purchase of the asset could be offset only over a period of time by way of set off against lease rentals. The evolution of leasing in India has been summed up in Annexure 1.1

- In July 2017, the entire indirect tax regime in India underwent as Goods and Services Tax was introduced. This addressed most of the concerns with respect to off-setting of taxes paid on inputs with the tax liability.

1.3 Leasing products in India

1.3.1 Financial Leases and Hire Purchase

As in case of most countries, in the early stages of evolution of the leasing industry in India, the industry offered simplest form of leases – hire purchase contracts, and financial leases. While leasing practically started in early 1980s, hire purchase has existed since 1930s.

With no tax or accounting benefits (both in case of financial leases and hire purchase), and yet significant extra costs on account of indirect taxes, financial entities in India prefer a secured loan over a financial lease or hire purchase. Thus, over a period of time, hire purchase and financial leases became very uncommon.

1.4 Legal aspects of leasing in India

1.4.1. Basic law of leases

There is no specific enactment dealing with leases of equipment; the governing law for leases is the law of contracts, or common law, i.e., the Indian Contract Act, 1872, which provides decisive force to the lease agreement. Additionally, the Transfer of Property Act, 1881 also deal with lease of properties, however, the law deals mainly deals with immovable property. As per common law principles, a lease of movable property involves 4 essential features:

a. The subject matter of lease, that is, the goods
b. Transfer of possession of goods to the lessee
c. Transfer of right to use the goods to the lessee
d. Re-delivery of the goods by the lessee to the lessor on expiry of the lease.

Characteristics of Goods

The *goods*, being subject matter of a lease, must have the following attributes as per common law principles:

Durability	• The goods must be expected to last till the end of the lease term
Movable	• The leased goods should remain movable property
Identifiable	• The goods provided on lease should not be rendered unidentifiable
Severable	• The leased goods should remain detachable so that they may be retrieved by the lessor at the end of the lease

1.4.2 Lessor's rights and obligations relating to leased asset

One of the commonest legal questions is – does the Indian legal system respect the paramount legal ownership of the lessor over the leased asset? Also, is the lessor liable to claims on account of quality, damages or third party losses caused by the leased asset?

The generic rights of the lessor, as the absolute owner of the leased goods, have been accepted through decades of court rulings in the context of hire purchase and lease transactions. Typically, the lessee's rights are limited to right of peaceful possession and use. In the event of a default, the lessor as the sole owner has the legal right to repossess the asset and to make reasonable use of force, and there are clear guidelines provided by the Reserve Bank of India on the use of recovery agents. There is no legal requirement for the lessor to seek court orders for repossession. However, in practice, it is common for parties to decide to use either court assistance, or orders of an arbitrator, to avoid any unpleasant situations.

Importantly, the ownership rights of the lessor are protected even if the lessee becomes insolvent, distressed or otherwise. No creditor of the lessee has a right to impound or attach the property belonging to the lessor.[3]

[3] The Bankruptcy Code protects the right of the lessor over leased assets. Section 36 of the Code excludes bailment assets from the estate of the bankrupt.

[4] National Industrial Classification Code 2008 or NIC Code 2008 is here: http://dipp.nic.in/English/acts_rules/Press_Notes/NIC-2008.pdf

[5] https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=930

1.5 Regulatory aspects of leasing business

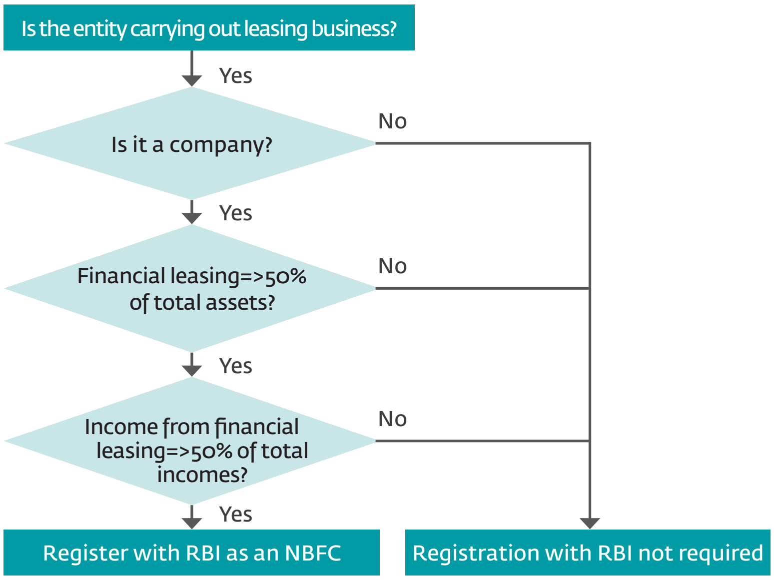
As per RBI regulations, it is mandatory for a company that is in the business of financing to have a certificate of registration classifying it as a financial services company. As per the National Industrial Classification Code[4], financial leases are regarded as financial transactions, considered under "financial services activities" while operating leases, are regarded as rental contracts, and dealt with in a separate section on "renting and leasing activities".

Since a financial lease is regarded as a financial contract, any entity principally engaged in the business of financial leases is considered to be a Non-Bank Finance Company (NBFC). An entity is considered to be principally engaged in financial activities if it satisfies the twin "principal business criteria" laid down by the RBI vide its press release dated 8th April, 1999:[5]

- At least 50% of the total assets of Company should be financial assets; and
- At least 50% of the gross income should be derived from the financial assets.

Therefore, the need for a leasing company to register itself with the RBI as an NBFC has been summarised graphically in Figure 1.

Figure 1: Need for leasing companies to obtain RBI registration



Since the test to treat a company as an NBFC is based on principal business criteria mentioned above, an entity principally engaged in operating leases may offer financial leases also as long as the financial leasing business remains a non-principal activity. Likewise, an NBFC may also do operating leases, within the limits of the principal business criteria mentioned above. In practice, most of the leasing players in the country are registered as NBFCs, who conduct lending and leasing activities under a common umbrella. There are some focused operating leasing players that are not regulated as NBFCs. In addition, there are some vendors engaged in diverse businesses, who offer leasing as a part of their business – these are also not NBFCs.

None of the regulatory norms apply to operating leasing companies, or manufacturing or trading companies, offering leasing as a non-principal part of their business.

1.6 Foreign Direct Investment (FDI) Regulations

For capital inflows from non-residents, the following investments are treated as "capital" and come under FDI regulations: investments in equity shares; fully, compulsorily & mandatorily convertible preference shares; fully, compulsorily & mandatorily convertible debentures; and warrants. All other financial instruments, and borrowings, will be regarded as "borrowings", and will come under external commercial borrowings (ECB) regulations.

Further as per the extant FDI Policy, 100% FDI is allowed under the automatic route for Financial Services activities regulated by financial sector regulations, viz., RBI, SEBI, IRDA, PFRDA, NHB or any other financial sector regulator as may be notified by the Government of India. In financial services activities which are not regulated by any Financial Sector Regulator or where only part of the financial services activity is regulated or where there is doubt regarding the regulatory oversight, foreign investment up to 100% will be allowed under Government approval route subject to conditions including minimum capitalization requirement, as may be decided by the Government.

Entities engaged primarily in operating leases are not covered by financial sector regulators. Operating leases are usually treated as a service transaction, close to asset renting services. Financial leases are treated under the caption "financial services".[6]

Since FDI in case of services sector, other than financial services, comes under automatic FDI, it is felt that there are no restrictions on FDI in case of companies primarily engaged in operating leases.

6 The Service Accounting Code for financial leasing services is 997114 and falls under the broad classification of financial services. On the other hand, leases other than financial leases are captured under the broad classification starting with 9973.

1.7 Accounting aspects of leasing in India

The key distinction between operating and financial leases, is in accounting standards, and is similar in India to that followed globally, that is, IAS 17.[7]

The accounting standard dealing with lease accounting in India is AS 19. India has set a progressive convergence roadmap to International Financial Reporting Standards (IFRS), whereby Indian versions of IFRSs have been announced as Ind-ASes. Non-financial entities are converging to Ind-ASes gradually. However, for financial entities, currently, the RBI has not come out with a roadmap as yet. Once the convergence takes place, the accounting standard will be IndAS 17, which is almost the same as IAS 17.

Broadly, if the lease is a financial lease, the lease liability, that is, the present value of future lease rental liability, is shown as a liability by the lessee, and correspondingly, the same appears as an asset on the books of the lessee. That is to say, the leased asset is not off-the-balance sheet of the lessee. The lessee depreciates the asset as well. The lease rentals are split into interest and principal – it is only the former which is treated as an income of the lessor and the expense of the lessee.

1.8 Taxation aspects of leasing in India

Lease transactions in India are impacted by both Direct (Income Tax) as well as Indirect Taxes (GST and Stamp Duty).

1.8.1 Direct Taxes

One of the key reasons that leasing has become popular, as a financial product, in many parts of the world is because it provides significant tax benefit, particularly for the lessor. However, in India, unlike other jurisdictions, the tax benefit for lessors is not as substantial, since the depreciation rates for most assets are quite low. However, for the lessee, the ability to write rental as an expense provides a faster write-off on the asset cost. See ahead, the Box with details on the True Value of the Tax Benefit in a leasing transaction.

1.8.1.1 Depreciation

There are two primary conditions for claiming depreciation– ownership of the asset, and use of the asset. In the case of operating leases, the asset is owned by the lessor, and the lessor puts the asset to use by leasing the asset. As a result, in the case of operating leases, there seems no uncertainty over claim of depreciation by the lessor, and the claim for rentals as an expense by the lessee.

On the other hand, depreciation allowance in case of financial leases continues to be a contentious issue over the years. There is no clear provision in the Income-tax Act distinguishing between financial and operating leases, leaving it open for tax officers to examine the "substance" of a transaction, and deny depreciation where the transaction is regarded as a camouflaged financial transaction. In 2014, there was a proposed Income Computation and Disclosure Standard on lease transactions[8], which sought to make the distinction clear by way of a "tax accounting" standard – however, the standard on lease transactions has not been notified.

[7] The International Accounting Standards Board has decided to replace IAS 17 by IFRS 16, with effect from Jan 2019. This is discussed in detail in Chapter 3.

[8] http://www.finmin.nic.in/the_ministry/dept_revenue/ICDS_draft_CBDT.pdf

True value of the tax benefit for lessor versus tax benefit for lessee

The relevance of tax depreciation in case of lease transactions has to be seen from the viewpoint of

A. Tax benefit to the lessor by way of depreciation;

B. Tax sacrifice, that is, the fact that the lessor pays tax on the entire lease rentals, comprising of the principal recovery as well.

India follows a written-down-value (WDV) method for depreciation for tax purposes, at rates laid down in the Income-tax Rules. For normal plant and machinery, the depreciation rate is 15%. In addition, India follows a "block of assets" rule for tax purposes, whereby assets eligible to a common rate of depreciation form a pool. Consequently, if an asset is sold at less than its WDV, the difference remains there in the block, giving a staggered claim for depreciation over the years. As a result of this rule, a 15% depreciable asset will take nearly 19 years to write off 95% of the asset cost. This is **Part A** in our list above.

On the other hand, the capital recovery, that is, recovery of principal by way of lease rentals, happens over the period of the lease. This is **Part B**.

Part A is front heavy, due to the WDV system. **Part B** is back-heavy, as capital recovery is slow in the beginning and picks up later over the lease term.

Therefore, the real tax benefit is realised only if the present value of Part A is greater than the present value of Part B. For most of the leased assets being plant and machinery, there is no appreciable tax benefit for the lessor, at least in present value terms.

On the contrary, in case of the lessee, the ability to write off rentals, comprising of Part B, becomes an incremental advantage, even though the lessee loses depreciation, being Part A.

Thus, the tax benefit to the lessee implies that the effective post-tax cost of the lease to the lessee is lower than it appears to be, due to the present value of tax benefit.

1.8.1.2 Tax Deducted at Source

India follows the system of deducting tax at source, akin to withholding taxes on international payments, on several items of expenditure. For items covered by these provisions, the payer would deduct taxes while making payments to the payee. The payee will be able to take credit for the tax deducted at the time of paying his own taxes.

With regard to lease rentals, the lessee is required to deduct tax at source, at the following rates:

Table 2: Rate of TDS for lease of assets

Particulars	Rates of Tax for all assesse
a) Use of any land, building, furniture or fittings	10%
b) Use of plant, machinery or equipment	2%

1.8.2 Indirect Taxes

There has been a paradigm shift in the indirect tax regime of India. Earlier, the indirect tax regime in India had separate legislations for sales tax and service tax, however, with the introduction of Goods and Services Tax (GST) with effect from 1st July, 2017, several taxes, including the above two, are subsumed into one comprehensive tax.

1.8.2.1 Sales Tax

In India sales-tax laws and administration used to differ from state to state, and often, this led to conflicting claims by different states on the same transaction. Clearly, one of the major deterrents that hampered the growth of leasing was the extension of sales-tax to lease transactions.

The tax regime in India is distributed between the centre and the state. According to the Indian Constitution, the centre is to levy taxes on inter-state sales or purchases, and the states are entitled to levy taxes in case of intra-state sale or purchase.

Lease transactions, irrespective of their classification as financial lease or operating leases, were considered to be a *"deemed sale"*, by virtue of a definition in the Constitution inserted way back in 1982. (See Box on the history of this legislative change.) As such, both the Central Government, and various state governments, impose sales-tax on lease transactions.

1.8.2.2 Service Tax

In addition to sales tax, leases were also subject to service tax. While it was anomalous that a transaction was treated as a "sale" and "service" at the same time, a Supreme Court ruling had opined that it is open for the government to levy taxes on both the sale and the service parts of a leasing transaction

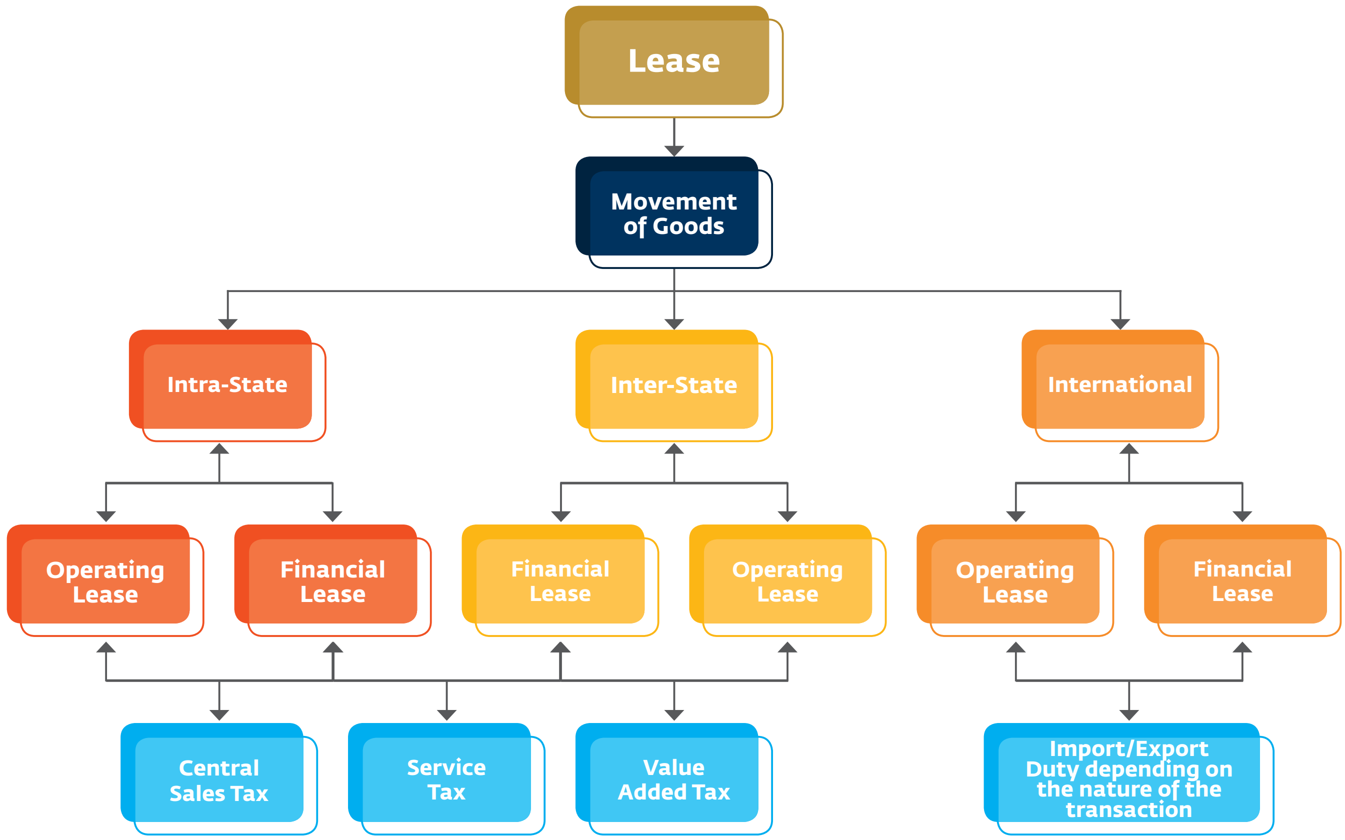
The following pointers explain service tax in case of lease transactions:

- As operating lease being a "deemed sale", there was no service tax on operating leases.
- In case of financial leases, the embedded interest element was regarded as consideration for "service", and hence, chargeable to service tax.
- There was an abatement to the extent of 90% of the interest portion: resultantly, service tax was payable only on 10% of the interest component.

- The service tax charged by the lessor was offsetable, if conditions for setoff of input services were satisfied, by the lessee. Likewise, the lessor could set off service tax paid by the lessor on input services used in the business of the NBFC. There was a general rule whereby 50% of the service tax paid on input services is allowed to be set off in case of an NBFC.

The applicability of erstwhile indirect taxes in case of lease transactions has been graphically presented in Figure 2.

Figure 2: Applicability of various indirect taxes on leases under the erstwhile regime



1.8.2.3 GST and lease transactions

The introduction of GST led to subsuming of differentiated taxes on production (excise), sales (VAT), services (service tax) and other several taxes such as entry tax, octroi etc. into one comprehensive tax.

The process of this change involved an amendment of the Constitution, presenting and passing of the GST Bill, and framing and implementing several procedural rules, besides, of course, administrative changes.

The GST law[9] covers both sales of goods and rendering of services – hence, it is based on "supply of goods/services" rather than a sale or service. The scheme of the GST law is that there will be a Central GST (CGST) and State GST (SGST) on every intra-state state supply, and an inter-state GST, Integrated Goods and Service Tax (IGST) on every inter-state supply. By and large, the law provides for a full set off for all inputs used in business, whether by way of purchase of goods or acquisition of services

The GST Law[9] provides a clear distinction between what is supply of services and what is supply of goods, thus ending the long standing litigation that exists in the present taxation regime. Schedule II of the Central Goods and Services Tax Act, 2017 (CGST Act) provides such distinction and it provides that:

Any transfer of goods or of right in goods or of undivided share in goods without the transfer of title thereof is ***supply of services***.

Any transfer of title in goods under an agreement which stipulates that property in goods will pass at a future date upon payment of full consideration as agreed, is ***supply of goods***.

Therefore, a financial lease, which stipulates automatic transfer of title in goods at the end of the lease tenure would be classified as supply of goods while an operating lease and financial lease, other than other mentioned above would be classified as supply of services.

In case of lease of business assets, the place will be the location of the lessee. Thus, from the viewpoint of compliance, a leasing entity may still have to maintain multiple tax registrations, based on the states where its lessees reside.

As it appears currently, GST law has brought in several positive changes for the leasing industry. The following points summarise the impact:

a. Earlier, certain lease transactions were chargeable to both VAT and service tax but now there is one comprehensive GST on lease transactions, removing the duplicity and loss of benefit of set off. In addition, earlier, there was no cross set off between taxes paid on purchase of goods, and on acquisition of services. GST law, being one comprehensive levy, enables this cross offsetting.

b. Earlier, there was significant tax inefficiency in case of lease of goods procured from other states, in form of Central Sales Tax. But under GST regime, IGST charged on inter-state supplies are fully deductible against GST liability. Henceforth, there will be full tax neutrality in case of leases of all assets, whether procured from within the state or from outside, except for loss of present value (since the input taxes are paid upfront, but recovered in form of lease rentals over a period of time). However, experience shows that the loss of present value will get eliminated soon as leasing volumes grow and there is substantial amount of output tax liability to take care of input taxes immediately.

[9] Available on http://www.cbec.gov.in/htdocs-cbec/gst/index

c. Earlier, leasing entities had to face substantial practical difficulties at the time of inter-state movement of goods, in form of entry tax, octroi, etc. All these taxes get subsumed into GST.

d. Earlier, there was discrimination in several states, mentioned above, where input tax set off was denied in case of lease transactions. This has been eliminated as the States now have to stick to a harmonised tax across all states.

In short, we visualise introduction of GST as a positive measure for the leasing industry in general. The table below is a brief representation of the impact of GST and a comparative with the erstwhile regime:

Particulars	Erstwhile regime		New regime	
	Operating Lease	Financial Lease	Operating Lease	Financial Lease
Service vs. Sale	Deemed Sale as per Article 366(29A)(d)	Both Sale and Service	Supply of Services	Supply of Services, except for cases where the transaction involves automatic transfer of title of goods at the end of the tenure, which would qualify as Supply of Goods
On Intra-state transaction	• Lease rentals are subject to VAT • Input Tax credit on VAT paid is available subject to the transaction and the asset being eligible for credit	• Lease rentals are subject to VAT • Service Tax is charged @ 10% of prevailing Service Tax rate on the Interest component	• Lease rentals would be subject to CGST & SGST • Input credit of CGST would be used to set-off output liability of CGST • Input credit of SGST would be used to set-off output liability of SGST	
On Inter-state transaction	• CST to be charged on lease rentals • Input credit of CST paid is not available for set-off and hence becomes a sunk cost	• CST to be charged on lease rentals • Service Tax is charged @ 10% of prevailing Service Tax rate on the Interest component • Input credit of CST paid is not available for set-off and hence becomes a sunk cost	• Lease rentals would be subject to IGST • Input Tax credit of IGST would be first used to set-off of IGST first, thereafter CGST and lastly SGST	
High seas Lease	• Basic customs duty chargeable • Additional duty u/s 3(5) is payable		• Basic Customs duty would be levied (as it will not be subsumed into GST) • IGST would be charged in place of Additional duty	

1.8.3 Stamp Duty

In India, stamp duty is chargeable on the lease agreement. Stamp duty is a state subject – hence, the duties from differ state to state. The provisions of a central law, Indian Stamp Act, 1899, are applicable to the whole of India excluding the states which have their own legislations on the stamp duty payable there. These states are: Karnataka, Gujarat, Kerala, Rajasthan and Maharashtra, where separate stamp acts have been enacted.

In case of leases, stamp duty is payable at a place where the agreement is executed, at the time of execution. The agreements are considered to be executed at the place where the last signatory signs the document.

Maharashtra is one of the states that provides ad valorem stamp duty, that is, duty based on the value of the transaction, on lease of movable property, at the rate of 3% of average annual rentals. Considering the fact that stamp duty is not a VAT-able cost, it becomes an additional cost on the transaction.

CHAPTER 2

STATE OF LEASING MARKET IN INDIA

In this Chapter, we take a close look at the state of the leasing market in India.

Before getting into details, it is important, at the outset, to state a few important features of the leasing market in India, necessary for a proper appreciation of the rest of this Chapter:

1. **Barring the financial leasing carried out by the IRFC, the market comprises mostly of operating leases:** Other than leases done by Indian Railway Finance Corporation (IRFC), most of the leases done in India are operating leases. As discussed in Chapter 1, financial leases suffered additional tax burden, while not offering any compensating tax advantages. Hence, over a period of time, most lessors had moved away from hire purchase and financial leases, into lending. IRFC continues to do financial leases – IRFC transactions are discussed briefly separately.
2. **Banks are currently not offering leasing:** While banks were permitted by the RBI several years back to offer equipment leasing as a part of the bank's business, none of the banks seem to be currently offering leasing facilities. A major reason for this may be that financial leases, which are the main product that can be offered by banks, do not have a high enough demand In the Indian context.
3. **Financial leasing activity is regulated**: As explained in Chapter 1, financial leasing is considered a financial activity and is regulated by the RBI; operating leasing is considered as a non-financial activity. Hence, entities predominantly engaged in operating leasing, and not offering other financial products, are considered non-banking, non-financial companies (NBNFCs). On the other hand, NBFCs, which offer other financial products too, also offer operating leases. Thus, in the marketplace, there are NBFCs, NBNFCs as well as vendors offering leasing facilities.

2.1 Major leasing players in the market

Leasing players in India can be categorised under the following heads:

a. Non-Banking Financial Companies
b. Non-Banking Non-Financial Companies
c. Specialised entities
    - Car finance companies
    - Captive financing arms of Vendors and OEM
    - Cab aggregators
    - Indian Railway Finance Corporation

2.1.1 Non-banking financial companies

Complementing the banking system, NBFCs occupy a significant position in financial intermediation. Though banks have lower cost of funds, NBFCs have advantages of speedier documentation, informal and closer access with customers, geographical outreach, strong relationships with Original Equipment Manufacturers (OEMs) and equipment dealers, less stringent regulatory requirements as compared to banks, etc. NBFCs are not bound by priority sector lending requirements, nor required to maintain Statutory liquidity ratio (SLR) and Cash reserve ratio (CRR). In terms of organisational structures, NBFCs have stronger decentralisation of decision-making, giving them ability to have faster turnaround times. These differences have resulted into NBFCs demonstrating higher rate of growth assets.

The sheer number of registered NBFCs in India may appear startling as there are 11790 NBFCs registered with the RBI as per its data updated till 1st December, 2015[10]; however, of these, the relevant category of NBFCs for leasing business are "Asset Finance Companies" (AFCs); there were 429 AFCs registered with the RBI as on 30th November, 2015.

While all the AFCs provide funding against productive assets, they mostly provide secured loans against assets. Some of them offer leasing facilities too.

2.1.2 Non-banking non-financial companies

There are several companies, which are not financial companies as they focus primarily on operating leases, and hence, are regarded as NBNBCs. These companies provide operating leases of several assets such as IT equipment, furniture, office equipment, equipment such as lifts and security equipment in commercial property complexes, etc. Most of these companies assign their rental receivables to other financiers such as banks and NBFCs, soon after origination of the transaction, and thus, extract out a large part of their investment in the transaction, leaving an investment in the residual value. Thus, the skin-in-the-game of such companies is the residual value.

2.1.3 Car finance companies

Several companies focus on leasing or financing of passenger cars. Car leasing has been viewed as a separate segment, as the lessee's motivations for car lease includes provision of an amenity for its executive, including an opportunity for the executive to acquire the car at the end of the lease term. From the lessor perspective as well, car leasing entities are either vendor affiliates, or they are specialised companies who have their expertise on car leasing and fleet management services.

2.1.4 Captive financing arms of Vendors and OEMs

As is globally the trend, major vendors and OEMs of capital equipment, including cars, healthcare products, IT equipment etc. provide, either by themselves or through dedicated captive companies, finance against equipment sold by the parents. Some of these captive financiers provide leasing option too. The captive lessors obviously have their own set of advantages – they may get a residual value or remarketing support from the parent. For the parent, the ability to provide the leasing option becomes a sales-aid tool, thereby becoming a win-win proposal for both. Of course, for the customer, quite often, the estimation of residual value by the captive is higher than what the customer would possibly fetch if he were to remarket the asset himself – making the leasing option attractive.

2.1.5 Self-drive car rental companies and Cab aggregators

The growth in the business of aggregation of cabs has led to a surge in short car renting business. Online cab aggregators are now making forays into the leasing space. Additionally, there has been a new opportunity of self-drive car rental business, with several such companies coming up in the recent past. A report by an industry insider puts the growth rate of self-drive car rental in India at around 12%.[11]

[10] https://rbi.org.in/Scripts/BS_NBFCList.aspx

[11] http://www.ibef.org/blogs/indian-car-rental-industry-opportunity-to-build-and-indian-travel-brand

Uber Car Leasing Model

In India, Uber has tied up with several financial institutions, like State Bank of India, Shriram Finance, AU Financiers, Toyota Financial Services etc., and leasing companies, like Xchange Leasing Company, for leasing of cars to the drivers enrolled with the Uber platform.

Here, instead of the platform paying the driver for the car, the driver pays the platform rent for using the car over the tenure of the lease and at the end of the tenure the driver gets an option to acquire the car.

The structure of the lease offered by Uber, along with the Xchange Leasing Company, is provided below:

- Security Deposit: ₹ 27,000
- Rent per week: ₹ 5,954
- Tenure: 3 years
- Resale value of the car at the end of the tenure: To be evaluated at the end of the tenure

2.2 Indian Railways Finance Corporation (IRFC)

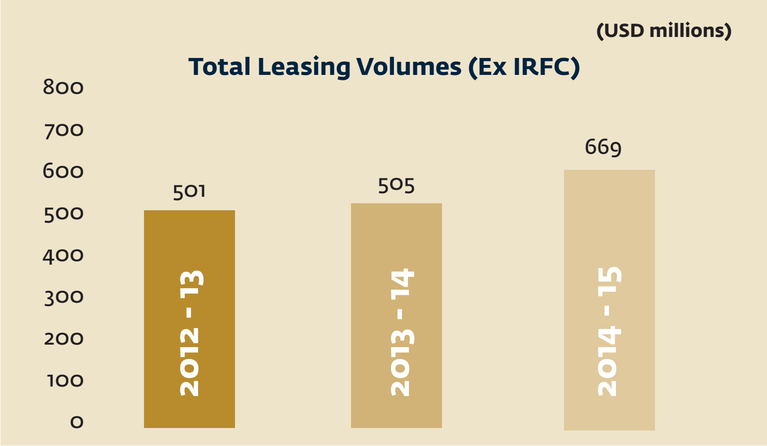
IRFC stands out as the largest among the lessors in terms of leasing volumes, and yet, so distinct from the rest of the leasing fraternity. IRFC was formed for, and continues to be solely focused on, financing its parent, viz., Indian Railways. So, all the financing done by IRFC is for Indian Railways, and all the financing done by IRFC is leasing only. IRFC leases a variety of assets – floating stock (wagons, coaches), as well as project assets (railway lines, bridges, etc.). Considering IRFC's business dedicated to the Indian Railways to be distinct from other players in the leasing, we have excluded IRFC's leasing volumes (see leasing volumes discussion below) from the total leasing volumes.

2.3 Leasing volumes in India[12]

During the FY 2014-15, the new business volumes (ex-IRFC) stood at around USD 669 million as opposed to USD 505 million during the FY 2013-14 and USD 501 million during the FY 2012-13.

Figure 3: Leasing volumes in India (Ex IRFC) and Figure 4: Leasing volumes (Ex IRFC) in India show the volume of leasing in India (Ex-IRFC) during FY 2012-13, 2013-14 and 2014-15.

Figure 3: Leasing volumes in India (Ex IRFC)

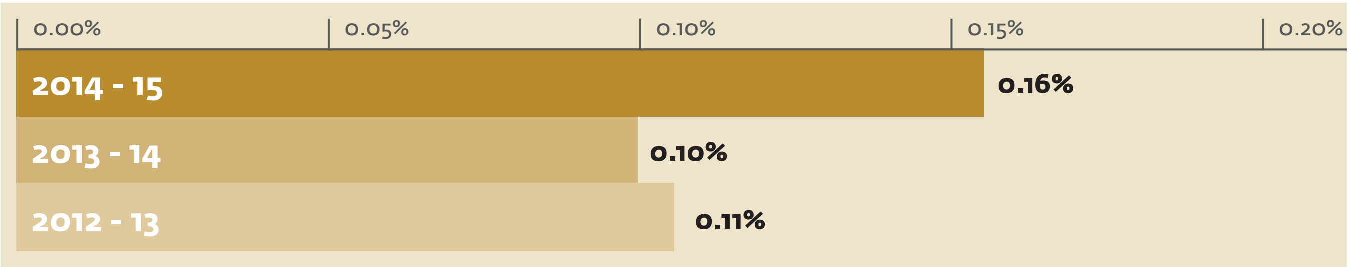


Source: VKC Analysis

[12] All data used in this section is collated by Vinod Kothari Consultants, as a part of annual publication India Leasing Report. The data is picked up, where available, from publicly available financial statements. The data in several cases is also picked up from anecdotal industry sources.

Expressed in terms of % of gross capital formation

Figure 4: Leasing volumes (Ex IRFC) in India



Source: VKC analysis

2.3.1 Leasing volume by asset classes

In terms of asset classes, apart from construction equipment and IT equipment, several new asset classes were leased in 2014-15; these included medical equipment, solar equipment, ATMs, business jets and several items of plant and machinery. Vehicle leasing continues to be a popular asset class amongst players, and currently, there are several new players exploring this asset segment.

Figure 2 shows the asset class wise performance during the financial years 2012-13, 2013-14 and 2014-15.

Table 3: Market share of various asset classes 2013 – 2015

Product wise break-up of assets given on Op lease #	2015*	%	2014	%	2013	%
						Amount in USD million
Plant & Machinery	56.42	9.74	54.11	17.85	50.68	16.26
Equipment (including office equipments and construction equipments)	41.34	7.14	22.26	7.34	5.06	1.62
Data Processing/computer software	33.86	5.85	21.07	6.95	19.22	6.17
Car	116.84	20.17	16.73	5.52	61.80	19.83
Commercial vehicles given on operating lease	151.56	26.16	73.11	24.12	67.58	21.68
Computer	99.98	17.26	72.93	24.06	61.63	19.78
Furniture & fixtures	39.61	6.84	40.96	13.51	43.89	14.08
Others (including Windmills, Buildings)	39.65	6.84	1.96	0.65	1.80	0.5
Total	**579.26**	**100**	**303.15**	**100**	**311.68**	**100**

Source: VKC Analysis

Note:

Excludes business done by Connect Residuary

* We have included operating leasing volumes of SMAS Auto Leasing (I) P. Ltd, Lease Plan (I) P. Ltd, Avis (I) P. Ltd, Transzlease Holdings (I) P. Ltd. Further, we could not get corresponding figures of Connect Residuary for 2015

2.3.2 Leasing volume by types of leases

In India, the leasing industry is dominated by operating leases financial leases represent only a fraction of the total leasing volumes.

Figure 5 illustrates the volume of operating leases and finance leases during the FY 2012-13, 2013-14 and 2014-15.

Figure 5: Operating lease volumes vs. Finance lease volumes

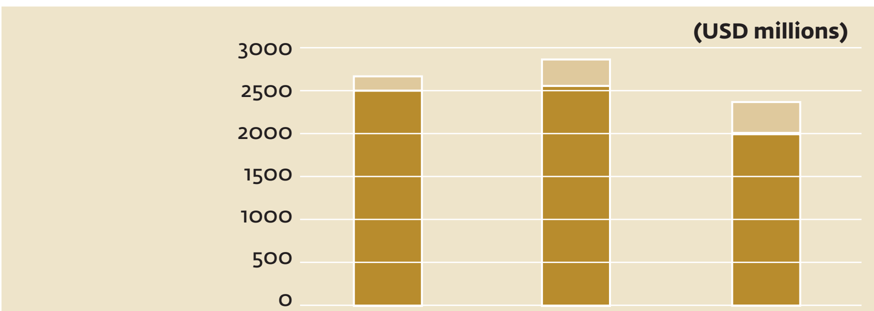
	2012 - 13	2013 - 14	2014 - 15
Total Operating Lease	318	327	564
Total Finance Lease (Ex IRFC)	183	178	105
Total Finance Lease (Incl. IRFC)	2,313	2,275	1,657

Source: VKC Analysis

2.3.3 Leasing volume by market concentricity

As discussed earlier in the report, leasing in India is carried out by both, financial and non-financial companies. Though the market is dominated by the financial companies, non-financial companies also represent a significant portion of the market. Figure 6 shows the performance of the two classes of leasing players.

Figure 6: NBFC leasing volumes vs. Non-NBFC leasing volumes



	2012-13	2013-14	2014-15
Non-NBFC Volumes	307	227	349
NBFC Volumes	2,508	2,552	1,977

Source: VKC Analysis

As per the study, top 5 leasing players offering operating lease products, represent more than 50% of the total volume of operating leases during the year, the same increased from 35.71%, a year ago. While operating leases can be carried out by both NBFCs and non NBFCs, finance leases are carried out only by NBFCs.

Future outlook of the market

We have mentioned in Chapter 1 that leasing is making a come-back in India purely on the strength of economic drivers, and not for reasons of regulatory or tax arbitrage. The fact that leasing is inciting renewed interest is vindicated by new entrants, new asset classes (for example, solar assets), and leasing option being offered for standard assets such as construction equipment. The general macro-economic scenario has not been good over the last few years – with slow GDP growth, rising NPA levels, etc.; yet, leasing has been able to register growth on year-on-year basis, although not on a very strong base.

In India, rising NPA levels is a concern currently and several corporates are getting into corporate debt restructuring or strategic debt restructuring to which one of the probable solutions is to look at leasing. There are two reasons to believe that leasing could be useful in a scenario of rising stressed assets in the economy. First, leasing provides the benefit of ownership, and thereby, the ease of repossession. Second, operating lease payments are operating expense for the borrower – if the borrower's business faces a stress, and there is a case of corporate debt restructuring, operating lease rentals will qualify as an operating expense, thereby gaining priority over payments to all other lenders..

Despite the slow growth, the market practitioners in India expect leasing to grow in India, owing to the recently launched government initiative, Make in India campaign[13], which is likely to boost the manufacturing industry in India, which would, in turn, increase the demand for capital goods. Also, it is hoped that introduction of Goods and Service Tax, will remove the tax inefficiency involved in case of lease transactions.[14]

Looking at the market demand and developments with respect to the various asset classes, asset classes may witness growth in ensuing years:-

a) **IT equipment:** The segment showed a lot of potential in the earlier years, and continues to show the same. The proportion of IT leases to total operating leases doubled in FY 2013-14 as compared to FY 2012-13. The growth in the sector is mainly due to the asset-light business models preferred by companies engaged in IT-enabled services. There are several reasons why these companies prefer acquiring IT equipments on lease. First, taking equipment on lease is an operating expenditure decision, which is easier as compared to capital expenditure decision. Secondly, computers including computer software are permitted depreciation allowance of 60% for income-tax purposes, thereby being a preferred item for lessors. Lastly, by virtue of e-waste disposal norms of Ministry of Environment and Forest and Climate Change[15], the bulk buyers of IT equipment will avoid the hassle of disposal of the electrical equipment as the same will be returned to the lessor at the end of lease term.

[13] http://www.makeinindia.com

[14] See also, recommendations later this Report.

[15] See the 2016 rules at http://www.moef.gov.in/sites/default/files/EWM%20Rules%202016%20english%20 23.03.2016.pdf; superseding the earlier rules at http://www.moef.nic.in/downloads/rules-and-regulations/1035e_eng.pdf

b) **Cars:** Car users world-over prefer to take cars on lease rather than own them, as this provides them the ability to switch over to new models and fuel efficiency. The lease option effectively provides a car buyer with higher residual values estimated by the lessor, than what is typically available in the used-car markets. In addition, employers provide cars to their executives as a part of employee compensation and retention strategy. Thus, car leasing may remain a strong component of the leasing market. The emerging self-drive car model or rent-a-cab model may also see substantial growth in time to come.

c) **Solar equipment:** Indian Solar power industry is still in the nascent stage. The government has an ambitious program for solar energy, contained in the Jawaharlal Nehru National Solar Mission. The government has announced several subsidy schemes for rooftop solar installations.[16] It is felt that the benefit of these subsidies will be available to a leasing entity also. Rooftop solar market has recorded a growth for nearly 50% per annum in the USA, and the proportion of third party (for example, a lessor is a third party) owned installations is as high as 72%, due to tax benefits available on such assets.[17] In India too, solar assets qualify for accelerated depreciation, which, in addition to the capital subsidies, provides a strong incentive to lessors to lease such assets.

d) **ATMs:** In the financial year 2014-15, several leasing players have taken exposure on ATMs. This asset class has gained popularity as more and more banks and financial institutions have now opted for electronic banking in order to broad-base their territory. NBFCs have also been permitted to put up white-label ATMs. Considering the fact that there are lot many locations where banks may want to offer ATM facilities, this asset class surely something to watch out for in the upcoming years.

[16] http://mnre.gov.in/file-manager/UserFiles/gcrt-cfa-notification-04-03-2016.pdf

[17] http://www.utilitydive.com/news/why-solar-financing-is-moving-from-leases-to-loans/403678/

CHAPTER 3

GLOBAL LEASING OVERVIEW

3.1. Overview of the Global Leasing market

Global leasing volume started rising from USD 93.5 billion in 1983 and reached USD 498.9 billion in 2000, implying a compounded annual growth rate (CAGR) of 10.35%. In 2014, the figure stood at about USD 944.3 billion[18], with a CAGR of 5.04% over this period.

The global financial meltdown post 2007 had its impact on liquidity, availability and demand for capital, which, in turn, affected the leasing industry as well. The US leasing industry suffered the most in terms of the world market share with its leasing volumes falling from USD 217.7bn in 2007 to USD 134.3bn in 2008. While the leasing volumes in the developed nations contracted, Asian countries still managed to register growth, largely because of China, causing a regional shift in the world market share.[19]

[18] Global Leasing Report, 2016 by White Clarke Group. CAGR computations are of the author, based on the data from the source.

[19] Ibid

The volume and growth of new leasing and hire purchase business by region during 2013-14 is demonstrated in Table 4.

Table 4: Volume and growth by region (2013 - 14)

Rank by Volume	Region	Annual Volume (US$bn)	Growth 2013-14 (%)	Percentage of World Leasing market volume 2013	Percentage of World Leasing market volume 2014
1	North America	368.4	9.9	37.9	39.0
2	Europe	327.8	-1.7	37.7	34.7
3	Asia	195.0	10.0	20.1	20.6
4	Australia/NZ	35.6	185.1	1.4	3.8
5	South America	10.7	-40.5	2.0	1.1
6	Africa	6.8	-10.0	0.8	0.7
Total		**944.31**			

Source: White Clarke Global Leasing Report, 2016

Further, Table 5 demonstrates leasing volumes in different regions from 2004 till 2014.

Table 5: Leasing Volume by Region: 2004 – 2014(US$ bn)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
								**	**	**	**
Europe	236.5	239.6	272.0	401.2	336.7	220.4	233.0	302.7	314.0	333.60	327.8
North America	240.7	236.7	241.1	237.9	226.1	190.8	213.3	292.5	336.4	335.10	368.4
Asia	78.2	74.0	81.7	84.6	99.2	103.8	105.6	134.0	180.2	177.30	195.0
South America	7.5	13.9	19.2	41.4	54.2	30.2	25.4	27.5	13.2	18.0	35.6
Australia/NZ	8.1	8.2	8.6	4.1	6.9	5.7	10.8	12.0	16.1	12.5	10.7
Africa	8.1	9.6	11.1	11.2	9.6	6.5	6.4	8.6	6.2	7.5	6.8
Annual Totals	**579.1**	**582.0**	**633.7**	**780.4**	**732.8**	**557.3**	**594.5**	**777.3**	**868.0**	**884.0**	**944.3**

Sources: White Clarke Global Leasing Report, 2016

***The figures for the years 2011 onward represent both leasing and hire purchase*

3.2 Leasing penetration and off-balance sheet leases

One of the indicators of the significance of leasing in global financial landscape is the penetration level, that is, annual leasing volumes relative to the GDP of the country.

Table 6: Penetration of leasing in selected countries

Ranking	Country	Annual volume leasing (US$ bn)	% Market penetration
1	US	336.95	22.0
2	China (People's Republic)	114.85	3.4
3	UK	78.16	28.6
4	Germany	68.19	16.4
5	Japan	55.85	8.9
6	Australia	35.27	40.0
7	France	31.86	13.1
8	Canada	30.89	31.0
9	Sweden	18.94	22.7
10	Italy	17.78	11.7
11	Russia	16.42	NA
12	Switzerland	13.05	12.0
13	Poland	12.23	15.7
14	Korea	11.11	9.8
15	Taiwan	9.45	8.3
16	India	2.33	0.41

Source: White Clarke Global Leasing Report, 2015

3.3 Volumes of operating leases and total lease penetration

The proportion of operating leases to total leasing volumes differs from country to country. For example, in the USA, the proportion of operating leases by the leasing industry is estimated at about 20%[20]. In Germany, operating leases constitute approximately 39% of the total lease volumes.[21]

An important point to note here is that a large part of operating lease volume may be commodity-specific, done by entities that specialize in sales, leases or servicing of particular type of assets, and hence, may not be forming part of the "leasing industry" as such. Examples are leases of assets like aircrafts, cars, furniture, etc.

An estimate of the extent of off-balance sheet leases was done by the International Accounting Standards Board (IASB), while trying to study the impact of the new lease accounting standard IFRS 16 (see later in this Chapter). IASB estimated the total present value of operating lease payments to be USD 1.66 trillion, constituting about 5.4% of the total assets of entities included in the survey.[22]

[20] http://www.elfaonline.org/cvweb_elfa/Product_Downloads/EOCT05BOSCO.PDF

[21] http://www.whiteclarkegroup.com/downloads/353/wcg_global_leasing_report_2015_public_final.pdf

[22] Effect Analysis IFRS 16: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_effects_analysis.pdf

It is apparent that there will at least be an equal amount of on-balance sheet assets, represented by financial leases. Therefore, the global penetration of leasing, including operating leases, may be taken at upwards of 10%.

3.4 New lease accounting standard

Year 2016 marks the culmination of a joint project of US accounting standard setter Financial Accounting Standards Board (FASB) along with the global accounting standard setter International Accounting Standards Board (IASB) to replace the lease accounting standard FAS 13 as known in the USA, and known as IAS 17 internationally. These standards have been prevalent for nearly 50 decades.

The new lease accounting standard IFRS 16 will apply effective accounting periods beginning on or after 1st Jan 2019.

The new standard was being discussed for a long time. The focus of the standard is to remove the distinction between operating and financial leases, which, it was being argued, creates an artificial and maneuverable distinction. It was being argued that lots of assets may stay off the balance sheet based on the ability of the parties to structure the lease as an operating lease. Originally, the standard proposed to eliminate the distinction between financial and operating leases both from lessor and lessee perspective. However, as finally promulgated, IFRS 16 eliminates the distinction between operating and financial leases only from lessee perspective. The following captures the substance of the standard:

- For lessee, the distinction between operating and financial leases goes away. All leases, other than short-term leases (typically up to 12 months) and small value assets (say a stand-alone computer), will be capitalized on the balance sheet of the lessee.
- The value to be capitalised will be the discounted value of lease rentals. This will appear, on one hand, as Right of Use (ROU) asset, and on the other, as Obligation to Pay (OTP) liability. The ROU asset will be depreciated in the books of the lessee over the lease tenure (unless the lease contract transfers title to the lessee), whereas the OTP liability will be amortised.
- As regards the lessor, the existing distinction between financial and operating leases continues. Therefore, assets given on operating leases will appear as fixed assets of the lessor, and those given on financial leases will be reflected as receivables. Splitting of receivables in case of financial leases into interest and principal, with the former part taken as income of the lessor, will also continue.
- Importantly, the new standard does not apply to SMEs – therefore, SMEs remain exempt from the requirement of on-balance-sheet recording of operating leases. Since IFRSs are implemented by each country, the domestic country provides its own definition of SME for this purpose.

The Figure 7: Summarises lease accounting under IFRS 16:

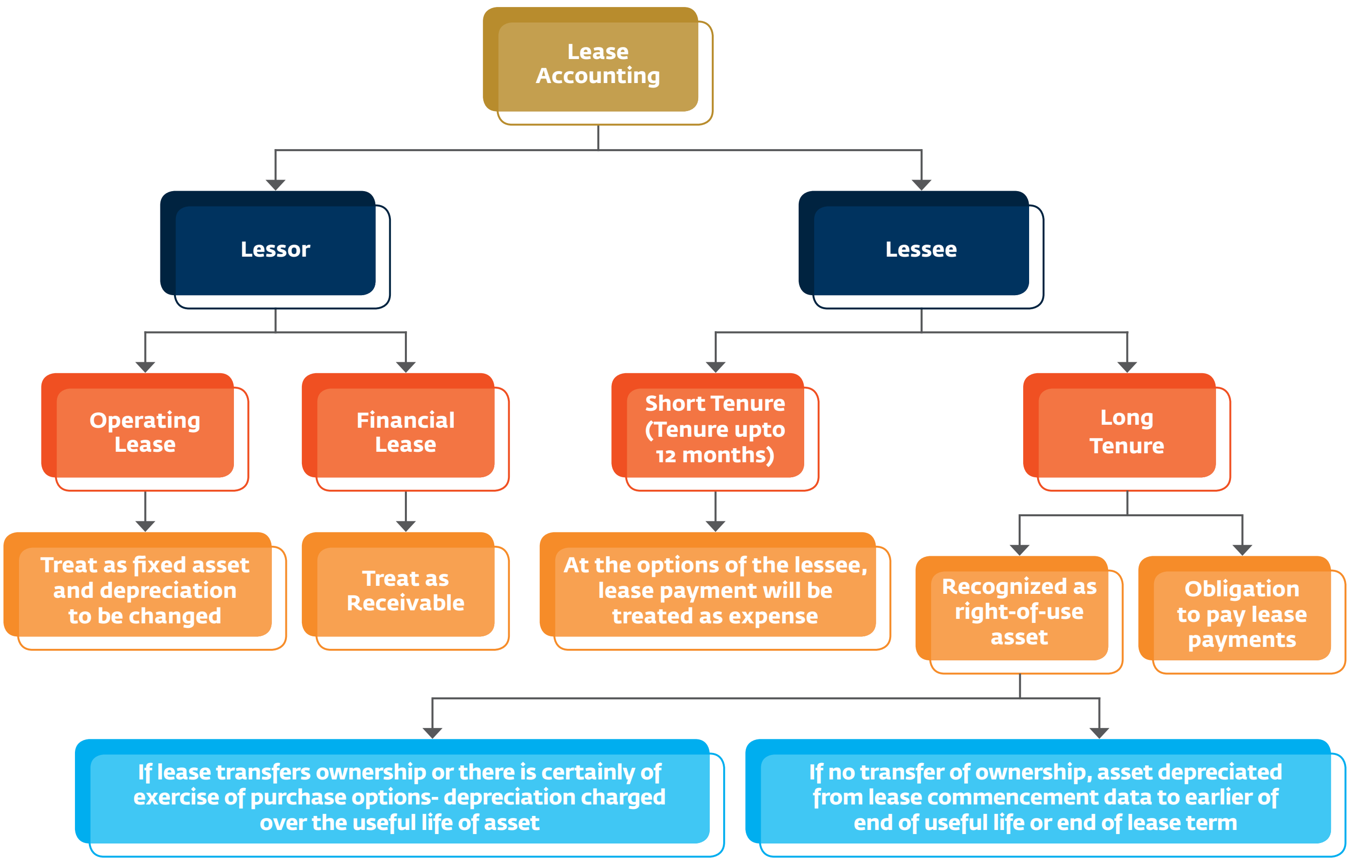


Figure 7: Lease accounting under IFRS 16

3.5 Impact of the Standard on leasing industry

IFRS 16 is admittedly one of most important changes in the history of the leasing industry, and therefore, question arises as to how the standard may shape up the industry in time to come. As IASB data above shows, the penetration rate of off-balance sheet leases is 5.4%. If the motivation for using leasing for off-balance sheet assets goes away, it remains a crucial question as to whether leasing as we know it today will continue to stay in time to come.

The key to the viability of an instrument is in its economics, and not in regulatory or tax arbitrage. Leasing has to appeal to lessees based on its ability to reduce the rental payments, align the cash outflows of the lessee to the revenues from the asset, and pass on residual position to the lessor. The fact whether the asset stays on the balance sheet or not does not affect these inherent economic benefits. Also, importantly, though an asset acquired by way of operating leases comes on the balance sheet of the lessee as per the new Standard, it is not the fair value of the asset that gets reflected on the lessee balance sheet – it is only the present value of lease payments over the lease tenure. Therefore, if lessors structure shorter lease tenures, the amount of on-balance sheet asset for the lessee will be significantly lower than the fair value of the asset, thus resulting into an off-balance sheet asset still. The table below indicates the extent of off-balance sheet asset equivalent, based on different lease tenures and residual value assumptions:

Table 7: Off balance sheet treatment of leases based on the different lease tenures and residual values

On-balance sheet treatment of operating leases						
Asset cost			1000			
Lessor's expected rate of return			10%			
Length of lease term	Lessor's estimated RV	Annual rental	Right of use Asset	Obligation to Pay liability	Fair value of asset, if owned	Off-balance sheet equivalent
Years						
1	75%	350.00	-	-	1,000.00	1,000.00
2	55%	314.29	545.45	545.45	1,000.00	454.55
3	40%	281.27	699.47	699.47	1,000.00	300.53
4	30%	250.83	795.10	795.10	1,000.00	204.90
5	22%	227.76	863.40	863.40	1,000.00	136.60
6	17%	207.57	904.04	904.04	1,000.00	95.96
7	15%	189.59	923.03	923.03	1,000.00	76.97

Notes: The Right of Use Asset/Obligation to pay liability, for a lease term exceeding 1 year, are computed as the present value of the lease rentals, discounted at the lessor's internal rate of return or the lessee's incremental borrowing cost.

The Table above illustrates that with higher residual value positions taken by the lessor, the off-balance sheet component of the asset, compared to a straight loan or financial lease, is higher. Going forward, lessors may have to assume more significant residual value positions – while this will result into lighter balance sheets of lessees, but that may be just the side-benefit, the primary one being the fact that the lessee is able to shift the residual value burden to the lessor and focus on the lessee's core operations. The increasing stress on residual value risk will also mean lessors may have to work more closely in association with OEMs and vendors, to seek recycling or resale of assets.

3.6 Comparison of Global leasing market with Indian leasing market

The penetration of leasing in some countries is as high as 30%[23] with existence of lease being traced to the early 1900s. In case of India, the lease penetration is not more than 2%.[24]

A comparative study of the legal, regulatory, accounting and taxation regime of the leasing in India as compared to other counties, globally, which has been illustrated in Annexure 3.

3.7 Lessons to learn from developed leasing markets

Among other objectives, this study intends to learn from global experience, particularly because leasing has successfully contributed to financing of small businesses across the world.

The outstanding feature of growth of leasing in global markets is that leasing has grown on its own strength, with regulatory efforts mostly limited to removing of de-motivators or undesirable bottlenecks. It is also clear looking at global data that most of the leasing volumes emanate from financial leasing: which is miniscule in the case of India. Therefore, the key immediate objective must be to remove the de-motivators that have squeezed financial leasing out of existence in India.

While trying to create a congenial environment for financial leasing, regulators must also obviously curb any potential misuse of leasing for generating tax shelters. The following treatment, holding true for major leasing markets in the world, ensures that there are financial leasing may compete with lending, without having the potential for tax shelters:

- Financial lease transactions are treated as "non-true leases" for tax purposes and do not result into tax shelters. US Revenue Procedure 2001-28 lays so-called "bright line" tests for distinguishing between true leases and non-true leases. In UK too, a "long funding lease", as per provisions inserted by the Finance Act, 2006, are treated for tax purposes based on their substantive similarity with loans and do not qualify for any tax benefits. Despite the specific tax provision for "long funding leases", UK tax rules are relatively more liberal for tax benefits to lessors, as the same are not based on accounting distinction between financial and operating leases.

[23] See penetration data in Table above

[24] Based on data detailed in Chapter 2

- At the same time, in most countries, it is clear that if the lease qualifies to be a true lease for tax purposes, which is mostly the case with operating leases, the lease will qualify for tax benefit of depreciation in the hands of the lessor, and rental expensing in the hands of the lessee.
- The substantive similarity of financial leases with loans carries through to the indirect taxes too. Thus, while most of the States in USA impose either use tax or sale tax on rental transactions, in respect of capital leases or so-called "financing transactions", there is no question of such a tax.[25] In UK, VAT rules treat hire-purchase transactions as a supply of goods, and other lease transactions as supply of services. In case of the former, if the finance element is separately invoiced, the same is treated as supply of finance, and not charged to VAT. In EU VAT regulations as well, the ruling of the European Court of Justice in *Eon Aset Menidjmunt OOD v Direktor na Direktsia 'Obzhalvane i upravlenie na izpalnenieto* goes to say the distinction between finance lease and operating as under IAS 17 will be adopted for VAT purposes, and accordingly, a finance lease will be regarded as "supply of goods" rather than supply of services. In Australia, on the other hand, GST is applicable on both the credit supply element, as well as that of supply of goods.[26]

Thus, finance leases provide the protection of ownership to the lessor, without being exposed to incremental taxation in most countries. Whether, in the event of bankruptcy of the lessee, the lessor will be able as an owner, or will rank at par with secured lenders – is a question still debated in courts. For instance, in a ruling called *United Airlines, Inc. v. HSBC Bank USA, N.A.*, the US Court of Appeals ruled, in a bankruptcy ruling, that a court must consider the substance of a transaction, rather than its form, in determining whether a transaction is a "true lease" or a disguised secured financing. The true lease vs security interest question also crops up in filings under Article 9 of the Uniform Commercial Code in the USA, akin to registration of security interests in several other countries.

While questions such as the one above continue to stir debates in courts of law, in most countries, financial leasing continues as a vibrant alternative to secured lending.

[25] See, for instance, a guide by State of California: http://www.boe.ca.gov/lawguides/business/current/btlg/vol1/sutr/sales-and-use-tax-regulations-art15-all.html

[26] https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/Agent,-consignment-and-progressive-transactions/GST---Hire-purchase-and-leasing/

CHAPTER 4

LEASING AND MSME FINANCING IN INDIA

4.1 MSME segment in India

The role played by MSME in India's growth story hardly needs to be stressed: many research reports have recognized the tremendous contribution of this sector to the GDP, employment generation, exports, and above all, economic stability by decentralisation of economic power. As per the annual report issued by the Ministry of Micro, Small & Medium Enterprises for FY 2014 – 15[27], the total working enterprises in MSME sector was 48.85 million with total employment of 111 million accounting for growth of Indian economy by contributing 37 per cent of the industrial output and 42.4 per cent of exports.[28] The total number of the MSMEs grew from 36.18 million[29] at the end of FY 2006 – 07 at a Compound Annual Growtvinodh Rate (CAGR) of 3.825% approximately.

[27] IFC Report – Financing India's MSMEs, Estimation of Debt Requirements of MSMEs in India

[28] IFC Report – Financing India's MSMEs, Estimation of Debt Requirements of MSMEs in India

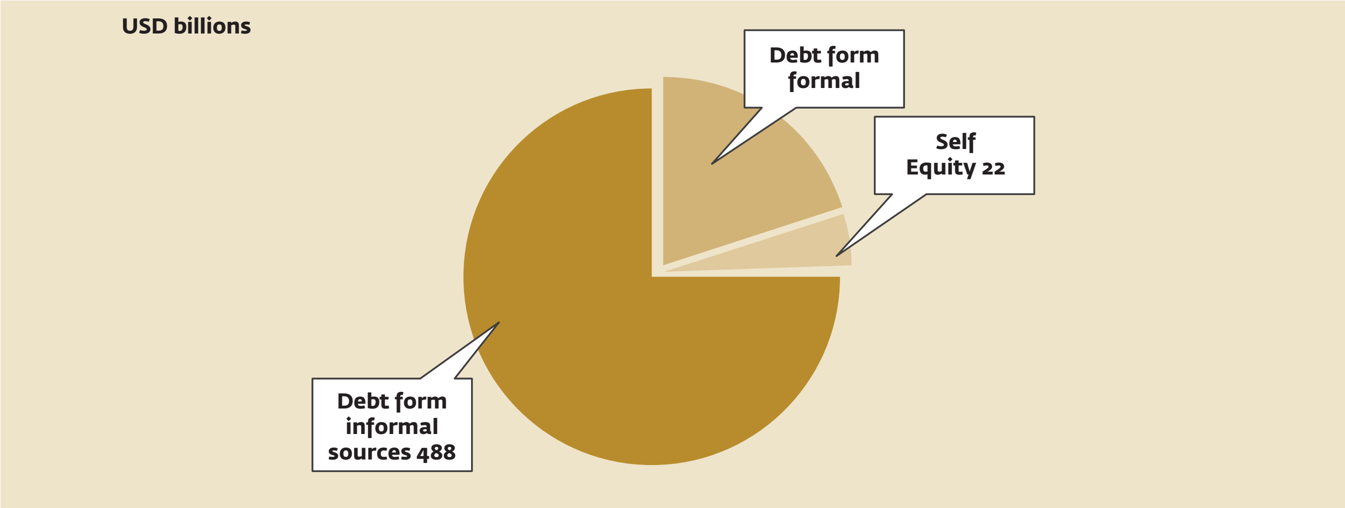
[29] The Fourth All India Census of Micro, Small and Medium Enterprises carried out by Development Commissioner (MSME) during the year 2006-07 ('Census') reported the number of MSMEs to be 36.18 million. (http://www.dcmsme.gov.in/publications/Final%20Report%20of%20Fourth%20All%20India%20Census%20of%20MSME%20Unregistered%20Sector%202006-07.pdf)

The growth and size of MSMEs is largely constrained by availability of owned funds. Conventional or traditional sources of funding may not be easily accessible due to unavailability of security or collateral to be offered or because of the inherent risks in the business itself, among other reasons. Therefore, the need for tapping alternative sources of funding is essential for the growth in the sector. Leasing can be a viable alternate to conventional sources of funding for addressing the capital expenditure requirements for the sector.

4.2 MSME financing

The financing needs of the MSMEs are met by either self-funded equity or through debt raised from formal and informal sources. As per International Finance Corporation (IFC)'s Report on MSME Financing in India , almost 75% of the total financing demand of the MSMEs is met through debt raised from informal sources, namely chit funds, registered or unregistered indigenous money lenders, and lastly resources from family, friends, family business etc. Total debt flow from the formal sources, namely banks and NBFCs, amounts to only 22% of the total demand. Figure 8 shows in details, the cashflows from various sources.

Figure 8: Cashflows in the MSME sector from the various sources



Source: IFC's Report on MSME Financing in India

The said Report suggests that out of 29.8 million units existing in the segment, only 10.3 million units are served by the financial institutions, and that too, only to the extent of 40% - 70% of the demand of an enterprise on an average, thus, leaving a huge funding gap.

The financial demand gap of this sector may be met with the introduction of alternative funding solutions designed to tackle the existing set of problems and this is where the need to offer leasing as an effective tool to fill, at least in part, the financing gap faced by the MSMEs in India is stressed upon.

[30]IFC Report – Financing India's MSMEs, Estimation of Debt Requirements of MSMEs in India

4.3 Leasing for MSMEs

4.3.1 The case for leasing for MSMEs:

In context of MSMEs, there are certain specific factors which make leasing as an attractive option for financing to this sector:

a. **Title provides better security:** In case of unincorporated entities, lenders are not able to register their security interest over the asset, as there is no filing of security interests in case of non-corporate borrowers. (See Box) Therefore, the traditional devices such as hypothecation of the asset do not have any publicly-manifest trail in case of unincorporated entities. On the contrary, because the title is reserved by the lessor, it allows the lessor to have a definitive ownership right on the asset.

b. **No need to use SARFAESI Act process:** In case of lease transactions, the procedure for enforcement of security interests given in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 were earlier not applicable, however, the SARFAESI Act, 2002 was amended in 2016 to include financial leases in the definition of financial assets and therefore, the rights under this Act can now be utilised for the enforcement of security interests. The SARFAESI Act requires the loan to become a non-performing loan, and then provide a minimum 60 days' notice before which repossession can be taken. Thus, from the point of non-payment, at least 5 months' time goes. In fact, even after repossession is taken, there is a minimum 30 days' notice requirement to the borrower before the asset is sold. However, the inclusion of financial lease in the definition of the financial asset does not limit the right of the lessor to enforce security interest under this Act, common law principles for repossession of assets can still be resorted to, i.e., the lessor may step into action, and if thought appropriate, may repossess and sell the asset without having to depend on the process of the SARFAESI Act. The above is in addition to the fact that the benefit of SARFAESI Act is not available for all NBFCs.[31]

c. **Minimisation of monthly outflows:** Assuming the asset is a standard product[32] for which the lessor is able to structure an operating lease, with higher residual value, the monthly rentals are consequently reduced. This has a significant benefit for the lessee/MSME. His monthly outflows being reduced, the lessee may save more cashflows every month, which he may use for other operating expenses and working capital. This is particularly important for those assets which are deployed to earn revenues – such as hired construction equipment, buses, hired machinery, packaging machines, etc.

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[31] As per a Union Budget announcement of 2015, the benefit of SARFAESI process is to be extended to systematically important NBFCs. The necessary notification was issued on 5th August, 2016, wherein 196 NBFCs were notified to whom provisions of SARFAESI shall become applicable. The notification can be accessed here http://egazette.nic.in/WriteReadData/2016/171157.pdf. Further, financial lease and hire purchase transactions have been brought within the fold of the SARFAESI Act vide Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016 dated 12th August, 2016. The said Enforcement of Security Interest and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Act, 2016 is available at- http://financialservices.gov.in/Banking/LAWS.pdf

[32] The term "standard asset" is commonly used in the leasing industry to refer to such equipment as are usable across a variety of users and purposes, and have deeper secondary markets. Mining or earth moving equipments are examples.

d. **Minimisation of lessee's equity:** A lease transaction is typically structured with minimal upfront payments, and hence, lessee will be required to make use of only a small portion of its equity capital, and thereby, preserve the same for working capital.

e. **Exposure based on asset value may avoid dependence on formal financial statements:** One of the difficulties faced by MSMEs in organising funding from formal lenders is the insistence, by the latter, on audited financial statements. Most of the MSMEs, being unincorporated entities, either do not prepare financial statements, or if they do, they are not audited, and hence, are far from being as per acceptable accounting standards. Therefore, lenders cannot rely on them. On the contrary, a lease transaction may be structured based on the value of a standard machinery or equipment. If the lessor stresses on the valuation of the asset, the lessor may treat the financial statements as secondary, and may, thus, afford to extend funding to a whole lot of MSMEs that would not qualify for bank lending. A case in point are the small road transport operators, who, for nearly a century now, have been depending primarily on hire purchase or loans from NBFCs, despite attractive interest rates offered by banks, as they would not qualify for such loans for want of proper documents.

Box: Registration of security interests in India:

India follows the traditional UK corporate law system where companies are required to file security interests (known as charges) with the corporate registry offices. There is no requirement for filing of security interests by non-corporate entities or LLPs.

Among other things, the SARFAESI Act, 2002 put in provisions for registration of security interests. These provisions remained unenforced for several years. After more than 10 years of the passage of the law, the RBI required banks and NBFCs to register a particular type of mortgage, viz., equitable mortgages, with the Central Registry under the SARFAESI Act. In early 2016, the requirement was extended to several other security interests. However, being a notification under the SARFSAESI Act, these provisions are limited to lenders covered under the said law.

f. **Faster write off for tax purposes:** The tax depreciation rates in India for normal plant and machinery items being 15%, it takes over 15 years to write off the cost of the asset on the declining balances method of depreciation. On the other hand, in case of lease transactions, the lessee may write off the cost of the asset, in form of lease rentals, over the lease period itself – say 3 or 4 years. Thereby, the post –tax cost of the leasing option becomes cheaper than a loan transaction. Computation in Annexure 4.1 shows that for a 15% depreciable asset, for a standard lease term of 4 years, assuming 30% residual value, and it is clear that the tax benefit alone pushes down the cost of the lease by approximately 96 basis points.

g. **Stronger outreach and decentralised delivery by NBFCs:** One of the biggest reasons for MSMEs not being able to approach formal lenders is the lack of access to the latter. In case of leasing, leasing facilities are currently being offered by NBFCs. NBFCs are known for their extensive outreach, pro-active marketing and strong franchise with vendors as well as customers. The possibility of NBFCs tying with vendors of standard equipment and promoting their lease may address the problem of difficulties in delivery.

h. **Vendor-promoted leasing options could make equipment more affordable:** In many countries, leasing of standard equipment such as printing machines, packaging machinery, machine tools, commercial vehicles, construction equipment, etc. as used by MSMEs are promoted by their vendors. For the vendors, this becomes a sales-aid tool. For the lessors, the vendor support comes handy in understanding and appraising assets, taking a view on residual values, and dealing with the second-hand asset on repossession. For the lessees, this obviously becomes an alternative, and with better residual values, cheaper way to access funding. Therefore, the transaction has benefits for all parties.

4.3.2 Primary Research Findings: MSMEs

With the background of the theoretically strong case for leasing, a survey (Primary Research) with 63 MSMEs was conducted to find whether leasing was at all being used by them, and the reasons for them using/ not using this product (Refer to Annexure for details of entities surveyed, the Limitations to the Primary Research and the Primary Research Sample Details).

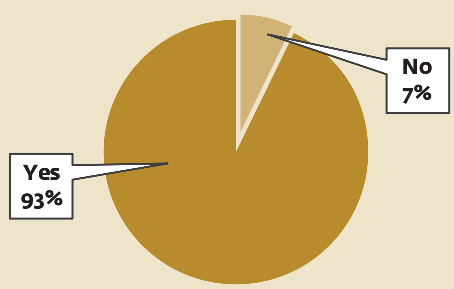
In addition, inputs from the following stakeholders was also received:

- NBFCs
- Vendors of standard equipment
- Consultants to MSMEs

The key findings of the Primary Research are as below:

1. **On exploring external/ alternate sources of financing:** It is a general perception that most of the MSMEs in the country are family-run businesses, and the general presumption is that they would generally not prefer to have an external interference of lenders into their business, even if it be in form of submission of period financial statements. Even though respondents held a conservative view or were indifferent towards their source of funds, they were open towards trying products other than loan for their financing needs. The Primary Research revealed that 93% of the Sample Population were open to exploring various source of funds as long as their funding requirements were met.

Willingness to try products other than loan



2. **On ownership vs. use of assets**: The respondents were asked whether they would prefer to own assets, or they are agreeable to using rented assets, as long as they had the benefit of continued usage. A majority of the respondents were comfortable with the idea of using rented or leased assets, thus dispelling the common notion that smaller businesses long-standing preference for ownership rather than use.

   Sometimes, the preference for ownership arises out of the business requirements. For instance, some of the respondents from the construction sector revealed that the basic requirement while placing tenders for construction contracts was demonstrating high ownership of construction equipment, which propelled the need for owning the assets more than just using them for completing the contracts. This puts leasing to a disadvantage.

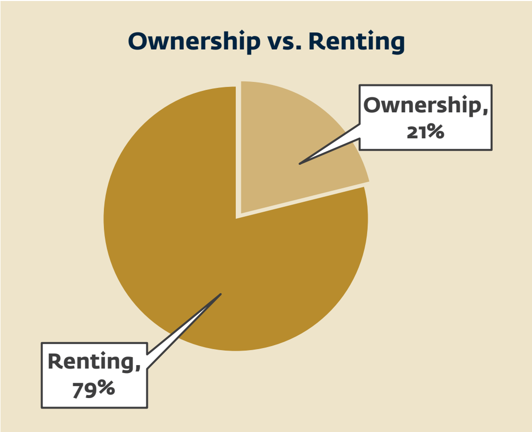
3. **On awareness of leasing:** The question to the respondents was whether they were "aware" of leasing as an option. "Awareness" here means awareness of leasing as a practical option for the funding needs of the respondent.

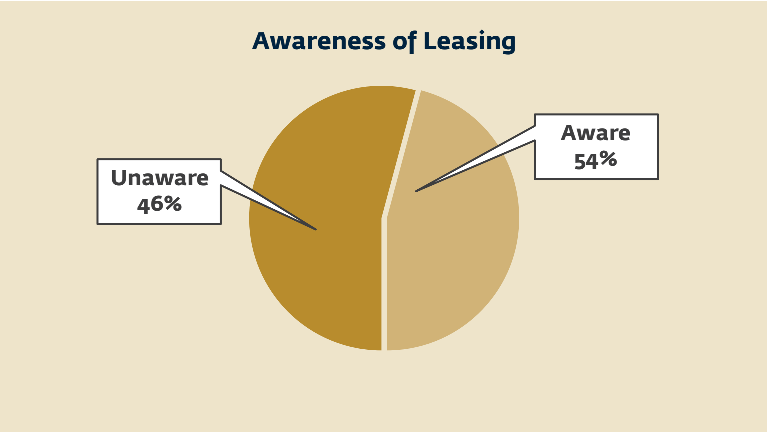
   The result of the Primary Research indicates that 54% of the respondents were aware of leasing as an option for their funding needs, while 46% were not even aware of the same. Of the former category of respondents, most confirmed that it was largely because they were approached by an NBFC and were made to understand the pros and cons of leasing. The 54% of the respondents who were aware of leasing comprised of:

   a. entities who were already using leasing for funding their requirements on being introduced to leasing as an alternative by their NBFCs lenders;

   b. entities which had high capital expenditure requirement;

   c. entities who were aware of leasing but had no in depth knowledge of the same and were advised by their consultants to not opt for leasing.





4. **On use of leasing as "aware" respondents**: Only 10 MSMESs out of those that were aware of leasing as options, nearly 30%, have tried leasing for their funding needs. This meant that the remaining 70% had either been advised by their consultants that leasing had complications, or were deterred by some VAT differentials or other factors, and decided not to opt for leasing. The following observations were given by respondents who had evaluated leasing as a funding, and decided to opt for it:
   a. The decision to opt for leasing was largely influenced by persuasive presentations by the NBFCs.
   b. Having taken assets on leasing, the MSMEs will be willing to repeat leasing option; the need for owning the assets did not withhold the decision.
   c. Most confirmed that the decision to opt for leasing was not based on a detailed financial evaluation; strong reliance was placed on the relationship with the NBFCs in making the decision to take assets on lease.
   d. Some Respondents mentioned that the costs of asset used by them were too high, so they preferred to take the asset on lease so as not to drain their bank balance.
   e. Some respondents mentioned that leasing was made available at costs lower than the existing cost of borrowing which was sometimes as high as 18%.
   f. Respondents could appreciate that the loss of depreciation in leasing was compensated with the rental expenses in leases. The treatment was explained by the NBFCs for the respondents to appreciate leasing.
5. **On reasons for not using leasing:** Of those respondents who had not used leasing before explained the reasons for not preferring leasing as below:
   a. **Lack of awareness about leases** – most respondents disclosed that they did not know about leasing and the lack of awareness was the primary reason for not opting for lease. These respondents also mentioned that if someone explained the concept of leasing and its suitability, merits and demerits, the respondents might be willing to consider leasing as the option.
   b. **Lack of awareness of financial institutions offering leasing** – The respondents were asked if they knew of financial institutions that were offering leasing. Most respondents did not know about the financial entities that offered leasing as a product.

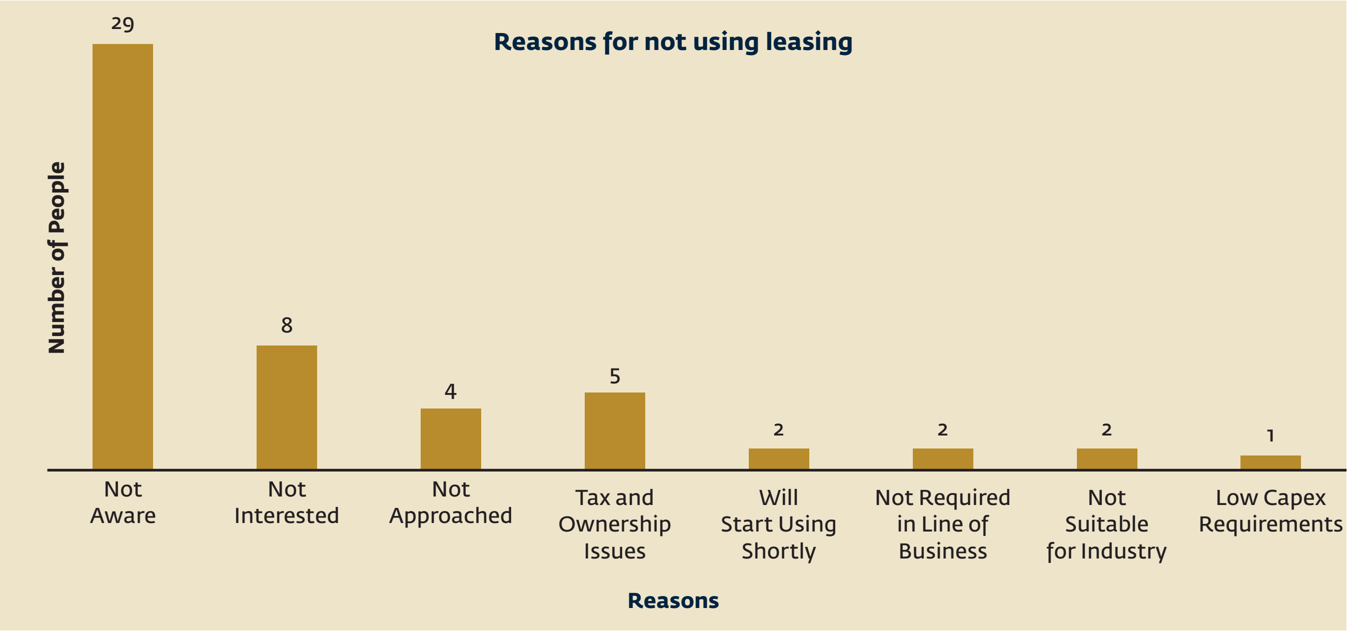
c. **Tax disadvantage** – Several respondents admitted that they were advised by their consultants to avoid the leasing option as it led to loss of depreciation as a tax shelter. Also applicability of indirect taxes (both sales and service tax) made leasing sound far more complex than loans. Also some respondents were under the impression that leases led to loss of Cenvat credit, which is not a correct notion as the Cenvat Credit Rules allow the lessee to claim benefit of cenvat credit even if the assets are acquired from financial institutions.[33]

d. **Low capex requirements, cash rich entity** – Some respondents stated that they had enough equity to fund the business requirements or were low on capex requirements hence they were not interested in understanding leasing at all.

e. **Ownership issues**– Some respondents explained that while leasing deferred cashflows over a period of time, unlike loan, despite paying for the usage of the assets, there was no transparency as regards transfer of assets at the end of the lease period. MSMEs preferred certainty and transparency, such as in case of conditional sales/ hire-purchase.

f. **Loan are easy to avail** – Owing to the existing banking relationships and faster turnaround time, some suggested that it did not matter whether the assets were taken on lease or loan as long as the funding requirement was met in timely manner.

Figure 9: Reasons for not using Lease



Source: VKC analysis

**Please do note, some of the respondents gave multiple reasons for not using leasing. Hence, the percentages to do not add to 100%*

[33] Rule 4 (3) of The Cenvat Credit Rules, 2004 states that - (3) The CENVAT credit in respect of the capital goods shall be allowed to a manufacturer, provider of output service even if the capital goods are acquired by him on lease, hire purchase or loan agreement, from a financing company. The Rules can be accessed here http://www.cbec.gov.in/htdocs-cbec/excise/cxrules/new-cenvat-rules

4.3.3 Primary Research Findings: NBFCs

10 NBFCs were interviewed during the Primary Research who have existing loan products to MSMEs, including some who have tried or are intending to offer leases to MSMEs as well.

Some of the NBFCs that offered leasing products in the past stated that they stopped doing leasing, as even their operating lease transactions were denied depreciation by the tax officers. Tax officers viewed every lease with a suspicion, causing harassment during the assessment process. Indirect tax complications, particularly at the time of movement of goods across state-boundaries, and taxes such as entry tax, were cited as common reasons for staying out of leasing.

The top reasons as quoted by NBFCs for not offering leasing to MSMEs, in order of significance, are mentioned below:

a. Tax complications;

b. Turn around time (TAT) in loans is faster and therefore sales team is motivated to sell loans rather than leases;

c. Past tax demands make lease cumbersome: Tax officers have, in the past, disallowed depreciation claims, and imposed hefty demands, even in case of operating leases;

d. Problems in asset management: lease transactions require lessors to go into asset-level management issues such as insurance, inter-state movement, indirect tax compliances;

e. Credit score updation is not possible: it is felt that filing of information with credit information companies in case of defaults on operating leases is not allowed, as lease transactions are not credit facilities.

4.3.4 Primary Research Findings: Consultants to MSMEs

In addition to the interview of MSMEs and NBFCs, it was pertinent to interview the financial consultants to MSMEs. It was quite evident that the MSMEs depended on the advice of their consultants. We interviewed 10 consultants who are currently providing advisory services to MSMEs.

The top reasons, in order of significance, cited by the consultants for MSMEs not preferring leasing are as below:

a. Lack of product knowledge;

b. Loan is easier to understand;

c. Complex nature of leasing;

d. Ownership issues.

4.3.5 Primary Research Findings: Vendors' viewpoints

The Primary Research with the MSMEs and the NBFCs clearly revealed that if a lease was a pure financial lease, it will have little differentiation from a secured loan, and on the other hand, suffer from differential taxation worries. Therefore, there is a need to push leasing by adding a residual value feature on to it.

Usually lessors will not be prepared to underwrite the residual value risk of assets, as it is difficult for them to build up asset expertise on so many different assets. It was, therefore, logical to expect that the vendors must be the first persons to absorb residual value risk, as they, understandably, are best positioned to understand the asset, its technology, retrofitting or refurbishing possibilities, and so on.

While some auto vendors, are, in fact, taking residual value risk, it was important for us to speak to some of the vendors in the plant and machinery segment, to get the feedback about the possibility of offering leasing of their equipment, and their preparedness, if any, to participate in residual values of their assets. Therefore, some vendors of standard equipment, used by MSMEs were interviewed during the Primary Research with this end in view. The results of the discussions with these vendors gave useful insights, which have formed the basis for some recommendations later in this Report.

4.3.5.1 Vendor of plastic injection moulding equipment

Since plastics industry is a significant part of the MSME segment, the Primary Research included a leading manufacturer of plastic injection moulding machines in the country.

This vendor has been successful in doing only 2-3% of their total sales as leasing sales, though a lot of their sales are financed by leading NBFCs.

Among the major reasons cited by this company, for which lease transactions are currently not happening, are the following:

a. The most important reason is that the lessors are not prepared to take a risk on residual values. The lessors typically do not want to take the asset-based risk and therefore, in most cases, end up reselling the equipments to the vendor, which the vendor is not prepared to agree.

b. The vendor also agreed that most of the customers seek the advice of their tax consultants, and the tax consultants will prefer something which is simple and clear.

Notwithstanding the above, there is a strong case for the vendor to himself provide residual value support to their own product, for the following reasons:

a. For every standard equipment, there is a resale market. For example, in the case of this vendor as well, the vendor confirmed that there is a strong second hand market, where assets having a life of 5 to 15 years are sold. These second hand assets typically are acquired by entry-point operators, who do not afford the cost of a new equipment, and therefore, settle on a cheaper second-hand equipment.

b. These second-hand equipment buyers currently deal with unorganised resellers, who do retrofitting on a used equipment. These resellers are typically far less reliable than the OEM themselves. It is rationally good business sense for an OEM to provide a market for his own second- hand equipment, so as to enable entry-point, low-cost operators to acquire the OEM's equipment, directly from the OEM, rather than from the unorganised resellers. The OEM may hope to convert these customers, in course of time, into buyers of new equipment.

When placed with this argument, the vendor said his company was not currently in the business of dealing in second hand assets. For this, they would need additional storage, etc. They will be willing to examine the possibilities in long-run.

It seemed, that the case for pushing up the sales of their product by support residual values has not been made to this vendor.

4.3.5.2 Vendor of packaging equipment

The next vendor included in the Primary Research is a leading supplier of packing equipment. This OEM is a global leader in packaging machinery, and most of their customers of capital equipments are MSMEs.

The OEM, being part of a global MNC, is well aware of leasing device, and is connecting with leasing companies all over the world. As per the vendor, 75% of their global sales comes through leasing companies. The most active markets for leases of their equipment are USA, Germany, Italy, Brazil, China, etc.

With experience of leasing all over the world, this vendor said, his company had tried to explore leasing possibilities, both on the balance sheet of his own company, as also through several NBFCs. Leasing on the vendor's own balance sheet had issues pertaining to FDI rules.[34] As regards leasing through NBFCs, this company actually said they tried speaking to several NBFCs. The company even offered to write residual value risk for the NBFCs, by either agreeing to provide remarketing assistance, or by even agreeing to take a first loss risk on a portfolio basis for their lease transactions.

Despite such attempts to absorb residual value risk, the experience of this vendor is that the NBFCs did not have any motivation to do lease transactions of assets eligible for low depreciation rates such as 15%.[35] The motivation for leasing is limited to only such items as qualify for accelerated depreciation.

The vendor confirmed that the strongest reason for lessees to opt for leasing is the low monthly rental. The vendor said, in case of packaging machines, while the quality of their machines is unarguably the best in the world, there are cheaper options available. If the rentals for their assets could be made lower, either by a residual value in-built, or by step up rental structure, the customer may be willing to shift from cheaper machines to a better machine, while keeping his differential cash outflow negligible. However, a full payout financial lease cannot provide this option to the customer.

[34] There is an impression, though wrong in our view, that a foreign-owned company or company having foreign direct investment cannot offer leasing facility.

[35] This is the rate of tax depreciation available in case of normal plant and machinery.

4.3.5.3 Conclusions from the Primary Research:

Conclusions from the Primary Research are as follows:

a. In most cases, respondents are not aware of leasing as an available option, or where aware, the lenders/financiers have not made a case for leasing at all.

b. Leasing continues to suffer from the old mindset of the 1990s when lease transactions were regarded as tax sheltering devices; most of the NBFCs are not offering leasing option at all and are reluctant to offer it due to tax complexities and VAT compliance burden.

c. Financial and tax consultants of MSMEs have a great role to play in advising their clients; most of them currently advise their clients against it, as they opt for simplicity rather than the complications of direct and indirect taxes. Unless there is a strong financial reason for leases to look appealing, the demand for leasing is pushed down due to its apparent complications as compared to a time-tested loan option.

d. Where MSMEs have evaluated and rejected the leasing as a financing option, they have not opted it for (a) higher costs and (b) incremental tax burden due to indirect taxes.

Residual-value based operating leases are rarely being offered by any of the lessors. Therefore, the classic benefit of leasing – that is, ability to create funding options with low monthly payments, does not hold ground until lessors work out residual value based plans with vendor.

4.4 Factors responsible for low penetration of leasing for MSMEs

Based on the Primary Research, and other insights, the following are the significant factors responsible for the low penetration of leasing for the MSME sector in India.

a. Low penetration of NBFC funding: NBFCs themselves have very low penetration in MSME financing, other than in case of commercial vehicles or construction equipment. As per IFC's Report on MSME Financing in India[36] , the proportion of NBFC funding to total MSME debt funding is around 5.4%. The reasons for this are not difficult to appreciate – banks are required to focus on MSME lending as there is mandated priority sector lending (PSL) requirement in case of banks. More often, banks end up short of their PSL targets – hence, banks are motivated to either lend to MSME, or acquire portfolios originated by MSMEs. Also, over recent years, due to increasing burden of NPAs in case of large-ticket lending to core sectors, there is an increased push on the part of the banks to originate more MSME portfolios.

b. Banks are not offering leasing option: As mentioned earlier, banks were permitted to start leasing subsidiaries during the early era of leasing in India. Banks were permitted to start leasing departmentally, that is, as a part of the bank's own credit portfolio itself, way back in 1994. While soon after the 1994 permission, there was a strong interest on the part of several banks to offer leasing, the period of 1997 and thereafter revealed several tax scams related to lease transactions coming to light.

[36] IFC Report – Financing India's MSMEs, Estimation of Debt Requirements of MSMEs in India

Hence, most banks withdrew their plans to offer leasing. Thereafter, the business compulsions to offer leasing as a product have never been strong enough, even though several banks are active in car financing, against which NBFCs offer competing leasing plans. Currently, there is no bank offering leasing, whether financial leases or operating leases.

c. **Risk perception about MSME lending:** The MSME sector understandably is heterogeneous, largely unorganised, etc. These factors have been discussed above. The credit risk perception about the MSME sector is high. The current rate of NPAs in MSME lending is estimated ~ 9 – 10%.[37] While there is a theoretical argument to suggest that leasing should be preferred if the risks are high, businesses typically want to start it safe and simple first. The penetration of leasing in the overall country being too low, the case for pushing leasing for the MSME sector has not been felt by the NBFCs themselves.

d. **Lack of risk transfer schemes:** There are no credit risk transfer schemes that cover lease transactions presently. Therefore, even if banks were to offer leasing facility, they will have to keep the risk to themselves, which is an obvious disincentive.

e. **Financial leases suffer value-added tax, and hence, distort the lease-borrow parity:** It is felt by most practitioners that the regulator's present dispensation permitting banks to offer leasing covers financial leasing only. If banks were to offer financial leases, there is no major incentive, at least from the perspective of the users, to use leasing option. There is an increased cost due to VAT, in particular, the denial of VAT credit in several states. There is also a service tax component. All these costs are slotted against no relative benefit. Therefore, a straight loan becomes a clear choice.

f. **Direct tax applicability far from clear:** Taxation of lease transactions for direct tax purposes has never been clear. With over 35 years of litigation on eligibility of lessors to claim depreciation or the right of the lessees to claim deduction for rentals, many of the players in the leasing industry have confirmed that even for what is clearly accounted for as an operating lease, tax officers at the first level deny depreciation claim and at the same time, tax rentals to the full extent. Lease transactions are typically seen with a suspicious eye as several lease transactions in the past have been unfolded by the tax officers as tax sheltering tool.[38] The proposed Income Computation and Disclosure Standards (ICDS) on lease transactions has not been implemented. If implemented it would have rendered some clarity on claiming of depreciation in case of financial leases.

[37] Interview of SBI Managing Director, quoted here; http://www.thehindubusinessline.com/money-and-banking/lending-to-smes-hinges-on-good-cash-flow/article7566391.ece

[38] Responsible for this mindset may be the facts that several lease transactions are done in case of those assets where the benefit of accelerated depreciation is allowed – such as renewable energy devices.

g. **Residual value risk transfers are not common:** There would have been clear case for operating leases, but as a necessary enabler in case of operating leases, there has to be a possibility of risk transfers on residual value risk. Even in case of most standard assets, there is no residual value insurance, residual value guarantee or other similar third party risk transfer devices. Vendors may be in a position to support residual values, but if vendors were to do so, their revenue recognition for the sale itself may be at stake.

h. **Securitisation of lease transactions is far from clear:** NBFCs originate MSME portfolios primarily with the objective of sell-down to banks who fall short of their PSL targets. Hence, most MSME lending by NBFCs ends up being securitised. In case of lease transactions, there is virtually no securitisation of leases, as the legal and tax scenario for securitisation of lease receivables is far from clear.

MFIs are currently not doing any leasing at all: While the contribution of micro finance institutions (MFIs) to promoting lending to micro enterprises is well known, currently, MFIs are not doing leasing at all. On several occasions, MFIs have expressed apprehension at the fact that they are financing income producing capital assets for micro enterprises, and that is the most right candidate of a lease transaction. However, the extant norms of the RBI for MFIs do not seem to permit any leasing, at least within the 85% of the assets which is required to be unsecured loans to eligible entities.

4.3.6 Limitations of the Primary Research

a. Most of the entities that we have tried to contact are either companies, or large partnerships. A large part of the MSME pyramid consists of micro enterprises, for which outreach is quite difficult. However, we understand that at least to begin with, leasing entities are likely to start with the larger of the MSMEs – therefore, our focus on formal and organised MSMEs does not prejudice the results of the Primary Research.

b. Most of the entities that we have tried contacting are those that have already availed some financial support, either from banks or from NBFCs in the past. Hence, it is quite likely that these entities would have been aware of the products being offered by the lenders, and therefore, there will be a natural bias, in terms of awareness of the leasing product, among the Primary Research respondents.

c. Technically, the definition of an MSME entity may include a truck operator or similar entity running a transportation asset. However, our approach is to identify leasing as an option for assets like plant and machinery and other utility assets – hence, we have not extended the Primary Research to operators of trucks or commercial vehicles.

d. Among lenders, we have not interviewed banks, as none of them are presently offering leasing facility.

4.3.7 Primary Research sample details:

Figure 10: Classification of Sample Population

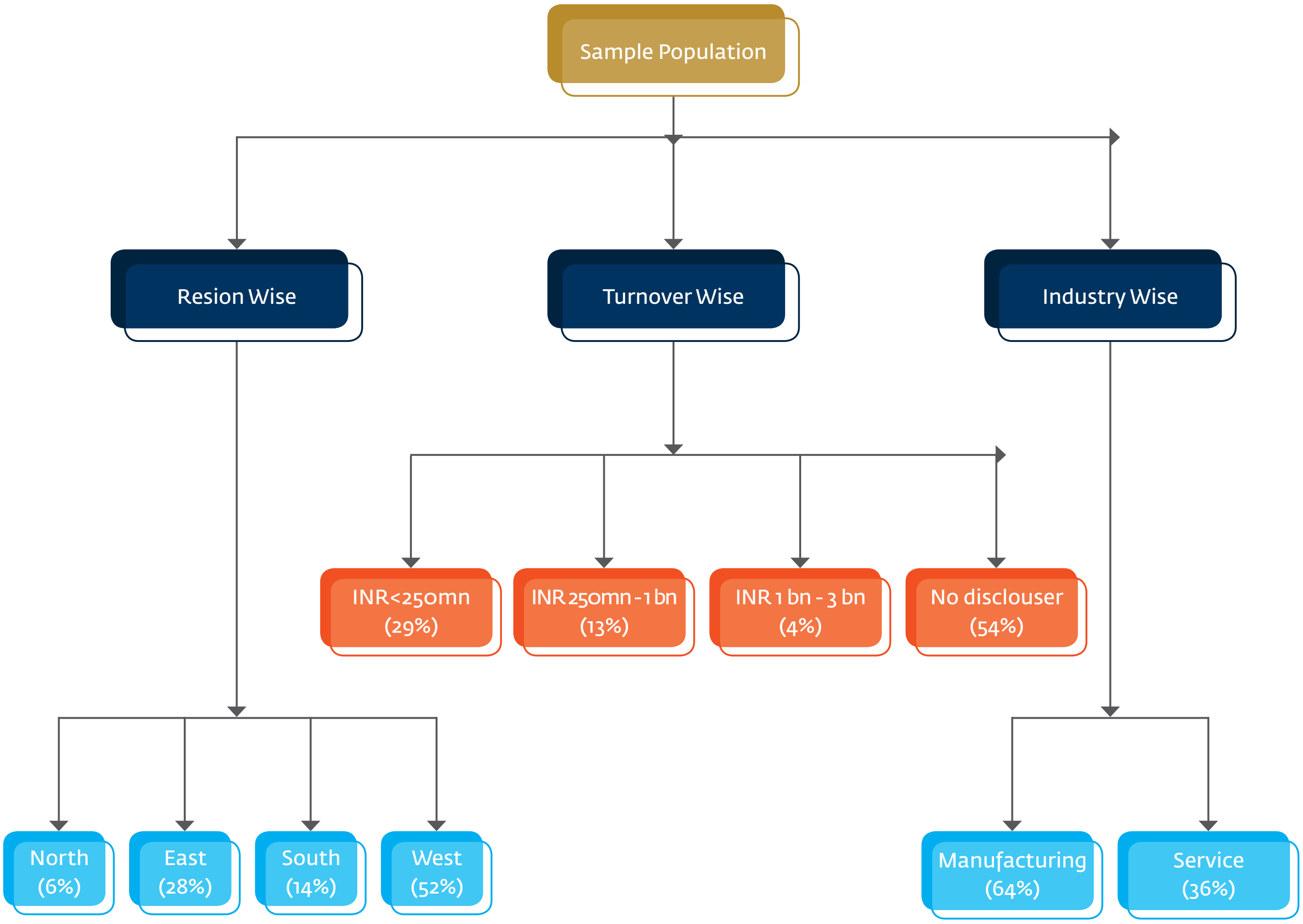


Figure 10: Classification of Sample Population

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS FOR ACTION

5.1 Conclusions:

5.1.1 Need to remove tax inefficiency for financial leasing to improve lease penetration

The analysis of the development of the leasing industry in India, its comparison with that in some of the leading markets in the world, brings up the inescapable conclusion that the penetration of leasing is very low in India. In leading leasing markets, the penetration of leasing may be upwards of 20% as in case of U.S.A. or U.K. Even in much smaller markets, and particularly those where the current state of development is comparable with India, the penetration of leasing is several times that of India.

World-over, major proportion of leasing business is financial leases. Even in advanced markets such as the USA, operating leasing forms approximately 20% of the market. In case of Germany, where leasing of vehicles is quite common, operating leases form about 33% of total leasing business. In India, leasing market mostly consists of operating leases only. This can only be explained by the unpopularity of financial leases due to – a) the advantages of financial leases being eliminated with the introduction of accounting standards, b) uncertainty of eligibility for tax benefits, and c) the disadvantages in terms of indirect taxes/ VAT being imposed meaning an uneven competition with loans.

Traditionally, hire purchase has been used extensively in the country, particularly in case of financing of transport vehicles. In case of leases of plant and machinery, volumes were quite significant till about year 2000, when the denial of depreciation due to past cases of tax-oriented lease transactions started surfacing.

Further, operating lease transaction require asset expertise, the scope for operating leases is limited. As a result, the aggregate penetration of leasing has come down sharply over the years.

Though financial leases are a look-alike of secured lending or other title-retention transactions, the case for financial leasing is strong, for the reasons discussed below.

In most mature financial systems, there are various types of title-retention transactions which seek to meet the needs of financiers looking for better security and priority in the event of default. These transactions bring down the perceived lender risk and therefore, bring down the cost of lending. Often, these transactions also make it convenient for the borrower to avail financing. Therefore, policy-makers should create enabling atmosphere, by removing inefficiencies. Assuming that a financial lease was not to result any tax benefit for either the lessor or the lessee, it is fair to extend the putative similarity of financial leases to loans, and therefore, exempt financial leases from taxes applicable to sales of goods or provision of services.

A scenario where a financial lease attains parity with secured lending from a tax perspective, may still have a significant role in the financial system. Notably, a financial lease provides the lessor with the benefit of title, which provides the lessor with a super-priority in the event of a default. The lessor does not have to depend on special recovery rights such as the SARFAESI Act[39], nor does the lessor have to depend on judicial or arbitral intervention. Thereby, the lessor's risk is reduced, and recovery prospects are improved. All of this will eventually reflect on cost of credit. It is notable that even under the Insolvency and Bankruptcy Code, 2016 assets acquired on lease basis have been excluded from the bankruptcy estate, thereby providing the lessor absolute priority over the leased asset.

[39] The SARFAESI (Amendment) Act, 2016 has included financial leases in the definition of "financial assistance". The benefit of the Act is available only to banks and a limited number of NBFCs, as notified by the Central Government

5.1.2 The case for financial leasing as an alternative credit mechanism for MSMEs is strong

The case for leasing for financing of small and medium enterprises is very strong, and accepted globally. For instance, as per a report by the US Federal Reserve System, of the total finance provided by finance companies to small businesses of USD 283.9 billion in 2012, USD 178.8 billion was by way of equipment leases.[40] In case of several European jurisdictions, leasing is very commonly resorted to by SMEs, and was very popular alternative method during the aftermath of the financial crisis in 2008. A survey by the European Commission reveals that nearly 50% of German SMEs used leasing in 2011, while around 40% of SMEs used it in France. In Spain and Italy, the proportion of SMEs was 25%. When firms were asked about the reasons for leasing an asset, price considerations (price of leasing relative to other financing forms) seemed to be the most important factor.[41] Obviously, that cheaper cost of leasing would have been possible primarily due to the lower credit risk spreads imposed in case of lease transactions.

5.1.3 Operating leasing has a strong appeal for certain MSMEs

While financial leasing essentially becomes an alternative to financing, operating lease becomes an alternative mode of acquisition of the asset itself. An operating lessor provides a different approach to acquiring the use of the asset, rather than investing in the whole value of the asset. In an era of fast technological change, the ability of MSMEs to adapt to the environment will largely depend on their ability to rapidly implement changes in product mix, technology and/or equipment. Units that do not invest in permanent capital and keep themselves asset-light will have far more adaptability, than those with heavy investments in capital equipment. Operating lessors absorb residual value risk. In addition, the monthly outflow in case of an operating lease will be lower than in case of a full-payout financial transaction, thus putting lesser burden on regular cashflows of the unit.

5.1.4 The perception of the tax officers and regulators continues to be negative for leasing transactions

In India, leasing suffers from its past history of being used, and in some cases, arguably abused, for generating tax shelters. During the period 1996-2000, several such lease transactions were exposed by the tax officers, many of which are in different stages of litigation currently. Some of this negative perception towards leasing continues, and can potentially have a negative impact even in the case of genuine lease transactions. In the course of primary interviews, several of the lessors pointed out the difficulty in establishing depreciation claims in case of even operating leases, which auditors have accepted as such in the financial statements.

[40] http://www.federalreserve.gov/publications/other-reports/availability-of-credit/September-2012-Providers-of-Credit-to-Small-Businesses.htm

[41] European Commission, "SMEs' Access to Finance Survey 2011", 2011. See also, Leasing as an Integral Part of Toolset for SMEs, in European Investment Fund Report, http://www.eif.org/news_centre/research/eif_wp_2012_15_The%20importance%20of%20leasing%20for%20SME%20finance_August_2102.pdf

Several MSME consultants said they advised their clients to refrain from leasing, as the claim for rental expense may be questioned by tax officers. In short, there appears to be continued concern about the misuse of leasing among revenue officials when it comes to leasing. It is important that there is awareness about leasing to do away with the negative perception existing among the consultants, tax officers and the business entities alike and to allow stakeholders to shed away the temptation of looking for tax shelters in leasing transactions.

5.1.5 There are significant communication gaps as regarding leasing, amongst financiers as well as borrowers

Our survey indicated that lack of awareness of leasing as an option is one of the key reasons why the product continues to be underutilized. While many NBFCs are reluctant to offer leasing for reasons noted above, even if the NBFCs are interested to attain leasing volumes, they seem to think leasing is meant for larger clients, and therefore, they never promote leasing for MSMEs. This is contrary to the case of several other countries where leasing is a regularly used financial instrument for MSMEs. There is a clear need to build awareness about leasing as an option. This continues to be a key gap, particularly in the absence of an industry body that would actively take on the advocacy role.

5.2 Recommendations

In view of the strong and clear case for leasing for MSME financing, it is felt that there is a strong and urgent need for action on the part of the several stakeholders. The recommendations for action below have been classified into actionable for different stakeholders.

5.2.1 Recommendations for Tax reforms:

5.2.2.1 Proposed ICDS on lease transactions may be implemented:

We have discussed a proposed "income computation and disclosure standard" (ICDS) in case of lease transactions, which sought to lay clear rules as regards taxation of lease transactions. It sought to provide that in case of financial leases, it is the lessee who will claim depreciation, and in case of an operating lease, it will be the lessor. Given the fact that the accounting standards have a possible scope for a synthetic structure where the same lease transaction is treated as financial lease by one party and an operating lease by another, the proposed ICDS also intended to plug any such confusion, by requiring both the parties to affirm that both have characterized the lease transaction alike. However, that proposed ICDS has not been implemented. In the interest of encouraging a leasing industry and the potential it holds for growth of the MSME sector, the CBDT could consider notifying the ICDS on lease transactions.

5.2.2.2 Use of leasing as a tax shelter may be curbed by appropriate tax provisions:

We have noted above that lease transactions may be used as a tax shelter; even a few cases where the leasing transactions is misused, creates issues overall for the industry and scepticism with regulators and tax officials.

Several countries have tried to tackle this issue by introducing a provision in their tax laws, to provide that where the net result of computation of income out of leasing business is a loss, such loss will not be allowed to be set off against income from other unconnected businesses. Singapore is one of such countries. In our view, insertion of provision such as this, could potentially prevent the use of leasing purely for generating tax shelters, while adequately protecting the interest of leasing entities.

5.2.2.3 Changes in the GST law

Currently, financial leases are charged to GST, whereas the interest component of loan is not subject to GST. There are Supreme Court rulings to suggest that financial leases are akin to a loan . Considering that in substance there is no difference between a loan and a financial lease, the tax treatment of the transactions should be similar.

In case of hire purchase transactions as well, the Supreme Court has held that the intent of hire purchase financing transactions is mere financing, and has rejected the applicability of any sales-tax in such transactions .

It is recommended that necessary changes must be made in the existing regime to bring financial leases at parity with loan transactions and therefore having same tax implications from GST perspective.

Currently, the rate of GST on leases rentals is equal to the rate of GST levied on normal sales/purchase of the same asset. A lessor pays GST upfront at the time of purchase of the asset; given the fact that the output of the lessor is spread over a period of time (in form of lease rentals), it takes long time for the lessor to actually absorb the GST paid on the input against the GST payable on the output. A lessor progressively increasing leasing volumes will continue to have a bulging carried-over unabsorbed ITC. Thus, leasing is effectively not tax-neutral. Since the objective may be to promote leasing as a mode of funding for MSMEs, there is a strong justification for a lower rate of tax on lease rentals compared to tax on sale of the asset. Globally, "Leasing" is being promoted as an important tool for capital formation. India too is making huge investments towards capital formation, be they for the infrastructure sector, manufacturing sector-including MSMEs, or the farm sector.

5.2.2.4 Stamp duty problems on lease of fixtures needs to be resolved:

The issue whether a fixture such as a machine or a plant, affixed for the purpose of its proper use, either by creating a civic structure, or otherwise, has been quite contentious from several viewpoints. Stamp duty is one of them. There are quite often leases of properties which may be fixtures - such as telecom towers, furnaces, pipelines, etc. The intent of fixing them to land or on structures is because that is how these assets may be used. If such assets are treated as immovable property, it creates a very unprofitable situation where stamp duty, close to about 5% or more of the value of the asset itself, may have to be paid. Stamp duty is not an offsettable expense – it, therefore, becomes a sunk cost.

Once again, stamp duty is a State law and several states have their own stamp laws, or, in any case, made state-amendments to the Indian Stamp Act. However, it is recommended that the Government may issue notification to affirm that a property shall not be treated as immoveable property merely by virtue of its annexation with any other immoveable property and shall be treated as moveable property, provided such property is provided on lease and the terms of the lease agreement provide for removal of such property by the lessor on termination of the lease.

5.2.2 Regulatory reforms

5.2.2.1.Concessions and exemptions in case of imported items need to be extended to lease transactions as well

There are several benefits and concessions applicable under Foreign Trade Policy in case of imported assets, or to promote exports. These include the Export Promotion (Capital Goods) Scheme (EPCG), duty concessions or exemptions in case of units located in SEZs, EPZs, etc. these benefits are based on use of a capital asset for the purpose of making exports, or being used in an SEZ, EPZ, etc. Since the benefits are obviously linked with the use of the asset, these benefits could also be considered to be allows in case of leased assets. Most of the leases of capital goods related to imported assets, and in many such cases, the importer/lessee may be exporting goods or services, and thus, be eligible to import under EPCG concession. In the Foreign Trade Policy for 2015, the provision for allowing the benefit of EPCG in case of lease transactions was deleted and could be considered for re-insertion.

5.2.2.2 Permissibility of cross border operating lease transactions needs to be clear

While financial leases are explicitly covered in the master circular pertaining to external commercial borrowings[44], it is not clear whether cross border operating lease transactions are permitted as per extant foreign exchange regulations. There may be reasons to argue that a cross-border operating lease transaction is not a "capital account transaction" and hence, may be permitted as a rental expense. A clarification in this regard could be helpful, particularly to ease the acquisition of certain equipment on a lease basis from overseas sources that may either be unavailable in India.

5.2.2.3 Micro finance companies could to be permitted to undertake leasing

Microfinance companies are a separate class of NBFCs. They are regulated by a separate set of regulatory guidelines[45] applicable to them. As per the guidelines, an MFI has to hold at 85% of its assets in form of "qualifying loans". Such loans do not include leased assets. Since the admitted purpose of microfinance is to finance income-generation opportunities, microfinance is often extended against small value capital assets such as sewing machines, auto rickshaws, etc. Leasing could potentially provide a good avenue for MFIs to increase the financing options to microenterprises, as it could provide the MFI with better access to the asset, and also the option to lend at cheaper rates.

[44] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10153&Mode=0

[45] https://rbi.org.in/scripts/NotificationUser.aspx?Id=6857&Mode=0#234

5.2.2.4 Extension of registration requirements for financial and operating leases

We have noted elsewhere that the provisions for the SARFAESI Act were amended to include financial leases in the definition of "financial asset", "security interest", etc. Since the SARFAESI Act provisions for mandatory registration of security interests[46] are not yet enforced, registration of financial leases is not a statutory requirement. As and when the said amendments are effective, registration of financial leases will take place with the integrated registry under the SARFAESI Act.

However, there is no registration requirement in case of operating leases.

We are currently in an environment of transparency and traceability of financial transactions; the concept of information utilities is one of the key institutional components under the Insolvency and Bankruptcy Code as well. Under this scenario, registration of both financial and operating leases will increase integrity and transparency of information.

We have compared the international scenario for registration of lease transactions under laws dealing with credit registry. We find that several countries currently require registration of leases. Annexure 5.1: provides the list of various countries requiring registration of lease transactions with credit registry.

Registration of lease transactions will improve the security of equipment title with the lessor, and will serve as a public notice of ownership to any potential buyer of the asset.

While extending these requirements to operating leases, there may be an exception for short-tenure leases, say, upto a term of 12 months, so that pure rental contracts do not get covered by the requirement.

5.2.3 Financing of MSMEs

5.2.3.1 Extending subsidies to leased assets

There are several capital investment subsidy schemes, targeted to promote MSMEs in specific states, based on the level of industrial development in the state or region. Most of these grant a subsidy, as a percentage of investment in capital equipment. There is potential to extend the subsidy to equipment acquired on a lease basis, particularly if it is financial lease.

5.2.3.2 Priority sector lending benefits could to be extended to leasing transactions

As a part of financial inclusion drive, banks are required to ensure that their priority sector lending (PSL) is at least 40% of their adjusted net bank credit. The sectors which qualify for the PSL benefit include loans to MSMEs as well. As per the existing language of the Master Circular of Priority Sector Lending[47], the RBI refers to "loans" to MSMEs. Since leasing is accepted as one of the permissible modes of financing by banks lease finance to MSMEs and other underserved groups such as farmers etc. could also potentially be considered for inclusion under PSL.

[46] Chapter IVA consisting of sections 26B to 26E.

[47] https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9857

5.2.4 Advocacy and interface between lessors and MSMEs

5.2.4.1 The need for an industry forum

The need for an industry body championing, advocating and protecting the interests of the leasing industry is well realized all over the world. Most countries have leasing associations, and there are global federations of such national associations as well. The two industry bodies that could be encouraged to play a significant role in advocacy and promotion of the leasing industry are the Association of Leasing and Financial Services Cos., and the Finance Industry Development Council. This will be a critical requirement to grow the leasing industry in India.

This includes organizing frequent meets, industry events or forums, including lender-borrower meets, where leasing players may get to interact with the potential borrowers.

5.2.4.2 MSME chambers need to take up the cause for alternative financing

The relevance of leasing and factoring as alternative financing tools has been noted by global bodies such as European Central Bank. The representative bodies for MSMEs in India, particularly chambers representing small business could play a critical role in bringing their members on a common platform to discuss the potential use of leasing and factoring for MSMEs.

5.2.4.3 Vendor engagement and residual value plays

Success of operating leasing has an important element – residual value positions. The most obvious stakeholder who can create secondary market in their assets and help leasing players to cushion residual value risk is the vendor. A vendor adds to the strength of his statement about the value of his asset by standing by its residual value. There is a potential for vendors of standard assets to explore ways in which they can provide residual value protection Potential recommendations in this regard include:

- A proactive effort by a strong industry forum to create a platform for a dialogue between vendors of standard equipment (such as packaging machines) and lessors, whereby the former structures some form of residual value assurance to the lessors.
- There are entities taking up synthetic positions on asset values by providing a put option on assets such as IT equipment. Leasing players need to sensitize dealers in second-hand equipment to take up residual value positions by agreeing to forward contracts or options in standard equipment.
- IT-enabled platforms for transactions in off-lease assets provide liquidity as well as better price discovery. Leasing players need to encourage such platforms.

Snapshot of recommendations

Table 8: Snapshot of recommendations

Activity	Concerned authority/ body	Likely resistance	Priority
Inclusion of financial leases in "financial services" under GST and exemption for interest component of financial leases from GST	GST Council, Central Board of Excise and Customs Ministry of Finance	Low	Very high
Reduction of rate of GST on lease rentals	GST Council, Central Board of Excise and Customs Ministry of Finance	Moderate	Very high
Creation of a forum for leasing entities	Leasing industry	Unlikely	Very high
Interface between leasing players and MSMEs	Chambers representing MSMEs, leasing industry	Unlikely	Very high
Restoration of EPCG benefits in case of leased capital goods	Ministry of Commerce	Unlikely	Very High
Clarificatory amendment in CST Act to provide financial leases are not "deemed sales"	Ministry of Finance	Medium	High
Implementation of ICDS on lease transactions	CBDT	Unlikely	High
Removal or full abatement of service tax on financial leases	Ministry of Finance	Medium	High
Amendment in State laws to clarify, financial leases are not "deemed sale"	Respective state governments	High	High, but not high once GST is implemented,
Micro finance companies may be permitted to offer leases, as a part of qualifying assets	Reserve Bank of India	Low	High

Activity	Concerned authority/ body	Likely resistance	Priority
Benefit of priority sector treatment to be available in case of leases, if the lessee is an MSME	Reserve Bank of India	Unlikely	High
Vendor engagement in residual value protection on leased assets	Leasing industry, leading vendors	Unlikely	High
Provision in Stamp Act to say, leased assets not to be treated as immovable property, even though fixed during the term of lease	Ministry of Finance/ Law Ministry	Medium	Medium
Insertion of an income-tax provision to restrict the tax benefits out of lease transactions to income out of leasing only	CBDT	Unlikely	Medium
Subsidies or benefits for new industrial units in certain areas/ sectors need to be extended to leased assets also	State governments	Medium	Medium
Technology platform for trades in off-lease assets	Leasing industry, dealers in second-hand assets	Unlikely	Medium
Permitting residual value insurance	IRDA	Medium	Medium
Clarification about operating leases on cross border basis, that rental payments constitute a current account expense	Reserve Bank of India	Medium	Low-medium

ANNEXURES

Annexure 1.1:

Important developments in the field of leasing

Year	Positive development	Negative development
1973	Incorporation of first leasing company in India	-
1981	-	Leases considered deemed sale u/s 266(29A) of the Constitution
1983	IFC's proposed investments in leasing companies in India	-
1995	Guidance note on leasing issued by ICAI	-
1996	-	Several states imposed sales tax on lease transactions
1996	-	CRB scam causing collapse of several leasing companies
1997	Prudential norms for leasing companies issued by RBI	-
2001	Accounting standard on leases issued by ICAI	Service tax issued on lease transactions
2004	Introduction of VAT allowing set off of sales tax paid on lease transactions	-
2006	Rebate of service tax on 90% of interest in case of financial leases/ hire-purchase	-
2017	Introduction of Goods and Services Tax replacing the existing indirect tax regime and subsuming different taxes (including CST, VAT and service tax) into a comprehensive tax structure.	

Annexure 1.2:

Difference between Finance Lease, Operating Lease and Hire Purchase

Particulars		Financial lease	Operating lease	Loan	Hire purchase
Legal	Nature of the contract	Renting out the asset	Renting out the asset	Loan of money	Renting out the asset with an option to buy
	Nature of the income	Rental	Rental	Interest +principal	Hire charge = rental
	Ownership	Financier	Financier	Borrower	Financier
	Residual value	Can be client-guaranteed	Cannot be client-guaranteed	Question does not arise	Usually Re 1
Accounting	Books of the finance company	Asset to be treated as current asset	Asset to be treated as fixed asset	Asset to be treated as current asset	Asset to be treated as current asset
	Book depreciation (finance company)	Not to be charged	To be charged	Question does not arise	Not to be charged
	Books of the client	Asset to be capitalized; liability to be recorded	Off the balance sheet	Asset to be capitalized; liability to be recorded	Asset to be capitalized; liability to be recorded
	Book depreciation (client)	To be charged	Not to be charged	To be charged	To be charged

Particulars		Financial lease	Operating lease	Loan	Hire purchase
Income tax	Income-tax (financier)	Rentals taxable. Depreciation claimable	Rentals taxable. Depreciation claimable	Interest taxable. No depreciation	Interest taxable. No depreciation
	Income-tax (client)	Rentals tax deductible; depreciation not claimable	Rentals tax deductible; depreciation not claimable	Interest tax deductible; depreciation claimable	Interest tax deductible; depreciation claimable
Financial regulations	Capital requirements	Regular capital requirements	Basel II capital requirements distinguish between asset risk and lessee risk	Regular capital requirements	Regular capital requirements
	Financial entity regulation	Applicable	Not applicable	Applicable	Applicable
	Concentration norms	Applicable	Not Applicable	Applicable	Applicable
	Provisioning requirement	Applicable	Not Applicable	Applicable	Applicable

Annexure 3.1:

Country wise Leasing Volumes

Ranking	Country	Annual volume leasing (US$ bn)	% Market penetration
1	US	336.95	22.0
2	China (People's Republic)	114.85	3.4
3	UK	78.16	28.6
4	Germany	68.19	16.4
5	Japan	55.85	8.9
6	Australia	35.27	40.0
7	France	31.86	13.1
8	Canada	30.89	31.0
9	Sweden	18.94	22.7
10	Italy	17.78	11.7
11	Russia	16.42	NA
12	Switzerland	13.05	12.0
13	Poland	12.23	15.7
14	Korea	11.11	9.8
15	Taiwan	9.45	8.3

Annexure 3.2:

Comparative study of legal, regulatory and leasing globally

Factors	India	USA	UK	China	Australia	Sri Lanka
1 Taxation						
1.1 Direct Taxes						
Governing law	Income Tax Act, 1961[48]	Revenue procedure 2001-28 of Internal Revenue Service (IRS)[49]	Capital Allowances Act, 2001[50]	Inland Revenue Ordinance[51]	Income Tax Act 1997[52]	Inland Revenue Act[53]
Determining factor	Tax treatment depends on whether the transaction is operating lease or financial lease.	Tax treatment of lease depends on whether the lease is a true (operating lease) or non-true lease (financial lease).	The tax treatment of lease depends on whether it long funding lease or a non-long funding lease.	The legal form of the transaction determines the treatment of a lease transaction.	Tax treatment of the leases depends whether the lease is a genuine lease (operating lease) or a non-genuine lease (financial lease).	Tax treatment of lease depends on whether the lease is a true (operating lease) or non-true lease (financial lease).
Depreciation/ Capital allowance	Operating lease – Lessor claims the depreciation	True lease – Lessor claims the depreciation	Non-long funding lease – Lessor claims the capital allowance	Operating leases are mostly not prevalent. If the lease qualifies as a lease, lessor claims depreciation.	Genuine lease – Lessor claims the depreciation	True lease – Lessor claims the depreciation
	Financial lease – Lessee claims the depreciation	Non-true lease – Lessee claims the depreciation	Long funding lease – Lessee claims the capital allowance		Non-genuine lease – Lessee claims the depreciation	Non-true lease – Lessee claims the depreciation

48 http://www.incometaxindia.gov.in/pages/acts/income-tax-act.aspx

49 https://www.irs.gov/pub/irs-irbs/irb01-28.pdf

50 http://www.legislation.gov.uk/ukpga/2001/2/section/1

51 http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CURALLENGDOC*112*100*112.1

52 https://www.comlaw.gov.au/Series/C2004A05138

53 http://www.ird.gov.lk/en/publications/Income%20Tax_Documents/IR_Act_No_10[E]_2006_(Consolidation_2014).pdf

Factors	India	USA	UK	China	Australia	Sri Lanka
1 Taxation						
1.1 Direct Taxes						
Taxability of income and allowance of expenses	Operating lease – Lease rentals paid are allowable expenses for the lessee	True lease – Lease rentals paid are allowable expenses for the lessee	Non-long funding lease – Lease rentals paid are allowable expenses for the lessee	Lease rentals paid are allowable expenses for the lessee – Lease rentals received are taxable income for the lessor	Non-genuine lease – Lease rentals paid are allowable expenses for the lessee	True lease – Lease rentals paid are allowable expenses for the lessee
	Lease rentals received are taxable income for the lessor	Lease rentals received are taxable income for the lessor	Lease rentals received are taxable income for the lessor	Interest component of the lease rentals paid are treated as taxable income	Lease rentals received are taxable income for the lessor	Lease rentals received are taxable income for the lessor
	Finance lease – Interest component of lease rentals paid are allowed as expenses for the lessee	Non true lease – Interest component of lease rentals paid are allowed as expenses for the lessee	Long funding lease – Interest component of lease rentals paid are allowed as expenses for the lessee		Genuine lease – Interest component of lease rentals paid are allowed as expenses for the lessee	Non-true lease – Interest component of lease rentals paid are allowed as expenses for the lessee
	Interest component of the lease rentals paid are treated as taxable income	Interest component of the lease rentals paid are treated as taxable income	Interest component of the lease rentals paid are treated as taxable income		Interest component of the lease rentals paid are treated as taxable income	Interest component of the lease rentals paid are treated as taxable income

Factors	India	USA	UK	China	Australia	Sri Lanka
1 Taxation						
1.2 Indirect taxes						
Sales tax & Service Tax	Lease is considered to be supply of services. There is no distinction between financial leases and operating leases tax treatment	True lease – Lease rentals paid are allowable expenses for the lessee	Leases are subject to VAT Act, 1994[54]	Financial lease is not subject to VAT[55]	Leases are subject to GST as per GST Act, 1999[56]	Leases are subject to tax as per the VAT Act, 2002.[57]
Sales tax & Service Tax	If inter-state transaction, then it is subject to Integrated Goods and Services Tax	No VAT for financial lease transactions	Where end of the lease term, it is established that the lessee will become the owner of the asset, then the lease is considered to be sale of goods and subject to VAT, else is regard as a supply of service subject to service	Financial lease is not subject to VAT[55]	Leases are subject to GST as per GST Act, 1999[56]	Leases are subject to tax as per the VAT Act, 2002.[57]
Sales tax & Service Tax	If intra-state transaction, then it is subject Central Goods and Services Tax and State Goods and Services Tax	No VAT for financial lease transactions	Where end of the lease term, it is established that the lessee will become the owner of the asset, then the lease is considered to be sale of goods and subject to VAT, else is regard as a supply of service subject to service	Financial lease is not subject to VAT[55]	Leases are subject to GST as per GST Act, 1999[56]	Leases are subject to tax as per the VAT Act, 2002.[57]

[54] https://www.gov.uk/guidance/rates-of-vat-on-different-goods-and-services

[55] http://www.chinatax.gov.cn/2013/n2925/n2956/c310105/content.html

[56] https://www.ato.gov.au/Business/GST/In-detail/Rules-for-specific-transactions/Agent,-consignment-and-progressive-transactions/Hire-purchase,-leasing-and-GST/

[57] http://www.ird.gov.lk/en/publications/Value%20Added%20Tax_Acts/VAT_Act_No_14[E]_2002_(Consolidation_2014).pdf

Factors	India	USA	UK	China	Australia	Sri Lanka
2 Accounting						
Governing accounting standard	AS 19[58] (now Ind AS 17[59])	ASC 840[60]	Section 20 of FRS 102[61]	ASBES 21[62]	AASB 117 (adopts IAS 17)[63]	LKAS – 17[64]
2.1 Treatment of financial leases						
Asset recognition	Lessor – Recognizes lease rentals as receivables	Lessor – Recognizes lease rentals as receivables	Lessor – Recognizes lease rentals as receivables	Lessor – Recognizes lease rentals as receivables	Lessor – Recognizes lease rentals as receivables	Lessor – Recognizes lease rentals as receivables at an amount equal to net investment in the lease.
	Lessee – Fixed asset recognized at lower of fair value or PV of lease payments whichever is lower	Lessee – Fixed asset recognized at lower of fair value or PV of lease payments whichever is lower	Lessee – Fixed asset recognized at lower of fair value or PV of lease payments whichever is lower	Lessee – Fixed asset recognized at lower of fair value or PV of lease payments whichever is lower	Lessee – Fixed asset recognized at lower of fair value or PV of lease payments whichever is lower	Lessee – Finance leases shall be recognised as an asset and liability at lower of fair value or present value of the minimum lease payments at the inception of the lease.

[58] http://resource.cdn.icai.org/27285asb-as-19.pdf

[59] http://resource.cdn.icai.org/23706IndAS-17.pdf

[60] http://www.iasplus.com/en-us/standards/fasb/broad-transactions/asc840

[61] https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-appli-(1).pdf

[62] http://www.asianlii.org/cn/legis/cen/laws/asfen21l443/

[63] http://www.aasb.gov.au/admin/file/content105/c9/AASB117_08-15.pdf

[64] http://www.casrilanka.com/casl/images/stories/content/publications/publications/accounting_standards/sri_lanka_accounting_standards_2011_bound_volume/18.20lkas_2017-leases.pdf

Factors	India	USA	UK	China	Australia	Sri Lanka
2 Accounting						
2.1 Treatment of financial leases						
Depreciation	Lessee	Lessee	Lessee	Lessee	Lessee	Lessee
Treatment of lease rentals	Lessor apportions the lease payments towards principal and interest income	Lessor apportions the lease payment towards interest income and deduction of net investment.	Lessor apportions the lease payments between principal and finance income	The Lessor shall recognize the financing incomes for subsequent periods on the basis of the revised net investment in the lease and the recalculated implicit interest rate.	Lessor apportions the lease payments between principal and finance income	Lessor apportions finance income between the principal and finance income.
	Lessee apportions the lease payments between finance charge and reduction of outstanding liability.	Lessee apportions the lease payments between the finance charge and reduction of outstanding liability.	Lessee apportions the lease payments between the finance charge and reduction of outstanding liability using the effective interest method.		Lessee apportions the lease payments between the finance charge and reduction of outstanding liability.	Lessee apportions the lease payments between the finance charge and reduction of outstanding liability.

Factors	India	USA	UK	China	Australia	Sri Lanka
2 Accounting						
2.2 Operating leases						
Asset recognition	Lessee – No treatment	Lessee – No treatment	Lessee – No treatment	Lessee – No treatment	Lessee – No treatment	Lessee – No treatment
	Lessor – To be recognised as fixed asset	Lessor – To be recognised as fixed asset	Lessor – To be recognised as fixed asset	Lessor – To be recognised as fixed asset	Lessor – To be recognised as fixed asset	Lessor – To be recognised as fixed asset.
Depreciation	Lessor	Lessor	Lessor	Lessor	Lessor	Lessor
Treatment of lease rentals	Lessor spreads the income over the lease term	Lessor spreads the income over the lease term	Lessor spreads the income over the lease term	Lessor spreads the income over the lease term	Lessor spreads the income over the lease term	Lessor spread the income over the lease term on a straight-line basis.
	The lessee takes the lease rentals as expenses in the books	The lessee takes the lease rentals as expenses in the books	The lessee takes the lease rentals as expenses in the books[65]	The lessee takes the lease rentals as expenses in the books	The lessee takes the lease rentals as expenses in the books	Lessee takes the lease rentals as expenses in the books on a straight line basis over the lease term.

[65] FRS 102 provides two situations where operating lease charges paid are not allowed to spread over the lease term other than the treatment provided in IAS 17 – a) if there is a method of systematically spreading the rentals other than over the lease terms and b) if there is an inflation in the value of the asset compensating the lessor on account of the rentals over the lease term.

Factors	India	USA	UK	China	Australia	Sri Lanka
3 Legal framework						
Specific laws	RBI governs financial leasing by NBFCs	There are no specific law pertaining to leases	There are no specific law pertaining to leasing	MOFCOM Decree No. 5. for establishment of foreign investment leasing companies[66]	NA	Regulated via the Finance Leasing Act (FLA), No. 56 of 2000[67], with Central Bank of Sri Lanka acting as its regulator. However, operating leases are not regulated under this statute.
Other legal issues	The agreements are generally governed by the provisions of Indian Contract Act, 1872.	The arrangements are covered by Article No. 2A of the Uniform Commercial Code.	The contracts will be governed by the following general laws: a. Consumer Credit Act 1974; b. Unfair Contract Terms Act 1977; c. Contracts (Right of Third Parties) Act 1999	Contract Law of the People's Republic of China[69]	NA	The arrangements will be governed by the following general laws – a. Roman Dutch Law - Common law of Srilanka b. Land (Restriction on Alienation) Act No. 38 of 2014.70 c. Rent Act
		The provisions in the Article No 2A are divided into 5 parts which provides various aspects covered in the leasing contracts[68]		Under Contract Law of China: Chapter XIII and Chapter XIV deals with leasing contracts and financial leasing contracts.		

[68] https://www.law.cornell.edu/ucc/2A/

[69] http://www.wipo.int/edocs/lexdocs/laws/en/cn/cn137en.pdf

[70] http://www.ird.gov.lk/en/publications/Acts_Land%20Tax/Land_Act_No._38(E).pdf

Factors	India	USA	UK	China	Australia	Sri Lanka
3 Legal framework						
Stamp duty	For the purpose of stamp duty, leases in India mostly refers to immovable property.	No stamp duty on leases.	No stamp duty on lease of moveable property.	Duty @ 0.01% of the leasing fees or 1 Yaun whichever is higher[71]	NA	Stamp Duty[72] is charged on lease or hire of any property at the rate of Rs 10 for every thousand rupees or part thereof provided the lease term exceeds twenty years. However, certain lease transactions are exempted from stamp duty. The exemption[73] pertaining to stamp duty are as follows:

[71] http://english.mofcom.gov.cn/article/lawsdata/chineselaw/200211/20021100053711.shtml

[72] http://www.ird.gov.lk/en/Type%20of%20Taxes/SitePages/StampDuty.aspx?menuid=1207

[73] http://www.ird.gov.lk/en/Type%20of%20Taxes/Stamp%20Duty_Acts/SDActNo.12[E]2006ConsolFinal.pdf

Factors	India	USA	UK	China	Australia	Sri Lanka
3 Legal framework						
						• Any Instrument relating to any finance lease executed in respect of any property other than finance lease in respect of motor vehicles used for travelling. • Any instrument relating to lease or rent of any building where such lease or rent payment does not exceed Rs. 5000 per month.

Annexure 4.1

Computation showing the post-tax cost of leasing and borrowing options

Table 9: Comparing the post-tax cost of a lease and loan

Comparing the post-tax cost of a loan versus lease							
cost of the asset	1000						
residual value	300						
Loan IRR	12.50%						
Lease IRR	12.50%						
Tax depreciation rate	15%						
Tenure of lease/loan	4						
Annual Loan payments	₹ 270.40						
Annual Lease rentals	₹ 270.40						
Discounting rate for NPV of tax benefits	8%						
	Post-tax cashflows	**Pre-tax cashflows**					
NPV of purchase option	₹ 824.08	₹ 1,000.00					
NPV of lease option	₹ 801.01	₹ 1,000.00					
NPV of differential tax shelter in case of lease	₹ 23.07						
Effective cost of the lease, incorporating tax shelter	11.54%						

Computations									
Year	**Loan cashflows**								
	Loan repayment	ballooon	POS	Interest	principal	deprn	tax shelter	CFBT	CFAT
			1000						
1	₹ 270.40		₹ 854.60	125	₹ 145.40	150	82.5	₹ 270.40	₹ 187.90
2	₹ 270.40		₹ 691.03	106.8255578	₹ 163.57	127.5	70.29766734	₹ 270.40	₹ 200.10
3	₹ 270.40		₹ 507.02	86.37931034	₹ 184.02	108.375	58.4262931	₹ 270.40	₹ 211.97
4	₹ 270.40	₹ 300.00	₹ 300.00	63.37728195	₹ 207.02	92.11875	46.64880958	₹ 570.40	₹ 523.75
5						78.3009375	23.49028125	₹ 0.00	₹ -23.49
6						66.55579688	19.96673906	₹ 0.00	₹ -19.97
7						56.57242734	16.9717282	₹ 0.00	₹ -16.97
8						48.08656324	14.42596897	₹ 0.00	₹ -14.43
9						40.87357876	12.26207363	₹ 0.00	₹ -12.26
10						34.74254194	10.42276258	₹ 0.00	₹ -10.42
11						29.53116065	8.859348195	₹ 0.00	₹ -8.86
12						25.10148655	7.530445966	₹ 0.00	₹ -7.53
13						21.33626357	6.400879071	₹ 0.00	₹ -6.40
14						18.13582403	5.44074721	₹ 0.00	₹ -5.44
15						15.41545043	4.624635129	₹ 0.00	₹ -4.62
16						13.10313287	3.93093986	₹ 0.00	₹ -3.93
17						11.13766294	3.341298881	₹ 0.00	₹ -3.34

	Lease cashflows						Diff in tax shelters
	rentals	RV	deprn	tax shelter	CFBT	CFAT	
	₹ 270.40			81.11866126	₹ 270.40	₹ 189.28	-1.381338742
	₹ 270.40			81.11866126	₹ 270.40	₹ 189.28	10.82099391
	₹ 270.40			81.11866126	₹ 270.40	₹ 189.28	22.69236815
	₹ 270.40	300	45	94.61866126	₹ 570.40	₹ 475.78	47.96985167
	0		38.25	11.475	₹ 0.00	₹ -11.48	-12.01528125
			32.5125	9.75375	₹ 0.00	₹ -9.75	-10.21298906
			27.635625	8.2906875	₹ 0.00	₹ -8.29	-8.681040703
			23.49028125	7.047084375	₹ 0.00	₹ -7.05	-7.378884598
			19.96673906	5.990021719	₹ 0.00	₹ -5.99	-6.272051908
			16.9717282	5.091518461	₹ 0.00	₹ -5.09	-5.331244122
			14.42596897	4.327790692	₹ 0.00	₹ -4.33	-4.531557504
			12.26207363	3.678622088	₹ 0.00	₹ -3.68	-3.851823878
			10.42276258	3.126828775	₹ 0.00	₹ -3.13	-3.274050296
			8.859348195	2.657804459	₹ 0.00	₹ -2.66	-2.782942752
			7.530445966	2.25913379	₹ 0.00	₹ -2.26	-2.365501339
			6.400879071	1.920263721	₹ 0.00	₹ -1.92	-2.010676138
			5.44074721	1.632224163	₹ 0.00	₹ -1.63	-1.709074717

Computations										
Year	**Loan cashflows**									
	Loan repayment	ballooon	POS	Interest	principal	deprn	tax shelter	CFBT	CFAT	
18						9.467013495	2.840104049	₹ 0.00	₹ -2.84	
19						8.046961471	2.414088441	₹ 0.00	₹ -2.41	
20						6.83991725	2.051975175	₹ 0.00	₹ -2.05	
21						5.813929663	1.744178899	₹ 0.00	₹ -1.74	
22						4.941840213	1.482552064	₹ 0.00	₹ -1.48	
23						4.200564181	1.260169254	₹ 0.00	₹ -1.26	
24						3.570479554	1.071143866	₹ 0.00	₹ -1.07	
25						3.034907621	0.910472286	₹ 0.00	₹ -0.91	
26						2.579671478	0.773901443	₹ 0.00	₹ -0.77	

Notes on the computation:

i. The computation has been done to take two similarly structured lease and loan transactions – so, while there is a residual value in case of a lease, we have assumed a balloon payment in case of a loan as well, so as to equalise the annual payments in case of both. We have also equated the pre-tax Internal Rate of Returns (IRRs) of both, so as to focus only on the tax efficiency of the lease.

ii. We have assumed, once again for creating parity of comparison, that the lessee actually acquires the asset, at the end of the lease tenure, for the residual value.

iii. We have stretched depreciation computation for 25+ years. Based on the block system of depreciation in India, it takes an infinite number of years to fully write off the cost of an individual asset. We have taken 26 years in the computation above, which makes the remaining value, beyond 26 years, too nominal to have

	Lease cashflows						**Diff in tax shelters**
	rentals	RV	deprn	tax shelter	CFBT	CFAT	
			4.624635129	1.387390539	₹ 0.00	₹ -1.39	-1.45271351
			3.93093986	1.179281958	₹ 0.00	₹ -1.18	-1.234806483
			3.341298881	1.002389664	₹ 0.00	₹ -1.00	-1.049585511
			2.840104049	0.852031215	₹ 0.00	₹ -0.85	-0.892147684
			2.414088441	0.724226532	₹ 0.00	₹ -0.72	-0.758325532
			2.051975175	0.615592553	₹ 0.00	₹ -0.62	-0.644576702
			1.744178899	0.52325367	₹ 0.00	₹ -0.52	-0.547890197
			1.482552064	0.444765619	₹ 0.00	₹ -0.44	-0.465706667
			1.260169254	0.378050776	₹ 0.00	₹ -0.38	-0.395850667

Annexure 4.2

Summarises the responses received from the Respondents

Table 10: Summary of the MSME Interview

	High	Moderate	Low
Companies willing to try financial products other than loan	●		
Companies aware of Leasing as a financial product		●	
Companies using Leasing as a financial product			●
Following were the responses of the companies not aware of Leasing:			
• Willingness to learn about it	●		
• Importance of ownership of assets		●	
• Knowledge about leasing entities in India			●
• Willing to consider leasing if approached by a leasing entity	●		
Following were the responses of the Companies aware of Leasing:			
• Difference between financial and operating lease		●	
• Dominance of financial lease	●		
• Ease of Documentation		●	
• Preference to Loan over Leasing		●	

Source: VKC analysis

Annexure 4.3

Questions posed to Sample Population

Sl. No.	Question	Total	Yes	No	Both
1.	Preference to borrowed funds than to owned funds	63	26	26	11
2.	Companies willing to try products other than Loans or owned funds	57	53	4	
3.	Awareness on leasing	63	34	29	
4.	Companies using Leasing	34	10	24	
5.	Awareness with respect to diff between op lease and fin lease	34	16	18	
6.	Awareness about leasing entities in India	48	13	25	
7.	Willingness to be educated about leasing	57	53	4	
8.	Preference to ownership of assets to renting	45	13	22	
9.	Ease for documentation	10	4	6	
10.	If an NBFC had to approach you for a lease arrangement -- would you like to consider?	44	30	14	

Annexure 4.4

Detailed list of respondents

No.	Region	Nature of Business	Awareness on Leasing
1	Gujarat	Manufacture of Ceramics	Yes
2	Andhra Pradesh	Infrastructure Company	Yes
3	Andhra Pradesh	Construction Company	Yes
4	Rajasthan	Manufacturing of Garments	No
5	Madhya Pradesh	Online Selling	No
6	Karnataka	Manufacturing of Electronic Components	No
7	West Bengal	Mining Contractor	Yes
8	New Delhi	Advertising and Event	No
9	Gujarat	Construction Business	Yes
10	Maharashtra	Infrastructure Company	Yes
11	Maharashtra	Land Development	No
12	Maharashtra	Land Development	No
13	Maharashtra	Manufacturing Garments	No
14	Maharashtra	Manufacturing of packaging material	No
15	West Bengal	Printing and Packaging	No
16	West Bengal	Manufacturing of CFL and LEDs	Yes
17	West Bengal	Material handling in steel plant	Yes
18	West Bengal	Manufacturing of Engineering products and catalytic converters	Yes
19	West Bengal	Xerox and photocopy	No
20	West Bengal	Printing and Packaging	Yes
21	West Bengal	Import, Value Addition & Distribution and Service Support	Yes

No.	Region	Nature of Business	Awareness on Leasing
22	West Bengal	Manufacturing of cotton tapes	Yes
23	West Bengal	Diagnostic Centre	Yes
24	Maharashtra	Manufacturing Company	No
25	Maharashtra	Manufacturing Company	No
26	Maharashtra	Manufacturing Company	No
27	Maharashtra	Manufacturing Company	No
28	Maharashtra	Manufacturing Company	No
29	Maharashtra	Manufacturing Company	Yes
30	Maharashtra	Architecture Company	No
31	Maharashtra	Service Provider	Yes
32	Maharashtra	Service Provider	Yes
33	Maharashtra	Service Provider	Yes
34	Maharashtra	Service Provider	No
35	Karnataka	Manufacturing Company	No
36	Karnataka	Construction Company	No
37	West Bengal	Manufacturing Company	No
38	West Bengal	Service Provider	Yes
39	West Bengal	Manufacturing Company	No
40	West Bengal	Manufacturing Company	No
41	West Bengal	Manufacturing Company	Yes
42	West Bengal	Manufacturing Company	No

No.	Region	Nature of Business	Awareness on Leasing
43	West Bengal	Manufacturing Company	Yes
44	West Bengal	Servicing Company	No
45	West Bengal	Construction Company	No
46	West Bengal	Construction Company	Yes
47	West Bengal	Construction Company	No
48	West Bengal	Manufacturing Company	No
49	West Bengal	Manufacturing Company	No
50	Rajasthan	Manufacturing Company	No
51	West Bengal	Construction Company	No
52	West Bengal	Manufacturing Company	No
53	West Bengal	Manufacturing Company	No
54	West Bengal	Manufacturing Company	No
55	West Bengal	Construction Company	No
56	West Bengal	Construction Company	No
57	Punjab	Manufacturing Company	Yes
58	Punjab	Manufacturing Company	Yes
59	West Bengal	Manufacturing Company	Yes
60	Assam	Construction Company	No
61	Assam	Construction Company	No
62	West Bengal	Manufacturing Company	No
63	West Bengal	Manufacturing Company	No

Annexure 5.1
Registration requirements for leases in selected countries

S.No.	Country	Whether information pertaining to financial lease is required to be filed	Governing laws/Acts	Governing Regulation for filing of information pertaining to security interest in financial lease	Governing regulation for inclusion of financial lease in the scope of 'security interest'
1	United states of America	Yes	The Uniform Commercial code	Article 9-501 read with 9-505 of the UCC	Article 9-501 lays down the requirement for filing information pertaining to security interests Article 9-505 lays down the requirement for filing details pertaining to leases, consignments, bailments and other transactions. Article 9-505 uses the term "leases", therefore, even true leases are required to be registered.
2	Canada	Yes	Personal Property Security Act (PPSA), 1990[74]	Section 42(1) and section 45 of the PPSA. Section 42(1) discusses about the power of the central registrar to prescribe manner of registration of financial statements. Section 45 of the Act prescribes for the registration of the financial statement with the registrar and contents of the financial statement.	The definition of the term "security interest" as per section 1 states the following: "security interest" means an interest in personal property that secures payment or performance of an obligation, and includes, whether or not the interest secures payment or performance of an obligation, (a) the interest of a transferee of an account or chattel paper, and (b) the interest of a lessor of goods under a lease for a term of more than one year; ("sûreté")

[74] https://www.ontario.ca/laws/statute/90p10

S.No.	Country	Whether information pertaining to financial lease is required to be filed	Governing laws/Acts	Governing Regulation for filing of information pertaining to security interest in financial lease	Governing regulation for inclusion of financial lease in the scope of 'security interest'
3	New Zealand	Yes	The New Zealand Personal Property Security Act (PPSA), 1999[75]	Sec 140 and 141 of the PPSA deals with the registration of the financing statement and the data required to register the financial statement with the registries respectively.	Section 17 of the Personal Property Security Act, 1999 defines the term "security interest" to include, among others, a lease for a term of more than 1 year.
4	Australia	Yes	Personal Property Securities Act (PPSA), 2009[76] The governing body is Australian Financial Security Authority	Section 150 of the PPSA requires registration to register a finance statement with respect to the security interest. Section 153 deals with the manner of submission of the financial statements to the registries.	The definition of security interest under section 12 of the PPSA includes interest in goods created for the purpose of securing payment or obligations under, among others, lease of goods, irrespective of the nature of the lease.
5	Zambia	Yes	The Movable Property Security Interest Act, 2016	Sections 12 and 13 requires registration of financial statements. The governing agency is the Patents and the Companies Registration Agency.[77]	The definition of the term "security interest", as per section 2, includes right under financial as well as operating leases.

[75] http://www.legislation.govt.nz/act/public/1999/0126/60.0/whole.html#DLM47161

[76] http://www8.austlii.edu.au/cgi-bin/viewdb/au/legis/cth/consol_act/ppsa2009356/

[77] https://www.bakermckenzie.com/en/insight/publications/2017/01/zambia-new-registration-system/

S.No.	Country	Whether information pertaining to financial lease is required to be filed	Governing laws/Acts	Governing Regulation for filing of information pertaining to security interest in financial lease	Governing regulation for inclusion of financial lease in the scope of 'security interest'
6	India	Partly yes	1. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI Act) 2. Master Directions - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016[78] (Master Directions – NBFC SI) 3. Master Directions - Non-Banking Financial Company – Non Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016[79] (Master Directions – NBFC Non SI)	Section 23 of the Act requires registration of security interests created in favour of "secured creditors". Secured creditors have been defined in section of 2(zd) of the SARFAESI Act and not all financial institutions are covered under it. The Act was amended to include sections 26B to 26E dealing with registration of security interests by entities other than the secured creditors. However, the said sections have not been notified yet. Para 105 of the Master Directions for NBFC-SI requires registration of all mortgages created in favour of NBFC-SIs. Para 92 of the Master Directions for NBFC-Non SI requires registration of all mortgages created in favour of NBFC-Non SIs.	The term "security interest" under section 2 of the SARFAESI Act involves interest property created under financial leases. The Act is however applicable only to few class of financial institutions. NBFCs other than those specified under SARFAESI Act do not have to comply with the provisions of the Act. NBFCs, other than those covered under SARFAESI Act, have to register only mortgages created in their favour.

[78] https://rbidocs.rbi.org.in/rdocs/notification/

[79] http://rbidocs.rbi.org.in/rdocs/notification/PDFs/MD44NSIND2E910DD1FBBB471D8CB2E6F4F424F8FF.PDF PDFs/45MD01092016B52D6E12D49F411DB63F67F2344A4E09.PDF

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