

The Role of leasing In Iran's Credit System

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Abstract

Advances in leasing industry as a means of finance mainly started in 1900 though leasing dates back to centuries ago. Despite its differences in different countries as a result of differences in laws and regulations, finance function has been a common distinctive function of leasing all over the world.

Leasing has its modern and unique features and advantages to establish itself as one of the most important means of finance in countries' economies. Studies by famous economic and research institutes of the world indicate that leasing ranks second among methods of finance with banks standing at the top. Although a major portion of leasing activities has mainly occurred in highly advanced economies, it will keep growing in such newly emerging markets as Iran in the future.

Having existed in Iran for 30 years, leasing industry is making progress toward completion. Figures show that over 300 leasing companies have been established in Iran most of which have been set up in the last 5 years.

This article sets out to explain the role of leasing industry in the country's credit system. It first gives an account of the theoretical bases of leasing industry and continues with the status of leasing in Iran and in the world. The final sections explain the different aspects of leasing including its legal aspects, pricing, credit risk, methods of financing, and its development capacities in the country.

Keywords: Leasing, Bases of Leasing, Types of Leasing, Gross Domestic Product (GDP) and Credit Risk

JEL Classification: G23

1- Introduction

Although leasing is not a new phenomenon, it has not yet made its breakthrough in developing countries as a means of finance for small-scale companies. This is while leasing has many advantages the most important of which is the ability to use the leased asset while still not owning it. Another advantage is the obviation of the need for collateralization. Still another advantage is its capability to prevent fund deviation, which establishes a great danger and threat to small-scale finance companies, by channeling the finance provided toward its sheer purpose, i.e. asset financing, rather than any other purpose, like debt servicing. Leasing breakthroughs have mainly occurred in the 20th century, although the industry is a far older one. Despite differences in leasing practices in different countries which are the result of varying laws and regulations all over the world, leasing as a method of finance has been a unifying concept and a common function in its different practices.

Leasing has its modern and unique features and advantages to establish itself as one of the most important means of finance in countries' economies. Studies by famous economic and research institutes of the world indicate that leasing ranks second among methods of finance with banks standing at the top. Although a major portion of leasing activities has mainly occurred in highly advanced economies, it will keep growing in newly emerging markets such as Iran in the future.

Having existed in Iran for 30 years, leasing industry is making progress toward completion. Figures show that over 300 leasing companies have been established in Iran most of which have been set up in the last 5 years. The purpose of this paper is to investigate the role of leasing in Iran's credit system.

The first part of this paper gives an account of the bases of leasing industry and a summary of its common methods. Next is an account of the leasing volume in Iran and other countries. And finally, some important aspects of leasing including regulations, legal considerations, pricing methods, credit risk, methods of financing, and leasing development

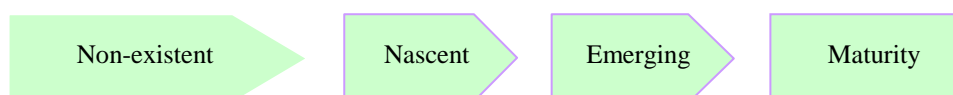
capabilities in Iran are examined.

2- Fundamentals of Leasing

The term "leasing" equates with renting in Farsi language. The best term in Farsi equivalent with leasing is "credit renting". Leasing is defined as a completely specialized credit process following rental method in which an agreement is reached between two or more parties including both real and legal entities to make available the use of a consumer or durable commodity, or its benefits. This process has as parts of itself such transactions and trading acts as buying, renting, and selling.

Leasing industry has developed in the form of a development cycle which is evident in other industries as well. The steps of this cycle include:

Illustration (1): Steps of Leasing Cycle



Different countries lie at different stages of the leasing cycle. Most undeveloped and underdeveloped countries including Afghanistan, Cambodia, Sudan, and some countries formerly part of the former Soviet Union are at the stage of the non-existent. Countries like Egypt, Nikaragua, Ethiopia, and Tajikistan are at the stage of nascent. Those countries in which leasing are at the state of emergence include Asian Pacific Countries, Latin American countries, Central and Eastern Europe and African countries. And finally at the maturity end of the continuum lie countries like Britain, the U.S.A., Australia, etc.

Nascent stage in Iran dates back to the Iranian calendar year of 1970. The first Iranian leasing company called "Iran Leasing Company" was established in 1975 by the French bank Credit Lione. A year later, the second leasing company in Iran was established called "Aria Leasing

Company" by the French Societe Generale and the Iranian Industry and Mine Bank.

Iran's leasing industry has changed a lot since then. Formal figures indicate that about 280 legal entities have been established in the leasing industry in Iran which offer a range of services. A wide range of assets including private and commercial vehicle, housing, medical equipment, office equipment, agricultural machineries, software, airplane, ship, etc are transacted through leasing.

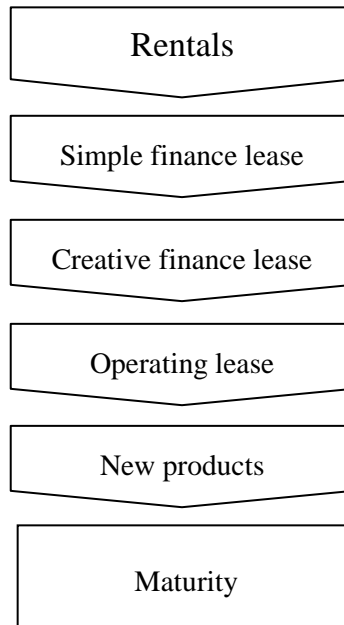
While most leasings carried out are finance leases, operating lease is also done in some companies. It seems that in the near future new products in the lease industry will be offered by the leasing companies. What all this shows is that leasing industry in Iran is at the stage of emergence. Optimistic to some extent about the future and regarding our rapid growth in the past, we can be fairly sure that the near future will witness Iran's passing onto the next stage of the leasing cycle.

3- The Six Phases of the Leasing Cycle

Leasing industry goes through six stages to completion since its birth:

3-1- Rentals

Rental phase is the first phase before a leasing product has emerged. This phase has existed for centuries and is still widely practiced all over the world. Among the characteristics of rentals are their short term and the return of the asset to the owner at the end of the rental period. Its period is usually less than 12 months all over the world.

Illustration (2): The Six Phases of Leasing Cycle**3-2- Simple Finance Lease**

The first phase of leasing is marked with simple finance lease which came into being in the 1950s. This is the first lease product in all the countries. In fact simple finance lease is the prerequisite for the emergence of the creative finance lease. This lease type is only a means of asset finance in which the leased asset is at the end of the lease period retained and owned by the lessee at a nominal cost. Therefore leasing exists with the lessee, the final owner of the leased asset but at a nominal cost. Here ownership risk falls on the lessee and the lessor has to bear the credit risk. Leasing companies are rate oriented and do not give weight to

lease value added. Among the countries at this stage are Bangladesh, Romania, and Honduras.

3-3- Creative Finance Lease

At this phase, leasing enjoys the highest degree of lease volume and market penetration. Lessors design different models and forms of finance lease and put forward different end-of-the-term options including, rental extension or renewal, asset purchase, renovation, and exchange. Another development at this phase is the establishment of new subsidiary leasing companies by those manufacturers who previously used independent leasing companies to lease their products.

Tax authorities are other role players at this phase when they start to have a closer look at the issue and make the pertinent laws and regulations for this industry.

While leasing companies at this phase are still as a general rule rate-oriented, as a result of intense competition, some pay attention to added value of lease. Among other things deemed important for these companies are the least possible response time since the application made to them and the packages to be sold to the customers that consist of services like asset maintenance.

Countries like Guatemala, India, Pakistan, Peru, and Portugal are among the countries at this phase.

3-4- Operating Lease

Factors like extreme competition, lease knowledge transfer among countries, application from multinational lessees, and developing and developed secondary markets have contributed to the transition of the leasing industry to the fourth phase of operating lease. In some countries like Mexico, however, factors like accounting policies or finance lease not being considered as a true lease has lead the industry toward operating lease phase.

Operating lease can be simple or full service. In a full service lease, the lessor provides the lessee with a full package of services. Lessee can,

at the end of the lease period, return the asset, purchase it, or continue to use it for another period. About 35 countries in the world - mostly developed countries - make a great use of operating lease.

3-5- New Products

Intense competition, more innovative plans, and transfer of leasing knowledge among countries have been factors that have pushed forward the industry into the next stage, the new products. The stage features a more advanced operating lease and more term-end options including purchase option and sale option. Among other options are early termination, asset upgrade, contract renewal. At this stage, new products like balance sheet foreign loans, synthetic lease and venture lease are concocted and offered to customers.

3-6- Maturity

A feature of this stage is the combinations and consolidations like the consolidation and acquisition of companies. Another characteristic of the maturity stage is its lower margin that leads to the lessors' seeking higher operation efficiencies and service qualities. Furthermore, leasing industry at this stage has a higher market penetration. This means that a greater proportion of trading in assets and services is carried out through leasing. And finally, use both finance and operating lease and a combination of them in their lease offers.

A few countries in the world including the U.S.A., the Britain, and Australia are at this stage.

It should be noted that the six stages of lease growth are not exclusive of one another. In other words, a country like the U.S. A. for instance, that is at the stage of maturity has lessors that still make use of finance lease and other leases like operating lease.

4- Lease Types

Owing to its wide application and its making use of various operational and profiting techniques, leasing industry has been practiced in different types in different operations. Different types of leasing are as follows:

4-1- Operating Lease

Operating lease is the oldest type of lease and the simplest one. In an operating lease, lessee has the right to use the leased asset and is required to return it at the end of the lease period. Asset cost is fully incurred by the lessor.

4-2- Finance Lease

Finance lease is completely similar to hire purchase agreement in terms of usury-free banking principles. The only difference is that the lessee has the purchase option in finance lease. This lease type is one of the most advanced of its kind in the world. Purchase option and asset ownership right at the term end allows this lease type to have a widespread use in credit market.

4-3- Sales-Aid Lease

In this method an arrangement is made between the lessor and the asset supplier and producer in which the supplier/producer leases its products throughout lease plans and via the leasing company and increases its sale.

Sales-aid lease, also known as vendor lease or program, is widely used in advanced countries and has enabled producers/suppliers to promote greatly their sale and marketing.

This lease plan has established a major proportion of lease market in Iran as well.

4-4- Leveraged Lease

This type of lease is mainly used in big ticket items like airplane, ship, satellite, and oil establishments.

The leasing company obtains financial facilities from different financiers like banks to provide the necessary finance for leveraged lease.

4-5- Sale And Leaseback

In this arrangement the client, the lessee, sells the asset to the lessor and leases it back from the lessor. This allows those lessees in short of cash to acquire an asset and use it while the required finance is provided through leasing, i.e. sale and leaseback method. The seller finally owns the asset.

4-6- Cross-Border Lease

This lease type occurs when the lessors and the lessees are in two different countries and helps the industrialized countries to sell their products in developing ones.

5- Global Lease Volume

According to the World Leasing Yearbook (2007), lease volume has boosted to 582 billion dollars in 2005 from its 2004 figure of 579.13 billion dollars.

As can be seen in the table, North America has witnessed a decrease in its lease trade volume from 2004 to 2005 while Europe has had a 0.8 percent increase and has accounted for 39.7 percent of the global market.

The figures in the World Leasing Yearbook reveal an important fact about Iran and that is the 64 billion Dollar lease volume in Iran which has

ranked the country 43, above countries like India, Malaysia, and Saudi Arabia. Iran has also gained the highest rate of volume increase (100 percent). Unfortunately restrictions imposed on lease interest rates have acted as a detrimental factor to the industry's growth and has led to the decrease of its growth rate.

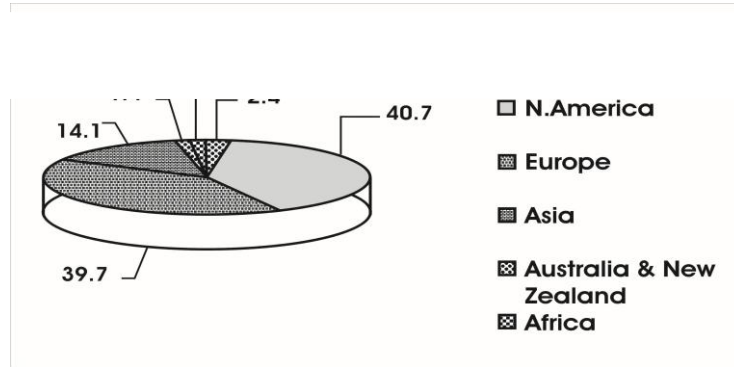
The last 20 years has witnessed a noticeable increase in leasing activity and leasing industry has during its relatively short life of 50 years financed about one third of the capital market in durable goods and capital assets.

Table (1): Lease Volume by Region

(Billion Dollar)

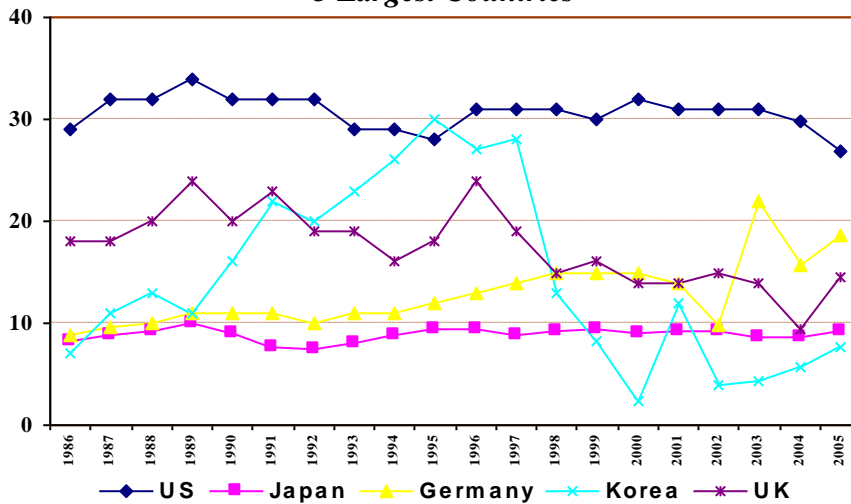
Area	Lease volume	Growth from 2004 to 2005	Percent of total, 2004	Percent of total, 2005	Percent of change
North America	236.7	-1.7	41.6	40.7	-.9
Europe	231.6	.8	39.6	39.7	.1
Asia	82	-3.5	14.7	14.1	-.6
Australia & New Zealand	8.2	1.9	1.4	1.4	0
Africa	9.6	18.6	1.4	1.7	.3
South America	13.9	86.5	1.3	2.4	1.1
<i>Total</i>	582	-	100	100	-

Illustration (3): Percentage of Lease Volume by-Area, 2005



One can approach the measuring of the market penetration of the leasing industry in two ways. One way is to regard leasing as having a share in the fixed investment in the provision and financing of capital and durable consumer goods. This method has been used in several countries since 1978. As the following diagram shows, lease finance has contributed greatly to the financing of capital goods in the large economies of the world. In the last 20 years, leasing industry has been one of the most influential financing sources and has enjoyed an upward trend in market penetration of capital and durable consumer goods financing.

Illustration (4) : The Growth of the Lease Share in Asset Finance in the 5 Largest Countries



In the second method, the share of the leasing industry in the country's gross domestic product is investigated. With this measure we can determine the relative strength of the leasing industry in a particular country and analyze the authorities' view to leasing as an important finance source in that country. This method has been increasingly used in developed countries like the U.S., Germany, and Japan. Its indices in the countries Estonia, Hungary and Slovakia stand at 5.26 %, 4.8 %, and 4.44 % respectively. Iran has been measured at .2 % which has ranked the country 50th. In comparison with Estonia, Iran's index measures 263 times lower. This is while this proportion in Turkey and Saudi Arabia is 60 and 43 in comparison with Estonia respectively. What all this shows is that Iran's leasing industry is endowed with a great growth capacity. This growth will occur provided the state authorities and the regulations take steps in this regard.

6- Leasing in Iran

Iran's leasing industry started in the Iranian calendar year of (1975) but most of the leasing companies to date have been established in the last 5 years. This is indicated in the following table.

Of all the registered leasing companies in Iran, 6 have been dissolved and 20 are public ones with a total registered capital of 2,479 billion Rials. These companies have been set up by banks and other public entities. The other 256 leasing companies are private entities and have a total capital of 1,024 billion Rials.

The earliest established leasing companies in Iran are Iran Leasing Company and Industry and Mines Leasing Company. Uncommon among the public and lack of familiarity with the potentials of leasing in the post-

revolution Iran mainly led to its low growth and the few number of the leasing companies in the two decades after the Islamic revolution. The whole lease finance provided by the first two companies until the 1984 had been 396 million Rials and this amount increased to 8.8 billion Rls in 1992, an increase and a cash flow yet considered unpleasant.

Table (2) : Registered Leasing Companies in Iran

Year	Number of registered companies	Registered capital by year end 1384 (Million Rials)
2005	73	448,828
2004	142	787,894
2003	30	145,553
2002	16	1,176,972
2001	5	104,112
2000	3	130,000
1999	2	3,001
1996	1	1,000
1995	1	800
1991	1	5,000
1977	1	400,000
1975	1	300,000
Total	276	3,503,050

Development of leasing industry in Iran has attracted the attention of the international interested bodies and Euromoney Institute's 2007 publication has referred to leasing statistics in Iran. Iran's lease figures according to this source come in the following table:

Table (3): Lease Volume in Iran

	2003	2004	2005
Gross fixed capital (Billion Rials)	185,126	240,664	281,622
Lease volume (Billion Rials)	4,500	9,000	18,000
Growth (Percent)	100	100	100
Share of equipment leasing (Billion Rials)	2,925	5,850	11,700
Market penetration (Percent)	1.58	2.43	4.15
Market penetration: Ratio of total lease volume to gross fixed capital			

The lease volume in Iran was not noticeable before 2002 but during 2003 to 2005 this volume witnessed a sharp rise. This rise has not been supposed and predicted for the year 2006 due to restrictions imposed on finance interest rates.

The following table illustrates the leasing industry market penetration in different sectors which shows a major role for the leasing industry in 2005.

In comparative study of leasing in Iran and in the world, rough estimates and figures of leasing in Iran for the years 2004 and 2005 show about a hundred percent growth in leasing industry. According to the same statistics, the proportions of lease volume to GDP were 0.65 and 1.07 for these years respectively. The 21% growth in GDP and rise in the proportion makes lease growth in the country a necessity. The proportions in global scale were 2.6 and 1.36 times bigger than those for Iran for the same years respectively.

All these figures highlight the necessity of the introduction of organization and clarification into the industry and the role that it plays in the country's credit system.

Table (4): Proportion of Lease Volume to GDP in Iran

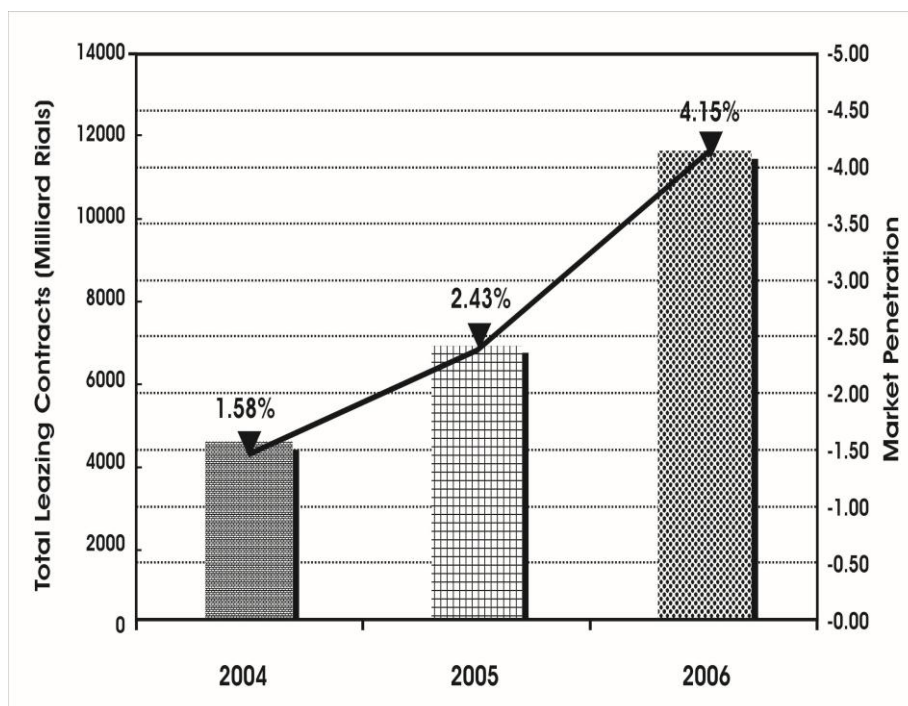
(Milliard Rials)

Description	2004	2005
Lease Volume in Iran	9000	18000
GDP with Oil	1.384,819	1.691.814
Lease Volume to GDP with oil in average	0.65%	1.07%
Global Lease Volume to GDP with oil in average	1.79%	1.45%
Average global-Iranian ratio	2.76	1.36

Leasing market penetration for Iranian private cars in 2005 was 13.8 percent and that for commercial vehicles and building equipment was 22.6 percent and 4.9 percent respectively. Table 5 indicates that a major portion of leasing operation in Iran belongs to passenger cars and commercial vehicles.

Table (5): Market Penetration of leasing in Iran in 2005

	Sale (Billion Rials)	Lease finance (Billion Rials)	Market penetration
Private cars	73063.0	10085.9	13.8
Commercial vehicles	20389.6	4600.0	22.6
Building equipment	1863.3	91.1	4.9
Market penetration: Ratio of lease finance to sale in each sector			

Illustration (4): Market Penetration of Equipment leasing

Leasing companies are categorized into three groups in terms of affiliation:

A- Bank Leasing Companies

Bank leasing companies are those companies owned and controlled by the banks both state and private ones. These companies include Industry and Mines Leasing Co., Iran Leasing Co., Parsian Leasing Co., Eghtesad Novin Bank Leasing Co. These companies have complemented the banking services range of their parent companies.

B- Captive Leasing Companies

These lessors are owned by the producers/manufacturers of the leased assets. Marketing and sale promotion of the parent company has been the

major purpose in the creation of these companies. Some examples are Iran Khodro Leasing Co., Rayan Saipa Leasing Co., Bahman Leasing Co.

C- Independent Leasing Companies

These are independent companies not regulated by any parent company or major shareholders.

7- Regulations In Leasing Companies

Leasing companies confront special legal risks. These risks show up especially when the customers of a leasing company are small-scale companies and this is because owners of these companies might not be familiar with legal issues. Lessors, therefore, should expect misunderstanding and disagreement with some lessees to occur. This is while strong and well-established leasing laws and regulations in a country can minimize legal risks in this industry.

In many countries a legal framework can be established for leasing by drawing leasing laws and regulations. These laws and regulations involve the following issues:

- ❖ Definition for leasing
- ❖ Rights and obligations of the different parties to a leasing agreement
- ❖ Lessor's right to repossession of the leased asset
- ❖ Claims about asset residual value
- ❖ License
- ❖ Care taking requirements and measures

Lease laws and regulations determine the legal authorities to refer to and tax regulations for the lease parties.

Legal risks involved in leasing stem from the fact that asset ownership is different from its use and possession. In any legal conflict involving leasing there is conflict between the lessee who has the right to the use of

the leased asset, the lessor who is the owner of the asset, and the producer which has sold the asset to the owner but has also given the guarantees to the user. Different parties to the contract might have different interpretations regarding their rights to the leased asset and their obligations against the other parties. According to the lease agreement the lessee has the right to use the asset. The lessor on the other hand should give the lessee unlimited power to use the asset. The agreement should oblige the lessor to accept the fact that his creating any problem for the use of the leased asset by the lessee will bring about changes in the liabilities of the lessee. The lessee, on the other hand, is required to use the asset for purposes as stipulated in the lease agreement. The pertinent laws and regulations for the producer/supplier are stipulated in the laws of goods and commodities sale in every country. These laws and regulations hold the seller accountable for goods quality and the suitability of the goods with the stated purpose for them.

Iran's Central Bank has set out and issued the directions and rules for establishment, activities guideline, and the relevant regulations for the leasing companies. A summary of these regulations and directions and some of the ambiguities thereof are as follows:

- 1-Leasing both movable and immovable properties (Articles 1 and 14 of Iran Central Bank's regulations) are carried out via two agreements including installment sale and hire purchase. The inclusion, however, of the phrase "through different methods" can lead to the conclusion that the different methods of installment sale and hire purchase like sale and leaseback are allowed by law according to the principle of will power.
- 2-Obtaining license from Iran's Central Bank following the conformity of the leasing company with the stipulations of the abovementioned directions and regulations, completion of form 2

and submitting it to the Central Bank (following the Articles 4, 10, and 11).

- 3- Having the least possible or base capital (paragraph C of Article 5)
- 4-Observing the regulations of interest rate and its calculation according to the formula approved and dictated by the Credit and Money Council (Article 14 and the Note thereof).
- 5- Acceptance by the leasing company of down payment binding it to structure an agreement. The down payment is payable on demand and does not earn interest. Furthermore, offering discount to the customer in this regard is optional (Articles 15, 17,19).
- 6-Receiving any amount under such various concepts as deposit, guarantee deposit, and the like is prohibited (Note 1 of Article 15).
- 7-The leasing company should present the customer a list of the required documents and the requirements and conditions for obtaining finance and should be clearly articulated to the customer (Article 16).
- 8-The leasing company should stipulate and determine in the contract the necessary bond to be accepted from the customer (Note 2 of Article 16).
- 9-The leasing company should agree to the customer's transferring of the financial facilities to a third party (Articles 13-16).
- 10-The leasing company should draw out the company's memorandum of association and should accept the Central Bank's laws and rules as the accepted and valid laws and rules the company shall refer to (Article 28).
- 11- At least 75 percent of the leasing company's funds and resources available to it should be allocated for financial facilities.

It appears that big ticket leasing companies are operating and extending financial facilities in accordance with the directions and stipulations of the Central Bank as to the establishment of a leasing

company and the regulations thereon. It also appears that the following ambiguities resolved and some changes made to the facilities contracts, most concerns regarding the abovementioned issues will be removed.

8- Some Ambiguities

- 1- On the one hand, the directions of the Central Bank restrict the leasing operations to the different methods of installment sale and hire purchase. On the other hand, these directions identify the company's memorandum of association as the company's set of laws and regulations that must be followed as obligatory. The fact is that other activities like factoring and futures are also mentioned and allowed in the leasing company's memorandum of association. The question is, can a leasing company carry out other activities apart from the installment sale and leasing as part of "facilities operations"?
- 2- Is there a similar restriction on leasing companies as to the maximum amount possible of financial facilities to be extended to real and legal persons as there is on banks?
- 3- What should some other operating expenses incurred in finance extension including assessment fees and others labeled and how should they be accounted for?
- 4- Supposing the governance of the Central Bank in terms of its directions and regulations and following by the leasing company the stipulations of usury-free banking system, are leasing agreements reached legally binding and enforceable?

Regulations for the establishment of a leasing company in Asia , in comparison with those in Iran are as follows:

Table (6): Legal Requirements for establishing a leasing Co. by Country

Country	License required for a leasing company	Minimum capital to start a leasing company	Are banks allowed to make direct investment
Australia	No	No	Yes
Bangladesh	Yes	4 million Dollars	Yes
China	Yes	60 million Dollars	No
Indonesia	Yes	1.25 million Dollars	No
Japan	No	No	No
Korea	No	19 million Dollars	No
Malaysia	Yes	No	No
Maldives	Yes	No	Yes
New Zealand	No	No	Yes
Oman	Yes	13 million Dollars	No
Pakistan	Yes	3.1 million Dollars	Yes
Philippine	Yes	180 million Dollars	No
Singapore	No	No	Yes
Sri lanka	Yes	75,000 Dollars	Yes
Taiwan	No	No	No
Thailand	No	No	Yes
Turkey	Yes	2 million Dollars	No
Iran	Yes	2 million Dollars	Yes

Pricing Of Leasing Services

A leasing company obtains most of its funds from external sources like banks and uses them to provide finance to customers. Another way to

obtain such funds is by issuing shares of the company. These funds are extended to customers in the form of lease finance.

A question arises here. How should the rentals to be received from customers be structured so that the investment is recovered, bad debts are set off, money value is saved against inflation, and finally so reasonable a margin is obtained by the leasing company that the company can service its debts to banks (capital and interest) and pay the expected dividends to its shareholders? The two important factors in lease services pricing are finance cost and administrative costs.

Pricing should be approached taking both sides' views, the lessor and the lessee. For the lessee the price of the finance influences its decision to accept lease finance or not. The lease pricing should be competitive enough. This is possible taking into account the net present value (NPV). While lessees can make use of NPV, lessors regard the profitability of each individual contract. Capital recovery in minimum is required by the lessor and it calculates the rates in proportion to this minimum value. The amount of investment in the lease agreement is equivalent to the purchase cost of the asset. The lessor seeks to recover its capital investment and achieve a rate of return on investment. This return on investment should cover the lessor's operating costs and interest costs on the finance it has obtained and a reasonable net profit for the lessor.

Lower pricing for lease products can only be achieved if the lessor can obtain funds with lower costs. There are a lot of limitations for a leasing company in Iran in obtaining the required funds for its operations. Funds diversification is one way to solve this problem.

9- Legal Considerations in Leasing

Structuring a lease contract and a guarantee is done by the parties' agreement. An article or note in a contract which might make one side to sustain a loss will deter that party from signing the contract. In fact a contract should be structured in accordance with the requirements, wishes and in the best interests of all the parties to a contract.

For the leasing industry to be promoted and popularized in the country, the legal considerations of leasing and the rights of all the parties should be taken into account. In fact structuring a leasing agreement is not possible unless there is an authority the parties can refer for solving any disagreement or conflict that might arise from the contract they have concluded. Iran's Judiciary constitutes the authority to refer to and safeguards people's rights and any issue arising from the contract between lessor and lessee is no exception. This is a generally understood fact the whole world over and the leasing industry's penetration into over half of the transactions in the world is for sure possible with the protection of the contents of an agreed-upon contract afforded by the legal authorities.

10- Steps of a Leasing Operation in Iran

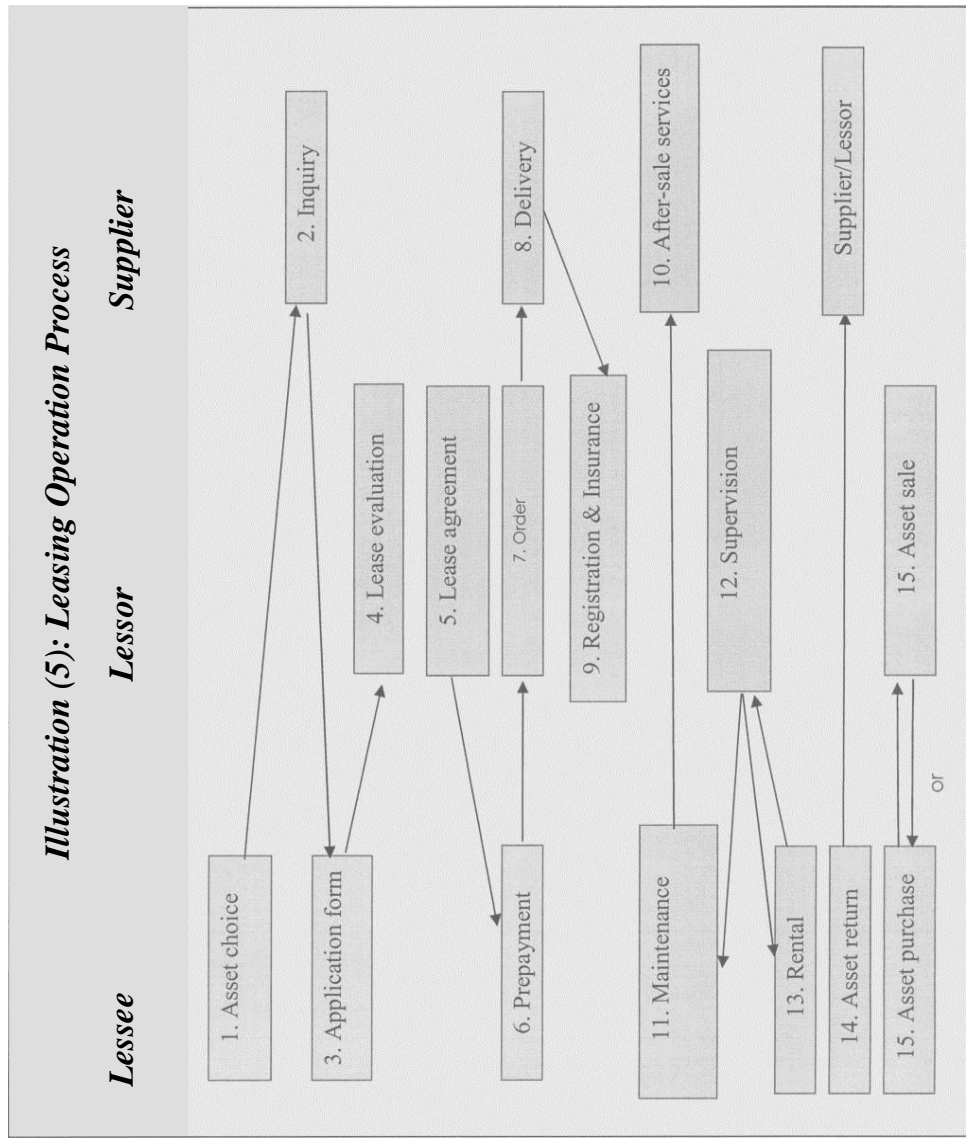
Leasing in general has 15 steps to be completed. These steps are as follows:

- 1- The lessee chooses the asset and the supplier/manufacturer
- 2- The supplier prepares an inquiry letter
- 3- The lessee lodges their application
- 4- The lessor processes the lessee's application
- 5- The contract is drawn and the parties sign it
- 6- The lessee pays rentals
- 7- The lessor puts in an order for the asset
- 8- The supplier delivers the asset
- 9- The lessee registers the asset and takes out insurance for the asset

- 10- The supplier provides after-sale service according to the contract
- 11- The lessee uses the asset with care
- 12- The lessor supervises the lessee's paying the rentals
- 13- The lessee pays rentals
- 14- At the end of the lease period the lessee returns or purchases the asset
- 15- In case the lessee purchases the asset, they should pay the final agreed-upon amount (sometimes a nominal amount) and the lessor transfers the ownership to the lessee.

Leasing companies are in general intermediaries between funds provider, the manufacturer/supplier and the customer. In other words, a leasing company buys the goods and commodities from manufacturer/supplier and leases them out to potential customers. The funds needed by the leasing company to do all these are provided from different financiers including banks, credit houses, etc. Leasing companies do business with customers either directly or through their agencies. Potential customers can lodge their lease application and submit the required documents to the leasing company and wait for their credit appraisal to be done by the leasing company. Then the lease contract is drawn and signed by the lessor and the lessee, and the lessee can receive the asset.

The leasing company determines the amount of the facilities to be granted to customers. The leasing company with the help of its credit appraising committee decides on the amount of the lease finance a particular customer can be entitled to. Credit appraisal system in leasing companies in Iran tends to appraise and base the creditworthiness of the customers on their employment certificate and in general the documentation that they make regarding their work status and ability to pay their debts. Guaranteeing the customer's debt servicing is done by requiring the customer to be backed by some guarantors. The guarantors are also required to provide documentation like employment certificates and some checks and/or promissory notes.



It should be noted that although credit appraising is an important part of lease finance process, the need for some independent credit appraising companies is felt. Despite this, we do not have such companies in Iran.

11- Risk Management in Leasing

Leasing industry faces the following risks:

A- Credit Risk

There are three types of credit risk in the leasing industry:

A-1- Customer Risk

The lessor is exposed to the risk of non-payment or late payment of rentals by the lessee.

A-2- Asset Risk

The asset itself is considered the main security in a lease agreement. The risks pertaining to the asset itself include the problems in the return of the leased asset to the lessor by the lessee, the problems arising from the sale of the returned asset in the second-hand market including the time and the possible costs incurred, and the gap between the second-hand market value and the predicted residual value of the asset and the undesirable condition of the asset on return by the lessee.

A-3- Supplier Risk

When the supplier can not live up to the demands and orders made to it or when the leased products are defective and have malfunction, this will affect the lessee and the lessor subsequently.

B- Transaction or Operation Risk

Transaction or operation risk concerns the strategies and systems of control in a leasing company. This kind of risk involves the technology used, the employees, organization of the company, and other factors

playing role in the administration of the company. In fact this risk arises from the inefficiency or problem in any of these factors and in the systems of control in the company. Management of this risk requires the great care to be taken by the management of the company in their employing the right strategies and systems and processes of control.

C- Legal Risks

Legal issues involved in leasing make leasing a highly risky business in comparison with other businesses. The risks arise mainly from the two relatively problematic concepts of asset ownership and right of use or possession that might bring about problems and conflicts among the three role players, lessee, lessor, and supplier and the added problem of the third party claims. Here the third party might be affected in some way or another and make claims.

All these conflicts and problems can delay the realization of the revenues resulting from delayed rentals and put the company to the expenses of solving these problems.

D- Tax Variation Risk

A lease is arranged on the basis of the tax rules applying at the time. Any unpredicted change in the rate of taxation will affect the profitability of the lease. Such a risk is higher in countries where there is no medium-term stability in the economic programs of the government.

E- Reputation Risk

Reputation risk arises from the damage that might be inflicted upon the leasing company or the industry itself as a result of malfunctions or breaking the rules. Reputation risk management is difficult today. Measures have to be taken on a national level to compile standards for leasing activities and making them law-oriented and rule-governed. On the leasing industry level, codes of practice have to be formulated by the leasing association. And finally, every leasing company have to study the context in which it is operating and identify and control the areas of

danger. Establishing a customer relations management system is one of the modern ways to tackle the reputation risk management.

F- Interest Variation Risk

Interest rate variation affects the lessor's income, costs, assets value, and the liabilities. Such a variation might bring about losses for the company.

G- Liquidity Risk

Liquidity risk refers to the consequences that lack or shortage of liquidity might have in meeting the liabilities when due. In the worst, liquidity shortage might lead the company toward bankruptcy. Optimum allocation of the resources and use of a technique for maintaining the right proportion between cash inflow and outflow are among the measures used in liquidity risk management.

H- Price or Market Risk

Price risk refers to a condition in which changes occur in the price of financial products such as stocks, participation papers, and derivative products like options which are not currently traded in leasing companies.

I- Foreign Exchange Risk

This type of risk arises from the variation in foreign exchange rates when a leasing company takes out foreign exchange finance, has foreign exchange lease arrangements, or has cross border leasing activities. The best way to tackle foreign exchange risks is to arrange foreign exchange lease agreements that involve the practice and use of foreign exchange liabilities. Concluding a foreign exchange lease agreement is suitable in those economic sectors which have revenues in foreign exchange and as a result credit risk is lower.

J- Strategic Risk

Strategic risk refers to the risks involved in deciding on the goals, strategies, business lines, and the like in a business. To manage this kind of risk, management should develop a strategic mind in the organization, launch a careful investigation of the environmental factors, concentrate more on strategies and strategic decisions, and formulate and implement rolling plans.

12- Financing in a Leasing Company

Suitable funds are required for a leasing company to develop and widen its activities. Studies by International Finance Corporation indicate that lack of enough funds has proved the biggest obstacle to the growth and development of leasing companies. A leasing company's funds and finance composition have direct effect on its capital cost and finally on the pricing of its lease products. Therefore, one of the major challenges a typical leasing company may face is obtaining funds and financing from different sources and with suitable cost.

Financing sources can be grouped into different categories:

12-1- Equity Based Financing

Equity finance refers to the money provided by the company's shareholders to form the capital of the company.

12-2- Debt Based Financing

Financing acquired through issuing participation papers or obtaining loans is called debt based financing.

12-3- Derivative Based Financing

This type of finance comes from the sale of derivative products. Derivatives are offered based on underlying assets. Examples are share

options based on shares and rental investment products based on a portfolio of rental contracts.

12-4- Embedded Based Financing

Financial contracts constitute another source of finance. For example, cross border lease is a kind of embedded based finance source.

These finance types can be obtained through formal markets, i.e. stock market, or informal markets, inside or outside the country.

Major financing sources for Iranian leasing companies are equity based financing and bank facilities.

A- Equity Based Financing

Shareholders of leasing companies do not cherish the idea of issuing the company's shares so that they can have more centralized control over the company. Another factor in this reluctance is the ownership composition of these companies. Iran Leasing Company, Industry and Mine Leasing Company, and Rayan Saipa Leasing Company have been listed in Tehran Stock Exchange in the last two years and this joining has enabled them to acquire more funds via share floating. The major shareholders of these companies, however, have displayed a reluctance to float more shares for reasons stated earlier.

It should also be noted that many of the leasing companies in Iran are not qualified and do not satisfy the requirements to join the stock market. Therefore, equity financing does not seem to satisfy their great need for fresh funds.

B- Bank Facilities

There are limitations placed on leasing companies in their securing bank loans. Collateralization as required by banks, high profit rates even for leasing companies which are categorized in the service sector, and limitations in the amount of the facilities that can be obtained are some examples. These are only some of the problems which have proved

formidable obstacles for leasing companies' raising finance from the banking system.

13- Agency Arrangement With Banks

As stated earlier, there are limitations in the amount of the facilities that can be obtained from banks as the country's Central Bank's directions and the credit procedure of the banking system have allowed a legal or real person to make use of a certain amount of bank facilities. To overcome such problems, leasing companies have proposed agency arrangements with banks. A leasing company according to this proposal acts as the bank's agency and concludes contracts with the lessees and offer services to them. The leasing company charges commissions from banks for these services.

14- Development Opportunities for Leasing in Iran

Lease markets are grouped based on the types of assets and customers. In terms of asset type, market is divided into micro ticket, small ticket, medium ticket, and big ticket items of assets. In developed countries lease markets are mainly involved in leasing medium and big ticket items in household, economic establishments, and state organizations sectors. This is while in less developed countries leasing companies are mainly involved in micro, small and medium ticket items for households and small-scale and large-scale economic establishments. Iran is no exception to this rule. Very few instances, however, of leasing arrangements have been made for large scale items with industrial companies. It is estimated that 40 percent of the leases in Iran have been arranged for private cars and 25 percent for commercial vehicles.

Table (7): Leasing Market in Iran

Market	Household	Economic establishments	State organizations
Micro-ticket items	*	*	
Small-ticket items	*	*	
Medium-ticket items	*	*	*
Big-ticket items		*	*

15-Major Stimulants for Leasing Industry Development

- ❖ Simplification of credit arrangements (solving collateralization problem)
- ❖ Promoting sale
- ❖ Tax
- ❖ Job creation and alleviation
- ❖ Major stimulants of leasing industry development in Iran
- ❖ Promoting sale (affiliate and subsidiaries)
- ❖ Funding and finance (bank related lease arrangements)

Leasing industry in Iran is at the stage of familiarization and growth and has a long way to go to achieve a higher degree of market penetration. Some major stimulants of Iran's leasing industry development in the future are as follows:

- ❖ Lower bank interest rates
- ❖ Problems in sale of durable products
- ❖ Development of small-scale, medium-scale, and large-scale industries

- ❖ Job creation
- ❖ Coming into play of foreign leasing companies
- ❖ Funds shortage in public sector organization like municipality, subway, railway, and airlines
- ❖ Engaging of the present leasing companies in international lease markets and big ticket markets

Iran's expanding its global contacts and promoting foreign investments can pave the way for the presence of foreign leasing companies in Iranian markets and Iranian leasing companies in international markets and finally the development of big ticket lease items.

16- Conclusion and Suggestions

Leasing industry in Iran is still a new one despite its increasing growth in the last three years. History of world leasing testifies to the prominent role of leasing in economic development of countries and this fact must encourage Iran's authorities to make efforts to promote this promising industry. The following facts characterize Iran's leasing industry:

- 1- Leasing is mainly a financing method that has for the most part taken the shape of finance lease.
- 2- Leasing has a long way to go to reach maturity and play its real role in the economy
- 3- Operating lease which can be considered an indicator of leasing development in a country has not yet been promoted in Iran
- 4- While most of the leasing companies registered in the last few years are private ones, bank related affiliate and subsidiary leasing companies and those leasing companies related to public institutes have the largest share in the holistic nationwide registered capital.

- 5- profit rate ceiling of up to 17 percent for lease products has exerted a damaging effect on the lease volume.
- 6- The rules and regulations for the establishment of leasing companies have not yet been completely enforced.
- 7- Iran ranked 43rd among the 50 highest ranking countries of the world in terms of lease volume in 2005.
- 8- In the same year, the ratio of the country's lease volume to its gross domestic product was 2 percent which has earned a ranking of 50 for the country in the world.
- 9- The government resolution to provide people with lease-held housing and the possible assumption of this duty by the leasing industry can be a turning point in the development of operating lease in the country.
- 10- Market penetration of the leasing industry in Iran is deeply low in comparison with that in developed countries.
- 11- Taking into account the above-mentioned facts, I would like to put forward the following suggestions:
- 12- The limitations and the ceiling for financing facilities obtainable by leasing companies should be reviewed.
- 13- Leasing companies should be considered and classified as production companies so that these companies can be granted facilities extended to the production companies.
- 14- Rules and regulations for the establishment and functioning of leasing companies ought to be enforced and supervised efficiently by the Central Bank so that the operation sphere and range of activities of these companies will be clearly defined for the current and potential investors.

- 15- The association of leasing companies ought to be a professional one and make great efforts to launch appropriate informative advertisement and communication directed both at the public and the authorities. This establishment should also take measures to exchange the latest information and developments in the leasing industry with other countries especially developed ones.

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