The Application of Leasing
Within the Small and Medium Enterprises Sector

*Developed by*
FinBi – Finance & Banking Consultants International

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We should draw the attention to the fact that this study was concluded prior to the acts and actions taken by the newly appointed cabinet on July 12, 2004, which upon formalization, may require amendment of the recommended implementation plans of the study to ensure valid activities responding to the expected changes.

Some of the areas that could affect the structure of the implementation plans of the study such as (1) the consolidation of Ministry of Foreign Trade and Ministry of Industry into one Ministry, (2) the creation of the Ministry of Investment, (3) the establishment of agencies under the Ministry of Investment responsible for non-banking financial services that include leasing, mortgage, rating agencies, venture capital, (4) the merging of the Investment Authority and the Companies Department whereby they report to one authority which should significantly simplify the whole process of company registration and hence avoid the presence of more than one body for registration for the same company (5) the clear focus on promoting exports as one of the main priorities with short and long term plans and strategies, (6) the changes at the customs level, where on September 7, the implementation of wide-ranging reductions to customs tariffs signified a whole new game for the Egyptian economy including reduced tariffs, the cancellation of customs fees and streamlining the tariff system; resulted in lowering the average tariff rate on a wide range of items – some 80 percent of which were production inputs – from 14.1 percent to 9 percent, or in some cases canceled altogether. Meanwhile, the number of tariff “bands” was reduced from 27 to six. (7) most significantly for leasing companies is the approval of the new tax law whereby (a) no entities are tax exempted (i.e. companies with current tax exemption will continue with their exemption till expiration, then they will no longer be subject to exemption), (b) tax reduction from 42% to 20%. While the tax incentives provided to leasing companies were more attractive, the ease of tax administration under the new law is also an important and significant change for these companies.

We also should not ignore the possible effect of the current development on the financial sector, where President Mubarak gave the official green light for a five-year plan preparing public banks for privatization. This is in addition to the merging of some of the small banks that do not meet the minimum capital requirement stated in the Banking Law. The government has also announced that the shares of public banks in private banks will be liquidated; hence there will be no public presence in any of the private banks. The implementation of this movement has already started its actions where the third quarter of the current year witnessed the merging and acquisition of several banks such as National Development Bank by the Commercial International Bank, MI Bank by Societe General, Bank du Caire and Misr Bank and the privatization of Bank of Alexandria.

It is expected that once all these changes are effective, some will have an impact on the activities included in the action plan for this study. Some of the changes/laws proposed could have a positive impact as with the tax reductions for example, where these will be to the advantage of SMEs that did not enjoy any tax exemptions, while there is also the possible negative impact of the absence of tax exemptions on companies that used to enjoy these exemptions such as the leasing companies.
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EXECUTIVE SUMMARY

Small and medium enterprises represent a crucially important sector of economic activity in Egypt. The Small, Medium and Micro Enterprise Policy Development Project (SMEPoL) has been developed in collaboration between the Government of Egypt, represented by the Ministry of Finance (MoF), the Canadian International Development Agency (CIDA) and International Development Research Centre (IDRC) to support Egypt’s transition towards a market economy by assisting the Government to improve the policy environment for Micro, Small and Medium Enterprises (M/SME) development.

A variety of M/SME support programs have been in place for some years with support from government, NGOs and donor agencies. The overall policy environment in Egypt remains complex but new or renewed M/SME policies are seen to be vital to support the employment challenges facing Egypt over the coming years.

The purpose of the project is to support the leadership of MoF in the development of M/SME policies, legislation and regulations. The overall impact of the project will be an improved M/SME policy environment resulting in reduced financial and non-financial constraints and increased opportunities for M/SME development.

SMEPoL supports MOF to develop specific policies and legislation for implementation by the Ministry and others at the same time as it works to strengthen the internal capacities of staff through training and technical assistance. The project also supports research to provide the Ministry and other stakeholders with better information on M/SME issues and will promote networking between the Ministry and other stakeholders within and outside government.

MOF is currently on its way to establish a favorable policy environment necessary for the development of M/SMEs in Egypt. In 2004, the Ministry of Finance published “Enhancing Competitiveness for SMEs in Egypt: General Framework and Action Plan”. This document was endorsed by former Prime Minister Dr. Atef Ebeid and H.E. Prime Minister Dr. Ahmed Nazif. This document constitutes a frame of reference for all SME stakeholders, governmental and non-governmental in the development of sound SME policies and programs with an objective to create a competitive SME sector in Egypt.

The objective of this particular study is to examine the existing constraints on leasing as a means of increasing finance for M/SMEs and allow for the utilization of this important financing instrument to better serve the real needs of SMEs. It is also proposed to develop an action plan that will allow for the implementation of leasing within the SME segment taking into consideration the experience of other countries and similar economies. The study first focused on explaining the definition of leasing and its different types. Leasing can be defined as a medium term funding facility in the form of an agreement by contract between a lessor and a lessee upon which the latter is entitled to use the lessor's asset in return for regular payments for a fixed period of time. At the end of the leasing period, the lessee has the right to buy the equipment. The main types of leasing are classified as financial lease; which is the most common form of leasing where it finances the eventual ownership of the asset after the completion of all the lease payments, operating lease, where the lessee pays for the terminal use of the asset through installments and the asset is returned to the lessor at the end of the contract period, hire purchase, where the ownership of the asset
gradually passes to the lessee with each lease payment, **leverage leasing**; where the lessor arranges to borrow part of the required funds from a third party lender, generally giving the lenders first mortgage on the asset, and finally **sale and lease back**; where the lessee sells the asset to the lessor and then leases it back to provide liquidity.

It was very important to view the international experience in SME leasing that incorporates and responds to the needs of the SME segment. Different models were developed in this regard; where some of them achieved favorable results as in the experience of Pakistan and Canada and others were not very successful and faced a number of problems as in the case of Ukraine and Bangladesh. Lessons learnt from these experiences have been taken into consideration to allow for the development of a successful model designed in light of the specific characteristics and different natures of emerging economies.

The study then moved to the local (Egyptian) market. The economy of the country and the status of the financial market were examined thoroughly to identify areas of strengths and weaknesses that should allow for the development of a realistic and workable action plan for the leasing model. Despite the fact that the economic status in Egypt is going through an unstable phase due to both internal and external causes; however it should be highlighted that the government started to take serious attempts to overcome this phase and improve the current status. This had its effect on the level of investment that has decreased noticeably during the last few years. As for the domestic investment, it is increasing at a very conservative rate reflecting the local investors' uncertainty regarding the economic environment within which they have to make their investment decisions. The new banking law could be of assistance regarding the growth of the leasing industry in light of encouraging new forms of investment but certain areas such as limiting the ceiling and form of investment should be further investigated.

It was very important to identify the real and main problems of the SME segment prior to the start of any corrective action. SME problems were clustered into financial problems that basically reflect the limited access of this segment to finance due to the fact that they lack collaterals and/or have no track record while non financial problems that are mainly represented in constraints on the inputs needed by SMEs, limited information and technology, low competitive advantage, informal sector and regulatory constraints imposed, limited managerial and accounting skills, declining demand on SME products, missing middle syndrome and poor marketing channels. It is within this context that leasing appeared as an effective tool participating in solving the problem of limited access to finance. The concept of leasing is highly related to the notion that profits are earned through the use rather than the ownership of the asset. The key impact of leasing in developing countries is to increase source of capital from an external source and leave the SMEs’ own sources to be consumed in other productive uses.

It was also necessary to carefully examine the leasing industry in the country to provide essential information about the market that is crucial for the development of a workable model. The analysis proved that the leasing business culture in Egypt is still in need for further development at large and particularly on the level of SME leasing. The number of actively operating leasing companies in the country is less than 10% of the total registered leasing companies. Among these companies, only one company is directed to SME leasing. Interviews with leasing companies and SMEs revealed high
levels of lack of awareness of leasing as a financial product in the SME client sample as well as low levels of knowledge on the side of the leasing companies with regards to the nature of the SME sector. This is in addition to a number of constraints that were articulated by the leasing companies that negatively impact the participation of these companies with the SME sector. Among these constraints are the; unfavorable macroeconomic conditions of the country, deficiencies in the legal and regulatory environment in the leasing business, lack of credibility of market information, difficulty in the client investigation procedures and difficulty of some leasing companies in accessing capital and their need for a guaranteeing tool to cover for the associated risk with SME leasing. Despite these constraints, there is a good potential for the development of the leasing market in Egypt and encouraging leasing as a tool of finance for SMEs. Accordingly it was very important to develop a plan that takes into consideration all these issues as well as tackling the impediments and obstacles that could hinder the application of the recommended model of leasing and SMEs.

The study in its final part focused on the development of this action plan that is mainly based on developing the SME sector and the supportive business environment, development of the leasing business market in Egypt, and the development of the SME/leasing business environment. Activities of the action plan have taken into consideration the latest actions by the government in announcing the SME law that emphasized on expanding the role of the SFD to include more responsibilities towards SMEs. Accordingly, some of the responsibilities of the SME oriented activities were delegated to the SFD in coordination with other involved parties such as banks, NGOs and Credit Guarantee Companies.
STUDY BACKGROUND AND METHODOLOGY

The primary goal of the Leasing study is to submit a plan that allows for the application of the leasing mechanism within the SME sector in Egypt as a means for increasing finance to SMEs. This was developed in three phases, where the final study was concluded on July 2004:

**Phase I**  
Assessment report  
Assess the involved markets in this relationship; i.e. the Leasing industry and the SMEs market in Egypt. The assessment focused on explaining the nature and the types of lease finance and the SME characteristics, as well as examining the international experience in this regard. The assessment report highlighted the different obstacles and problems at the levels of SMEs and the leasing industry. It also examined other countries' experiences in overcoming these obstacles and problems. The assessment report expressed explicitly that the targeted relationship between SMEs and leasing companies already exists in Egypt; however, it is in need of further promotion and establishment to increase the number of effective leasing participants. The report examined thoroughly the possible obstacles expected when applying leasing to the SME sector, and presented different recommendations to allow for developing this relationship. The report also highlighted the importance of understanding that SME leasing could be only applicable to small and medium businesses, excluding the micro.

**Phase II**  
Analysis of the assessment outputs to determine the components of the action plan and the different objectives and methodologies used to achieve these objectives.

**Phase III**  
The development of a realistic and workable action plan that reflects the outputs of the different meetings and roundtables, as well as the outcomes of the analysis and examinations of different documents, and experiences of other countries with similar economic characteristics.

**Methodology used in developing the subject study was as follows:**

- The core of the research was built on the assumption that M/SMEs access to finance could be enhanced if a suitable leasing model is developed. It was our role to examine this assumption and develop the suitable implementation and action plan for this. The team developed different questions to address this assumption, with a clear focus on the relationship between Leasing business and increasing access to finance for M/SMEs.

- Throughout the study, the team tried to answer the pre-developed questions that resulted in presenting a comprehensive analysis of the current Leasing business, its add-on value to the M/SMEs, and its participation in developing M/SMEs.

- Different documents were reviewed that included periodical materials and journals by international institutions. Different references regarding the types and mechanisms of Leasing were also reviewed, presenting the literature part of the
research. The literature part was examined with the practical side of leasing business to ensure the conceptualization of the theoretical parts into practical forms. A workable and feasible base of this study was presented throughout the study.

- Examination of the international experience and best practices was an integral part of this research that allowed for the development of a suitable and workable model based on other experiences. A sample of Leasing companies presenting different countries that are geographically diversified was selected. The team ensured the incorporation of companies in developing countries with similar economic characteristics.

- Reviewing the current laws and regulations governing the Leasing industry in Egypt by a specialized legal advisor was an integral part of this study. A presentation of these laws and regulations, their effectiveness, obstacles, applicability on M/SMEs and recommendations was already included in the study.

- Different sets of interviews took place for more than once with the same groups to ensure the accuracy of information collected and analyzed. A list of these interviews is attached (attachment 1). Leasing companies were interviewed whether operating or not. Questionnaires were developed to allow for a scientific analysis of the outcomes (attachment 2). Interviews with the target group (Small and Medium businesses) took place in the form of a round table, where we ensured the existence of a diversified group to cover different sectors of the economy. Interviews with different financial and international institutions, as well as the governmental bodies were also part of this interview process to ensure the involvement of all stakeholders.
CHAPTER ONE: OVERVIEWS

1. M/SME OVERVIEW

Governments throughout the world are turning their attention to Micro, Small and Medium Enterprises M/SMEs. This follows on their realization that attempts to promote economic progress by establishing large industries have usually failed to improve the lot of the majority of the population, and M/SMEs are now viewed as an important element in economic development. Moreover, the recent concern for the problems of employment creation, income-generating job opportunities and income distribution, specifically in developing and less-developed countries, has stimulated interest in the role of M/SMEs.

The awareness in the international and national communities of the important role and potentiality of M/SMEs in fostering socioeconomic development in developing countries is increasing. Changing perceptions about state, market, and society are having a substantial impact on the political economy of development and putting more emphasis on the role of M/SMEs, where this segment is currently seen as the most important alternative source of employment creation in the future.

In many developing countries the market is characterized by a severe shortage of a large number of commodities and the trend towards production in small units using labor intensive processes. M/SMEs, in this context, satisfy local needs and can react swiftly to the market requirements. Policies need to be designed in a way that supports this role and provides solutions to the possible drawbacks or problems resulting from them.

Governments in these countries are concerned that M/SMEs development should coincide with, and contribute to, the objectives of national development. Local entrepreneurs will start and develop their business ventures largely outside the framework of these kinds of government incentives. So long as the economic environment is appropriate, successful small business will make their due contribution. Governments should endeavor to increase the chances of success for those entrepreneurs by introducing well-planned and effectively integrated systems of assistance rather than by directing them into particular types of business activities.

Serious attempts started by most of the governments, particularly in the developing countries, to specify the main problems of this sector and try to overcome them to allow this segment to play its expected role. Financing SMEs is one of the major issues faced by the governments of developing countries. Financing, in general, is either in the form of equity or debt finance. Currently, the majority of the SME sector operates through debt financing, which is borrowed money either from banks or any other financial institution. The lender expects to get paid back over a specific period of time. A business would be considered attractive to the lender if it has good credit history and projections indicating enough cash flow to repay the loan and sufficient collaterals. Nowadays many businesses do not fulfill the conditions required to obtain a loan due to the fact that their capital may be largely human capital rather than monetary capital (e.g. software firm, internet-based commerce, etc.) or unconventional forms of capital (e.g. manufacturing prototypes of a new machine, etc.). Such forms of capital are difficult to inspect, and virtually impossible to seize, if the circumstances
dictate such actions. Hence, the Leasing product would then be an attractive tool of finance.

2. LEASING OVERVIEW

Leasing can be defined as a set of property relations, where one party (lessor) provides assets for use by another party (lessee), for a definite period and in exchange for payment. More specifically, Leasing is a medium-term funding facility in the form of an agreement by contract between a 'lessor' and a 'lessee', upon which the latter is entitled to use the lessor's asset in return for regular payments to him/her for a fixed period of time. At the end of the Leasing period, the lessee has the right to buy the equipment. The lessee is usually allowed to deduct the cost of lease rentals from taxable income (trading expense)\(^1\).

A. Historical Background

Leasing has been an existent phenomenon in the developed world for many years; however, it has only penetrated into the developing spectrum in the latter half of the twentieth century. Transactions of this nature can be traced back thousands of years ago. However, it has only developed a legal framework 40 years ago. In the days of the industrial revolution, mass producers began leasing type schemes as a marketing tool that helped them sell more of their manufactured goods. With the approach of the 20\(^{th}\) century, producers had the resources to finance the production of the assets; however, their clients were short on finance for payment. This is in addition to the fact that the majority of the clients did not qualify for the bank financing. The producers were then left to pass their products in return for deferred payments with a markup to cover their cost of capital. This idea of deferred payments enabled producers to increase the number of clients, volume of output, and gain significant competitive advantage in the market.

With the increase in the number of deals, this selling technique broke into a separate type of business and Leasing developed into a specialized financial service. In 1952, the first independent leasing company in the United States was founded, "United States Leasing Corp". The Company was originally established to administer one specific lease. Soon, the founder realized that Leasing had a lot of undiscovered capabilities. The industry then extended to Europe in the 1960s, and spread to developing countries since the mid 70s. By the year 1994, Leasing had been established in 80 countries including 50 developing countries.

Leasing in developing countries has grown enormously from a USD15 billion to a USD44 billion industry, between the years of 1994 and 1998. Leasing as shares in the private investment context has more than doubled in developing nations during this time period. South Korea has demonstrated the most growth in this scenario, opening a leasing market in 1975 and becoming the fifth largest Leasing Market in the world by 1994. Leasing has increasingly improved itself to be one of the only suitable forms of medium to long term financing for the purchase of capital available in developing countries. It is more suitable to developing nations' SME markets due to their weak collateral laws, and the fact that the funds cannot be diverted for other efforts. Overall, Leasing in these nations provides financial sector linearization and stabilization\(^2\).

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\(^1\) Leasing in Ukraine – Manual by IFC Ukraine Leasing Advisory Project
\(^2\) IFC and the Leasing Sector
Figure 1 indicates the trend that has been taking place in the world leasing volumes within the period from 1978-2001. There has been an evident increase in the leasing industry throughout this period, with the exception of several drops during the years 1993 and 1995.

![Fig (1) – World Leasing Volume](image1)

Source: London Financial Group, Global Leasing Report

Fig (2) – Percentage of World Market Volume by Region

![Fig (2) – Percentage of World Market Volume by Region](image2)

Source: London Financial Group, Global Leasing Report

It is clear from Figure 2 that the region of North America enclosing the US includes, by far, the world's largest leasing volume. However, in 2001, the US; the largest leasing market, has suffered a downstream in the leasing volume for the first time since nine years. This downstream had its effect on the global leasing drop, where the leasing volume of the top 50 ranked countries was calculated to be USD476.55 bn in 2001, after being USD498.95 bn in 2000.

Despite the global drop that took place in the leasing volumes, Egypt and South Africa both recorded impressive growth rates of 88.2% - which was the world's strongest growth rate in 2001 - and 25.4%, respectively. South Africa remains the largest leasing market in Africa with an annual leasing volume of USD2.79 bn².

² Recession Hits the World Leasing Markets* - Global Leasing Report

³ Source: London Financial Group, Global Leasing Report
B. Leasing Business Components

1. Macroeconomic Conditions

The Macroeconomic conditions are among the vital tools for nourishing the leasing business. This dictates the presence of fiscal and price stability, undistorted prices of capital and foreign exchange, competitive markets and availability of medium term local currency finance. The most important macroeconomic condition for leasing companies is foreign exchange convertibility. Some of the Leasing transactions may require importing capital equipment, where clients do not want to bear the risk of leases dominated in dollars. Therefore, leasing companies need foreign exchange convertibility, in order to import equipment from abroad and, hence, dominate leases in local currency4.

2. Operating Structure

The operating structure of the Leasing business defines the different types and forms of Leasing available, the relationship between the lessees and the lessors highlighting the advantages of leasing to each party as well as the disadvantages of the Leasing business; the risks affecting the Leasing business; including both general risks, and specific risks associated with the Leasing industry and its components.

➢ Types of leasing

A lease is negotiated, often on tailor-made terms, with the lessor who acquires the asset, which has been chosen by the lessee. The unique feature of Leasing is that it enables the lessee to use assets by making payments out of revenue. Office equipment (including photocopiers and fax machines), furniture, cars and commercial vehicles, computers, machine tools, laboratory equipment and contractors' plant are likely candidates for leasing. There are five forms of lease that include: Financial leases, operating leases, hire purchase, leverage Leasing, and Sale and Lease Back.

a. Financial Lease

Financial leasing is the most common form of leasing. Through financial leasing, businesses can finance the eventual ownership of equipment, unless they have not fulfilled all payments of the contract period. During the leasing period, the lessee should make periodical payments, which consist of the principle amount plus interest representing the return on investment. The amount and the structure of the payments are tailored between the lessee and the leasing company to reach a pattern that is compatible with both. The payments over the fixed time frame, eventually, should cover the cost of the asset itself, and at the end of the contract the lessee can purchase the asset for a nominal value.

Unlike the case with banks, lessors place less emphasis on security beyond the leased asset itself; in other words, Leasing does not require tedious financial records or collateral provisions. Leasing finances fixed assets for a business and deletes the probability of funds diversion, rather than working capital that would be sold off by the business. Therefore, it ensures long term use. In this type of lease, the lessee does not have the right to terminate the contract before the end of the lease period.

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4 World Leasing Yearbook 2003
b. Operating Lease

In the case of operating lease (also called leasehold), the lessee does not finance equipment purchase, but pays for a terminal use and maintenance of the asset again by installment amounts (not adding it to their balance sheets), and since these are short term leases, the lessor will seek to, successively, loan out his/her asset. In other words, the lessee makes leasing payments over the whole leasing period against the rights to use the leasing asset. Upon expiry of the leasing period, the leasing asset is returned back to the leasing company or, if the parties agree on the price, it may be purchased by the lessee. The tenure of the operating lease contract is designed as such to be terminated prior to the full depreciation of the asset.

The leasing company may then lease out such an asset for several times, therefore, the leasing payments are lower than in the case of financial leasing, because the lessee does not pay full value of the asset, but just the part of its depreciation.

c. Hire Purchase

Hire purchase, sometimes called Lease Purchase, is very similar to a financial lease in terms of operation. Payments are made at an agreed rate and for an agreed duration, but the important difference is that ownership of the asset gradually passes to the customer with each lease payment. This method of leasing also entails handing over the ownership of the asset in question, yet the ownership is directly transferred at the end of the agreed upon payment period. For the slightly higher risk to the hirer, the costs are somewhat higher.

This type of leasing is most commonly found in the retail sector with smaller scale assets. In the tax context, the customer, once a lease is started, is the owner, who can claim capital allowance5.

d. Leverage Leasing

Leverage leasing has almost the same set up as the previous types of leasing. However, it entails three parties where the lessor arranges to borrow part of the required funds (third party lender), generally giving the lenders a first mortgage on the asset. The lessor still receives the full amount of the investment tax credit, the tax shelter associated with accelerated depreciation and deduction on the interest paid to lenders.

e. Sale and Lease Back

A sale and lease back takes place when a company sells an asset it owns to another firm and immediately leases it back. The advantage of this type of leasing is that the lessee receives cash from the sale of the asset and the lessee makes periodic payments, thereby retaining use of the asset6.

➢ Relationships: Lessees and Lessors

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5 Finance and Leasing Association
6 Corporate Finance, Second edition
Advantages of leasing to lessees:

- The lessee does not need to include the leased asset in its accounting records and disclose it in the balance sheet. Very often leasing is called non-balance sheet leasing, as there are neither entries in the asset, nor the liabilities side of the balance sheet. In such a case, the client does not have to calculate the depreciation for the asset, which simplifies its financial accounting. The only expenses appearing on the lessee’s profit and loss account are leasing expenses.
- Fairly often, the companies have limited money resources and they cannot pay a large amount for the selected asset at once. In such a case, leasing is more helpful, as it does not require a large amount of money, and additional resources may be invested in other projects.
- In case of using operating lease, the lessee has the opportunity to avoid the risk connected with physical outdating of the asset, because, upon expiry of the lease period, the asset does not remain at the client’s property and the price, for which this asset will be sold, is fixed already before entering the transaction.
- Operating lease is more beneficial than other types of financing, also in situations, when the asset is necessary only for the execution of some specific project, or for a certain period of time. In such a case, the company neither needs to purchase it for being its property, nor takes steps for selling it after the end of the project.
- Leasing is important for rapidly growing companies, which need to realize several projects at once. As the payment schedule is clear when the contract is concluded, it is possible to forecast precise expenditures in the future.
- Leasing provides a hedge against inflation, as the use of the asset is obtained immediately - payments are made out of future funds and are made in fixed money terms, with real costs falling as inflation increases (this is of less benefit at times of low inflation).
- The asset cannot be withdrawn once the contract is signed and its conditions complied with.
- Leasing provides a medium-term source of capital, which may not be available elsewhere.  

Disadvantages of Leasing to lessees:

- It is generally not possible to dispose of the asset before the end of the lease.
- The asset is not owned.
- Funds must be found from the cash flow generation to pay the lease throughout its duration.

Advantages of leasing to lessors:

- The lessor directly purchases the equipment from the supplier or the vendor, once the lessee has settled on the desired equipment. Thus, the lessor is eliminating the probability that the lessor utilizes the funds in other means. This, indirectly, guarantees the payback of the lease installments due to the presence of the source of cash flow generation.
- The leasing companies (lessors) are not "deposit taking" institutions, hence cannot be treated as banks. This allows them higher leverage in comparison to

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7 Leasing to Support Micro and Small Enterprises
other financial institutions, where they are not subject to lending mandates and quotas dictated by the government policies as is the case with banks.

- The lessor, as the owner of the asset, is expected to enjoy a strong security position, where enforcement of asset reposition, in case of non-payment, is simpler.
- The tax advantages that the lessors enjoy, where they have the luxury as the owners of the asset financed to consider the depreciation expense a shield against the taxes realized on the revenues generated from the leasing business. In the case of normal debt finance through loans offered by the banks, banks do not realize this benefit.

➢ **Risks Associated with the Leasing Business**

The leasing business entails a number of risks that can be grouped into two main categories: general risks that are encountered by all business and risks that are associated to the leasing transaction. The general risks include, but are not limited to, the following; political risks, macroeconomic risks, legal risks, and tax risks. As for the **risks that are specific to the leasing transactions**, they include:

i. **Project Risks** – This type of risk is associated with the nature of the project performed by the lessee, in which the leased assets will be used. Most important aspects to be carefully examined are the projects financial solvency, environmental safety, and marketing plan.

ii. Risks related to the leased asset itself – these risks can occur in a number of cases. In the case that the leased asset will be lost, the lessee will refuse to return the leased asset and the lessor will not be able to find a secondary market to sell the asset, if the client defaulted and the asset is returned to the lessor.

iii. **Financial Risks**; – including a) portfolio risks that take place when the portfolio of the lessor is concentrated with one lessee or in one industry; b) interest rate risk that is derived in the case that the pricing of the loan, taken by the lessor to finance a leasing transaction, is a floating interest rate, while the interest rate charged in the structuring of the leasing deal is a constant interest rate. In the case that the floating interest rate increases to exceed the interest rate paid by the lessee, the lessor bears the loss of the difference between the two rates; c) currency risk is valid when the lessor either takes the loan in foreign currency or undergoes the purchase of the equipment in foreign currency, while the leasing transaction is structured in local currency.

iv. **Risk of default of lease payments by the lessee**

3. **Legal Framework**

Both parties of a lease contract, the lessor and the lessee, have the right to benefit from a clear definition of their rights as stated clearly in a legal framework. Lessors, as an example, would benefit from an automatic right of repossession of the asset, in case the lease contract is breached by the lessee. If the repossession process was to take place in a legally and judicially easy manner, leasing companies can then price their lease with a lower risk premium, thus allowing for less cheap credit availability.

4. **Regulations**

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8 Leasing: Legislation, Practical Applications and Prospects
The government should work on encouraging the leasing business, where tight regulations should not be exercised. The reason for this is that the leasing companies, in comparison with banks, do not take deposits from the public and do not participate in central bank-operated money markets. The only advisable control governments should practice on leasing companies concerns some prudential conditions they should respect in their operation. As an example, leasing companies should respect some maximum debt/equity ratios or some minimum capital requirement. They should also operate within the framework of transparent and standardized financial statements.

C. The Significance of Leasing for Economic Development

On the whole, the Leasing sector has proved to have contributed greatly to the economic development of the countries of practice, as it has become a substitute for other types of financing and has been characterized as an additional form of long-term financing. In many countries, Leasing has become an important financial tool, which facilitates financing, especially for small and medium enterprises, and hence, enables them to overcome a lot of obstacles, which may hinder their growth and decrease their reliance on overdraft facilities.

As explained earlier, there are three parties involved in the leasing process, the lessee, the lessor and the vendor (the supplier of the equipment/machinery). For all three parties Leasing has proved to be beneficial. The Leasing mechanism enables the lessee to obtain capital investments in return for scarce financial resources. The leasing mechanism will thus allow the lessee to start production and generate sufficient income enough to pay back the lessor in the form of leasing payments. Leasing companies mainly channel funds into capital investment, and accordingly, they are not hindered by the issue of funds being diverted by borrowers for non-priority uses as is the case with banks and other financial institutions. Moreover, leasing companies are more interested with the lessees’ expected cash flow as opposed to their credit worthiness which may represent a major obstacle that hinders SME financing and accordingly growth and development.

On the other hand, Leasing has contributed to the countries' economies by encouraging the domestic manufacture of machinery through the introduction of vendor leasing schemes. In the case of vendor leasing schemes, the vendor bears the risk of default, and accordingly, the leasing companies have less risks/financial burdens. In other words, the vendor agrees to purchase the lessor's remaining financial interest in the lease as a result of default. The amount of payback paid by the vendor can be as little as 1% of the leasing contract value and as much as 100%. The vendor leasing scheme is more popular in the cases where vendors know that they are minimizing their risk; i.e. when they know the lessee well and they know that they will be up to paying their lease payments, or in the case where the lessee is a very important client and therefore paying back the lessor in case of default will be worthwhile.

D. Why Leasing to M/SMEs?

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9 World Leasing Yearbook 2003
10 What is leasing? The significance of the leasing sector for economic development
11 Vendor Guarantees - IFC
It is important to highlight the increasing focus of the governments, in both developed and developing countries, on the Micro, Small, and Medium Enterprises (M/SMEs) segment, a focus that resulted from the recent realization of the important role of this segment in fostering socioeconomic development. The huge size of this segment in the different economies and the changing perceptions about state, market, and society are having a substantial impact on the political economy of development and putting more emphasis on the role of M/SMEs. Currently, the M/SMEs segment is seen as the most important alternative source of employment creation in the future. Governments started to take serious actions supporting this segment and allowing it to play its potential role. Developed countries were more active in this regard and started from more than 5 decades to provide this segment with serious and organized support and assistance. Some of the developing countries took the lead in supporting this segment of their economies as per South Asian and South Americans countries. It was through these approaches that these countries were able to achieve high development rates and rank high among the other developing countries.

The approach of assisting this segment should start by identifying their problems and try to provide suitable solutions for these problems. Problems of this segment could be clustered in two groups:

**Financial problems**: basically reflect the limited access of this segment to finance due to the fact that they lack collaterals and/or have no track record.

**Non-financial problems**: mainly represented in management, marketing, accounting, and other business aspects of operation.

It is within this context and among governments' attempts of overcoming this segment’s problems; particularly the financial problems, leasing appeared as an effective tool participating in solving the problem of limited access to finance. This potentially resulted from the nature of the Leasing business relevant to the M/SMEs segment characteristics.

The concept of Leasing is highly related to the notion that profits are earned through the use rather than the ownership of the asset. The primary source of repayment in medium to long term lending is through the cash generated by the investment that has been partly financed. The collateral, serving as security for the loan, should be a secondary source of repayment, only in the event that the borrower is unable to pay back from the cash generated by the business operation. Conventional methods of finance through bank loans focus on both ability to generate cash and secondary sources of security through the collaterals. On the contrary, Leasing focuses on the ability of the lessee to generate cash from the leased asset. This would make leasing well suited to SME activities, where they rarely possess credit history or formal financial statements to present to the banks. **The key impact of leasing in developing countries is to increase sources of capital from an external source and leave the SMEs’ own sources to be consumed in other productive uses**.12

**E. Highlights on International Experiences:**

The review of the international leasing market was important to perceive the experiences of different countries, in order to compare the performance of the

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12 IFC and the leasing sector
Egyptian market to other relevant experiences. The incorporation of SMEs in these experiences was included whenever possible. In this review, both developed and developing countries were included. The number of countries reviewed was narrowed down to include Pakistan, Ukraine, Bangladesh and Canada. Despite the recent introduction of the developing countries experience in this industry, yet successful achievements have been made by some of them such as Pakistan. An example, where the market has not yet been fully developed and prepared for the introduction of the leasing product, was evident in the experience of Ukraine, while the involvement of the banks in the leasing service was introduced through the experience of Bangladesh. As for Canada, it is considered to be an example of the developing countries experience with the leasing product, where the government contribution in the support of leasing to SMEs was encountered. In light of the main mechanisms and components of the leasing business, the following experiences have been examined.

1. Pakistan

In 2002, Pakistan has had above average growth in all sectors of its economy except for the manufacturing sector, with its GDP increasing 3.6% and GNP going up 5.4%. The International Monetary Fund (IMF) program’s successful completion has led to a rescheduling of external debt by the IMF and Paris Club creditors. In addition, foreign currency reserves have reached record levels, and with the absence of inflation, the Rupee has appreciated from 67 back to 60 against the dollar. Private sector investment and public sector development have been increasing in funding and size, due partly to the incentives provided by the government; such as, lower custom tariffs, corporate and personal income taxes, high tax depreciation, reduced government-sponsored saving schemes and Central Bank discount rates causing overall interest rates to fall, thus, encouraging spending, and minimizing authorities powers and contact with tax payers in the tax administration. Overall, the Securities Exchange Commission of Pakistan has been pushing to refine corporate governing standards through its Code of Governance.

Leasing Market in Pakistan

The financial market in Pakistan entails 45 local and international commercial banking institutions, and 105 non-bank financial institutions. Banks are allowed to carry out leasing with marked benefits of lower costs in funds, and establish large networks. This is definitely an impediment for leasing companies.

Leasing companies in Pakistan have also been enjoying growth rising to a Rs.22 billion market, 15% higher than in 2001. Between 1995 and 1999, the leasing sector has entertained growth from Rs.9 billion to Rs.29 billion, quite a remarkable feat. As of 2000, Pakistan had a penetration of leasing at 6% of fixed private capital formation, still below most developing countries that have penetration levels of 10-15%.

Equipment and vehicle leasing have been the primary sectors in Pakistan, where leasing activity has flourished (finance leasing), with a 7-8% market penetration, and full tax approval of lease rentals and no delay in transaction dispensation. When referring to equipment, machinery is included and is considered the single most popular form of leasing, followed closely by vehicle leasing, which has
increased from 27% to 37%. A previously absent sector, the real estate sector is also growing in the leasing spectrum.\footnote{World Leasing Yearbook 2003}

**Changes in Regulations**

To minimize entry into the leasing market, the government has established a Rs.200 million-boundary line for entry into the business. The regulators want fewer, better-capitalized leasing providers and companies have of late been marginalizing to this guideline through mergers (horizontally and vertically), and directly increasing their capital through various methods. The SECP is also releasing new regulations for non-bank financiers, with respect to housing finance, venture capital, fund management, and investment guidance. The Leasing Association of Pakistan serves as an intermediary between the government and the market, with 38 member companies as of 2002.\footnote{International Conference on Small and Micro Leasing}

**Funding**

Bonds have become the major source of medium term funds for leasing companies, and listed bonds have been the driving mechanism for growth in this industry. The Swiss government, in addition, is helping Pakistan’s leasing endeavors through its Swiss Agency for Development and Cooperation, which placed its first loan in 1996 and a further loan in 1998 at 17% interest due to good performance. The SDC had the option of liquidating its loans into equity, but has yet to do so in the Pakistani context. Also the Asian Development Bank has provided such assistance.\footnote{World Leasing Yearbook 2003}

**Success Story**

One notable success story in the leasing context of Pakistan is its Network Leasing Corporation (NLC), which was founded in 1995 and is quoted in all of Pakistan’s stock exchanges, exclusively to render support for development of cottage industries and SMEs. Although most shareholders are Pakistani financial institutions and private investors, the NLC also maintains Dutch FMO as a shareholder. As of 1999, the NLC has charged a total interest rate of 23-25% to its clients with insurance inclusive, and a deposit of 10% of the asset value and two personal guarantors (these guarantees are seldom called but provide good repayment pressures).

The NLC handled the Pakistani market in a number of ingenious ways to ensure success, for example, through the use of post-dated checks (rather than the costly process of collecting monthly installments, 36 post-dated checks are written when the lease is made), and the requirement of clients to open or use an existent bank account because of this. NLC leases are also covered by insurance on the client’s life to avoid repossession of the asset if the client dies, and ensure all risks on the leased asset provide residual value insurance, if the reclaimed asset is cheaper than the amounts due by the lease. The NLC does not deal exclusively with new equipment, rather it has learned from the rest of the Pakistani economy that secondhand equipment works just as well (assessed by independent machinery
valuators). In addition the NLC avoids seasonal variation in installment sizes by implementing differing payment patterns for different sectors, and in accordance with the financial health of the country.

The final, but perhaps most important factor for the success of the NLC is its attitude towards management. The NLC does not rely on a hierarchy of managerial skills; rather, it encourages integration and keeping personal motives socially and profiting oriented. The management also makes sure not to portray itself as non-profit oriented (or that it receives its funds through aid), because repayment is a healthy characteristic for both the NLC and the customer16.

Conclusion

Despite the success of the experience of Pakistan in leasing, there is a need to focus on improved governance even in light of the recent SECP guidelines, which are not proving enough, in terms of eliminating entry barriers into the leasing, or indeed the spectrum of microfinance providers itself; such as, connections, concessions, tax evasion, rent seeking behavior, and loan defaults.

The leasing sector itself in Pakistan is defined through high risk, high reward, but this is a wrong approach to the industry. The country should reduce the level of risks and maintain high rewards, which can only be attained through the diversification across sectors (with respect to geographic areas, the size of the enterprise, and the development of new products and invention). Leasing activities need to be extended beyond the urban areas. In light of its Islamic background, rural areas in Pakistan are intensely opposed to paying and receiving interest, which could be a barrier to other microfinance activities, but does not prove to be in the context of leasing. This de-concentration from urban centers will introduce more clients and will reduce risks overall, and will ensure that not only the upper section of the SME sector gets assistance.

Pakistan must also reduce risk through reaching out to the world market through exports. The government of Pakistan has revealed four priority areas for development, agriculture, SMEs, Oil and Gas, and IT. Leasing can most easily be implemented in SMEs, since they entertain a higher capacity for labor assimilation, use domestic resources, and have good repayment records (due to the reasons discussed earlier). The Leasing industry of Pakistan needs to adjust its focus on industrial equipment and vehicles, and must diversify; this diversification will at first provide a higher return in initial stages so entry should be pioneered quickly. There are also too many financial institutions with a weak capital base in terms of technology and human capital; this must be remedied.

2. Ukraine

The current economic situation in Ukraine dictates the necessity for the presence of a leasing market. The banking sector's lack of liquidity and experience in lending to SMEs has resulted in a no-access to capital available to the enterprises. The shortage of long term asset financing negatively affects the competitiveness of even Ukraine's most creditworthy enterprises and thus its overall economic development.

16 Micro and Small Enterprise Leasing – Lessons from Pakistan
Most bank loans are made to medium/large sized borrowers already known to the banks and are heavily collateralized. Moreover, the banking system as a whole is under capitalized, and can be discriminatory, and has not provided new market instruments to replace the collapsed state subsidy system.

**Leasing Market**

Financial leasing is considered a tool of high potential in Ukraine that addresses the problems of many Ukrainian enterprises which do not qualify for bank finance. However, the development of the leasing industry there has been hindered mostly by legal and tax related issues for the lease transactions.

There are market driven factors that negatively influence the potential development of leasing in Ukraine and also create problems for banks and other sources of financing. Most of these factors are related to the lack of macroeconomic stability in terms of inflation and currency devaluation and consequently, higher country risk. This results in high cost of capital, difficulties in long term financial planning, high interest rates and lack of funding sources for lessors. Moreover, lessors experience problems in finding creditworthy lessees that can generate high enough returns to qualify for financing on a cash flow basis.

**Legal Framework**

Ukraine is also suffering from insufficiency of its civil court system leading to an increase in the risks associated with the lessor. This is represented in the slow and expensive legal proceeds and lack of transparency. This makes it more difficult for local lessors to raise long term lower cost funds from foreign capital markets, as well as drives away foreign lessors from entering the Ukrainian market.

**Tax and Accounting**

Another important factor hindering the development of the leasing business in Ukraine is the outdated depreciation policies, where the major benefit of the leasing models are the tax benefits associated with the depreciation of the leased asset. Most countries realize that providing flexible accelerated depreciation as an option to enterprises will lead to increased investment, as enterprises will be looking to replace fixed assets more often. The net effect is that tax revenues from increased economic activity, particularly by manufacturers of equipment and other fixed assets, outweighs any tax revenues lost from allowing enterprises to claim more depreciation early in the useful life of an asset\(^{17}\).

**Conclusion**

There is a huge demand for leasing in Ukraine. This strong demand is backed up with pseudo-leasing transactions; such as sale with deferred payments and operating leases with purchase options that lessors developed in response to the impossible tax and legal requirements for financial leasing requirements.

3. **Bangladesh**

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\(^{17}\) Leasing in Ukraine – Manual by IFC Ukraine Leasing Advisory Project
During the period of 2001-2002, the economy of Bangladesh recorded a 4.8% growth in GDP compared to 5.2% in 2000-2001. The domestic and national savings, as percentage of GDP, were 17.91% and 23.18%, respectively. The investment GDP ratio was estimated to be 23.10%, where 16.08% was the contribution of the private sector.

Leasing Market in Bangladesh

The leasing industry recorded an estimated growth rate in 2001-2002 of 25.5% over the previous year. This growth rate is mainly owed to the expansion of the market that resulted in 19 Non Bank Financial Institutions (NBFIs) engaged in leasing operations. With the increase of the number of leasing companies in the market, as well as banks offering leasing services, the market has become more competitive. The growth trend in the country reflects the preference and shift towards lease finance due to faster services, tax benefit and simplified documentation.18

The leasing experience of Bangladesh started through Grameen Bank. The bank started leasing as one of its activities in 1992 in limited areas in Bangladesh; namely Araihazar and Dhaka. The successful results achieved led to the expansion of the experience in other areas. Currently all of the 14 zones covered by the banks branches incorporate leasing in their SME programs. As of October 1996, the leasing program has booked 1951 leases.

The bank managed to maintain a default rate of 7.12% in terms of number and 1.47% in terms of value of lease contracts which is considered in line with the banks SME programs. This is in addition to 18.35% of lease contracts that transferred into asset ownership after the end of the leasing contracts.

The credit procedure followed by the bank simplified the entrance of the leasing model. The bank has opened the leasing program only for second time clients that have previously borrowed from the bank in its SME programs. This would ease up the process of client investigation on the field officers due to the banks prior experience with the borrowers.

Changes in Leasing Rules and Regulations in Bangladesh

- Withdrawal of the initial depreciation on assets and the five year tax holiday for new leasing companies.
- The annual budget for year 2002-2003 has reintroduced the provision of initial depreciation at 25%, in addition to the normal depreciation in the first year, thus enabling the leasing companies to defer tax payments.
- Withdrawal of the tax exemption status of foreign shareholders and foreign lenders of a leasing company in terms dividend and interest income. Thus, remittance of foreign dividend is subject to Bangladesh income tax, as well as interest payable to foreign lending agencies.

Funding Requirements

The tight availability of funds is representing an obstacle in the operation of the leasing companies. The current regulations dictate that the leasing companies maintain
a non interest bearing cash reserve equivalent to 2.5% of public deposits with the central bank, in addition to the companies maintaining 5% of their liabilities in the form of liquid assets.

To meet the funding requirements, the leasing companies can do one of the following:

- Issuance of shares, debentures or bonds
- Procurement of long term credit from banks, insurance companies, or other financial institutions
- Deposits from public institutions or individuals

Conclusion

There is a potential for further growth in the Bangladesh leasing market due to the fact that the percentage of the leased assets, as a percentage of the industrial advances, is low, in comparison to other similar countries in the region. However, the rules and regulations must be adjusted and tailored to accommodate and facilitate for the growth of this market; through the resolution of the obstacles encountered in the tax, depreciation, funding and reserve requirements.

4. Canada

The Canadian economic performance as of the last quarter of 2001 has exceeded expectations, where after recording a growth rate of 1.5% in 2001, a growth rate of 3.5% was recorded in 2002 and the same percentage is expected in 2003. The combination of a strong growth in the employment accompanied by a decrease in the interest rates has satisfied consumer expenditures. In comparison to the US economy, the Canadian economy stands in contrast. This difference is ascribed to the fact that the Canadian economy did not reach as high as the US economy did, and hence, the downturn will not be as deep or prolonged.

Leasing Market in Canada

The current market share of leasing relative to the total industry has remained steady for the past two years estimated to be ranging between 22% and 25%. This steady feature in the penetration of the leasing market is attributed to the consolidation that has taken place by the leasing companies, hence resulting in fewer players in the market. This led to the creation of an increase in the number of large leasing companies. This phenomenon has created a shortage in the leasing services provided to the small and medium clients and more focus on large ticket transactions. This is also coupled with the introduction of chartered banks to the leasing market in Canada, where in 2001 they held 19% of the total leased assets. Therefore, the current leasing industry in Canada is a collection of different companies operating with different business models.

In an attempt by the Canadian government to support the small and medium clients, the government has launched a pilot project, whereby it guarantees small business capital leases. The project commenced in April 2002 with expected duration of five years. The government under this project guarantees up to 85% of the lessors eligible losses on capital leases in the event of default.

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19 Leasing to Support Micro and Small Enterprises
Legal Framework

The legal framework governing the leasing industry in Canada is a grouping of several Canadian laws that are not highly organized together. The reason behind this is that the constitutional structure of the country dictates the presence of federal and provincial laws that affect the leasing industry. On the other hand, the equipment leasing industry bases its legal foundation on the rentals law, as well as the law governing secured transactions. However, the leasing industry addresses issues that are stated in the previously mentioned laws and at the same time tackles other issues that are not included in the governing laws.

Funding

Funding leased transactions in Canada takes place through more than one source. The most common source of funds is through a loan to the lessor secured by a security interest such as the lease receivables or the leased equipment. Another source of funds in case of non recourse transactions can take place through a syndication or participation, where the risk in this case is transferred to the provider of funds. The final source of funding in Canada is through securitization of the lease portfolio receivables. In this case, the lessor would sell its portfolio of leased assets receivables to a special purpose vehicle (SPV).\(^{20}\)

Conclusion

The leasing industry in Canada is considered to be better structured in comparison to the previously tackled experiences. However, its legal framework still lacks the presence of a coherent leasing law addressing the leasing industry with all its needs, in particular, rather than a conglomeration from the state laws. The main feature characterizing the Leasing market in Canada is the support of the Canadian government to the Leasing companies to finance small and medium clients.

F. General Conclusion

After having examined the different experiences of selected developing and developed countries in regard to Leasing activities with all their obstacles and achievements, it becomes easier to discern that successful leasing operations exist in countries with more or less stable economic conditions (particularly with regard to income growth, interest and foreign exchange rates). Sustainable leasing practices were found to exist in sustainable economic environments as opposed to non stable economies.

In several countries, mainly developing countries such as Pakistan and Bangladesh, it was very clear how the government intervention in these countries with several rules and regulations helped sustain and enhance the level of leasing activities (particularly in the case Bangladesh with its modified leasing regulations and tax structures). On the other hand, it was also noticeable in the developed countries' experience (such as Canada) that the intervention of the government to ensure leasing services provision to the SMEs (by introducing pilot projects) was a must as SME's benefits from leasing activities wouldn't have seen any light, should it have only relied on the perfect competition of large leasing companies existing in the Canadian market.

\(^{20}\) World Leasing Yearbook
It is also worth noting that there is a critical importance to *rules and regulations*, which must be set in accordance with the market status of the country. In other words, outlining rules and regulations and accounting and taxations strategies for the leasing market in Pakistan for instance must take into consideration the "Islamization" of the banking and financial practices there, where people may intensely oppose the idea of interest (which may in turn hinder the development of the leasing as well as other financial activities).

In addition to the previously mentioned findings we can also conclude that:

- **Foreign technical partners are largely undesirable.** For instance in the case of Bangladesh, the government took this lesson into consideration when they decided to withdraw the tax exemption of foreign shareholders and foreign lenders of a leasing company in terms of dividend and interest income. This is also highlighted in the successful experience of the Pakistani Network Leasing Corporation with a very limited foreign partner intervention.

- Another lesson to be extracted from the international experience analyzed above is that **portfolios must be managed carefully in a way to achieve balance and avoid concentration by client or sector**. For instance, in the case of the leasing market in Pakistan which mainly focused on specific sectors; namely, equipment and vehicles, analysis showed that sector diversification with regards to leasing activities will be highly favorable and would result in minimizing risks and increasing returns and thus diverting the leasing sector in Pakistan from its high risk-high reward policies. On the other hand, balance should also be realized on the level of the nature of the client and not only the sector. In the case of the leasing market in Canada for example, such imbalance became obvious, where leasing was mainly provided to large companies only as opposed to SMEs, which forced the government to interfere to provide the SMEs with unattained leasing services.

- It has also been noticeable that leasing companies in developing countries such as Pakistan and Bangladesh, for instance, are highly constrained to local currency due to the SME client base. This led many leasing companies to write foreign currency leases to match loans to finance imported capital, so their market only includes exporters.

- Along the several examples studied, it becomes discernable that difficulties in mobilizing financing within a country have proven to be the most serious hindrance to growth. Leasing companies have to be able to mobilize financing resources so as to be able to provide better services. One case observed to facilitate financing by introducing simpler forms of finance and simplifying matters to ensure success of the leasing activities in a specific market is the case of the NLC leasing company of Pakistan. It made finance mobilization a lot smoother by introducing the post-dated checks to facilitate financing to SMEs\(^{21}\).

\(^{21}\) Leasing to Support Micro and Small Enterprises
CHAPTER TWO: LEASING AND SMEs IN EGYPT

1. Analysis of the Economic and Financial Market in Egypt

Introduction

This section will mainly cover the revision and examination of the main actors in our target study as well as the revision of the dominating markets. A review of both the current economic situation in Egypt and the Egyptian financial market is presented to allow for the determination of the needed action to establish and/or promote the leasing industry in Egypt. The SME sector, the banking sector, and the leasing market in Egypt were examined, in details, to allow for the development of a leasing industry taking into consideration real and actual roles expected from each party.

A. Review of the Current Economic Situation of Egypt

Egypt's economic performance and reform program in the 1990's gained recognition and praise during the 1990's from international observers for increasing growth while decreasing inflation and the budget deficit to low single digits.

However, this momentum, due to both internal and external factors has stopped and initiated a slow down trend in the Egyptian economy. The September 11 crisis, the War in Iraq and some internal policies were some of the factors affecting the economic growth of the country, where the main characteristics of the country's main economy22 summarized as follows:

- The GDP has been growing at a decreasing rate since the year ending June 2000 reaching 3.2% growth rate in the year ending June 2002, compared to a growth rate of 5.9% in 2000.

- The private sector has been gradually increasing its contribution to GDP where this contribution has increased from 68.6% in 1996/1997 to 70.1% in 2001/2002, where the main contributors are the industry & mining, trade and the agricultural sectors representing a 68% of the total private sector GDP.


- The external debt remains relatively low, accounting for around 35% of GDP. Furthermore, the bulk of the debt comprises long-term, low-cost bilateral loans; the average interest rate paid on Egypt's external debt over the past five years was just 2.6%.

- The high rate of unemployment that reached 9% in 2002 is a result of insufficient number of jobs created to fulfill the high growth of the labor force.

In Summary, the Egyptian economy has been struck by a wave of predicaments caused by external disturbances or local problems that has caused a general decline in the main economic indicators of the country as a whole. This downturn has inevitably

*Quarterly Economic Digest” Ministry of Foreign Trade, April-June 2003
affected all sectors operating in the economy. However, it should be highlighted that the government is trying to take some steps and actions that should participate in improving the status and enabling a better growth rates. Examples of these actions could be viewed in the government decision of January 28, 2003 to shift from a managed peg system to a free-float that was highly appreciated by the international community and is believed that it reflects a more transparent picture of the economy. Another example is the government steps in organizing and stabilizing the tax system by approving the 2nd and 3rd phase of GST (General Sales Tax) as a final stage before applying the VAT tax. The clearance of the Mortgage Law and the Intellectual Property Rights Law are also examples of the government attempts in activating the different markets and enforcing the international agreements. A third example is witnessed in the different attempts by the government to open more markets and doors with the international market and where the government finally succeeded in concluding the agreement with the EU in April 2003.

The leasing industry is affecting and being affected by the market and in accordance to our previous analysis of the leasing industry and the experience of other countries, it was clear that the economic status and stability has a critical impact on the business growth. This could be easily witnessed in Egypt, where in excess of 100 companies were registered as leasing companies and 93% of them were not working in leasing activities.

B. Review of the Financial Market in Egypt

The financial market in which the leasing business is functioning was also reviewed in light of the leasing business requirements and the international experience to allow for understanding the mechanics and dynamics of this market in relationship with leasing and determine needed changes and/or development to enable a healthy climate for leasing business.

The financial market in Egypt hosts almost all of the financial intermediaries23 as per the general definition. However, it should be noted that the banking sector has a monopoly over the financial sector in Egypt, where it assumes an increasing percentage of the overall budget financing of the government that reached 86% in 2001/2002.

Debt and equity are the broad categories of any financial market. Analyzing them allows for examining the finance market in a comprehensible manner. The equity market will be examined through an assessment of the investments profile in the country as well as trends in the stock market. As for the debt market, it will be analyzed through an overview of debt instruments issued in the capital market as well as another overview of the credit market in Egypt, this will be complemented by analyzing the banking sector in Egypt – the main, if not the sole institution dominating the credit market in Egypt.

Domestic & Foreign Investment

23 Financial intermediaries could be grouped in two broad categories namely: banks and non-bank. The non-bank include various institutions including venture capital companies, leasing companies, factoring companies, pension funds, insurance companies and mutual funds.
From the equity side of financing, gross domestic investment has been increasing at a decreasing rate till the year 1998/1999. In 1999/2000, gross domestic investment was stagnant and actually witnessed a 1% decrease in 2000/2001. The growth rate picked up in 2001/2002 reaching a modest 5% growth rate relative to an aggressive 32% in 1997/1998.

As for foreign direct investment (FDI), and despite an increase of more than 370% in 1998/1999 to reach US$2.01 billion, a decline trend in FDI started in the year 1999/2000 to reach US$0.46 billion by 2001/2002. Moreover, it should be highlighted that Egypt’s FDI is extremely modest compared to FDI flowing to other emerging economies, where the Egyptian share reached 0.4% of the total FDI to all developing countries, compared to China's share of more than 37%, Brazil's Share of 11.7% and Mexico's of 9.3%.

Another indication of the status of equity investment is the decrease in the size of issued capital from almost EGP25 billion in 1999 to almost EGP8.5 billion in 2002.

C. The Banking Sector – Key Financial Institution

In general, the banking sector in Egypt is being operated by 62 banks, classified according to the CBE as commercial banks, business and investment banks and specialized banks. Out of the total of the 62 banks, 28 are classified as commercial banks including the four state-owned banks (National Bank of Egypt, Banque Misr, Banque du Caire and Bank of Alexandria), 31 as business and investment banks, and 3 as specialized banks (the Industrial Development Bank of Egypt, Principal Bank for Development & Agriculture and the Egyptian Arab Real Estate Bank). These operate via a network of 2,561 banking units spread throughout the country.

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26 The Egyptian Real Estate Bank has been merged in the Arab Real Estate Bank in December 1999, according to the CBE decision in 21/6/1999.
Approximately, 80% of the banking sector assets are held by the commercial banks as of June 2002 (EGP 390,537 million out of a total assets base in the banking sector of EGP 495,467 million). However, we should highlight that banks, registered as business and investment banks with the CBE, are currently operating as commercial banks. This means that more than 90% of all Egyptian Banking assets are being "commercially" operated.

As stated above, the Egyptian banking sector is the main, if not the sole provider of credit in Egypt, particularly to the private sector. Lending is the main consumer of the banking industry funds accounting for 54% of total assets balance as of June 2002.

It should be noted that analyzing the loan portfolio of the banking industry indicates that the private sector represents the major share of total bank lending that reached 73% as of June 2002. Almost 36% of the banking industry loan portfolio goes to the industrial sector, followed by 28% to the services sector, and 21% to the trade sector as of June 2002. One of the most important observations regarding the Egyptian banking sector is the focus and interest of banks in short-term lending versus medium or long-term lending. Secured lending consumed 67% from the banks' total portfolio; whereas 33% of all banks lending is granted without any collateral as of June 2001.

The Unified Law of the Central Bank of Egypt, Banking System and the Foreign Exchange has been passed and approved by the government in mid 2003. This law has been passed as part of the government's support and attempt to restructure the financial sector in Egypt and its key players. The law focuses on four main goals²⁷:

- Create the legal infrastructure suitable for the proper functioning of the banking sector and guarantee its independence;
- Adopt the recent international standards set by the World Trade Organization (WTO), which, in turn, increase the competitiveness of the banking sector on a free market basis;
- Set the legal framework necessary for the management of foreign currency sector;

- Reduce contradictions or conflicts between the provisions of different laws that govern the banking sector by providing a unified legislation.

D. Conclusion

The above analysis allows us to subtract certain points and observations that should be considered while developing the leasing industry in Egypt:

- Despite the fact that the economic status in Egypt is going through an unstable phase there are serious attempts by the government to overcome this phase.

- The banking sector is the main entity painting the profile of the financial market in Egypt. To develop the leasing industry in the country, a more positive role of this segment should be considered.

- The new banking law could be of assistance regarding the growth of the leasing industry, in light of encouraging new forms of investment but certain areas; such as, limiting the ceiling and form of investment should be further investigated.

- Both local and foreign investments are decreasing; a fact that has undermined the role of this mechanism as a source of financing, especially for the private sector.

- Domestic investment is increasing at a very conservative rate, reflecting the local investors' uncertainty regarding the economic environment within which they have to make their investment decisions.

2. Review of SMEs in Egypt

The ministerial decree no.1241 for 2004 enabled the issuance of Executive Regulations of the Law on Development of Small and Micro Enterprises Promulgated under law no 141/2004. The law was issued May 29th, 2004 mainly emphasizing on the role of the Social Fund for Development (SFD) with regards only to the Small and Micro Enterprises with no referral to the Medium Sized Enterprises. Also, the law did not address the issue of the SME definition in its executive regulations, which will leave space for many interpretations and definitions for that sector.

A. Definition of M/SMEs

The size of the firm (in terms of number of employees and the magnitude of the investment it represents) is the most commonly used indicator for the type of firm. While the simplicity of this approach makes it attractive, it does not tackle two important aspects of any businesses which; are fixed assets, and sales.

One of the important issues of SMEs in Egypt is the lack of one definition of Micro, Small and Medium businesses. There are more than 27 definitions in the country and each institution, organization or governmental body is using its own definition. For this study we are applying the definition of the Ministry of Finance that focuses on the number of employees, fixed assets and sales, as factors of definition and differentiates between "Manufacturing and Construction Sectors" and "Services and Trade Sectors".

28 (Helming, 1993, p. 24-26).
B. M/SMEs Role in Economic Development

Similar to other developing countries, M/SME development has been gaining the attention of the government as a means of addressing the country’s dramatic unemployment problems as well as a poverty alleviation tool.

There are hundreds of thousands of SMEs throughout Egypt, where in 1998 it was reported that M/SMEs constitute around 99.70% of the private sector, excluding agriculture in Egypt, and produces about 80% of the value added. The M/SME sector is also accredited for 75% of private sector employment29.

For decades this segment suffered serious problems and lack of attention from the government, where the restrictive policies and indifference to their needs contributed to keeping this segment poor and under-developed. The segment was not viewed by the policy makers as an essential component of the economy. The structure of the private sector was not incorporating this segment and the system of the banks could not facilitate provision of credits to SMEs. These, in addition to other factors, were behind the ineffective impact of this segment in the economic development of the country.

However, and during the last two decades, the government started to exert serious effort in developing this segment and currently the M/SMEs receive strong support from the government and it appears on the top of its agenda.

C. Main Characteristics of M/SMEs in Egypt

It has been noticed that the majority of M/SMEs are concentrated in whole sale and retail trade, as well as in the vehicle and maintenance sectors. It is interesting to note that regardless of the concentration of M/SMEs in the above mentioned sectors, the services, trade, finance and transport sectors are the ones experiencing the most significant job growth rates; 60%, 30%, 28% and 28%, respectively, over the period of ten years from 1988 to 1998. It should be mentioned that over the same period of time, 1,848,000 jobs have been created in the services sector, versus 584,000 jobs in the trade sector, 72,000 jobs in the finance sector, and 206,000 jobs in the transport sector30.

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29 Quarterly Economic Digest, April – June 2003, Arab Republic of Egypt, Ministry of Foreign Trade
30 Profile of the M/SME in Egypt, Ministry of Foreign Trade
D. SMEs Geographical Distribution

The majority of the SME density is located in the Delta, followed by Greater Cairo, Upper Egypt, North Coast, Canal and then Sinai. It is also interesting to note that Cairo, being the capital, has been deemed to have the largest number of formation of new small manufacturing firms, 2,221 firms (32.92%) from 1986-1991. This concentration stemmed from the fact that Cairo enjoys relatively better infrastructure than the other cities, and possesses the highest concentration of larger scale companies. It should be noted that Sharkia follows with 1,161 (17.21%) new small manufacturing firms over the same period of time, which could be related to the industrial areas located in Sharkia.31

E. Main Problems of SMEs.

It was very important to identify the real and main problems of this segment prior to the start of any corrective action. Thorough analysis, studies, and surveys were conducted in this regard, with the support of different donor organizations, where the problems of M/SMEs segment were clustered in two main groups: (1) financial problems and (2) non-financial problems. The main problems faced by the segment could be summarized as follows:

- Financial Problems.

Limited access to capital and financial services

One of the main problems facing the development of the M/SME sector is the shortage of collateral required by the banks and/or other financial institutions to acquire loans. Another major problem is the insufficient capacity of the M/SMEs to produce the

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31 Profile of M/SME in Egypt
required financial and operational information and statistics. It should be also mentioned that the M/SMEs lack good negotiation skills to allow them to obtain credit at more advantageous terms.

- **Non Financial Problems**

**Constraints on the inputs needed by M/SMEs**
The factors of production are offered at high costs to the M/SME sector, this problem is augmented with the high costs of tariff and non-tariff barriers.

**Information and Technology**
As all other sectors in the economy, M/SMEs are in constant need of the latest information and advanced technology. However, the M/SME sector faces two main problems; the first is related to the cost and availability of information; and the second is related to the ability of those M/SMEs to absorb and utilize latest information and advanced technology.

**Low Competitive advantage**
The output of the M/SME sector is affected by the lack of internal control systems, as well as a proper system and means to adopt the international specifications. This, in return, affects the quality of the products of the M/SME sector, and its ability to penetrate international markets or at least compete on the value added basis.

**Informal Sector and the regulatory constraints imposed on M/SME activities**
The routine and the paperwork imposed by the government on the M/SME sector lead to the formation of a significant informal sector. This informal sector has similar demand from and supply to the market, but does not fulfill any of the prerequisites and requirements of the formal sector and thus puts the formal M/SME in a disadvantageous position.

**Limited managerial and accounting skills**
The M/SME sector lacks the internal capacity to build proper management and accounting staff. Moreover, the Egyptian economy is still short in providing sufficient and effective institutions that provide this kind of services that would help M/SMEs build the internal capacity required to compete on a value added basis in the local market, as well as penetrate international markets.

**Declining effective demand on M/SME products**
The shrinking size of the market, in addition to the intense competition from the imported products have had a negative effect on the M/SME sector. As a result M/SMEs are cutting down on their wages and labor force. They are also reducing the scale of their operations and accordingly, their profit margin has decreased.

**Missing middle syndrome**
One of the factors that hinder the growth of the M/SME sector in Egypt is the lack of healthy and dynamic medium scale enterprises. This trait is known as the “missing middle syndrome”. The shortage in middle sized enterprises weakens the linkage between the SME sector and the larger scale companies which in turn has a negative impact on the competitiveness of the country. It is also noticed that countries that enjoy a solid base of medium scale enterprises are witnessing high export growth
rates, while countries experiencing the missing middle syndrome are suffering from low export growth rates.\textsuperscript{32}

\textit{Poor marketing channels}
Most SMEs owners cannot undertake any useful marketing activities due to their limited abilities in this field, as well as their limited access to information about the market.

Attempts by the government to assist the M/SME segment started with the initiation of the Draft National Policy for SMEs Development in Egypt. The draft policy addresses several key issues that tackle the financial and non-financial constraints facing SMEs. Subsequently, the Prime Minister has endorsed the “Enhancing Competitiveness for SMEs in Egypt: General Framework and Action Plan”, a document that was published by the Ministry of Finance. This is in addition to the issuance of the new SME law. Parallel to this step, the government started through its different bodies and in coordination with specialized development institutions, to implement different programs and projects targeting: (1) increasing access to finance; and (2) providing the needed technical assistance in different aspects of the M/SMEs businesses.

Lease Finance is viewed as one of the possible tools that could serve this segment and participate in solving both financial and non-financial problems of the SMEs.

3. Analysis of the Leasing Market in Egypt

The leasing market in Egypt involves three groups, a) the product providers represented in the leasing companies; b) product recipients who are in accordance with the scope of work of this study are the small and medium enterprises; c) the leasing law that regulates the relationship between the aforementioned parties.

The interviews conducted included; the product providers, product recipients, some of the intermediary parties involved; such as, the financial institutions and NGOs. Despite the fact that the NGOs are not currently involved in the leasing cycle, their interviews targeted the examination of their potential participation as means of outreach for the leasing companies. The sample of the leasing companies interviewed included established companies operating in a diversified portfolio of leased assets, specialized leasing companies leasing only the equipment they produce, companies currently operating with SMEs, companies that stopped operating in leasing and transferred their leasing portfolio to another leasing company, and finally a new company that is still in the process of establishment.

According to the General Authority for Investment and Free Zones (GAFI), the size of the leasing market in Egypt is estimated to be LE 7 billion. The number of registered leasing companies is 100 companies in the market. However, only 6% of these companies are actively operating in Financial Lease. The 6 operating leasing companies represent 89% of the leasing market in Egypt. The vast majority of the registered companies have registered this product merely to enjoy the tax exemption and customs incentives, while in reality they are inactive in operation. The main source of funding for the leasing companies is through banks. Banks are either shareholders in some of the leasing companies or provide them with credit facilities.

\textsuperscript{32} (Enhancing Small and Medium Enterprises Competitiveness and Exports in the 21st Century a proposed action plan First Draft).
Some of the leasing companies can also depend on donor funds as a method of finance.

A. Why Leasing with Small and Medium Enterprises and Not Micro Enterprises in Egypt?

The M/SMEs can be categorized into micro project activities and small and medium project activities. The financial assistance and needs of each category differ according to its size. A micro scale project financial need is access to working capital to finance the purchase of supplies and material. Hence, the finance suitable for their needs is short term finance of repeated cycles of loans and repayment. These enterprises will not be a suitable candidate for the leasing mechanism. Moreover, the interview findings indicate that in future stages leasing with the micro sector can take place provided their existence in a formalized environment. This participation will probably take place through the utilization of the NGOs as a means of an intermediary party between the leasing companies and the micro lessees.

The second category entailing the small and medium projects requires financing for the possession of tools and equipment to support the growth and expansion of their production. Therefore, their financial need would be for loans of larger size and longer maturities to meet their generated cash flow and hence develop them from marginal enterprises into proper businesses in the formal organized sector.

B. Leasing Companies in Egypt (Service Providers) and their Potentiality with SMEs

The percentage of leasing companies operating in SME leasing represent 15% of the actually operating leasing companies in Egypt, while the remaining 85% of the companies are limited to larger size transactions. The interviews conducted indicate that there is a good potential for their involvement in providing lease finance to the SME segment. This would entail certain changes and modifications in their currently applied systems. The following is a highlight of the main business components of the leasing companies in light of their involvement/potential involvement with SME clients.

Transaction Size - The majority of the leasing companies limit their operation to large ticket transactions with a minimum size of LE 1 million. However, based on the interviews with them, there are no constrains on the minimum size of their performed leasing deals provided that the risks associated are calculated and fall within the company's allowable risks. The only company currently providing financial lease to SMEs has transactions as low as LE 13,000 and would not exceed a maximum of LE 2 million.

Collaterals/Securities - In common practice, the leased asset is the security of the leasing company, and hence, limited additional collaterals (in some cases none at all) are required. While in the case of their operation with SMEs, they agreed that additional security will be required. This could be in the form of a government guarantee (as was earlier mentioned in the experience of Canada), a mutual fund guarantee, or a guarantee from the Credit Guarantee Company. It is worth mentioning that the current practice applied with SMEs does not include additional securities or collaterals.
Risks of Leasing to SME – The risks associated with providing leasing to SMEs has been a controversial issue. Some of the approached companies commented that they bear higher risks due to the possibility of a higher default rate in the lease installment payments. A second group debated that this segment, in reality, bears lower risks in comparison to the large ticket transactions due to the presence of a diversified portfolio of risk, where the loss suffered from the SME percentage of defaulted clients will be less in comparison to clients with large size transactions provided that we have a constant default rate in both. The concept of Vendor Leasing (as explained earlier) was also suggested by one of the companies as a suitable model that should be introduced to the Egyptian leasing market as a means of decreasing the risk on the leasing companies and hence lowering the product pricing charged to SMEs\textsuperscript{33}.

Percentage of the Deposit – Different perspectives were perceived in addressing the percentage of the deposit that should be charged to SMEs. A group of companies agreed that this initial deposit is a must, however their reasons differed. According to a number of companies, the deposit is a tool of security, where the company will not finance more than 70% of the leased assets in an attempt to limit its risk borne. Another company perceived the issue of the deposit as an encouragement/incentive to the SME client to maintain a positive repayment schedule of the lease installments being contributed in the finance of the equipment. Other companies can actually waive the initial deposit to some SME clients but on case by case basis. Another point of view was to standardize this issue when dealing with small ticket transactions.

Pricing – The pricing of the leasing product is dependant on several factors including but not limited to; the companies’ cost of funds, the administration cost, the risk involved and the profit margin. Will this pricing increase with the SME clients as a result of the possible increase of the risk factor (as mentioned by some of the companies) is an important question. The feedback from the companies indicated that there would be an increase in the pricing charged to SME clients in comparison to average pricing charged in the large ticket leasing deals. However, this pricing will still be competitive with the pricing charged by other sources of finance, such as the banks. The aforementioned factors can highly impact the pricing of the leasing product, especially the risk and cost of funding factor. The issue of funding will be discussed as one of the constraints limiting the involvement of leasing companies with the SME segment.

C. The SME Clients (Product Recipients) and their Potentiality with Leasing Companies

A sample of the SME clients was interviewed to examine; their knowledge of the existence of leasing as a method of finance, their financial needs and available sources of finance. The sample represented mainly the small sector rather than the medium enterprises.

50% of the samples interviewed were knowledgeable of the presence of the leasing product as a tool of finance for their assets; however, they were only aware of the presence of only one leasing company. This group has actually resorted to one of the leasing companies seeking finance to lease assets for his project. The remaining 50% of the sample were unaware of the existence of such a product.

\textsuperscript{33} This issue of risk will be further examined to allow for determining the methodology of covering the risk.
The feedback received from the clients that were knowledgeable of the leasing product indicates that there is a good potential of business cooperation between the leasing companies and SME clients. These clients prefer using the leasing companies rather than the banks, as they faced numerous problems when approaching the banks; namely, demand for collaterals, documentation and lengthy time procedures that could extend to months. The clients also confirmed that the pricing charged by the leasing company is inline with the bank pricing (after adding all the bank charges to the interest rate on the bank loan).

D. The Role of Financial Institutions

Financial institutions play a vital role in the relationship between the SMEs and the leasing companies. Financial institutions are represented by; banks, development banks, Social Fund for Development (SFD), Donor Organizations, etc. The interest of these institutions in providing leasing as a means of finance to SMEs, as an alternative in addition to traditional short and medium term loans, has been clearly expressed especially by the SFD.

Interviews with the donor organizations indicated that their role in the development of the leasing industry in Egypt can be presented in one of two forms; either in the form of loans provided to the leasing companies, or in the form of funds. While the advantage of the donor loans is that they provide long term loans. On the other hand, pricing of the loans is not competitive with the banks loan pricing. Hence, they will only be attractive for the leasing companies with limited bank facilities. Moreover, some of the donor organizations expressed that they are willing to provide funds for the development of the leasing industry provided that the funds are allocated for SMEs, and there is an attractive plan proposed by the leasing companies to attract these organizations.

The SFD, NGOs and development banks are the largest source of SME client information. Their client database is an important source of information for the leasing companies. Due to the fact that the majority of the leasing companies in the local market have no previous experience with leasing to SMEs, they are, therefore, unaware of this target group, and hence, can not calculate the risk associated with doing business with this sector. Therefore, means of communication should be developed in order to facilitate access to the credit history of the SME clients that have been previously engaged with the SFD, NGOs, and development banks to the leasing companies. Such counterparts need to communicate for further cooperation where APEX donor institutions such as (SFD, Japan International Cooperation Agency (JICA), Canadian International Development Agency (CIDA), etc.) could be an important source of finance to leasing companies in their business with SMEs.

Further interviews conducted with financial institutions; mainly, national banks, indicated that this sector was not highly recommending leasing as an alternative means of finance to SMEs. Their opinion was based on the fact that the SME sector is satisfying its needs of finance through the banks, especially that the banks currently request less collaterals and bank procedures have been accelerated (however this contradicts with the feedback we received from the interviews conducted with the SMEs as explained earlier). Interviewed personnel in these banks believe that the leasing product is best suited for large projects rather than small ones due to the difficulties that the leasing companies will encounter in outreach to the SME clients or
in identifying the clients and reaching them in case of ones that are located outside Greater Cairo, where all the leasing companies are concentrated.

E. The Egyptian Leasing Law

The Egyptian government has taken several actions to promote leasing as a financial product in the Egyptian market. Most important is the issuance of the Leasing Law No. 95 for the year 1995 and Law No. 16/2001 amending certain provisions of Law 95/1995, as well as the Prime Minister's Decree No. 498 for year 2002, concerning Law No. 16/2001 and amending the original Law of 95/1995. Despite the weak elements present in the leasing law that will be discussed in the following section, the law has provided several incentives for the leasing companies:

- The lessor enjoys a tax exemption for a period of five years starting from the first year of operation. This tax exemption can be ten years in the case that the leasing company is located in the new industrial areas.

- The leasing company can, in its own capacity or through a liaison, import the equipment necessary for its establishment, expansion or operation without the need for registration in the importers' register.

- The leasing company is exempted from stamp tax and fees of notarization, establishing companies’ contract fees, contracts’ fees for loans and pledges related to the business for three years from the date of being registered in the Commercial Register. The leasing company is also exempted from the taxes and fees related to contracts that register the land on which the leasing company will be established.

- The leasing company is exempted from customs, where a unified custom is collected amounting in 5% of the value of all machines being imported for the establishment of the leasing company.

- If the leasing company is a joint stock company and its stocks are registered in any of the capital markets, an income tax exemption is applied in an amount equal to a percentage of the paid in capital. The percentage is determined according to lending rate and discount rate of the Central Bank for an accounting period.

- Bond holders and holders of similar financial papers that the leasing company issues are exempted from the tax on return if the leasing company is registered in any of the capital markets on the condition that these financial papers have been offered in a public subscription.

F. Constraints to the Expansion of the SME Leasing in Egypt:

In light of the conducted interviews with the leasing companies and the clients representing the small and medium enterprises, a number of constraints were deduced that negatively impact the participation of the leasing companies with the small and medium enterprises. These constraints are as follows:

- Unfavorable macroeconomic conditions
- Deficiencies in the legal environment
- Lack of credibility in market information
- Limitation on the types of leasing practiced in Egypt
- Difficulties in the client investigation procedure
- Administration problems in the leasing companies
- Difficulties in fund raising
- Need for marketing and awareness campaigns of the leasing product to the SMEs

The above mentioned constraints can be categorized into the following categories:

a) Macroeconomic Constraints
b) Legal Constraints
c) Supervision Constraints
d) Other Constraints

a) Macroeconomic Constraints

Unfavorable macroeconomic conditions
The devaluations of Egypt’s currency have been negatively affecting the Egyptian economy, particularly to the sectors that rely heavily on imports as a source of raw materials that have to be paid for in hard currency. Concerns over the convertibility of the currency and the government’s intentions to resolve the issue have deterred foreign investment.

In the past three years, the pace of reform has become sluggish and budget deficits widened to 5.9% of GDP. The deficit is expected to widen to 6.5% of GDP in 2002/2003. Servicing foreign debt will become more expensive and revenue growth will be well behind spending, due to slow growth in private-sector activity. This will be somewhat offset by a rise in the local currency value of customs duties caused by depreciation of the pound.

The monetary policy will need to shift to target inflation. This is complex to manage and will require the implementation of sophisticated tools to subtly control interest rates. The Central Bank announced in November, the authorities’ intention to introduce a range of tools to influence monetary conditions using open-market operations and other such means. In addition, liberalization of the closely controlled Treasury Bill market will be required – the government has tended to keep T-bill rates artificially low to limit its debt obligations.

As was previously mentioned, the stability of the macroeconomic conditions and environment is essential for the leasing companies to secure the foreign exchange convertibility, and hence, reducing their risk factor that will eventually affect the pricing of the product. The presence of desirable conditions will positively contribute to the acceleration of the development of the leasing industry. Meanwhile, the current conditions will not prevent the development of the leasing companies with the SME sector; however, accelerating its development will highly depend on the country’s macroeconomic conditions.

b) Legal Constraints

Deficiencies in the legal environment
All of the interviewed companies agreed on their complaint from the leasing law in the essence that it does not clearly define the actions to be taken in case of defaulted clients, where the lessor has to repossess the asset. The law and its amendments in
article 20 state that, "On termination of the contract by rescission or for any other reason, without its renewal, and without the lessee buying the leased property, the lessee, his successors, the rest of partners, the bankruptcy trustee, or the liquidator in bankruptcy, according to each case, shall deliver to the lessor the leased properties in their condition as agreed upon in the contract. If the lessee or the others refrain from delivering the properties, the lessor may submit a petition to the summary justice at the court of jurisdiction to issue a court delivery order…..A court delivery order shall be issued if the petition is coupled with the contract, an evidence of its expiry, and the name and place of the party committed to deliver". However the leasing companies are currently facing enormous difficulties in implementing the law with this regard. The two major obstacles faced are the lengthy time taken to issue the court order of repossession and the impossibility of implementation, where in this case the lessee refuses to return the equipment, and hence, the lessor would resort to the court again in an endless attempt of acquiring his equipment.

Limitation on the types of leasing practiced in Egypt
According to the Leasing Law of 95/1995, the only type of leasing that is allowed to be practiced in Egypt is Financial Lease. Existing leasing companies that have well established themselves with the SME sector in the financial lease are keen for the law to include operating lease as well. This will enable them to expand their clientele base with a diversified portfolio of assets.

Difficulty in implementation of the tax and customs incentives
The Leasing Law has defined several incentives to encourage the leasing companies to enter into the leasing business as previously mentioned in section (E) of this chapter. The most important incentives are the customs and tax exemption. Despite their presence in the leasing law, the leasing companies encounter some difficulties in applying these incentives when dealing with the customs and tax authorities. This could be illustrated in the following examples; leasing companies enjoy a tax exemption on their income for a period of five years, however, in the case of leasing passenger cars, this tax exemption does not apply on the leased vehicles and hence the leasing companies are obliged to pay the associated taxes. We are also aware of another example whereby a company registered under law no 8 (which exempts it from paying custom duty taxes on capital equipments imported for the company's operations) imported capital equipment. The company then decided to opt for sale and lease back of the imported equipment. Upon the realization of this transaction, the company was asked to pay the previously exempted custom duty taxes, since the authorities considered the sales for lease transaction as a breach to the capital equipment for operation term. The company was also requested to pay sales tax on the equipment. This is in addition to the leasing company having to pay sales tax when it attempted to lease back the equipment.

In an attempt to overcome this problem, the leasing company attempted to import the equipment on behalf of the lessee. The leasing company is also exempted from custom duty taxes on capital equipments necessary for its operation. Upon the execution of the leasing transaction, the leasing company was requested to pay back the previously exempted taxes (claiming that this is no longer capital equipment). This problem basically arises from the fact that the nature of the leasing business operation is not clear to the authorities.

c) Supervision Constraints
Lack of credibility in market information
The Egyptian economy is severely lacking information, and the available information thoroughly lacks credibility and that is one of the main hindrances to the leasing industry in Egypt. This is a characteristic that was felt by all the operators of the leasing business in Egypt. Bureaucracy and stringent lengthy official governmental regulations are other factors over-burdening lessors. This is in addition to the unavailability of records in the size of the leasing business in Egypt and its percentage of penetration relative to the fixed private capital. When the leasing companies were approached by this question, no accurate figure was given. The answers represented educated guesses based on their interpretation of related figures.

Difficulties in the client investigation procedure
There was a consensus among all of the interviewed leasing companies that there is a high difficulty in performing the needed client investigation prior to any leasing deal. This becomes more difficult with the SME clients due to the absence of a credit history or banking history for this sector. Hence, they resort to informal methods of investigation that mainly depend on the reputation of the prospective lessee in his area of work and residence and feedback from his circle of acquaintances. This practice entails higher risk on the lessor that is reflected in the pricing of the product.

d) Other Constraints

Administration problems in the leasing companies
The vast majority of the leasing companies believe that leasing to SMEs requires high administration costs on the lessor. This is due to the nature of the lessee and the need to adjust and modify the companies' internal software and follow up systems to serve this segment in an attempt to minimize the risk of default.

Difficulties in raising funds
43% of the leasing companies in the Egyptian market have banks as major shareholders in the companies. These companies use the banks as their major source of funds, however, according to the new banking law; the bank can only fund 30% of its capital and cannot participate with more than 40% of the shares of the company. Leasing companies that do not have banks as major shareholders in the company also suffer from limited sources of funds. Banks can fund these companies using the lessee checks as bank guarantees, where only checks that are due within one year of the facility are utilized, therefore, creating cash flow shortage to the leasing companies.

Need for marketing and awareness campaigns of the leasing product to the SMEs
Based on the interviews with both the leasing companies and the SME clients themselves, it was evident that there is lack of awareness to the vast majority of the SME clients with leasing as a financing product. They were both unknowledgeable with the mechanism of the product and the companies that offer this product. This was confirmed by the interviews with the leasing companies that already work with SMEs, where they seek the clients themselves and market their products not depending on the clients to approach them.

G. Conclusion
In conclusion, it is discernable from the analysis and the interviews with the leasing market players in Egypt that there is a good potential for the involvement of the leasing companies in providing their services to the SMEs sector in Egypt. Still, there are some companies, which are worried about the high risk, that can be involved in SME financing which may result in higher pricing strategies or need for initial deposits.

On the other hand, SMEs awareness of leasing activities in Egypt was not very remarkable, as almost half of the SME interviewees were not even aware of the existence of leasing companies in Egypt. Despite such lack of leasing awareness, SMEs interviewees demonstrated interest in leasing activities, highlighting a great potential for SME Leasing success in Egypt, as they have assessed the conveniences leasing provides as an oppose to bank lending. In other words, leasing financing was found to be more attractive to SMEs than banking financing in Egypt.

On the legal horizon, the Egyptian law, although provides incentives for leasing companies to operate in the Egyptian market, there are still some deficiencies – which are mostly related to default as per the interviewees – in need to be revisited and amended. These regulatory and legal deficiencies were also evident in Ukraine, and was one of the main reasons hindering the development of the leasing market there despite the suitability of the economic conditions. Moreover, since the only type of leasing, which practice is allowed in the Egyptian leasing market is financial lease, it would be, therefore, beneficial to assess the possibility of introducing new types of leasing activities.

Lessons learned from the encounter of the international experience of leasing to SMEs should be taken in consideration, while developing the leasing and SME market in Egypt. Pakistan has placed boundary limits to limit the number of leasing companies entering the market. This is to acquire better capitalized leasing providers. This possibility should be investigated in the Egyptian leasing market to account for the high percentage of inactive leasing companies in Egypt. Lack of funding and absence of guarantees still represent an obstacle towards the development of the leasing market worldwide. Issuance of bonds is a major source of medium term funds in Pakistan. Government guarantee was another alternative approached by the Canadian government, and in Bangladesh the funding issue still represents a major problem. Diversified means of guarantees will be proposed in the action plan to guarantee the risk of the defaulted SME clients with the leasing companies in an attempt to replicate the successful model presented in Canada. The utilization of leasing second hand equipment has proved its success in Pakistan. Examination of the means of applying this system in Egypt will be investigated.

Finally, it could be concluded that there is a good potential for the leasing market in Egypt, but still, there are several constraints, both on the leasing, as well as the SMEs levels, which need to be overcome so as not to hinder the success/effectiveness of the leasing activities with the aim of facilitating SMEs financing and promoting their growth/development. These constraints will be the main core of the action plan that is presented in chapter three this research.
CHAPTER THREE: SME LEASING ACTION PLAN

In light of the assessment results and the analysis of the different international experiences encountered in the study, a set of objectives and their corresponding activities have been concluded to constitute the essence of the action plan aiming at the enhancement of leasing as a means of finance for SMEs. This action plan has taken into consideration the economic and the financial conditions in the Egyptian market that has been overviewed in the previous chapters.

It is also to be noted that the latest action by the government, in announcing the new SME law, has emphasized on expanding the role of the SFD to include more responsibilities towards SMEs. These roles include but are not limited to; raising awareness of the importance of the Small and Micro Enterprises, marketing their products, expressing opinions with regards to draft laws and decrees, fostering the existence of companies specialized in Technical Assistance to this group, establishment of training centers to qualify owners of firms to properly establish and manage their businesses. Moreover, the SFD will undertake planning and coordination to assist firms in obtaining the finance and services needed by them, gather data related to the activity of the Small and Micro Enterprises from banks and other financial institutions and simplify forms of registration for obtaining licenses, permits, etc. Therefore, the activities of the action plan have taken this into consideration when delegating the responsibilities of the SME oriented activities to the SFD, in coordination with other involved parties; such as, banks, NGOs and Credit Guarantee Companies.

Since the SFD is the SME body receiving most of the international institutions aid and support targeting SMEs; it is our understanding that it is of the interest of this body to promote new means of finance serving SMEs, such as the subject SME Leasing scheme. This is in addition to the fact that despite the SFD support and facilities to the banks in lending SMEs, the banks are still not covering a significant percentage of the available client base that is in need of finance. Therefore, the involvement of the SFD in the development of diversified models of finance targeting different groups is to the advantage of SMEs. Moreover, it is worth mentioning the importance of the establishment of a Credit Bureau and a Credit Scoring system. These are to facilitate the process of the due diligence to the leasing companies leading to more accurate calculations of the risks involved, and hence lower, cost/pricing of the service.

The activities of the subject action plan fall under three main categories; activities related to the SME sector, others related to leasing companies, and activities that target the SME leasing business environment. These activities have been clustered into three main objectives, which are as follows:

I. Development and organization of the SME sector and supportive business environment;
II. Development of the leasing business market in Egypt
   1. Legal and Regulatory Reform
   2. Training Requirements for the Leasing Companies
III. Development of SME/Leasing Business Environment
   1. Encourage existing leasing companies that are already operating with SMEs to increase their market share
      a. Evaluation of the current SME leasing experience
b. Facilitate access to capital.
2. Encourage existing leasing companies that are interested to initiate business with the SME sector through mitigation of their risk
3. Encourage the involvement and establishment of new leasing companies specialized in SME leasing

I. Development and organization of the SME sector and supportive business environment

Management skills, marketing and business planning are essential to facilitate access to SMEs finance. Lending institutions have a primary focus to monitor their risks to avoid losses, while SMEs are interested in obtaining funds free of constraints that can limit their flexibility in business. Without the skills to demonstrate their business, SMEs will not be able to acquire access to finance.

The performed assessment indicated that the current status of the SMEs is in need of further development, in order to provide them with required skills to fulfill the needs of the leasing companies. The main information required by the leasing companies is as follows:
- Client credit profile and history,
- Projected cash flow of the client’s operation throughout the life of the lease contract.

The proposed activities are geared towards ensuring the presence of successful business skills needed for the operation of SMEs as well as the needed training and awareness activities.

Objective 1

To develop and organize the SME sector and supportive business environment, we propose the following:
- Creating a unit inside the Social Fund for Development responsible for lease finance to SMEs.
- Come out with a unified definition to be used with all the leasing companies.
- Develop a reliable database for SMEs to be able to use it as an SME reference and a means of evaluation to the sector performance.
- Collect information on different business service centers established by different programs and ensure that the requested services in providing managerial, finance, marketing and technical assistance to SMEs are existing, if not negotiating its incorporation, expansion or establishment of new Business Service Centers (BSCs).
- SME Training Activities
  - Develop business and competitive skills for SMEs.
  - Orientation of government bodies and other SME bodies as a means of information streamlining.
- SME Awareness Activities
  - Develop a directory listing all the leasing companies interested in dealing with SMEs and their contact information.
• Provide advisory services to SMEs on suitable means of finance for their projects, in addition to organizing periodical seminars to introduce the concept and basics of leasing to SMEs.

**Creating a unit inside the Social Fund for Development responsible for lease finance to SMEs**

In order to allow for specialization and focusing on efficient advisory services provided to SMEs with regards to lease finance, we proposed the establishment of a unit inside the SFD, where its main responsibilities would be to promote leasing to SMEs, approach leasing companies with possible SME leasing business opportunities along with the needed information that the leasing companies may be in need of about the SME sector. It is proposed that the creation and operation of this unit be the responsibility of the SFD.

**Come out with a unified definition to be used with all the leasing**

As part of the SME development and organization activities, it is highly advised to unify the definition used for small and medium enterprises across all involved bodies in the country. This was expected to take place with the issuance of the new SME law; however, the law came out with a focus on only the micro and small enterprises. Therefore, it is proposed to be the responsibility of the unit created inside the SFD to unify a definition for small and medium enterprises to be used across all the leasing companies and throughout all the leasing transactions.

**Develop a reliable database for SMEs to be able to use it as an SME reference and a means of evaluation to the sector performance**

It is of great importance to develop a database including the size, geography, nature of business, etc. of SMEs in Egypt. Availability of this type of information will allow proper evaluation of this sector, and the development of means to measure the sector performance through a group of performance indicators.

We propose that the SFD be the responsible body for this task due to the existence of its own database. A comprehensive database can be acquired through the coordination with other bodies that endorse information on the SME sector; such as, NGOs, banks and the Credit Guarantee Company.

It should also be highlighted that this database should be accessible to all bodies that are or could be involved with SME development or finance for better understanding and evaluation of the subject sector.

**Collect information on different business service centers established by different programs and ensure that the requested services in providing managerial, finance, marketing and technical assistance to SMEs are existing, if not negotiating its incorporation, expansion or establishment of new BSCs.**

The SME sector lacks the internal capacity to build proper management and accounting staff. Moreover, the Egyptian economy is still short in providing
sufficient and effective institutions that provide this kind of service that would enable SMEs to build the internal capacity required to compete on a value added basis in the local market, as well as penetrate the international market. This is in addition to the fact that most of the SME owners cannot undertake any useful marketing activities due to their limited abilities in this field, as well as limited access to information about the market especially the international market.

It is through the establishment of BSCs that delivery of consultancy, advisory services and access to information to SMEs takes place. The established BSCs are to be geographically distributed to serve as much SMEs as possible. The following services should be part of the BSC activities:

- provide proper management skills with a focus on finance, marketing and planning;
- provide knowledge and access to capital market;
- provide advice on business structures and planning to meet the needs of the market;
- introduce SMEs to business support programs;
- promote the exchange of knowledge and use of new technology; and
- assist individuals and firms to interact, communicate and form cluster groups.

Therefore, sufficient information on the efficiency and applicability of these units must be gathered to enable the responsible parties to decide on the needs for complementing activities of Government of Egypt (GOE) and other international institutions or think of expansion/establishing new BSCs.

To coordinate these BSCs, there will be a single government body (proposed to be the SFD) that will ensure the consistent quality of the service delivered to the SMEs. This body will also be the point of contact between the centers and the government, international institutions, and any relevant organizations. It will be responsible for facilitating SME initiatives and supporting SME interest through availability of specialists.

This service should be provided to SMEs, both in the start up phase and during their operation.

**SME Training Activities**

- **Develop business and competitive skills for SMEs**

The SME segment is in need for business development and enhancement of competitive skills. This has been highlighted in the previous activity to take place through he BSCs. It is through this training that the SMEs will be advised on aspects; like, product development, production management, and equipment maintenance and productivity improvement.

- **Orientation of government bodies as well as other SME bodies on means of information streamlining**

All the government bodies that are responsible for implementing any of the legal and regulatory incentives related to the leasing business should acquire a certain understanding of the leasing business, its mechanics, its target group of SMEs, its
risks and means of overcoming this risk. It is important for the government bodies to have this basic understanding to allow for smooth communication, streamlining of documentation and effective participation in this relationship. In addition, being involved in amending and updating certain regulations and laws for leasing, the government will help a lot in having and acquiring this basic understanding. This activity could be achieved through presentation sessions organized by SMEPOL with the involvement of leasing experts.

- **SME Awareness Activities**

  - **Develop a directory listing all the leasing companies interested in dealing with SMEs and their contact information**

  The interviews conducted with the SME sample in the assessment phase has indicated the lack of awareness on the side of the SME of the existence of the leasing service and in turn the service providers. It was previously mentioned in the above activities that the unit to be created inside the SFD will be responsible for introducing and orienting SMEs to lease finance. Therefore, as a complementing activity, the development of a leasing companies directory is essential to enable the SMEs (once they have an understanding of the service) to develop full knowledge of the product and its providers. The directory should be updated periodically, and should include a brief description of the product, as well as the main requirements of leasing companies.

  - **Provide advisory services to SMEs on suitable means of finance for their projects in addition to organizing periodical seminars to introduce the concept and basics of leasing to SMEs**

  Among the roles of the SME responsible body is to advise the SME client seeking a loan on the best financial means for the project. It will be the advisors role of this unit to direct the SME client either to a bank loan, leasing option, venture capital option, credit guarantee, etc., after discussing and examining with the client the nature of the service/product, where finance is being sought. This is in addition to the need to organize seminars and open forums to gather the product recipients (SME clients), product providers (leasing companies), and any other intermediate party that could have a role in this relationship; to provide communication between the SME clients and leasing companies. The leasing companies will then be able to, better explain the advantages and privileges offered to the SME clients, and the latter will be able to better understand the leasing product through questions and clarifications addressed to the leasing companies.

**II. Development of the Leasing Business Market in Egypt**

As a result of the assessment study conducted and based on the findings of the interviewed institutions and legal advisors, we were able to reach the conclusion that the leasing business culture is yet undeveloped in Egypt, and that the market is in need for further development. Development of the leasing business culture in the Egyptian market will enhance the leasing business in general and will help enhance leasing with SMEs once the market, at large, is developed. This development will be taking place through; reformation of the legal and regulatory procedures, providing proper training to leasing companies on successful
international SME leasing experiences, as well as in field training with SMEs in Egypt.

**Objective 2**

**For development of the leasing business market in Egypt, we propose the following:**

1. Reform the legal environment through:
   - Establishing a court specialized in leasing cases;
   - Amending article 20 of the leasing law to be merged with an enforcing clause to the article;
   - Establishing an implementing body/force responsible for returning equipment to the leasing company in case of defaulted clients;
   - Activation of the Egyptian Leasing Companies Association; and
   - Periodical research on the performance of different industries and their potential growth/decline in the near future.

2. Training requirements for Leasing companies:
   - Training of leasing companies on successful international models of leasing companies with SMEs;
   - In the field training for leasing companies with SMEs in Egypt;

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1. **Legal Reform**

   - **Establishment of a court specialized in leasing cases**

   With an endeavor to speed up the legal procedures in issuing the court order allowing the leasing company to repossess its equipment in case of a defaulted client, and based on the advice of the legal advisor, we are proposing the establishment of a court or a unit specialized only in leasing cases. This will facilitate the ability to obtain an immediate court order provided the presence of the required documents (leasing contract and the defaulted payment checks).

   - **Amending article 20 of the leasing law to be merged with an enforcing clause to the article.**

   The establishment of a leasing court is not sufficient. Therefore, amendments to the law must be performed. Article 20 of the Leasing Law (that has previously been stated and discussed in chapter 2) must be amended to include an implementing clause clearly identifying the government body responsible for implementing the repossession clause instead of the current practice that does not secure to the leasing companies their actual repossession of the equipment, despite the presence of the court order, whereby the repossession act is the responsibility of the leasing company.

   - **Establishing an implementing body/force responsible for the repossession of the equipment to the leasing company in case of defaulted clients.**

   We are proposing the delegation of the task of implementing article 20 of the Leasing Law to an official national body rather than the current practice that
requires the leasing companies to repossess their own equipment from the client in the case of default. The role of this national body would be to receive the court order of repossession upon its issuance, implement the order and deliver the equipment to the leasing company.

- **Activation of the Egyptian Leasing Companies Association**

The Egyptian leasing companies association has already been established, however, it has not been activated yet. The importance of this association has been highlighted by all the interviewed leasing companies. It has also been highlighted through the assessment of the different international experiences. Procedures of activating the association must be accelerated in order for the association to carry out its roles. It will be the role of this association to act as a representative body for the Egyptian leasing companies, representing the companies in front of the different government bodies.

Regular and periodical meetings must be organized that would include all the active leasing companies in the market to share market information, discuss obstacles encountered and means of their resolution, survey the international leasing market and benchmark the local market against its international counterpart. Newsletter should be issued periodically through the association including; update of information about the local leasing market, figures indicating the growth/decline of the leasing business, important deals that have been booked by any of the leasing companies, etc.

The published newsletter of the association is to be distributed on the member leasing companies, as well as to be made available to the commercial, industrial and financial bodies. This is to communicate the updates of the leasing market to the various government bodies.

It is also the role of the association to propose reform measures suggested by the leasing companies to be conveyed to responsible parties in the government for the examination of its implementation and to propose incentives to further develop the leasing market and increase its market penetration.

- **Periodical research on the performance of different industries and their potential growth/decline.**

One of the main factors of success of the leasing business is availability of reliable market research on the different industries that is highly correlated with the leasing business. This is to provide the leasing companies with a projected performance of these industries, and hence, guide the leasing companies to their target market to avoid increase in the number of defaulted clients, as a result of the collapse or decline of a certain industry as was the case with several leasing companies that encountered a relatively high percentage of default with clients leasing construction equipment, due to the decline of the construction industry in Egypt in the past couple of years.

2. **Training Requirements for Leasing Companies**

As is the case with the need for training to the SME sector, the leasing companies as well are in need for SME training in order to develop a better understanding of
this sector, and hence, be able to properly evaluate their associated risk in an attractive manner to the SME clients, as well as reduce the administration costs associated with SME leasing. The assessment results, as previously mentioned, indicated the absence of the link between the two major players of this relationship; the leasing companies and the SMEs. This absent link indicates lack of knowledge that needs to be developed through the proper training to both parties.

- **Training of leasing companies on successful international models of leasing companies experiences with SMEs**

Examples of the international experience of leasing companies with the SMEs have been demonstrated in the assessment report. We recommend the training of the local leasing companies on the international leasing models that proved their success with SMEs. This training will introduce to the leasing companies the successful models with their accompanied administration systems, the incentives provided to the SMEs and to the leasing companies as well, the follow up procedures, collection mechanisms and means of reprocessing the assets in the case of default. This training will give the leasing companies a base to build on the SME leasing Egyptian model, as well as prevent mistakes that led to the failure of some of these experiences.

- **In the field training for leasing companies with SMEs**

Due to the fact that the majority of the leasing companies have not been experienced with the SMEs before, we recommend the organization of in the field training for the leasing companies. The leasing companies as part of this training will visit the SME in their locations, examine their projects and introduce them to the policies and regulations governing the SME sector. The purpose of this activity is for the leasing companies to be able to understand the SME business; hence they will accurately be able to design a leasing model suitable for their needs and demands and will also be able to accurately calculate their expected risk in the SME transactions.

**III. Development of the SME/Leasing Business Environment**

The SME/Leasing business currently exists in Egypt where one leasing company is operating in leasing to this sector. However, the leasing as well as the SME market is in need for development to increase the ability of this company to serve more clients and to attract and accelerate the involvement of the existing leasing companies that are interested to work with SMEs. This will also lead, in a following stage, to the encouragement of establishing new leasing companies specialized in SME leasing, once this business environment is developed.

Due to the fact that there is currently a leasing company operating with SMEs, it is, therefore, essential to assess and evaluate this experience. Despite the fact that the study on hand has defined the obstacles that this company has encountered and proposed activities to try to eliminate these obstacles, it is deemed necessary to perform in-depth, economical and financial evaluation of this experience, especially that this company has previously been involved with an international institution seeking access to capital and is still in need for more access to capital. In the following activities we are proposing providing the SME/leasing companies
with access to capital through donor institutions such as the SFD to increase its SME client base. This will have a more positive encounter if it is superceded with an evaluation of the previous experience with this regard.

This environment could be further developed through the encouragement of other existing leasing companies in the market to include the SME sector among their target clientele base. This is through providing alternatives to the subject companies, whereby they can mitigate their risk. Once this environment is well established, it will then be able to attract new players in the market specialized in SME leasing.

### Objective 3

**For development of the SME/leasing business environment, we propose the following:**

1. Encourage existing leasing companies that are already working with SMEs to increase their market share through;
   a. Evaluation of the current SME Leasing Experience:
      - Assessment of the success and failed experiences;
      - Recommendations to develop the Egyptian SME leasing experience.
   b. Access to capital:
      - Orient leasing companies to SFD and other donor programs;
      - Setting joint annual targets between the leasing companies and donor institutions
      - Settlement on the size of finance between the two parties;
      - Defining criteria of eligible beneficiaries;
      - Concluding a contractual agreement between the two parties including the terms, conditions and obligations of each;
      - Implementation of the contract terms and conditions.

**For development of the SME/leasing business environment, we propose the following:**

2. Encourage existing leasing companies that are interested to initiate business with SME sector by mitigating their risk through one of the following alternatives:
   - **Alternative 1**: Initiation of a mutual fund sponsored and funded by leasing companies to be deposited as a guarantee fund to cover the expected risk of SMEs;
   - **Alternative 2**: Utilization of the presence of credit guarantee mechanisms to act as a guaranteeing tool to the leasing companies;
   - **Alternative 3**: Encourage and promote vendor leasing, whereby the leasing companies will have recourse on the vendor incase of the defaulted clients;

3. Encourage the involvement of new leasing companies specialized in SME leasing:
   - Organize semi annual forums to share on the experience of leasing finance to SMEs with both leasing companies and SMEs;
   - Take positive steps to streamline documentation and standardize procedures.
1. Encourage existing leasing companies that are already working with SMEs to increase their market share through providing them with access to capital, through donor institutions such as the SFD, through the following steps

In light of the assessment phase, where the interviewed companies that are currently involved in SME leasing, have indicated their need and shortage of access to capital as one of the obstacles heavily impacting their performance in the market with regards to the number of clients served.

The need for access to capital can be addressed through channeling finance to the subject companies, through the donor institutions such as the SFD. A practical approach for this scheme can be explained in the following activities:

a. Evaluation of the current SME Leasing Experience(s)

   - Assessment of the success and failed experience(s);

   The current SME leasing experience(s) should be carefully assessed from the economic and financial aspects to both parties (SMEs and leasing companies). This is in order to come up with a suitable SME leasing model that is building on the country experience and taking into consideration the drawbacks and obstacles encountered.

   - Recommendations to develop the Egyptian SME leasing experience;

   Based on the assessment of the Egyptian SME leasing experience, concrete and specific recommendations will be developed to be encountered in the Egyptian SME leasing model and to be taken into consideration in the involvement of other donor institutions with providing access to capital.

b. Access to capital

   - Orient leasing companies to SFD and other donor institutions programs;

   Since we are proposing that donor institutions such as the SFD be responsible for channeling finance in the form of a loan/fund to the SME leasing companies (access to finance will be based on the evaluation of the companies' performance), it is proposed that these companies be oriented to the donor institutions and SFD programs in order to get an understanding of their systems of finance and follow up, and hence, develop a comprehensive perception of the institution to facilitate communication between the two parties in the contract negotiation.

   - Setting joint annual targets between the two parties;

   Jointly, the leasing companies and the funding donor agency will determine their annual targets, taking into consideration the previous assessment that has taken place, the resources of the company, and the financial capacity of the donor.

   - Settlement on the size of finance between the two parties;
Based on the targets defined, the size and method of finance are to be determined highlighting actual expected volumes, interest rates, deal flow rates and repayments rates, in the case that the finance is in the form of a loan. However, in the case that the method of finance is through a form of fund, the type of fund, use of the fund, and eventual ownership of the fund at the end of the contractual agreement, should be predefined.

- **Defining criteria of eligible beneficiaries;**

With reference to the interviews conducted with the leasing companies, it is the norm that each leasing company as part of the company strategy and objectives has a criteria for eligible beneficiaries defined. This criterion is to be shared between the two parties to make sure that it is to the best benefit of the SME client base served.

- **Concluding a contractual agreement between the two parties including the terms, conditions and obligations of each;**

Once all of the previous terms have been settled, they should be included in a contractual agreement, including all the conditions and obligations and signed by both parties.

- **Implementation of the contract terms and conditions;**

This activity is the responsibility of both the donor institution and the chosen leasing company(s) in accordance with the contractual agreement and the contract duration.

2. **Encourage existing leasing companies that are interested to initiate business with the SME sector by mitigating their risk through one of the following alternatives:**

One of the main obstacles preventing leasing companies from being engaged in SMEs finance is their associated risk. While a diversified portfolio of SME clients should be of less risk than a portfolio with a limited number of large ticket transactions, yet leasing companies still view the SME sector as a high-risk sector due to the high possibility of defaulted clients. Therefore, we propose the following alternatives as means for risk mitigation to the leasing companies;

**Alternative 1 : Initiation of a mutual fund sponsored and funded by leasing companies to be deposited as a guarantee fund to cover the expected risk of leasing companies with SMEs.**

We are proposing the establishment of a mutual fund, where the participants will be the leasing companies. The aim of this mutual fund is to act as a guarantee fund guaranteeing up to 70-80% of the risk of SME clients to the finance providers (leasing companies). In case of defaulted clients, the mutual fund will pay the lenders for any eligible loss on borrowers that have defaulted, after leasing companies have taken the usual steps to recover any possible installments to decrease the amount outstanding.
This fund will be managed by a Fund Manager, where the return of investment will be distributed to the participants, according to their share of participation after deducting the cost of managing the fund. The main source of finance of this mutual fund will be the leasing companies, while a secondary source of finance will be financial institutions or donors willing to participate in promoting the SME leasing model.

**Alternative 2: Utilization of the presence of Credit Guarantee Mechanisms to act as a guarantee tool to the leasing companies.**

The Credit Guarantee Model can be introduced in this relationship, as it would guarantee the risk of the SME client to the leasing company. The percentage of guarantee will differ according to the status of the business. In the case of start up activities, the guarantee can reach up to 100% of the risk for the leasing company. This percentage can decrease gradually as the SME develops its ability to generate reliable cash flow, hence, the leasing company would then take over the associated risk. In the case of an operating business, the Credit Guarantee Model would provide a guarantee of a percentage of the SME risk. The percentage would depend on several factors; the nature of the business, client credit history and previous lending experience, etc. The Credit Guarantee Model will include a guarantee fee in return for the guarantee service that; would be agreed upon between both parties, depending on the percentage of risk carried out by each.

The essence of the proposed model that includes the guarantee mechanism is:

- 100% guarantee of SME risk to leasing companies
- High involvement with leasing companies in outreach and marketing of the SME/leasing product.
- High involvement with the leasing companies in the follow up procedures.

The expected results of this model according to designed financial projections are:

- Encourage leasing companies and increase their involvement in SME/leasing
- Lease transactions issued totaling LE 250 million in the case of allocating a LE 35 million fund in duration of five years.
- Financial leverage to reach 1:3, applied upon performance assessment of the leasing companies.

Both the donors and financial institutions can participate in any of the previous two alternatives, through providing accessible funds, either through the mutual fund or channeled through the guarantee mechanism. In the case of alternative (1), donors can be one of the participants of the mutual fund. In the case of alternative (2), donors can place a fund (e.g. trust fund) with a Credit Guarantee Company. This fund will be deposited in the bank and leveraged against to guarantee SME clients to leasing companies.

**Alternative 3: Encourage and promote vendor leasing, whereby the leasing companies will have recourse on the vendor in case of defaulted clients**

The concept of vendor leasing has been explained in phase one of the study; the assessment phase. Encouragement and promotion of this model will directly have its impact on limiting the risks carried out by the leasing companies. The
nourishing of this scheme is mainly dependent on the development of awareness and the leasing business culture in the local market.

3. Encourage the involvement of new leasing companies specialized in SME leasing

Once the SME business market is on its way of development and the leasing business culture is well established through the implementation of the previous activities, this environment will be able to attract new companies specialized in SME leasing to enter the market.

- **Organize semi annual forums to share on the experience of leasing finance to SMEs with both leasing companies and SMEs;**

The results acquired through all of the previous activities and the development taking place in the SME leasing market should be conveyed to interested and involved parties through organized seminars and workshops to share the outcome of this experience. SMEPOL is proposed to be the responsible body to organize such seminars and workshops to share the findings acquired based on the subject action plan.

- **Taking positive steps to streamline documentation and standardize procedures;**

In line with the activities taking place in developing the SME, leasing and SME/leasing markets efforts should be geared towards streamlining of documentations and standardizing procedures that would contribute in saving time, effort and cost to all involved parties, and hence, attract new participants in the field. This includes, but is not limited to, the cycle that starts with applying for the loan/lease facility, the due diligence procedures and this is where we stress on the importance of the Credit Bureau to streamline all the client credit related information in one unit, ending with the actual payment of the credit facility.
## Leasing for Small and Medium Enterprises Action Plan

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<th>Objective</th>
<th>Activity</th>
<th>Responsible Party</th>
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<th>Indicators</th>
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<tr>
<td>Development and organization of the SME Sector and Supportive Business Environment</td>
<td>Organize a workshop to introduce the findings of SMEPoL leasing study and propose recommended activities to the SME community</td>
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<td>- Unit inside the SFD established and operating - SME definition unified - Database developed - Directory listing leasing companies issued</td>
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<td>Creating a unit inside the Social Fund for Development responsible for lease finance to SMEs</td>
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<td>Come out with a unified definition to be used with all the leasing companies</td>
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<td>Develop a reliable database for SMEs to be able to use it as an SME reference and a means of evaluation to the sector performance</td>
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<td>Collect information on different business service centers established by different programs and ensure the existence of the requested services in providing managerial, finance, marketing and technical assistance to SMEs if not negotiate its incorporation, expansion or establishment of new BSCs.</td>
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<td>SME Training Activities</td>
<td>Develop business and competitive skills for SMEs</td>
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<td>Orientation of government bodies and other SME bodies on means of information streamlining</td>
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<td>SME Awareness Activities</td>
<td>Develop a directory listing all the leasing companies interested in dealing with SMEs and their contact information</td>
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<td>Provide advisory services to SMEs on suitable means of finance for their projects as well as organization of periodical seminars to introduce the concept and basics of leasing to SMEs</td>
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<td>Development of the Leasing Business Market in Egypt</td>
<td>Establishment of a court specialized in leasing cases</td>
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<td>- Court Specialized for leasing is established</td>
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<td>Amendment to article 20 of the leasing law to be joined with an enforcing clause to the article</td>
<td>People's Assembly, Legal Authorities</td>
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<td>- Article 20 of the leasing law is modified to include an enforcing clause</td>
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<td>Establishment of an implementing body/force responsible for implementing article 20 of the leasing law</td>
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<td>- Implementing body established</td>
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<td>Activation of the Egyptian Leasing Companies Association</td>
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<td>- Egyptian Leasing Companies Association active and operating</td>
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<td>Periodical research on the performance of different industries and their potential growth/decline in the near future</td>
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<td>2. Training Requirements for Leasing Companies</td>
<td>Training of leasing companies on successful international models of leasing to SMEs</td>
<td>Leasing Companies / SFD</td>
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<td>In the field training for leasing companies with SMEs in Egypt</td>
<td>BFD / Leasing Companies</td>
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**Leasing for Small and Medium Enterprises Action Plan**
# Leasing for Small and Medium Enterprises Action Plan

## Development of SME / Leasing Business Environment

1. Encourage Existing Leasing Companies that are already operating with SMEs to increase their market share (immediate implementation)

   a. Evaluation of the current SME Leasing Experience
      - Assessment of the success and failed experiences
        SFD / Leasing Companies 6 m
      - Recommendations to develop the Egyptian SME leasing experience
        SFD 6 m

   b. Provide leasing companies with access to capital through donor institutions such as the SFD
      - Setting joint annual targets between the two parties
        Donor Institutions / Leasing Companies 3m
      - Settlement on the size of finance between the two parties
        Donor Institutions / Leasing Companies 3m
      - Defining criteria of eligible beneficiaries
        Donor Institutions / Leasing Companies 3m
      - Concluding a contractual agreement between the two parties including the terms, conditions, and obligations of each
        Donor Institutions / Leasing Companies 3m
      - Implementation of the contract terms and conditions
        Donor Institutions / Leasing Companies on going activity

- Assessment of SME leasing experience conducted
- Contractual agreement concluded between SFD/Donor Institutions and the current SME leasing company
# Leasing for Small and Medium Enterprises Action Plan

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<th>Objective</th>
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<th>Indicators</th>
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<tr>
<td>Development of SME / Leasing Business Environment</td>
<td>1. Encourage Existing Leasing Companies that are interested to initiate business with SME sector</td>
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<td>- Existing operating leasing companies that were not involved in SME leasing; leasing to SME clients</td>
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<td>Risk Mitigation through one of the following alternatives:</td>
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<td>- Model Developed for the Credit Guarantee Company to Guarantee SME clients to Leasing companies</td>
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<td><strong>Alternative 1</strong></td>
<td>Leasing companies / Fund Managers</td>
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<td>Initiation of a mutual fund sponsored and funded by leasing companies to be deposited as a guarantee fund to cover the expected risk of defaulting SMEs</td>
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<td><strong>Alternative 2</strong></td>
<td>Credit Guarantee Company / Leasing Companies</td>
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<td>Utilization of the presence of the Credit Guarantee mechanism to act as a guarantee tool for the leasing companies</td>
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<td><strong>Alternative 3</strong></td>
<td>Leasing Companies</td>
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<td>Encourage and promote vendor leasing whereby the leasing companies will have recourse on the vendor in case of the defaulted clients</td>
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<td>4. Encourage the involvement and establishment of new leasing companies specialized in SME leasing</td>
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<td>- Organize semi annual forums to share on the experience of leasing finance to SMEs with both leasing companies and SMEs</td>
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<td>SFD / MOF / Leasing Companies</td>
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<td>Taking positive steps to streamline documentation and standardize procedures</td>
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REFERENCES

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