

**LEASE FINANCING IN KENYA: A CRITIQUE OF THE ADEQUACY OF THE  
LEGAL AND REGULATORY FRAMEWORK**

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## DECLARATION

I **PETER JOSEPH KEYA**, do hereby declare that this is my original work and that it has not been submitted for award of a degree or any other academic credit in this or any other University.

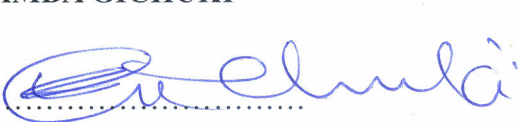
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This thesis has been submitted for examination with my approval as the University supervisor.

**NJARAMBA GICHUKI**

Signed.....

Date.....28/11/2016



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## **ABSTRACT**

Leasing as a business model continues to thrive and develop in the Kenyan market thus requiring banks to be innovative to cater for this emerging niche by offering lease financing. Lease financing is an emerging bank product that helps banks move away from the traditional financing models in the wake of competition amongst banks and from other players in the financial sector including capital market and mobile services. The development of lease financing is also occasioned by the emergence of and aggressive marketing by independent leasing companies. The main challenge facing banks in offering this product is the lack of a clear legal and policy framework . The Banking Act as the main statute regulating banking business and activities is unclear as to whether lease financing is permissible under the realm of banking business or whether some of the activities undertaken in the course of offering lease financing are prohibited under part III of the Banking Act. The Central Bank of Kenya as the regulator is yet to make any policy directive with regards to lease financing.

Lease financing therefore is currently offered in a disharmonised manner. Some banks have continued to apply the existing statutes like Hire Purchase Act, Chattels Transfer Act and Companies Act especially when taking securities from the borrowers. This state of affairs inevitably leads to the arising of several legal issues that this study has highlighted and considered in relation to the adequacy of the existing legal framework. In its consideration, this study examines the legal framework in other relevant jurisdictions and considers a case study in respect of Tanzania and South Africa to put in perspective how these jurisdictions grapple with lease financing, and what aspects are worth emulating. The study concludes with making recommendations with the optimism that the policy makers may consider implementing.



## **LIST OF STATUTES AND REGULATIONS**

### **KENYA**

1. Banking Act. Cap. 488 of the Laws of Kenya.
2. Central Bank of Kenya Cap.491 Laws of Kenya.
3. Chattels Transfer Act Cap. 28 Laws of Kenya.
4. Companies Act Cap.486 Laws of Kenya.
5. Hire Purchase Act Cap. 507 Laws of Kenya.
6. Law of Contract Act, Chapter 23 Laws of Kenya
7. Legal Notice No. 52 of 2002.
8. Statutory Miscellaneous Amendments Act No.52 of 2012.

### **TANZANIA**

1. The Banking and Financial Institutions Act No.5 of 2006.
2. The Banking and Financial Institutions (Financial Leasing) Regulations, 2011.
3. The Financial Leasing Act No.5 of 2008.

### **SOUTH AFRICA**

1. Banks Act No.94 of 1990
2. Inspection of Financial Institutions Act 1998
3. National Credit Act No.34 of 2005.
4. Financial Services Board Act 1990.

## CHAPTER ONE

### INTRODUCTION

Leasing is a concept that is gaining popularity in developing countries.<sup>1</sup> Lease, as a general term, has two meanings. The first meaning is in the realm of real property and is basically a conveyance of lands or tenements to a person for life, for a term of years, at will, in consideration of a return of rent or some other recompense.<sup>2</sup> The second meaning is called finance leasing and it involves movable assets or chattels instead of land. Consequently, leasing is an equipment acquisition method with payment structured over time. . The UNIDROIT Model Law on Leasing define a lease as a transaction in which one person provides another poerson with the right to possess and use an asset for a specific term in return for rentals and includes sub-lease.<sup>3</sup> It is a commercial arrangement whereby an equipment owner or manufacturer conveys to the equipment user the right to use the equipment in return for rent.<sup>4</sup> One party allows the other party to use their property, plant, or equipment for a stated period of time in exchange for consideration. The distinction between land lease and leasing lies in the subject matter. Leasing in effect separates the legal ownership of an asset from the economic use of that asset.<sup>5</sup>

Leasing has increasingly become commonplace as businesses and consumers look for alternatives to finance the acquisition of fixed assets.<sup>6</sup> Leasing, instead of purchasing, can be a cost-effective option, particularly if one does not have the cash on hand, but needs the equipment - from computers to phone systems to capital equipment and other gear

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<sup>1</sup> Ary Naïm, (2008) "Leasing in Developing Countries: IFC Experience and Lessons Learnt" *IFC, World Bank Access Finance Newsletter, June 2008, Issue No. 23. Pp 2-3.*

<sup>2</sup> Law Dictionary, <http://thelawdictionary.org/lease/#ixzz2ZkmIOalU> [Accessed on 22<sup>nd</sup> July 2013].

<sup>3</sup> Article 2. The UNIDROIT Model Law on Leasing can be accessed at <http://www.unidroit.org/leasing-model-law-2008/>.

<sup>4</sup> Business Dictionary, <http://www.businessdictionary.com/definition/finance-lease.html>. [Accessed on 22<sup>nd</sup> July 2013}.

<sup>5</sup> International Finance Corporation (2005) *Leasing in Development Lessons from Emerging Economies*, International Finance Corporation 2121 Pennsylvania Avenue, NW, Washington, DC 20433, 2005.

<sup>6</sup> Mohammad S. Al-Shiab & Shamsi Bawnih, (2008) "Determinants of Financial Leasing Development in Jordan" *Studies in Business and Economic Journal*, Qatar University, Vol. 14 No. 2, 2008. P 2. Such other alternatives are direct financing and other traditional approaches used to acquire assets beyond the scope of this study.

needed to run a company.<sup>7</sup> Apart from being motivated by financial limitations, this type of leasing can be undertaken by companies even where the financial ability to purchase is present.<sup>8</sup> This is because by leasing, one is able to find that they can regulate cash flows more effectively, because of predictable, regular monthly instalments as opposed to a single lump sum payment incurred in making a purchase. In addition, leasing can help in avoiding the tying up lines of credit, which leaves the finances available for other areas of business<sup>9</sup> usually the core business of the company. Moreover, for businesses which are prone to transfer, leasing is a more cost effective method.<sup>10</sup> Leasing is based on the proposition that profits are earned through the use of assets during their useful life rather than from their ownership. In Kenya, some corporate entities and multinationals have embraced and adopted the concept of leasing and it is becoming an acceptable business model to companies for one reason or the other.<sup>11</sup>

For purposes of this study, leasing is the business model adopted by companies or enterprises whereby they approach an intermediary not being a manufacturer or dealer of the assets, known as a leasing company to acquire assets for a period of time being the useful life in exchange for payment or rentals. Lease financing is the product offered by banks for purposes of extending finances towards the lease transaction described above. Banks are the institutions as defined and operating within the realm of the Banking Act.<sup>12</sup>

Competition in the traditional asset financing market is forcing major Kenyan commercial banks to innovate and explore the formerly untapped areas of financing including lease financing.<sup>13</sup> In view of the financial crisis in the financial sector

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<sup>7</sup> Mike Albu, (2004) "Leveraging Leases for Small Businesses: A working analysis of opportunities, with special reference to the situation in Kenya," *AG 2630 Micro Leasing for Poor Peoples Enterprises*, January 2004.

<sup>8</sup> For instance when leasing is undertaken by multinationals, blue chip companies and the government who all have the purchasing power.

<sup>9</sup> Mike Albu (2004).

<sup>10</sup> Ibid.

<sup>11</sup> Based on the author's own knowledge and experience while working as a Legal Officer in a bank.

<sup>12</sup> Chapter 488 of the Laws of Kenya.

<sup>13</sup> Pietro Calice, Victor M. Chando & Sofiane Sekioua, (2012) "Bank Financing to Small and Medium Enterprises in East Africa: Findings of a Survey in Kenya, Tanzania, Uganda and Zambia" *African*



elsewhere in the world experienced tat about the year 2008 and the aspirations of Kenya's Vision 2030 for financial services sector to keep up with the global best practices, this study argues that it is high time financial institutions moved away from the traditional way of lending and with the help of the regulators in the industry, formulate innovative products that will be beneficial by diversifying and developing novel bank products responsive to the customers' needs. This is so bearing in mind the progression by other sectors in the country including the Capital Markets and mobile money transfer all targeting the same customers as the Banks.

Lease financing in Kenya is carried out by banks within the general realm of loan transactions.<sup>14</sup> In the premises, only high net worth companies, established blue chip companies and multinationals have embraced the concept of leasing owing to the developed nature of the said entities and the business model elsewhere in the world where such entities trace its origins. The banks therefore only offer lease financing to such entities in order to minimise on the risk of default on the lending as it remains unclear on how banks can deal with the legal issues of banking business, securitisation in the event of default and tax implications. Some of these issues shall be dealt with in greater detail in subsequent chapters. In 2002, the Income Tax Leasing Rules, 2002<sup>15</sup> were gazetted by the then Minister of Finance. These are the only guidelines issued since and expressly relating to leasing in Kenya although limited to the tax implications which matters are beyond the scope of this study. The rules gave a new lease of life to leasing in Kenya.<sup>16</sup> Thus, the legal effects of leasing and lease financing are largely deduced from common law and the tax implications from Income Tax and Value Added Tax Acts.<sup>17</sup> The lack of a

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*Development Bank, Working Paper Series, No 146* March 2012. ADB Working Papers are available online at <http://www.afdb.org/>

14 Oliver Wakelin, Louis Othieno & Kirugumi Kinyua, (2003) *Leasing Equipment for Business, A Handbook for Kenya*, DFID.

15 Through Legal notice No. 52 of 2002.

<sup>16</sup> Financial Sector Deepening News Issue 03 February 2008. p.2 Available at [http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCwQFjAA&url=http%3A%2F%2Fwww.fsdkenya.org%2Fnewsletters%2F080215\\_FSDNewsletter\\_Issue\\_03.pdf&ei=KwPtUdmbFMj4sgbWp4HwBA&usg=AFQjCNHYkhSkPxx0qwe8JEIINMEA0ZhuOw&sig2=s41P9ZbtfutGyM5KA7jYTg&bvm=bv.49478099.d.Yms.](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCwQFjAA&url=http%3A%2F%2Fwww.fsdkenya.org%2Fnewsletters%2F080215_FSDNewsletter_Issue_03.pdf&ei=KwPtUdmbFMj4sgbWp4HwBA&usg=AFQjCNHYkhSkPxx0qwe8JEIINMEA0ZhuOw&sig2=s41P9ZbtfutGyM5KA7jYTg&bvm=bv.49478099.d.Yms.) {Accessed on 22<sup>nd</sup> November 2012}.

17 The Judicature Act in section 3 on provides for the application of Common Law in Kenya and is to the effect that where there is no written law addressing a matter, the Common Law of England applies.



clear legal and policy framework for leasing and lease financing and the effectiveness of the applicable laws is the subject of this study with the ultimate possibility of developing a standard lease financing product and guidelines for the banks in Kenya.

Despite the lack of adequate legal or regulatory framework addressing itself to lease financing in Kenya, lease financing is taking root in the country. Owing to the need by banks to develop their relationship with their high end, multinational and blue chip companies and the emergence of leasing companies that have been aggressive in marketing leasing as a business model, banks in Kenya have somehow managed to develop a product to cater for this segment. The Leasing Association of Kenya has been established incorporating the stakeholders and it has in the past made a case for a regulatory framework that will allow leasing to flourish in the country to the Kenya Revenue Authority and Ministry of Finance for fundamental changes to be made to the legal framework.<sup>18</sup>

It is therefore necessary to consider the existing legislative framework governing banks to ascertain how exactly banks have been engaged in providing lease financing as a product. For instance the Banking Act<sup>19</sup> is enacted as an Act of parliament to amend and consolidate the law regulating the business of banking in Kenya and for connected purposes. Section 2 thereof defines a bank and banking business. Lease financing is not expressly included in the definition of banking business and the study will thus consider whether there is need to extend the definition to specifically cover lease financing (as was recently extended to cover mobile money transfer, bancassurance and agency banking in line with developments in the banking sector to deal with emerging aspects).

Part III of the Banking Act deals with prohibited business. Section 11 (h) of the Banking Act prohibits banks from granting advances or entering into contracts or transactions or

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Financial Leasing transactions, like other commercial transactions, have tax implications and these are addressed by the Income Tax Act, Value Added Tax Act and the relevant rules.

<sup>18</sup> Financial Sector Deepening, (2008) *FSD News* Issue 03 February 2008.

<sup>19</sup> Cap. 488 of the Laws of Kenya.

conduct business in a fraudulent or reckless manner.<sup>20</sup> Section 12 of the Banking Act prescribes restrictions on trading and investments by banks. Of particular interest is subsection (b) which restricts banks from holding directly or indirectly any part of share capital . . . interest in any financial . . . commercial undertaking. Section 18 of the Act provides for the ratios that banks need to maintain between capital and assets. This is because, as discussed in chapter three, some of the banks opt to own the asset and then become the lessor in a lease transaction and not just take as security for the loan made.<sup>21</sup>

The Central Bank of Kenya is empowered to advise and direct among other things to ensure that banks maintain a stable and efficient banking and financial system. The Central Bank of Kenya is the regulator of banks and other financial institutions and therefore retains a critical role in providing direction on the development of new bank products such as lease financing through issuance of regulations and rendering advice to the Minister in situations, particular measures or transactions.<sup>22</sup> In exercise of its mandate, the Central Bank of Kenya has issued several prudential guidelines to guide banks in the conduct of their banking business. It is worthy of note that section 52A gives the Banking Act supremacy to prevail in the event of conflict with any other laws.

In grappling with the question of the bank's security under a lease financing transaction, it remains unclear how the banks need to approach it. Recourse is currently made to the existing statutes like the Hire Purchase Act<sup>23</sup> and the Chattels Transfer Act<sup>24</sup> to which banks rely on to create securities over assets through the creation and registration of specified documents and instruments notwithstanding the peculiar nature of lease financing. The Chattels Transfer Act defines chattel as 'any moveable property that can be completely transferred by delivery...'<sup>25</sup> Under the Chattels Transfer Act, the definition of

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<sup>20</sup> section 11(1A) defines recklessness as offering facilities contrary to guidelines of regulations issued by Central Bank of Kenya.

<sup>21</sup> Section 12 of the Banking Act allows banks to take property as security for loans made.

<sup>22</sup> Section 50 (3) of the Central Bank of Kenya Limited.

<sup>23</sup> Cap. 507 Laws of Kenya.

<sup>24</sup> Cap. 28 Laws of Kenya.

<sup>25</sup> Section 2 of the Chattels Transfer Act.

instrument<sup>26</sup> excludes debentures and hire purchases which are specifically dealt with under other statutes.<sup>27</sup> The relevance and applicability of the Companies Act to lease financing is also considered by this study. The applicability and limitations of these statutes shall be considered in greater detail in chapter three under legal issues arising from the current practice of lease financing transactions by the different banks.

### 1.1 Statement of the problem

Vision 2030 envisages 'a vibrant and globally competitive financial sector driving high levels of savings and financing Kenya's Investment need.'<sup>28</sup> To achieve this noble standard, there is need for financing mechanisms that will encourage the emergence, growth and sustainability of businesses at all levels.<sup>29</sup> Finance has a vital role to play in development.<sup>30</sup>

Kenya, like other developing countries, has continued to face challenges in the financial services sector as it strives to develop with the rest of the world. Independent leasing companies have also continued to emerge and expand within the country as they market their transactions, with several banks anchoring themselves in financing the leasing transactions. Banks have continued to be challenged to forge closer relations with low income earners who require their services by developing appropriate products. The Central Bank of Kenya Governor has said that there is need for the financial sector to develop diverse financial products that will help the low income segment manage short and long-term liquidity and investment in the face of uncertainty in the incomes and consumption needs.<sup>31</sup> Whereas the Governor did not expressly mention lease financing,

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<sup>26</sup> Section 2 of the Chattels Transfer Act.

<sup>27</sup> Companies Act Cap.486 Laws of Kenya and Hire Purchase Act.

<sup>28</sup> This is an excerpt from the First Medium Term Plan under the economic pillar of the Kenya Vision 2030 statement. Kenya, Government of (2008) First Medium Term Plan (2008-2012).

<sup>29</sup> See generally UNCTAD, Improving the Competitiveness of SMEs in Developing Countries, The role of finance to enhance enterprise development, UNCTAD/ITE/TEB/Misc.3, United Nations, NY 2001.

<sup>30</sup> Ibid. p.11.

<sup>31</sup> Remarks made by Prof. Njuguna Ndung'u the Central Bank of Kenya Governor during the launch of Kenya Financial Diaries Shilingi Kwa Shilingi – A Study of Financial Lives of the Poor s reported in



development of lease financing product is one of the ways to effect the Governor's intentions. Moreover, with increased competition, some analysts in the banking industry reckon that the banking sector growth witnessed in the recent past may slow down with the growth in the economy. Accordingly, as the banks become mature, most of them will need to reinvent themselves by exploring new growth areas<sup>32</sup>.

Several start-ups and Small and Medium Enterprises are hampered by financial constraints.<sup>33</sup> For instance, it has been observed that the Kenyan dairy industry has failed to develop as expected because of the failure to adequate equipment at the small holder firm level.<sup>34</sup> This is because the small dairy farmers are not able to afford the purchase of modern equipment. Traditional commercial lenders including banks, are reluctant to finance them because their capital base is low and they do not have a credit history.<sup>35</sup> Thus, lease financing in Kenya is a possible panacea for Small and Medium Enterprises' low-capitalisation, small profit margins and a lack of creditworthy history. There is a large unsatisfied demand for leasing in East Africa especially in the Small and Medium Enterprise industry.<sup>36</sup>

## 1.2 Research questions

This research is guided by the following questions;

- i. What is the current Kenya's legal and regulatory framework governing lease financing by banks in Kenya?

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Zachary Ochuodho 'CBK tells banks to woo low income earners' People Daily Wednesday August 13, 2014 at page 25.

<sup>32</sup> Remarks by Paul Mwai Chief Executive Officer of Afrika Investment Bank as quoted in Joshua Masinde 'Only the most innovative financiers will survive 2015' Sunday Nation December 28<sup>th</sup> 2014 at page 34.

<sup>33</sup> I.M.D. Little, "Small Manufacturing Firms in Developing Countries", *The World Bank Economic Review*, vol. 1, no. 2, p. 212-213.

<sup>34</sup> Mike Albu, (2004) p 1.

<sup>35</sup> Peter N. Maina, (2010) "Fair value reporting challenges facing Small and Medium-Sized Entities in the agricultural sector in Kenya," University of South Africa, July 2010.

<sup>36</sup> Leonard K. Mutesasira , Sylvia Osinde and Nthenya R. Mule, "Potential for Leasing Products: Asset Financing for Micro- & Small Businesses in Tanzania and Uganda", MicroSave-Africa, An Initiative of Austria/CGAP/DFID/UNDP. p6.

### **1.3 Research hypothesis**

The research works with the general hypothesis that the current legal and policy framework for lease financing in Kenya is inadequate.

### **1.4 Significance of study**

There has not been any or any major academic study analysing Kenya's legal adequacy to promote lease financing as a banking product. Banks nevertheless continue offering lease financing in an disharmonised or unstandardised way as discussed in chapter four of this study . various banks continue to rely on their own 'tailor made' products under lease financing. As a result, lease financing as a business model has been faced with myriad of challenges.<sup>37</sup> Due to the potentially immense benefits that leasing as a business model present to the financial services industry and the country's economy at large, there is a need for reinforcement of the practice and the legal and regulatory framework should address the subject comprehensively to limit the challenges and promote the practice.

This study analyses the existing legal framework and its adequacies from the perspective of banks with the ultimate intention of encouraging innovative lending through such untapped areas as lease financing. This will be a positive step by banks to be able to keep up with the aspirations contained in Vision 2030 of making the financial sector competitive globally. It is no doubt that there is concerted effort by leasing companies to popularise the leasing business model and increased uptake thereof by Kenyan companies. It is argued that the uptake of leasing increases financial accessibility resulting to financial inclusion and can serve as an investment trigger.<sup>38</sup> Developing the leasing sector as a means of delivering finance increases the range of financial products in the marketplace and provides a route for accessing finance to businesses that would otherwise not have it, thus promoting domestic production, economic growth and job

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<sup>37</sup> Benson Kathure B (2007).

<sup>38</sup> Mike Albu (2004) p3.

creation.<sup>39</sup> It is hoped that from the study, the issues discussed and recommendations made can be pursued by the stakeholders in the financial services industry to test their veracity and practical applicability.

### 1.5 Theoretical framework

One of the most cited theory of regulation is the public interest theory of regulation.<sup>40</sup> This theory states that the law must regulate the financial industry for the good of the public. The theory posits that government regulation is the instrument for overpowering the shortcomings of imperfect competition, unbalanced market operation, missing markets and other undesirable market results.<sup>41</sup> In the context of lease financing, the public interest theory of regulation is relevant in that certain financial institutions should not be allowed to monopolise the leasing industry or create cartels.<sup>42</sup> Moreover, the regulatory framework should allow more involvement of banks so that the services are more accessible to the public whilst also remaining acceptable to the banks. With a well regulated leasing industry, the members of the public are more likely to venture into leasing as a business model. Besides, there is likelihood of increased confidence in the product once offered by banks owing to the existing stringent regulations governing the activities of banks particularly in the wake of what happened in the 1990s as a result of which public confidence in banks waned and several banks ended up collapsing. In addition, the existence of a standardised product creates certainty in the market which is good for the public participation.

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<sup>39</sup> Ary Naïm, (2008) p.13.

<sup>40</sup> For an expansive explanation of the Public Interest Theory of Regulation, see Johan den Hertog, 5000 General Theories Of Regulation, Economic Institute/ CLAV, Utrecht University, 1999. pp 3-13.

<sup>41</sup> Arrow, Kenneth J. (1970), 'The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation', in Haveman, Robert H. and Margolis, Julius (eds), *Public Expenditure and Policy Analysis*, Chicago, Rand MacNally College Publishing Company, 67-81.

<sup>42</sup> William A. Jordan, (1972) "Producer Protection, Prior Market Structure and the Effects of Government Regulation," *Journal of Law and Economics* , Vol. 15, No. 1 (Apr., 1972), pp. 151-176. at p 154.



Critics of this theory argue that practically, the market cures its own inefficiencies and does not need regulation.<sup>43</sup> The other criticism relates to costs and argues that government regulation is costly.<sup>44</sup> This study adds to the criticisms by stating that practically, it is very difficult to determine public interest, given the diversity of the populace, and translate it into legal regulatory terms. This theory has therefore not been advanced in this study.

The other theory is the private interest theory of regulation.<sup>45</sup> It provides that regulation comes to the rescue of the concerned industry, in this case, the leasing Industry<sup>46</sup> as propagated by the banks and other stakeholders. It explains that the law brings in regulation initially to curb abuse of an economic position by a player or players in the industry. Later, other political interests that may interfere with the industry come in and the regulator becomes the defender of the players in that industry because it depends on the players for its information.<sup>47</sup> Moreover, the regulators will defend or protect the industry to protect their careers as regulators in the industry.<sup>48</sup> This study posits that banks can be major players in the leasing industry. Currently, the direct involvement of banks in leasing is minimal.<sup>49</sup> If the ultimate outcome of a legal and regulatory framework is to regulate the banks in its offering of a standard lease finance product, then it is welcome.

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<sup>43</sup> See Cowen, Tyler (ed.), (1988) *The Theory of Market Failure*, Fairfax, George Mason University Press.

<sup>44</sup> Posner, Richard A. (1974), 'Theories of Economic Regulation', 5 *Bell Journal of Economics and Management Science*, 335-358.

<sup>45</sup> For a detailed description of this theory, see Bruce M. and Braeutigam, Ronald R. (1978), *The Regulation Game: Strategic Use of the Administrative Process*, Cambridge, MA, Ballinger, 271 p.

<sup>46</sup> Michael E. Levine and Jennifer L. Forrence, (1990) *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, *Journal of Law, Economics, & Organization*, Vol. 6, Special Issue: [Papers from the Organization of Political Institutions Conference, April 1990], pp. 167-198. Pp 174-176 available at <http://www.jstor.org/stable/764987> {Accessed on 24th July 2010}.

<sup>47</sup> Ibid.

<sup>48</sup> Ibid.

<sup>49</sup> See generally Pietro Calice, Victor M. Chando & Sofiane Sekioua (2012).

George Stigler developed the theory of Economic Regulation in the year 1971.<sup>50</sup> The primary basis of the theory is that:

*“As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit”.*<sup>51</sup>

The theory provides that the economic benefits of regulation to an industry are obvious and they include subsidies from government, maintenance of fair prices by the government, avoid cartels establishing themselves and running the market among others. The outcome then is that regulation is good for both the players in the industry and the consumers of services therein. Stigler’s theory has faced criticism and top among the criticism was the fact that regulation tends to protect the consumers of a commodity only and not the producers.<sup>52</sup> George Stigler’s<sup>53</sup> theory is theoretically or if well applied, ideal. This is because, unlike the previous theories, it sees regulation from both the supply and demand sides of the respective industry. Just as regulation should ensure that the consumers are receiving good products and are not being exploited, it should also ensure that suppliers of those products are comfortable and profitable in the market.

This study reiterates the need for the legal and regulatory framework to protect lessors, lessees banks and other third parties. This study adopts Stigler’s theory of economic regulation with a bias on the role of banks and financial institutions and the government as players in the leasing industry.

The most common theory that is given against regulation is the free enterprise theory or free market economics.<sup>54</sup> The theory asserts that regulation has no place in the market and the market forces will regulate themselves.<sup>55</sup> That when the market is free from

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<sup>50</sup> George J. Stigler, (1971) "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science*, Vol. 2, No. 1 (Spring,1971), pp.3-21. Available at <http://www.jstor.org/stable/3003160> (Accessed on 24th July 2013).

<sup>51</sup> George J. Stigler (1971).

<sup>52</sup> Posner, Richard A. (1971), 'Taxation by Regulation', 2 *Bell Journal of Economics*, 22-50.

<sup>53</sup> For a biography of George Stigler, visit <http://www.econlib.org/library/Enc/bios/Stigler.html> (Accessed on 24th July 2013}.

<sup>54</sup> McKie, James W. (1970), 'Regulation and the Free Market: The Problem of Boundaries', 1 *Bell Journal of Economics*, 6-26.

<sup>55</sup> Ibid.



regulations, competition is enhanced and service delivery improves. Time has proved this theory wrong. The theorists in the strict sense fail to appreciate that it is not markets that act, but people.<sup>56</sup> Moreover, most markets, if not all, are never perfectly competitive.<sup>57</sup>

## 1.6 Literature review

There is not much academic literature specifically addressing lease financing in Kenya. The writings on the topic tend to focus more on leasing as a business model and not from the perspective of financial institutions and lease financing as highlighted below. However, there exists some literature on the role of legal regulation of leasing in other jurisdictions and this study has benefited from them.

Following the financial crisis in America and parts of Europe, Kolb Robert W. in his book *Lessons from the Financial Crisis: causes, consequences, and our economic future* has analysed the financial crisis and the economic future.<sup>58</sup> The book looks at the financial crisis both from the management and regulatory perspective as well as innovation and development of new market products by financial institutions to enhance their lending products as they strive to remain relevant and competitive in the modern market.

According to the International Finance Corporation Publication, *Leasing in Development Lessons from Emerging Economies*<sup>59</sup>, leasing provides a means for delivering increased domestic investments within economies. By developing additional financial tools such as leasing, countries are able to deepen the activities of their financial sector by introducing new products and/or industry players. Accordingly, developing the leasing sector as a means of delivering finance increases the range of products in the market place and

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<sup>56</sup> Paul C. Roberts, (2011) "The Case for Regulation, The Failure of Free Market Economics, Global Research," *The International Economy*, Fall 2011 issue 10 November 2011.

<sup>57</sup> See generally Gal, M., "Competition Policy in Small Economies", in *OECD Global Forum on Competition* (2003).

<sup>58</sup> Kolb Robert W. (ed) (2010) *Lessons from the Financial Crisis: causes, consequences, and our economic future* Hoboken, N.J: Wile.

<sup>59</sup> International Finance Corporation, (2005) *Leasing in Development Lessons from Emerging Economies*, p.28-32.

provides a route for accessing finance to businesses that would otherwise not have it, thus promoting domestic production, economic growth and job creation. All these attributes resonate well with the Kenya Government's vision 2030 initiative.

Unal Tekinalp in *Turkey's New Financial Leasing Law and Industry*<sup>60</sup> observes that the number of transactions in leasing increased when law in the sector was introduced. The article highlights the possible strong points in the Turkish law that might have spurred the growth.<sup>61</sup> The law in Turkey regulates leasing companies in terms of organisation, nature and their structure. He points out that the exclusivity of the law on financial leasing alone encouraged the growth.<sup>62</sup> The other aspect brought out in the article is that the law embraces the tripartite nature of leasing transactions.<sup>63</sup> This tripartite nature is reflected in the rule that the lessor may not necessarily be a producer or supplier of assets in any single leasing transaction. Other aspects of the Turkish law cited by the author in the article relate to the insulation of lease property from creditors, a required four-year lease period. In that context the transfer of ownership of lease property is not fatal and the fact that the lessor's liability is diminished while they retain title of the subject matter.

Judy L. Woods, in *Risk of Economic Loss and Implied Warranty Liability in Tripartite Finance Leases*, decries the dangers of allowing finance leases to be tripartite.<sup>64</sup> The author argues that if the equipment is defective, the lessee is at risk because the lessor and the equipment vendor may not be willing to incur the liability. In explaining the above, the article points out that, a contract exists between the lessor and the seller for the purchase of the equipment.<sup>65</sup> A lease agreement is between the lessor and the lessee. No contract exists between the equipment seller and the lessee, who is the ultimate user and consumer of the equipment. The result of this is that, if there is a problem with the equipment, there

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<sup>60</sup> Unal Tekinalp, (1992) "Turkey's New Financial Leasing Law and Industry", 60 *Fordham L. Rev.* S117 available at: <http://ir.lawnet.fordham.edu/flr/vol60/iss6/7> (Accessed on 24<sup>th</sup> July 2013).

<sup>61</sup> Law Concerning Financial Leasing, Turkish Official Gazette No. 18795.

<sup>62</sup> Unal Tekinalp, (1992),p.3.

<sup>63</sup> *Ibid.* p 6.

<sup>64</sup> Judy L. Woods, (1988) "Risk of Economic Loss and Implied Warranty Liability in Tripartite Finance Leases," 22 *Val. U. L. Rev.* 593. Available at: <http://scholar.valpo.edu/vulr/vol22/iss3/3> (Accessed on 24th July 2013).

<sup>65</sup> *Ibid.* p 3.



is finger pointing between the lessor and the equipment seller thus jeopardizing the lessee. Incorporating a bank in a lease transaction can only complicate the matters as the bank and the lessor may not have adequately made provisions to govern the particular situation arising. Judy's concern is valid and genuine especially in the context of securitization but can easily be cured through appropriate legal and regulatory framework.

Peter W. Heermann examines the remedies for both the lessor and lessee in a leasing transaction. In his article *The Structure of Lessees' and Lessors' Remedies Regarding Finance Leases of Equipment and Personal Property under United States and German Law*, the author emphasizes the structure of the parties' rights and their remedies in leasing arrangements.<sup>66</sup> The paper observes that the movement towards statutory regulation of leasing was prompted by the rapid growth of equipment leasing in the countries of study. The author uses Germany and the United States of America and comes up with conclusions worth considering. Firstly, the article concludes that the role of finance lessors is what determines the nature of trilateral finance lease transactions.<sup>67</sup> This means that, the law must be clear on the place of banks and the rest of the transaction will fall in place.

This study also considered the input of a financial advisory service provider in Kenya, KPMG East Africa, one of the leading auditing firms in Kenya who opines that Kenya also lacks legislation to govern leasing of assets.<sup>68</sup> The opinion by the auditor is in consideration of the existing capacity by the Kenya Revenue Authority and the Central Bank of Kenya to deal with lease financing issues. Central Bank of Kenya as a regulator of banks should be instrumental in capacity building and development of innovative products by banks including availing the necessary policy and legal framework that relate

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<sup>66</sup> Peter W. Heermann, (1993) "The Structure of Lessees' and Lessors' Remedies Regarding Finance Leases of Equipment and Personal Property under United States and German Law", 15 *Loy. L.A. Int'l & Comp. L. Rev.* 307 Available at: <http://digitalcommons.lmu.edu/ilr/vol15/iss2/2> (Accessed on 24th July 2013).

<sup>67</sup> *Ibid.* p. 83.

<sup>68</sup> Mr. Lawson Naibo as quoted by Benson Kathuri B (2007) "KRA, CBK can't handle issues on asset leasing, expert says" *The Standard* Newspaper 24th July 2007 accessed at <http://allafrica.com/stories/200707231876.html> on 12th January 2012.

to leasing and lease financing aspects. The auditor further argues that the Kenya Revenue Authority can use the tax incentives to assist in the development of the product. This is what might have informed the Minister for Finance at the time in coming up with the Income Tax Leasing Rules of 2002.

This study has considered the possible adoption of UNIDROIT model Law on leasing and the principles of UNIDROIT Convention on International Financial Leasing of May 28, 1988.<sup>69</sup> The convention contains certain principles that can be helpful in guiding the development of the legal regulatory and policy framework domestically. The study also considered aspects of cross border leasing.

### **1.7 Proposed methodology of study**

The study contains elements of two defined research methods or approaches; 1) an analytical element, in that it adopts a descriptive, analytical and critical approach to desk, electronic and other materials or information available on the topic under study; and 2) an empirical element in that it is in part informed by the authors own experience. The author having worked as a legal officer at Diamond Trust Bank Kenya limited at the time when lease financing was being introduced in the bank, was instrumental in the development of the bank's manual on lease financing which was finalised in the year 2011. The author generally acquainted himself with the industry developments across the banks through participation in several meetings of stakeholders.

### **1.8 Proposed structure**

The research is presented in five chapters.

Chapter one – Introduction. This is the introductory part that sets out the background, the problem statement, scope, rationale, context theoretical framework and limitations of the study.

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<sup>69</sup> Ibid. p.85.

Chapter two - An overview of lease financing. Lease financing being a fairly new and developing concept in Kenya, this chapter considers the historical development of lease financing and its various aspects in general including the types of leasing transactions and lease financing in comparison to the existing lending products offered by banks in Kenya in light of the existing statutory provisions. The chapter also sets out the general advantages and challenges of leasing.

Chapter three – The practice of lease financing in Kenya. This chapter discusses how lease financing is undertaken in Kenya. This takes the form of outlining the current practice by banks in offering lease financing as a product with examples on select banks. The chapter also considers the legal issues arising and challenges faced by the selected banks in devising the lease financing product in the context of the existing legislative, regulatory policy and institutional framework whilst addressing the adequacy thereof. The issues arising discussed are the need for regulatory intervention of leasing companies, the sufficiency of the definition of banking business, asset trading aspects of banking business, securitisation and enforcement thereof and the case for legislative intervention in lease financing. Though there are tax and accounting issues that arise and need to be addressed, that is beyond the scope of this study.

Chapter four – Comparative analysis. Having looked at lease financing in Kenya in chapter three, this chapter considers the case study in so far as legislative framework as it obtains in other countries with the intention of obtaining the best practices that can be adopted in Kenya. In particular, the study will focus on two African countries, Tanzania and South Africa. Tanzania because it neighbours Kenya and it is part of the East Africa Community in the wake of integration within East Africa Community member states and the potential need to harmonise legislation in the long run. In addition, Tanzania has a specific legal and statutory regime governing leasing and lease financing unlike Kenya. This regime has been developed through the assistance of the International Finance Corporation's effort towards developing lease financing framework in developing countries. South Africa is ideal because it is considered to be advanced both economically and in terms of policy and legislative framework particularly on lease financing. In



Africa, reference is usually made to the South African experience that is considered to be a model and ideal in bench marking. Moreover, Kenya has previously relied on South Africa on their constitutional experience, and truth, justice and reconciliation in shaping the legislative and policy situation in Kenya. With South Africa's economy ranked better than Kenya, it is only fair that the South African situation can be emulated by other countries like Kenya that seek to develop and are considered progressive on the international scene. In addition, the chapter also considers cross border leasing where model laws on leasing as developed by UNIDROIT are highlighted.

Chapter five – Conclusion and Recommendation. The last chapter gives the conclusion and recommendations.

### **1.9 Delineation and limitations of the study**

The nature and scope of the study limits and delineates this research in some ways. First, whereas there is a corresponding need for a comprehensive and effective legal, policy and institutional framework for the development of leasing as a business model as a whole, this study is limited in that it focuses only on the participation of banks as financiers in the lease financing transaction. In addition, whilst focusing on the bank's perspective, the study appreciates that there are tax aspects of lease financing that arise for which the study does not delve into.

## CHAPTER TWO

### AN OVERVIEW OF LEASE FINANCING

Despite continuing to take root in Kenya, lease financing is a fairly novel and developing concept that requires more insight. This chapter therefore not only highlights the historical development of leasing and lease financing but also illustrates the different types of lease transactions. The chapter discusses lease financing in juxtaposition with existing lending transactions as currently offered by banks before concluding by briefly considering the advantages and challenges of leasing.

#### 2.1 Historical development of lease financing transactions

The ancient Greek Scholar, Aristotle is quoted to have said that "true wealth lies not in the ownership of property but in the right to use it."<sup>70</sup> This in essence underlies the importance of leasing in the early years where the importance of equipment and assets is in their actual use as opposed to ownership. The earliest record of equipment leasing occurred in the ancient Sumerian city of Ur about 2010 B.C. These leases involved the rental of agricultural tools to farmers by the priests who were, in effect, the government officials. The city of Ur was then a thriving commercial center. Land, as well as agricultural tools, was leased to the people which gave them an opportunity to grow crops and sell their commodities with minimal investment. The existence of leasing is further documented in ancient history. In 1750 B.C., a Babylonian king named Hammurabi acknowledged the existence of leases of personal property in his famous code of laws.<sup>71</sup> Other cultures of ancient times, such as the Egyptians, Greeks, and Romans, engaged in leases of both personal property and real property.<sup>72</sup> Ship charters have been recorded as a thriving business since the time of the Phoenicians. These ship charters were actually a very pure form of equipment leasing. In fact, short-term charters and trip charters were

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<sup>70</sup> Aristotle's quote can be accessed at [www.bankofcardiff.com/leasing-history](http://www.bankofcardiff.com/leasing-history) accessed on 12th March 2015

<sup>71</sup> Jeffrey Taylor, "The history of leasing - SlideShare" accessed at [www.slideshare.net/pk18july/the-history-of-leasing](http://www.slideshare.net/pk18july/the-history-of-leasing) accessed on 12<sup>th</sup> March 2015.

<sup>72</sup> Crutcher K. (1986) "A Short History of Leasing" speech given by Keith Crutcher, GMAC's vice president of sales at that years AFLA Convention. The article was accessed at [www.automotive-fleet.com/article/story/.../a-short-history-of-leasing.asp...](http://www.automotive-fleet.com/article/story/.../a-short-history-of-leasing.asp...) on 12th March 2015.

really operating leases. Long-term ship charters were actually net finance leases, since the charters lasted for most of the useful life of the ship asset and the lessee assumed many of the benefits and obligations of ship ownership. Certain net leases today contain what are sometimes referred to as "pay come hell or high water" clauses. Such provisions originated in these ancient ship charter agreements.

One of the first laws to refer to leasing in the United Kingdom was the Statute of Wales written in 1284.<sup>73</sup> The statute used existing land laws as a legal framework for leasing immovable property like farming equipment. The arrival of the railways in the mid 19th century saw small enterprises investing their capital in coal wagons and in turn leasing them to mining companies. Leasing agreements often gave the lessee the right to purchase the equipment at expiration. Asia, South America and Africa did not embrace leasing until the 1970s and 1980s. The states of the former Soviet Union, including Russia, began to develop leasing after the fall of communism in the early 1990s. Advances in technology created a need for enterprises to renovate their capital assets more often. Leasing enabled businesses to acquire assets on more profitable terms than simply purchasing equipment. The benevolent interest rate environment of the 1950s worked in concert with more favourable tax treatment to drastically increase the number of leases underwritten across the globe.<sup>74</sup>

A major event in the history of leasing occurred in the late 1960s with the development of modern leveraged lease structures where the lessor provides a portion of the purchase price of the asset, and the remainder is borrowed from institutional lenders on a non recourse basis. Until the 1970s leasing remained something of a novelty or mystery for most companies. Although most airlines and railroads utilized leases in financing major portions of their equipment needs, most non-transportation companies still did not utilize leasing except for short-term operating leases of computers, office copiers, and

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<sup>73</sup> Bank of Cardiff "Leasing History." Accessed at [www.bankofcardiff.com/leasing-history](http://www.bankofcardiff.com/leasing-history) on 12th March 2015

<sup>74</sup> "CHAPTER 1 LEASING: HISTORY AND TRENDS - FlexStudy" accessed at [www.flexstudy.com/catalog/schpdf.cfm?coursetnum=94080](http://www.flexstudy.com/catalog/schpdf.cfm?coursetnum=94080) on 12<sup>th</sup> March 2015.



transportation equipment. In most cases, these leases were not even handles by the company's finance departments, but instead were handled by the operating departments involved. Since leasing competed with conventional sources of financing, such as loans offered by banks and insurance companies, those financial institutions often discouraged their non-transportation customers from using leases. Equipment leasing was thus still regarded as "last resort financing."<sup>75</sup>

## **2.2 Independent Leasing Companies<sup>76</sup>**

Independent leasing companies were formed in the early 1900's. These companies recognized that many railroad companies and other types of end users were not interested in long-term control or ownership of the leased asset, which was an inherent part of the equipment trust (bank) program. They began to offer more short term contracts or leases, with which, at the expiration of the term, they would retain title and control of the equipment. At the end of the term, the railcar was to be returned to the leasing company; this type of lease financing was the beginning of the true or operating leases, which are still common today. Other manufacturers, because of capital limitations, had to work with independent financial concerns to set up vendor finance programs, if they wanted to retain control of their customer or equipment. The independent companies, which were formed to provide vendor financing were, and are today called third-party leasing companies. They earned that categorization, as they were not related to either the manufacturer or the end user. After World War II, as manufacturers sought to upgrade and modernize their operations, leasing as a viable financing tool continued to grow, leading us into the "modern" era of equipment leasing. More recently, there has been significant growth of independent financing companies of all sizes from the very large operating in dozens of countries, to a myriad of small and medium-sized businesses specializing in the financing of particular kinds of equipment and vehicles.<sup>77</sup>

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<sup>75</sup> Crutcher K. (1986).

<sup>76</sup> This sub topic is a direct excerpt at [https://www.cfla-acfl.ca/CLEO/Reference\\_Materials/CLEO\\_Chapter-History\\_of\\_Leasing-Sep3010.pdf](https://www.cfla-acfl.ca/CLEO/Reference_Materials/CLEO_Chapter-History_of_Leasing-Sep3010.pdf) accessed on 12th March 2015.

<sup>77</sup> Bank of Cardiff "Leasing History." Accessed at [www.bankofcardiff.com/leasing-history](http://www.bankofcardiff.com/leasing-history) on 12th March 2015.

The first American leasing company was founded by Henry Shofield in 1952 in the United States of America.<sup>78</sup> The company was established to service the railway transportation industry. Europe soon followed with leasing companies of its own in the late 1950s and early 1960s.<sup>79</sup> By 1990s leasing had been established in over 80 countries.<sup>80</sup>

There exist two types of lessors - independent lessors and captive lessors.<sup>81</sup> Captive lessors involve parent companies, manufacturers or dealers of specific equipment which undertake in-house leasing of their equipment to the lessee. This lease largely follows leasing transaction in the realm of real property involving the conveyance of an interest over land to a person for a term in consideration of a return of rent or some other recompense. The most common captive lessors in the Kenyan market are dealers of motor vehicles and other specialized equipment such as ambulances and medical equipment. Recently, the government of Kenya is reported to have leased police vehicles while county governments leased ambulances through the Kenya Red Cross under such an arrangement.<sup>82</sup> Independent lessors on the other hand deal with a variety of suppliers and equipment matching the needs of the lessees to the various assets by different suppliers. This study focuses on the latter category.

Independent leasing companies have continued to grow. Figure 2.1 below indicates the dominance of independent leasing companies in comparison to banks and captive lessors in the United States of America.

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<sup>78</sup> Canadian Finance & Leasing Association, September 2010 "The History of Leasing"

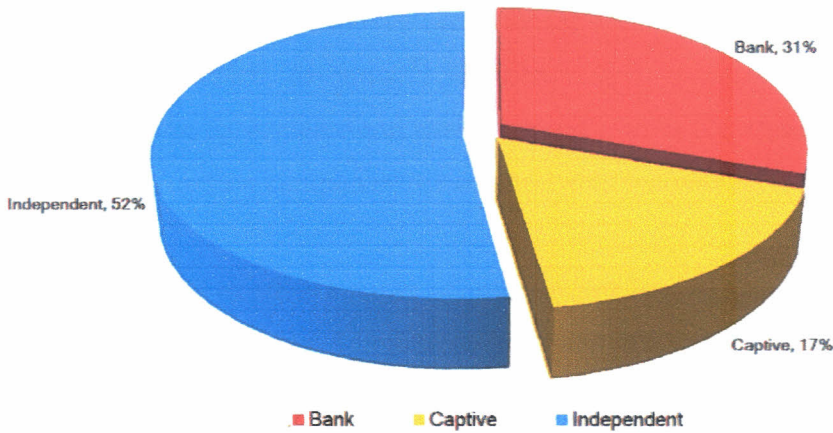
<sup>79</sup> Bank of Cardiff "Leasing History." Accessed at [www.bankofcardiff.com/leasing-history](http://www.bankofcardiff.com/leasing-history) on 12th March 2015.

<sup>80</sup> Canadian Finance & Leasing Association, September 2010 "The History of Leasing."

<sup>81</sup> Magan Jugurnauth (2014) Lessor Training Manual - Fundamentals of Leasing, a presentation made at the Lease Convention 2014 at the Kenya School of Monetary Studies on 28<sup>th</sup> May 2014.

<sup>82</sup> Remarks made by Mr. Henry Rotich, Cabinet Secretary for the National Treasury during the leasing Association of Kenya Convention 2014 held on 27<sup>th</sup> May 2014 in Nairobi. See also Moses Odhiambo and John Shilita "Is Shs.600,000 too much for a monthly ambulance lease? *Sunday Nation Newspaper* January 19<sup>th</sup> 2014.

Figure 2.1 Regular members of the leasing industry by type in the United States of America<sup>83</sup>



Similarly, independent leasing companies have taken root in Latin America as per figure 2.2 below. The most common captive leasing company is Caterpillar of Mexico specializing in earth moving equipment.

Figure 2.2 - distribution of leasing companies in Latin America as at November 2013<sup>84</sup>



<sup>83</sup> The Alta Group (2014) "Leasing as a Game Changer: The Experience of the Western Hemisphere" a presentation made on May 27, 2014 at the Kenya School of Monetary Studies during the 4<sup>th</sup> Annual Leasing Convention. A copy of the presentation can be obtained from the author.

<sup>84</sup> Ibid.



Since Basel III, banks tend to withdraw intensity to the business of leasing. After the 2008 economic crisis, captives were forced to become stronger but they have many institutional barriers to grow.<sup>85</sup> Resiliency and growth of independent lessors has continued to be appreciated and attract interest from private and equity funds<sup>86</sup> and banks. Independent leasing companies are credited with innovation in the leasing industry.

In Kenya, there exists a number of independent leasing companies that include Vehicle and Equipment Leasing Limited (abbreviated VAELL)<sup>87</sup> and Rentworks East Africa Limited.<sup>88</sup> Captive leasing companies include Express Automation Limited<sup>89</sup> which focuses on the lease of photocopiers, printers and other office related equipment and many other motor vehicle dealers such as Toyota and Simba Colt Motors.

### **2.3 Types of leases (under a leasing transaction)**

In order to understand the nature of lease financing transactions, it is imperative to appreciate the nature of leases in the context of this study. According to the UNIDROIT model law on leasing, a financial lease has three main features.<sup>90</sup> First, the lessee specifies the asset and selects the supplier, secondly, the lessee acquires the right of possession and use of the asset according to the lease agreement and thirdly, the rentals or other funds payable under the agreement take into account the amortization of the whole or a substantial part of the lessor's investment. There may or may not be the option of purchase in the lease agreement.<sup>91</sup> There are several forms of finance leases which include operating lease also known as service lease, the capital lease and the sale-and-lease-back, leveraged leasing arrangement and direct financing leasing arrangement.

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<sup>85</sup> Risk culture and revenue recognition.

<sup>86</sup> The Alta Group (2014).

<sup>87</sup> [www.vaell.co.ke](http://www.vaell.co.ke)

<sup>88</sup> [www.rentworks.co.ke](http://www.rentworks.co.ke)

<sup>89</sup> [www.expressautomation.co.ke](http://www.expressautomation.co.ke)

<sup>90</sup> Unidroit model law on leasing, Article 2.

<sup>91</sup> Ibid.

### 2.3.1 The Operating/Service Lease

The business dictionary defines an operating lease as a cancellable short-term lease written by the lessor who expects to take back the leased asset after the lease term and re-lease it to other users.<sup>92</sup> The lessee has the exclusive right to possess and use the asset for a particular period and under definite conditions. The lessor retains the risks and rewards of the ownership. The lessor only transfers the proprietary right of use of the assets to the lessee.<sup>93</sup> This form of arrangement comes with benefits to both the lessor and the lessee. In an operating lease, the lessee is not given the option to purchase the asset subject of the lease at the expiry of the lease period.<sup>94</sup> Assets that have a high obsolescence rate such as computer hardware, trucks, automobiles and mines are suitable for operating lease.<sup>95</sup>

Operating leases are not fully amortized meaning that the lessor is not able to recover the cost of the asset from the payment of the rentals by the lessee.<sup>96</sup> However, the leasing contract provides for a shorter period during the economic life of the asset<sup>97</sup> considering that the asset in question may not have a long useful life for instance a computer software. The lessor can generate more money to fully cover the whole cost of the asset by re-leasing the asset or renewing the lease at the end of the initial term. The FlexiRent

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<sup>92</sup> Business dictionary accessed at <http://www.businessdictionary.com/definition/operating-lease.html> accessed on 8th August 2013.

<sup>93</sup> An example of an operating lease would be where a Computer rental company charges their client (lessee) Ksh.400 per computer per day for the use of leased computers. The computer rental company undertakes to maintain and service the computers (subject to the lease agreement). The lessee is free to lease the computers for the necessary number of days as need may be. The cost of one computer may be Ksh. 60,000 and if the lessee needed 10 computers, they will need 0.6 million shillings to purchase. They are however, able to secure the use of those computers for Ksh. 4,000 per day under the operating lease. This makes a lot of sense especially where the lessee needs the computers for a short time. The computer rental company will be motivated to service and maintain the computers in good condition so it can rent them out to other people. They can recover the cost of the computers plus profits through leasing and re-leasing of the same computers.

<sup>94</sup> International Finance Corporation, (2005) *Leasing in Development Guidelines for Emerging Economies*, International Finance Corporation 2121 Pennsylvania Avenue, NW, Washington, DC 20433 pp18-20.

<sup>95</sup> Ibid.

<sup>96</sup> Business Dictionary, <http://www.allbusiness.com/glossaries/operating-lease/4943576-1.html> accessed on 10th August 2013.

<sup>97</sup> Statement 6 of the Financial Accounting Services Board. The economic life of the asset refers to the estimated remaining period during which the asset is anticipated to be economically functional by one or more users, with normal repairs and maintenance, for the function for which it was intended at the initiation of the lease, without limitation by the lease term.

arrangement at Barclays Bank is an example of an operating lease offered by a bank in Kenya. Operating lease arrangements in Kenya are offered by companies such as Investeq Capital Limited.<sup>98</sup>

### 2.3.2 Capital Lease

In a capital lease, the lessee acquires significant property rights in the asset.<sup>99</sup> Accordingly, ownership of the property is transferred to the lessee at the end of the term of the lease. In addition, there is always the option for the lessee to purchase the property in its residual state usually at a far much depreciated cost. The lessee obtains almost all the rights and risks of ownership of the asset and the subject of the lease is treated an asset to the lessee.<sup>100</sup> In essence, such a lease has the features of a purchase though it is still treated as a lease. The term of capital leases must be at least 75% of the approximate economic life of the asset.<sup>101</sup> The exception is where the term of the lease falls within the last 25% of the total estimated economic life of the property. The term of a capital lease is non-cancellable.

In a pure capital lease, the lessee identifies the property and negotiates the price and terms of delivery. After that, the lessee arranges with a leasing firm to buy the property from the manufacturer and then execute a leasing agreement. The lease payments are arranged in such a way that they return full payment of the purchase price plus returns on the same. At the end of the lease term, the property in the assets transfers to the lessee. Capital lease is practically a purchase by instalments ( referred to as rentals in the lease transaction).

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<sup>98</sup> Under their Asset Finance Product, the client also enjoys the choice of either operating lease or finance lease whereby the user of an asset can enjoy huge cost benefits over the entire life of an asset in addition to affording them the flexibility of acquiring new assets or equipment to accommodate changes in technology or simply just o upgrade to more efficient asset alternatives to improve productivity whenever the need arises. <http://www.investeqcapital.com/asset-financing.php> (accessed on 26th November 2014).

<sup>99</sup> IPSAS 13, Leases – International Public Sector Accounting Standard, December 2001, ¶7.(b) defines a finance lease as, “a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.”

<sup>100</sup> Statement 13 of the Financial Accounting Standards Board.

<sup>101</sup> section 7 of Standard No. 13 of Statement of Financial Accounting. November 1976.



### 2.3.3 Sale and Lease Back

In a sale and lease back, the owner of the assets sells the assets to the buyer who in turn leases the same asset to the seller.<sup>102</sup> Thus, the buyer in the sale transaction becomes the lessor in the leasing transaction while the seller in the sale transaction becomes the lessee in the lease transaction. The assets are not physically transferred. It is just a paper transaction. The main advantage of this arrangement is that the lessee is sure of the quality of the assets having been in possession of it. It can be used as a source of capital for the asset owner through sale of the assets but continues making use of the assets. It is argued that raising funds is the primary motivation behind sale and lease back.<sup>103</sup> It may be appropriate for a firm that seeks to increase its liquidity<sup>104</sup> and can also come in handy when an enterprise is arranging to relocate in the near future and wishes to dispose certain assets. A sale and lease back arrangement enables the enterprise to sell the assets but still continue to make use of them before relocating. Unlike other leasing options, sale and lease back is a source of revenue to the lessee<sup>105</sup> and a potential tax saving avenue.<sup>106</sup> In a typical sale and lease back situation, the lessee has a less effective tax rate than the lessor. The depreciation tax rate can be sold. The lessor can then translate the tax shields into lower rentals by the lessee.

### 2.3.4 Direct (Financing) Lease

The business dictionary defines direct financing lease as an arrangement between a person who is neither the manufacturer nor the dealer, wherein the lessor acquires the property for the purpose of leasing it out and generating revenue through interest payments.<sup>107</sup> For instance, businessman may purchase a fleet of vehicles and engage in

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<sup>102</sup> UNCTAD, Accounting And Financial Reporting Guidelines For Small And Medium-Sized Enterprises (SMEGA) LEVEL 2 GUIDANCEUNCTAD/ITE/TEB/2003/5, UNITED NATIONS 2004, p 25.

<sup>103</sup> Barris, Roger D., (2002) "Sale-Leasebacks Move to the Forefront: What Is Motivating Buyers and Sellers and What Are Their Preferred Methods?", *Briefings in Real Estate Finance* Vol. 2, pp. 103-112.

<sup>104</sup> Wells, Kyle S., (2007) "Evidence of Motives and Market Reactions to Sale and Leasebacks" (December 2007) available at SSRN: <http://ssrn.com/abstract=1081461> or <http://dx.doi.org/10.2139/ssrn.1081461> accessed on 13<sup>th</sup> August 2013.

<sup>105</sup> *Ibid.*

<sup>106</sup> *Ibid.*

<sup>107</sup> Business dictionary accessed at <http://www.businessdictionary.com/definition/direct-financing-lease.html> (accessed on 19th August 2013).

the business of hiring them out whether on a short term or long term basis at a premium pre-agreed rate. The most common direct finance leases are those offered by the owners and operators of taxi or car hire services who purchase vehicles for hire being neither the manufactures nor dealers of the motor vehicles of the subject vehicles.

### 2.3.5 Leveraged Leasing

The financial dictionary defines leveraged leasing as “a lease arrangement under which the lessor borrows a large proportion of the funds needed to purchase the asset. The lender has a lien on the assets and a pledge of the lease payments to secure the borrowing.”<sup>108</sup> Leveraged leasing has a number of common features.<sup>109</sup> Firstly, it is tripartite as it involves the lessee, the lessor and the lender.<sup>110</sup> The other aspect is the presence of a non-recourse debt. A non-recourse debt or loan is one secured by collateral. The lender agrees that the lessor will not be personally liable for the debt but only looks at the payment of the rentals as the source of paying the loan. In this case, the property, subject matter of the lease is the collateral. The lender has a form of protection in that the lender’s right to the property supersedes that of the lessor in case of default.<sup>111</sup> The third aspect is that there must be a substantial degree of leverage in the arrangement. This means that the loan from the lender must form a substantial part of the purchase price of the asset.<sup>112</sup>

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<sup>108</sup> Financial Dictionary accessed at <http://financial-dictionary.thefreedictionary.com/Leveraged+Lease> (accessed on 13<sup>th</sup> August 2013).

<sup>109</sup> James C. Ahlstrom & Iris C. Engelson, (1999) "The Economics of Leveraged Leasing Equipment Leasing/ Leveraged Leasing." 4th Edition, *Practising Law Institute*, 810 7th Ave., New York 1999, N.Y. 10019.

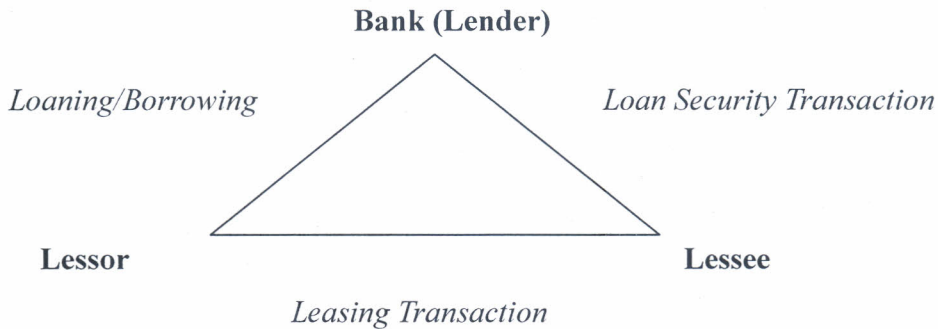
<sup>110</sup> *Ibid.*

<sup>111</sup> Financial Watch, (2013) "A Leveraged Lease Primer: Understanding the tax and accounting treatments of this powerful equipment finance tool", available at [http://www.elfaonline.org/cvweb\\_elfa/Product\\_Downloads/E06MAYBRADY.PDF](http://www.elfaonline.org/cvweb_elfa/Product_Downloads/E06MAYBRADY.PDF) (Accessed on 13th August 2013). In addition, the Lender does conduct credit appraisal of the lessee to satisfy itself of the lessee’s repayment capacity prior to financing the transaction.

<sup>112</sup> Take the case of a chattel like a pick-up worth Ksh. 1 million. The lessor wants to acquire the pick-up with Ksh.200,000/- in cash and borrow Ksh.800,000/- from a lender at an interest rate of 20 percent p.a. with the pick-up as the collateral. After the purchase, the lessor leases the pick-up to the lessee for 15 years. Rents are paid on the same day the debt services are due, and the rents always are sufficient to pay debt service. The lessee may be given an Early Buy-Out Option after say 10 years. In most cases, it is a broker who brings the lessor and the lessee together and the lessor may have to pay the broker. Rent payments go to the lender directly to service the loan and the surplus, if any, are sent to the lessor.



Figure 2.3 The tripartite nature of lease financing



Leveraged leasing can be modelled to suit the circumstances of the parties involved. Leveraged leasing attracts tax benefits such that it brings down the money over money rate to the lessee relative to a typical lease or straight loan.<sup>113</sup> In the United States of America, tax on leveraged leases is calculated on the depreciated value subject to certain conditions.<sup>114</sup> In such an arrangement, it is apparent that it is a gain-gain situation for all the parties involved as the lessee will get to use the asset whilst paying for the rentals over a period of time unlike needing to make an upfront capital investment in purchasing the asset. The lessor benefits by having obtained an asset that is leased to the lessee without the lessor having made any substantial financial contribution towards the purchase of the asset considering that the lessor borrows from a lender and the repayment is through the rentals from the lessee. The lender also benefits by having extended a loan towards the transaction thus extending the lender's loan base from the traditional lending arrangements and earning interest out of it. The loan is non-recourse and therefore secure as the lender relies on the lessor to ensure repayment of the financed amount.

#### 2.4 Other lending transactions involving movable assets in Kenya

There are other lending transactions that are closely related to lease financing and can easily be confused. It is therefore prudent to consider some of those transactions for purposes of distinguishing it from lease financing as espoused in this study.

<sup>113</sup> *Ibid.*

<sup>114</sup> Financial Watch (2013) pp 4-5.

### 2.4.1 Lease financing and hire purchase

The business dictionary defines hire purchase as a system by which a buyer pays for a thing in regular installments while enjoying the use of the thing. During the repayment period, ownership (title) of the item does not pass to the buyer. Upon the full payment of the loan, the title passes to the buyer.<sup>115</sup>

In Kenya, hire purchase is governed by the Hire Purchase Act<sup>116</sup>. This Act applies to and in respect of all hire-purchase agreements entered into after the commencement of this Act under which the hire-purchase price does not exceed the sum of four million Kenya shillings or such other higher or lower sum as the Minister may, after taking into account market forces from time to time prevailing, prescribe other than a hire-purchase agreement in which the hirer is a body corporate, wherever incorporated; but that monetary limitation does not apply so as to affect the definition of "hire-purchase business" in section 2 (1)<sup>117</sup>. The Hire Purchase Agreement is defined as an agreement for the bailment of goods under which the bailee may buy the goods or under which the property in the goods will or may pass to the bailee; and, where by virtue of two or more agreements none of which by itself constitutes a hire-purchase agreement there is a bailment of goods and either the bailee may buy the goods or the property therein will or may pass to the bailee, the agreement shall be treated for the purposes of the Hire Purchase Act as a single agreement made at the time when the last of those agreements was made.<sup>118</sup>

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<sup>115</sup> <http://www.businessdictionary.com/definition/hire-purchase.html#ixzz2dAHKEddd>. In the United States of America it is referred to as installment payment by which a buyer pays for a thing in regular installments while enjoying the use of it. During the repayment period, ownership (title) of the item does not pass to the buyer. Upon the full payment of the loan, the title passes to the buyer. Installment buying is a social innovation that expands the economy with additional income. Cyrus McCormack (1809-84, one of the inventors of the arvesting machine) pioneered it in the early 19th century US, and Issac Singer (1811-75, one of the inventors of the sewing machine) made it a common practice. More information can be accessed at <http://www.businessdictionary.com/definition/installment-buying.html#ixzz2dAMjHmua>.

<sup>116</sup> Cap.507.

<sup>117</sup> Section 3(1) Hire Purchase Act. "hire-purchase business" as defined under section 2(1) of the Hire Purchase Act means a business, whether carried on alone or with other business, of entering into hire-purchase agreements, whatever the hire-purchase price under any agreement;

<sup>118</sup> Section 2(1) of the Hire Purchase Act.

As noted in this study, hire purchase is a different and definite bank product separate from lease financing<sup>119</sup> though some banks incorporate some aspects of hire purchase particularly in the area of securities in lease financing as shall be discussed further in chapter three. The main distinguishing factor between lease financing and hire purchase is that whereas hire purchase provides for an option of purchase of the asset at the end of the hire period, lease financing arrangements may not necessarily provide for the option to purchase at the end of the lease period. Some banks however under their lease financing products allow for purchasing at the end of the lease period.<sup>120</sup>

#### **2.4.2 Lease financing and bank loans**

The substantive difference between a bank loan and lease financing is the ownership of the asset. With a loan, the asset belongs to the borrower while with lease financing the asset belongs to the lessor. This difference can only be viewed from the lessee's perspective.<sup>121</sup> There are however many similarities between a bank loan and lease financing. These include the legal rights by both the lender and the lessor to reclaim/repossess the assets should there be default, as long as the loan is secured, the non-cancellable nature of the agreements until either the lessor or the lender has recovered its outlay, and the repayment over the period of both interest and capital (equipment cost).<sup>122</sup> As noted above, the lease financing product designed by banks is largely modelled along normal loan transactions.

#### **2.4.3 Lease financing and bank financing.**

It is no doubt that lease financing through leasing companies and bank financing both involve financial risks and credit decisions being made by the leasing companies and the banks respectively. There are however two additional factors that apply to leasing companies<sup>123</sup> First, leasing companies have a greater knowledge of the asset (and often

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<sup>119</sup> International Finance Corporation (2005), *Leasing in Development Lessons from Emerging Economies*, (2005) p5 for a further distinction and discussion on the difference between financial leases and hire purchase.

<sup>120</sup> An example is the FlexiBuy product by Barclays Bank.

<sup>121</sup> International Finance Corporation (2005) p.4.

<sup>122</sup> *ibid* p.4 where additional similarities are indicated.

<sup>123</sup> *Ibid*. This differentiation set out herein between leasing and bank financing has been explained at pp 4-5.



the industry) and thus lend to some extent on an asset basis. The lending is based on the ability of the asset to contribute cash flow either to the lessee or in the event of a forced sale. Banks on the other hand tend to look at the balance sheet value of the collateral making bank financing more collateral-based lending. The second factor is that leasing companies are more sales and service oriented thereby bridging the gap between suppliers and purchasers. Lessees are generally not specialists in finance or equipment acquisition and dealing while suppliers are not specialists in finance or credit decisions hence the importance of the leasing companies as intermediaries.<sup>124</sup>

#### **2.4.4 Lease financing and Chattels Mortgages**

A Chattel Mortgage is a negotiable instrument under the Chattels Transfer Act. It refers to an instrument by which an owner of a movable property conveys conditional title in the property to secure the payment of a debt or performance of other obligations. Movable properties are capable of being sold and can be mortgaged to secure payment of a loan. The mortgagor (owner) transfers the property to the mortgagee (lender). A chattel mortgage is distinct from lease financing in that in lease financing, the property does not move. Only possession and right to use transfer but the title remains the lessor's. Moreover, chattel mortgage is solely to secure payment of a debt. Some lease financing products do adopt the chattels mortgage approach to securities as shall be discussed in the next chapter.

Currently, lease financing by banks is offered to blue chip and high net worth companies. Under the Chattels Transfer Act, chattels are defined to exclude debentures.<sup>125</sup> Similarly, instruments under the Act exclude debentures, charges and hire purchase agreements. The Chattels Mortgage regime therefore is limited to individual borrowers who are not included for purposes of lease financing.

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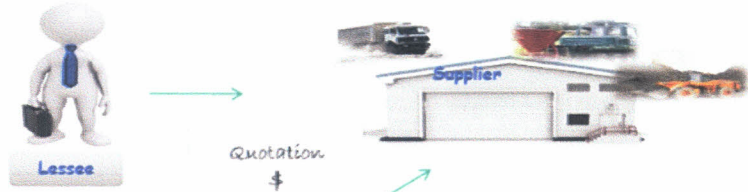
<sup>124</sup> In effect both the supplier and the lessee outsource certain portions of their business to a service provider that also happens to have a certain capacity to borrow and lend money.

<sup>125</sup> Section 2.

Figure 2.3 How leasing works<sup>126</sup>

**Step 1**

The entrepreneur, or the "lessee," approaches a supplier, chooses the needed equipment, and negotiates the price and the terms of delivery.



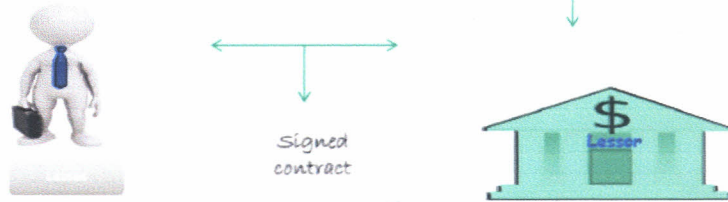
**Step 2**

The supplier provides a quotation. The lessee then approaches a "lessor" (bank or leasing institution) and submits an application for financing.



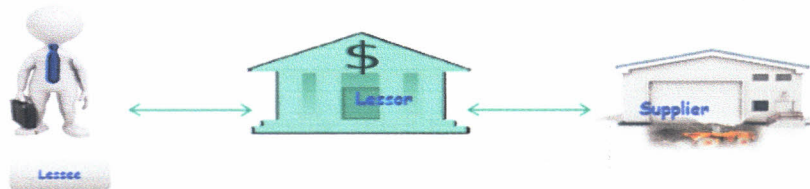
**Step 3**

The lessor then evaluates the lease application. If it is approved, the two parties sign a contract.



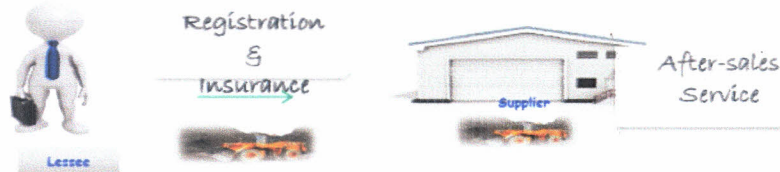
**Step 4**

The lessee pays the advance lease payment. The lessor purchases the equipment from the supplier and leases it to the lessee for a period close to the economic life of the asset, normally exceeding 75% of the useful life.



**Step 5**

The lessor registers and insures the equipment. The supplier then provides after sales services as per contract.



<sup>126</sup> Riadh Nour (2014) "Fueling your economy with leasing" a presentation made during the Kenya Leasing Convention on 26<sup>th</sup> May 2014 by the Regional Leasing Program Manager, an International Finance Corporation Leasing Expert pp.23-25.

## How leasing works (cont'd)

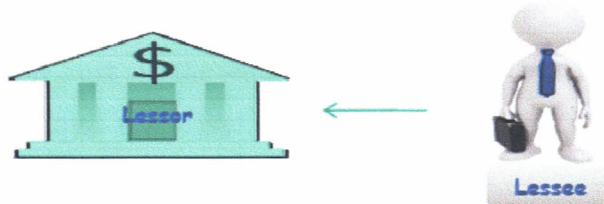
### Step 6

The lessee has the right to use the equipment and maintains the equipment.



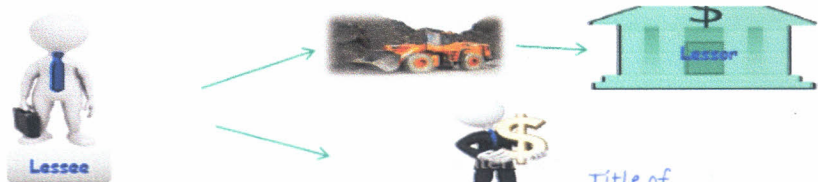
### Step 7

The lessor monitors the lease operation. The lessee makes regular installment payments to the lessor.



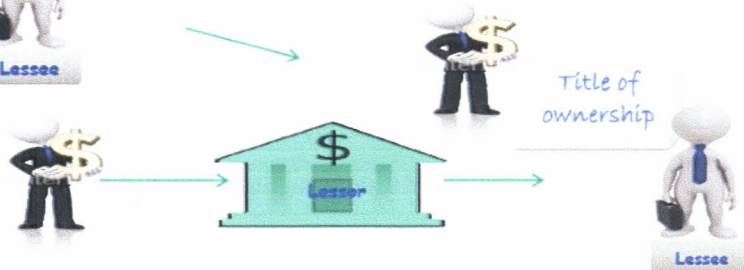
### Step 8

At the end of the lease, the lessee either returns the equipment or exercises the option of purchase.



### Step 9

If the option is to purchase, the lessee pays the agreed final sum and the lessor transfers the ownership of the equipment to the lessee.



## 2.5 General advantages of leasing

Leasing has become popular in recent years because there has been a trend focusing on the ability to use property rather than on the legal ownership of the property. It is predicated upon the quote *“buy that which appreciates, lease that which depreciates.”*<sup>127</sup>

The equipment and vehicle leasing industries have proven to be one of the most resilient services. Despite struggling with varying economic conditions, leasing is still a predominant force in capital asset financing. Leasing has shown a unique ability to adapt and thrive in an ever changing economic and regulatory environment, producing new and innovative financial products.<sup>128</sup> Other reasons for the popularity of leasing include sharing of tax benefits (beyond the scope of this study). However, the big incentive for leasing continues to be its non tax benefits. These include flexibility of leases, leasing as a hedge against obsolescence and inflation, servicing and maintenance contracts,

<sup>127</sup> The phrase was accessed at [www.bankofcardiff.com/leasing-history](http://www.bankofcardiff.com/leasing-history) on 12th March 2015 and is attributed to Paul Getty, a billionaire who in the oil business.

<sup>128</sup> Canadian Finance & Leasing Association, September 2010, “The History of Leasing.”



convenience, cheaper costs (economies of scale), off balance sheet financing<sup>129</sup> and a simple inability to obtain the financing to buy.<sup>130</sup>

Leasing, as a way of acquiring assets, has a number of advantages over the traditional purchasing. Leasing covers the full cost of the equipment used in the business by providing 100% finance. Leasing allows the lessee to take possession and use of the equipment but does not require the lessee to pay any money as down payment at the inception of the lease.<sup>131</sup> The saved capital can be put in other investments and core activities of the business concern which is in turn advantageous to the lessee.

Leasing allows flexibility with which the leasing agreement can be tailor made according to convenience of the parties.<sup>132</sup> Firms which face uncertainty of their future survival can frequently adjust their capital needs in a lease arrangement. Moreover, parties can choose any of the above leasing arrangements depending on their circumstances. For instance, if the assets sought have high obsolescence rate; the lessee may opt to go for operating lease. If the lessor has limited funds to purchase the assets, leveraged leasing may be sought so that a lender (bank) may provide the purchase price. If an asset owner wants to sell the assets but continue using them, they may opt for sale and leaseback arrangement<sup>133</sup>.

Leasing also makes it possible for the lessee to plan its cash flows well.<sup>134</sup> The lessee can use the cash flow from the business to pay the rentals under the leasing transaction.

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<sup>129</sup> That is when the lease does not appear on the face of the balance sheet. For more on off balance sheet financing see Jeffrey Taylor (2006) *The Future of Equipment Leasing* previewed at [www.amazon.com/Future-Equipment-Leasing-Jeffrey-Taylor/dp/0972704736](http://www.amazon.com/Future-Equipment-Leasing-Jeffrey-Taylor/dp/0972704736). He promotes his theory on how Enron destroyed off-balance sheet financing for all corporations and predicts the demise of public leasing companies in favour of a new form or private leasing company.

<sup>130</sup> Cutcher K., (1986).

<sup>131</sup> Marie Loughran, (2013) "The advantages of Leasing, Intermediate Accounting for Dummies," accessed at <http://www.dummies.com/how-to/content/the-advantages-of-leasing.html> on 14th August 2013).

<sup>132</sup> See Zhang, Na, (2011) "Leasing, Uncertainty, and Financial Constraint (November 17, 2011)", Available at SSRN: <http://ssrn.com/abstract=2020162> or <http://dx.doi.org/10.2139/ssrn.2020162> (Accessed on 14th March 2013).

<sup>133</sup> [www.rentworks.co.ke](http://www.rentworks.co.ke)

<sup>134</sup> An Yan, (2006) "Leasing and Debt Financing: Substitutes or Complements?", *WA 98195, Journal of Financial and Quantitative Analysis Vol. 41, No. 3*, University Of Washington, Seattle, September, p7.

Leasing makes it possible for lessees to improve their liquidity position.<sup>135</sup> The funds that could have been put in the purchase of assets can be used to improve the company's liquidity.

Leasing also allows the costs of using the equipment to be treated as expenses and thus lease payments are exempted in tax calculation.<sup>136</sup> This in effect translates to the tax advantage of leasing though the tax aspects are beyond the scope of this study.

This study puts it forward that leasing is a product that banks in Kenya can tap into more vibrantly. The product is easy to sell as it provides numerous benefits to all the parties involved. The lessee gets the benefits from the advantages outlined above. If banks come in as lenders, like in leveraged leasing, lessors are able to acquire ownership of assets with lower amounts and pay for the balance which is substantially paid through loans borrowed from the bank.

The loan is serviced from rental payments for the same asset. It is also advantageous to the bank as the loan is non-recourse. There is also a stronger legal position to seize the property from the lessee in case of default in loan payment because the legal ownership of the property is not with the lessee.<sup>137</sup> Banks on the other hand would also expand their lending portfolio through the lease financing product.

*Figure 2.4: SMEs' reasons to use leasing*<sup>138</sup>

*(0=not at all important. 1 = very important)*

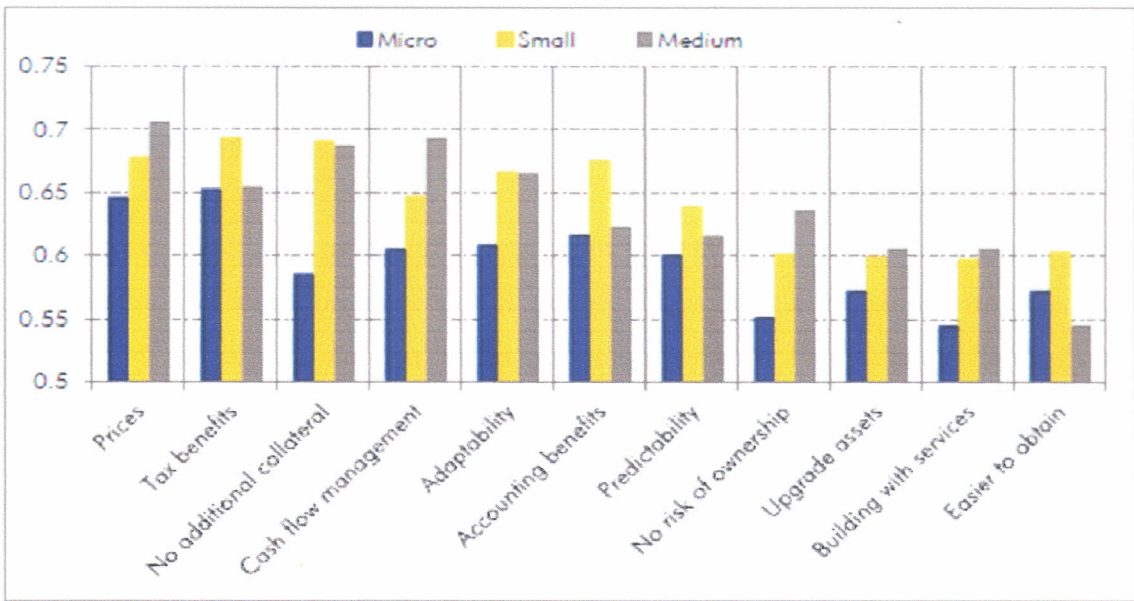
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<sup>135</sup> Ibid.

<sup>136</sup> Marie Loughran (2013).

<sup>137</sup> Glenn D. Westley, (2013) "Finance for the Poor, Equipment Leasing and Lending: A Guide for Microfinance," Inter-American Development Bank, p3. Accessed at [www.adb.org/documents/periodicals/microfinance](http://www.adb.org/documents/periodicals/microfinance) Fourth Anniversary Issue on 14<sup>th</sup> August 2013)

<sup>138</sup> Riadh Naouar (2014).



Source: Oxford Economics (2011)

The government and other government entities in embracing leasing drives home the point that they have no business committing taxpayer money into purchasing and owning expensive but depreciating assets together with the attendant maintenance costs. This in turn allows the government to focus on service delivery while eliminating opportunities for kickbacks.<sup>139</sup>

## 2.6 Challenges of Leasing

Although leasing and lease financing have a number of benefits, there are also shortcomings. To the lessor, the ultimate cost of the asset is higher than the purchase price.<sup>140</sup> This is because of payment of interest on the bank loan.<sup>141</sup> Leasing also requires an agent (leasing company) in most cases and that may have a cost effect.<sup>142</sup> Moreover, there is the possibility of the lessee misusing the property since the ownership is not

<sup>139</sup> Jaindi Kisero (2015) “Leasing depreciating assets makes a lot of cents for the government” Daily Nation February 11, 2015 p.12

<sup>140</sup> Zhang, Na, (2011).

<sup>141</sup> For details on how leasing is expensive in the long term see generally McConnell, J., and J. S. Schallheim. (1983) “Valuation of Asset Leasing Contracts.” *Journal of Financial Economics*, 12 pp.237–261.

<sup>142</sup> *Ibid.*



theirs hence low degree of care. The lessor does not benefit from the obsolesce advantage that the lessee enjoys.

For the lessee, unless it is an operating lease, they have to bear maintenance and servicing costs even though the property is not theirs. These shortcomings can however be mitigated by the fact that the lease arrangement is flexible.<sup>143</sup> For the lessor, the risks of leasing are summarized into five as per the table below:

*Summary of Risks<sup>144</sup>*

|   | <b>RISK</b>          | <b>IMPACT</b>                              | <b>SOLUTION</b>                   |
|---|----------------------|--|-----------------------------------|
| 1 | Financial Reporting  | Lower Earnings                             | Limit % of operating leases       |
| 2 | Managerial Reporting | Return of assets becomes meaningless       | Treat depreciation like principal |
| 3 | Funding              | Higher cost of debt higher cost of capital | Higher profits                    |
| 4 | Pricing              | Loss of transactions to competitors        | None!                             |
| 5 | Legal                | Full service liability                     | Seek legal counsel                |

Business risks have also been identified by banks in undertaking lease financing such as difficulty in verifying the correctness and accuracy of the assigned agreements and particulars thereof.<sup>145</sup> Such risks force the banks to shift responsibility and rely on the leasing companies to ensure satisfactory adherence and address of any challenges arising.

Be that as it may, banks continue to undertake lease financing. Banks that undertake lease financing face significant hurdles in the wake of existing legislative framework.<sup>146</sup> Banks have continued to be innovative in undertaking lease financing and devising suitable

<sup>143</sup> See Zhang, Na. (2011)

<sup>144</sup> Magan Jugurnauth (2014) at p.109.

<sup>145</sup> Diamond Trust Bank Lease financing Manual 2011, a copy of which can be obtained from the author

<sup>146</sup> Canadian Finance & Leasing Association, 2010.

products. Unfortunately, despite the increasing uptake by government into leasing as a business model, none of the local banks in Kenya currently have the balance sheet size to finance government financial deals like the Shs.38 Billion medical equipment leasing deal recently rolled out by the government.<sup>147</sup> The next chapter considers in greater detail some of the legal issues that arise in the current lease financing structures and practice by banks.

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<sup>147</sup> This stems from the lending limit on the banks' lending to any one borrower and its associated companies pegged at 25% of the core capital under section of the Banking Act. See also only Jaindi Kiseru (2015) in which he suggests a debate increasing capitalisation requirements and how to force some banks to merge – the way it happened in Nigeria.

## CHAPTER THREE

### THE PRACTICE OF LEASE FINANCING IN KENYA

There is limited discourse on when and how leasing was introduced in Kenya. By 2002 there was need for legal intervention and incentives to assist in the development of lease financing in Kenya.<sup>148</sup> This led to the publication of the Income Tax Leasing Rules of 2002 by the then Minister for Finance.<sup>149</sup> Significant emergence and development of lease financing in Kenya can be traced to the formation of the Leasing Association of Kenya as an umbrella association of asset finance and leasing practitioners in Kenya. The origin of the Association was the East, Central & Southern Africa Leasing Association which was registered in Kenya in 2003.<sup>150</sup> It was an association limited by guarantee but the name was later changed to the Leasing Association of Kenya in 2007 to better reflect the membership. The association comprises banks, vendors, independent leasing companies, audit firms, legal firms and other leasing affiliated businesses as its stakeholders.<sup>151</sup> The objectives of the association include bringing together all firms and individuals engaged in leasing with the aim of developing a sustainable leasing industry in Kenya, raising awareness of leasing and its benefits to all stakeholders, education and capacity building, self regulation and control of ethical behaviour among industry players and advocacy.<sup>152</sup> The association traces its roots from the African Leasing Association, the continental body of leasing practitioners and organisations in Africa with an interest in leasing.<sup>153</sup>

Efforts by the independent leasing companies and the Leasing Association of Kenya have been instrumental in popularising lease financing in Kenya. Through the now annual leasing conventions held in Kenya, stakeholders have continued to find ways to shape the

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<sup>148</sup> Mr. Lawson Naibo as quoted by Benson Kathuri B (2007) "KRA, CBK can't handle issues on asset leasing, expert says" *The Standard Newspaper* 24th July 2007 accessed at <http://allafrica.com/stories/200707231876.html> on 12th January 2012.

<sup>149</sup> Through Legal Notice No.52 of 2002.

<sup>150</sup> <http://www.lak.co.ke/about-us/>

<sup>151</sup> <http://www.networks-webdesign-computers.com/lak/about-us>

<sup>152</sup> Ibid.

<sup>153</sup> [http://www.ifc.org/wps/wcm/connect/REGION\\_EXT\\_Content/Regions/Sub-Saharan+Africa/Advisory+Services/AccessFinance/AfricaLeasingFacility/AfricaLeasingAssociation/](http://www.ifc.org/wps/wcm/connect/REGION_EXT_Content/Regions/Sub-Saharan+Africa/Advisory+Services/AccessFinance/AfricaLeasingFacility/AfricaLeasingAssociation/)



leasing industry in Kenya as they share their experiences and discuss challenges. The latest convention held in May 2014 was graced by the Cabinet Secretary in charge of Treasury.<sup>154</sup> During the opening of the Lease Convention 2014, the Cabinet Secretary for the National Treasury gave the government's commitment to do all that it takes to ensure leasing succeeds in Kenya including addressing any challenges facing the industry including the government's adoption of leasing.<sup>155</sup> The Recommendations of an Inter Ministerial Task Force established in 2009 paved way to the formulation of an Official Government Transport Policy which resulted in the leasing of motor vehicles for the National Police Service.<sup>156</sup> He further stated that going forward, the Government has adopted leasing as a framework for providing access to critical assets necessary to facilitate faster and efficient service delivery. The leasing association views the proposals by the Cabinet Secretary as reflecting a paradigm shift by the government particularly the consideration of leasing solutions to deliver core public services. The association has also noted that the government's move to adopt leasing solutions is likely to spur a ripple effect within the private sector.<sup>157</sup>

Leasing companies have also continued to emerge and expand within the country as they market their transactions, with several banks anchoring themselves in financing the leasing transactions. For instance immediately after the March 2013 elections that resulted into the establishment of county governments, one of the leasing companies, trading as Vehicle and Equipment Leasing Limited (VAELL) placed a newspaper advertisement calling upon the newly elected Governors to try out the leasing option

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<sup>154</sup> <http://www.lak.co.ke/events/the-lease-convention/>.

<sup>155</sup> Remarks by Mr. Henry Rotich, Cabinet Secretary for the National Treasury during the Leasing Association of Kenya Convention 2014 held on Tuesday 27<sup>th</sup> May, 2014 at the Kenya School of Monetary Studies, Nairobi. A copy of the entire remarks can be obtained from the author.

<sup>156</sup> Ibid. Remarks by the Cabinet Secretary whereby the Minister revealed that the government has on an operational lease basis acquired 1,200 vehicles to motorise security enforcement. This exercise was advertised through an Expression of Interest published in The Standard on June 12, 2013 p.27.

<sup>157</sup> The Chairperson of the Leasing Association of Kenya, Edna Kihara as quoted in Kangethe K. "Private Sector welcomes government leasing route" 17th June 2013 accessed at [www.capitalfm.co.ke/business/2013/06/private-sector-welcomes-govt-leasing-route](http://www.capitalfm.co.ke/business/2013/06/private-sector-welcomes-govt-leasing-route) (accessed on August 26, 2013). see also Kenya Broadcasting Corporation "Leasing association hails budget proposals" Monday 17th June 2013 accessed at [newskenya.co.ke/news/latest/kenya-broadcasting-corporation/leasing-association-hails-budget-proposals/1e5tb.130343](http://newskenya.co.ke/news/latest/kenya-broadcasting-corporation/leasing-association-hails-budget-proposals/1e5tb.130343).

juxtaposing its efficiency compared to traditional purchase.<sup>158</sup> The remarks together with the marketing of leasing companies seem to have borne fruit as both the county and national government have also adopted leasing model as evidenced from the public tenders published subsequently.<sup>159</sup> Several county governments have also opted to lease ambulances from the Red Cross although the said model is beyond the scope of this study as it did not involve bank financing of the leasing transaction.<sup>160</sup>

### 3.1 Current practice by Banks

Banks have also not been left behind with this development. In an effort to remain relevant and attractive to the industry development, banks have positioned themselves as stakeholders in this emerging aspect of leasing by offering lease financing. Banks in Kenya offer both standardized and tailored lease financing products.<sup>161</sup> The study has considered and sets out how some of the banks undertake lease financing in Kenya

Barclays bank of Kenya has a lease financing arrangement under its asset finance services and it is divided into two products; FlexiBuy and Flexirent.<sup>162</sup> The interest rate charged depends on the customer's risk profile and is calculated on a reducing balance basis. The terms relating to the repayment duration range from 12 to 60 months. Under the FlexiBuy arrangement, ownership of the asset moves upon payment of full and final payment. Under FlexiRent, there is the option of secondary rentals<sup>163</sup> and ownership can be negotiated between the bank and the customer.

Diamond Trust Bank Kenya Limited does offer lease financing with the help of independent leasing companies largely along two models – full sale and sale of

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<sup>158</sup> Advertisement titled 'Letter to my Governor' published in the *Standard Newspaper* of 10<sup>th</sup> June, 2013 p.9.

<sup>159</sup> Carlos Mureithi (2014) 'Public Tenders' *Sunday Nation* 22<sup>nd</sup> June, 2014 at p.39.

<sup>160</sup> Moses Adhiambo and John Shilitsa (2014) 'Is Shs.600,000/= too much for a monthly ambulance lease?' *Sunday Nation* 19<sup>th</sup> January, 2014.

<sup>161</sup> See Pietro Calice et al, (2012).

<sup>162</sup> Accessed at <http://www.barclays.com/africa/kenya/commercial/assetfinance.php> on 20/08/ 2013.

<sup>163</sup> Secondary rentals refer to the periodic payments that the parties may agree for the lessee to start paying once the primary term of the lease arrangement has expired. In UK, they are also called peppercorn rentals. See <http://www.hmrc.gov.uk/manuals/bimmanual/bim61020.htm> accessed on 20/08/ 2013.



receivables.<sup>164</sup> Under the sale of receivables model, the leasing company (not being the manufacturer or distributor) sources for the lessees and matches it with the assets sought to be leased and required by the lessee. The leasing company becomes the lessor by acquiring the assets from the manufacturer or distributor and leases them out to the lessee under a Rental Agreement between the lessor and the lessee. Accordingly, the lessee provides irrevocable promissory notes to effect payments in favour of the lessor over the tenure of the useful life of the assets based on regular predetermined intervals usually quarterly. However, since the lessor does not wish to commit its own funds to finance the acquisition, it approaches the bank and assigns its obligations under the Master Rental Agreement together with the receivables which have to be paid through the lessor's account held under lien at the bank. To further secure itself, the bank takes joint registration over motor vehicles and machinery between itself and the lessor in addition to noting its interest in the insurance cover obtained over the assets. The lessor retains the obligations to follow up on the management and maintenance of the assets and the bank has no contact whatsoever with the lessee with recourse made to the lessor. At the end of the tenure, the full title over the property reverts back to the lessor.

The only difference between the Sale of Receivables model and the Full Sale option is that in the latter, the lessor fully divests itself of the proprietary rights over the property whose ownership remains with the bank and the bank instead becomes the lessor. This arrangement is not very common owing to the lack of clarity under the existing laws to govern such transactions. In both models, the bank engages in credit appraisal of the lessee to inter alia establish the credit worthy and repayment capacity prior to concluding the transaction.<sup>165</sup> In the circumstances, the loan is made in the name and in favour of the independent leasing company who in turn maintains an account under lien of the bank through which the lessee pays the pre agreed rental instalments due to the independent leasing company. The bank on the other hand recovers its loan repayment from the instalments deposited into the independent leasing company's account with the bank.

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<sup>164</sup> Diamond Trust Bank Kenya Limited Lease Financing Manual 2011, a copy of which can be obtained from the author.

<sup>165</sup> Ibid.



NIC Bank makes use of an independent leasing company which becomes the lessor.<sup>166</sup> This can be construed as designed in order to comply with the Central Bank of Kenya Prudential Guidelines. The bank however holds the title of the asset and releases it to the lessor, the leasing company, at the end of the lease program when the loan and interest of the bank is discharged.<sup>167</sup> NIC bank has both operating and sale and lease back arrangements.<sup>168</sup> Chase bank does follow the NIC Bank model and has set up a subsidiary company known as Servlease through which it undertakes lease financing.<sup>169</sup>

In summary, it can be deduced that lease financing in Kenya is undertaken through either within the existing bank structures or through the formation of a subsidiary company. Moreover, the funding of a lease financing transaction is done within the realm of bank loans and takes the form of either revolving credit lines, term loans, discounting or warehouse.<sup>170</sup> The funding models are largely determined by the independent leasing companies as each independent company seeks to be unique in its relationship with the banks and carve out its niche with the lessees involved. The loans under lease financing arrangement are made in the name of the independent leasing company and designated to the lessee with each loan running independent and separate for each lessee.

### 3.2 Legal issues arising

The International Finance Corporation recognises legislative issues as a key challenge for the development of the leasing market.<sup>171</sup> Among the legislative issues noted are the non favourable tax environment occasioned by a misunderstanding gush between lease financing products and classic rental activity; the delay and potential impossibility in repossession of the equipment due to lessee's default and the complicated process of

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<sup>166</sup> See <http://www.nic-bank.com/faq/corporate-banking/operating-leases/> (accessed on 20<sup>th</sup> August 2013).

<sup>167</sup> *Ibid.*

<sup>168</sup> *Ibid.*

<sup>169</sup> Seth Onyango (2014) "Leasing taking root with awareness" *The People Daily* August 28, 2014 p25. In this newspaper article, Servlease, a subsidiary of Chase Bank is reported to have acquired nine Hyundai Trucks from CICA Motors to be leased to customers.

<sup>170</sup> Magan Jugurnauth (2014) at p.65

<sup>171</sup> Riadh Naouar (2014) p.28

implementing the legal framework which does take a long time.<sup>172</sup> Other legal issues include registration regime of leased assets, the rights and responsibilities of the parties to a lease and bankruptcy of the lessee or lessors.<sup>173</sup>

As mentioned in chapter one and as can be seen from the current practice, it is evident that there is no standardised mode in which lease financing as a banking product is offered to the Kenyan market. These variations by banks can be attributed to lack of a clear legislative framework to guide the banking activities. Banks are thus left to their varied ingenuity, innovation and interpretations within the existing legislative framework in the wake of stringent regulations and supervision by the Central Bank of Kenya. The Central Bank of Kenya as the regulator of banks has yet to reign on lease financing transactions thus perpetrating the confusion. With the existing bank practice observed earlier in the chapter, it is evident that certain legal issues do arise in the wake of the existing legislative framework. In this chapter, the study discusses some of the issues arising out of lease financing transactions as currently structured in Kenya. The legal issues include banking business and prohibited business as prescribed under the banking business, security, the independent leasing companies, tax and accounting concerns and the case for legislative intervention.

### **3.2.1 Banking business and prohibited transactions under the Banking Act**

The Banking Act is the substantive legislation regulating the business of banking in Kenya.<sup>174</sup> The provisions of the Banking Act prevail in the event of conflict between its provisions and the provisions of any other written law.<sup>175</sup> Under the Banking Act, a bank is defined as a company other than the Central Bank which carries out or proposes to carry out banking business.<sup>176</sup> Banking business on the other hand is defined to include . . . (c) the employing of money held on deposit or on current account, or any part of the

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<sup>172</sup> Ibid.

<sup>173</sup> International Finance Corporation (2005) , *Leasing in Development Lessons from Emerging Economies* pp.28-32.

<sup>174</sup> As per the short title of the Banking Act Cap.488 Laws of Kenya.

<sup>175</sup> Section 52A.

<sup>176</sup> Section 2.

money by **lending, investment or in any other manner for the account and at the risk of the person so employing the money** (emphasis supplied).<sup>177</sup>

From the foregoing, there is no doubt that the bank is supposed to be lending or investing moneys held by it in a prudent manner. The provisions do not in any way make reference to leasing as part of the banking business but there is a general provision allowing banks to lend or invest in any other manner at the risk of the person so employing the money. It can therefore be argued that the lease financing transactions can be understood to occur in the general realm of banking business as allowed under the Act. By an amendment, the definition of banking business was expanded to incorporate such other business activity as the Central Bank may prescribe.<sup>178</sup> The amendment can be applauded for taking into account the emerging trends and innovations in the banking sector. It is another attempt yet to empower the Central Bank of Kenya as the regulator to address such matters as and when need arises without recourse to legislation process. The Central Bank is however yet to prescribe anything regarding lease financing though it has issued a guideline on incidental business.<sup>179</sup> As per the Banking Circular No.4 of 2013, the purpose of the guideline is to enable licensed institutions to provide a distribution channel for authorised financial services as part of an initiative to offer Kenyans a “one-stop shopping experience” where licensed institutions can offer various financial services under one roof.<sup>180</sup>

However, when other provisions of the Banking Act are considered, it becomes unclear whether lease financing is indeed permitted. For instance, Part III of the Banking Act provides for prohibited business. The Central Bank of Kenya has issued guidelines on

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<sup>177</sup> Section 2.

<sup>178</sup> This was through the introduction of subsection (d) to the definition of banking business through Act No.57 of 2012.

<sup>179</sup> <https://www.centralbank.go.ke/images/docs/legislation/GuidelineIncidentalBusinessActivities-Final.pdf> issued pursuant to Banking Circular No.4 of 2013.

<sup>180</sup> Banking Circular No.4 of 2013 accessed at <https://www.centralbank.go.ke/images/docs/bankingcirculars/2013/BankingCircular042013.pdf>.



prohibited business.<sup>181</sup> Clause 3.4 deals with restriction on trading and investments. Accordingly, banks are prohibited from granting advances or entering into contracts or transactions or conduct business in a fraudulent or reckless manner or otherwise other than in compliance with the Act.<sup>182</sup> Reckless is described to include transacting business beyond the limits set under the Act or the Central Bank of Kenya Act and offering facilities contrary to any guidelines or regulations issued by the Central Bank. Penalties have been prescribed for offences and default by officers to buttress the seriousness of compliance under the Act.<sup>183</sup>

Banks are further restricted on trading and investment activities.<sup>184</sup> In particular, banks are not allowed to engage alone or with others in wholesale or retail trade except in the course of the satisfaction of debts due to it.<sup>185</sup> In addition, banks are not allowed to have a beneficial interest in any financial, commercial, agricultural, industrial or other undertaking where the value of the institution shall exceed 25% of the core capital of that institution<sup>186</sup> provided that the institution may engage in such undertaking in satisfaction of debt due to it but if it does so it shall dispose off the interest within such time as the Central Bank may allow.<sup>187</sup>

An analysis of the practice by banks raises the possibility of banks engaging in prohibited activities especially when under one of the models the bank ends up being the lessor by purchasing the assets through the loan offered owning the assets prior to leasing them out to the lessor. Banks are therefore constrained to literally outsource the trading portions of the lease.<sup>188</sup> In such situations, the independent leasing company ends up being a mere

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<sup>181</sup> Guidelines on Prohibited Business CBK/PG/07 and in particular clause 3.4 accessed at [https://www.centralbank.go.ke/images/docs/legislation/prudential\\_guidelines\\_2006.pdf](https://www.centralbank.go.ke/images/docs/legislation/prudential_guidelines_2006.pdf).

<sup>182</sup> Section 11(h).

<sup>183</sup> Sections 49 and 50 and The Banking (penalties) Regulations 1999.

<sup>184</sup> Section 12.

<sup>185</sup> Section 12(a).

<sup>186</sup> Section 12(b).

<sup>187</sup> Proviso (1) to section 12.

<sup>188</sup> Kenyan banks sign deal to offer leasing services accessed at [http://www.africanmanager.com/site\\_eng/detail\\_article.php?art\\_id=14980](http://www.africanmanager.com/site_eng/detail_article.php?art_id=14980) (accessed on 20<sup>th</sup> August 2013).

broker or agent to the transaction without the underlying risk. Similarly, where the independent lessor assigns to the bank its rights under the Master Rental Agreement, the bank inevitably takes up the proprietary risk including monitoring the assets and the independent leasing company by retaining the supervisory rights to monitor the lessor and the assets can be construed to be a mere agent of the bank. It should also not be forgotten that at the end of the lease period the assets revert to the owner (in some cases the banks) who may have to dispose off the assets. Some banks have thus designed their products to allow secondary and subsequent lease of the same assets upon expiry of the initial term.<sup>189</sup> By banks becoming lessors, they will become involved in selling of assets which amounts to trading as prohibited by the Banking Act.

It is also worthy of mention that the ownership of such assets to be leased affects the banks ratio between capital and assets. Banks are required to maintain a prescribed minimum ratio between core capital and total capital on one hand and assets (including total loans and advances) and off balance sheet items on the other hand.<sup>190</sup> This therefore means that while preparing the annual balance sheet for the bank, such assets under lease financing need to be adequately and properly reported. This complicates the preparation of bank books as required by statute in distinguishing the bank's assets and those assets that are only there for purposes of leasing and the attendant requirement to maintain the capital to assets ratio. This brings about the accounting and the attendant tax challenges which are however beyond the scope of this study.

In acknowledging the existing legal challenges, a publicity firm, Wheels Media in a statement stated that the Kenyan banking law may restrict financial institutions from engaging in trading, but the zeal of banks to make a kill from the fast growing leasing sector is causing a stir in the local assets market.<sup>191</sup> A fear has been expressed by analysts that agreements signed between Kenyan commercial banks with an independent leasing

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<sup>189</sup> For instance the FlexiRent arrangement offered by Barclays Bank. See also the Diamond Trust Bank Leasing Process Manual.

<sup>190</sup> Section 18.

<sup>191</sup> Kenyan banks sign deal to offer leasing services accessed at [http://www.africanmanager.com/site\\_eng/detail\\_article.php?art\\_id=14980](http://www.africanmanager.com/site_eng/detail_article.php?art_id=14980) (accessed on 20/08/ 2013).

company could be illegal.<sup>192</sup> It is in an attempt to grapple with the possibility of contravening the provisions of the Banking Act that the braver banks have opted to offer lease financing within the existing lending framework and structures in the bank while the conservative banks have opted to incorporate associate companies to specifically deal with the lease financing.<sup>193</sup> The study argues that the existence of ambiguous statutory provisions to deal with the emerging lease financing products has led to the lack of standardisation of the lease financing products and approaches.

### 3.2.2 Security

The most important qualification of a successful banker has been the ability to judge the character and credit worthiness of its customers.<sup>194</sup> Security for a proposed advance should normally be required, even though the borrower's financial position appears to be sound as the borrower's position can and sometimes does change very quickly. The appropriate time to obtain security is at the outset, when the loan is being negotiated.<sup>195</sup> When assessing the value of the security, the bank will check to see if the value appropriately compensates for the risk, if it fits in the bank's criteria/policies and if it is easy to realize / liquidate to recover costs (in the case of default)<sup>196</sup> The Banking Act allows for banks to take security against assets provided. However, the Banking Act does not specify what security can be taken or how security can be effected.<sup>197</sup> Recourse is therefore made to other statutes such as the Hire Purchase Act, Chattels Transfer Act and Companies Act to establish and perfect its securities over moveable assets as specifically provided for under the respective statutes.<sup>198</sup>

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<sup>192</sup> Ibid.

<sup>193</sup> See <http://www.nic-bank.com/faq/corporate-banking/operating-leases/> (accessed on 20<sup>th</sup> August 2013) where the bank indeed acknowledges this difficulty faced by banks.

<sup>194</sup> J. Milnes Holder (1987) *The Law and Practice of Banking Vol.2 Securities for Bankers Advances* 7<sup>th</sup> ed Pitman Publishing, London.

<sup>195</sup> Ibid.

<sup>196</sup> Kenya Bankers Association (2013) *A Consumer Guide to Banking: Standard Banking Practices* Compiled by the Kenya Bankers Association (KBA) chapter 5.4 accessed on 14/05/2014 at <http://www.kba.co.ke/images/stories/KBA%20Consumer%20Guide%202014.pdf>.

<sup>197</sup> Section 14(3) expressly allows the bank to accept security over land for advances made for any other purpose in good faith. The study is however focused on moveable assets as security.

<sup>198</sup> Other statutes include the Land Act that provide for securities over immovable properties.



Figure 3.2 Common securities under lease financing

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|---|
| Sale of Receivables <sup>199</sup> between the Bank and the Lessor together with all rights to the title/s of assets under lease in accordance with the Master Rental Agreement between the Lessor and the Lessee |
| Assignment of Master Rental Agreement between the Lessor and the Lessee stipulating the terms and conditions of the Lease in favour of the Bank with full benefits thereof.                                       |
| Notice of Assignment of the receivables to be issued by the Lessor and duly acknowledged by Lessee  |
| Back to Back Promissory Notes from the Lessor in favour of the Bank   |
| Board Resolution of the Lessor and Lessee authorizing the arrangement.  |
| Landlord waiver of any interest whatsoever over the assets under lease.   |
| Comprehensive insurance cover(s) over the vehicles and other assets under Lease Finance to be obtained from an insurance company acceptable to the Bank with the Bank's interest noted.                           |
| Joint Registration over motor vehicles between the Lessor and the Bank.   |
| Lien over the receivables account to be opened by the Lessor with the Bank  |

There are three distinct methods of making goods available as security, namely by way of mortgage, pledge or hypothecation.<sup>200</sup> From the figure above, it is evident that the main security is the sale of receivables in form of assignment of debt with the other securities being collateral. Assignment of debt to secure a loan is a comparatively rare type of security. Usually, assignment of debt is undertaken in the form of discounting<sup>201</sup> As a general rule, bankers look upon the proposition to obtain an assignment to a bank of a debt owed to a customer by a third party (the lessee) with disfavour as the value of the security depends upon the ability of the third party to pay the debt. The value of the debt

<sup>199</sup> Sale of Receivables essentially means that the lessor assigns all the rental payments together with all rights to the title of the assets under lease in favour of the Bank; until such time that the full rental outstandings have been paid by the lessee, whereafter, the title reverts to the lessor. It is worth noting that some Banks opt to have a general Sale of Receivables Agreement between the Lessor and the Bank in respect of the lease financing facility and to apply to all lessees/ Renters under that facility.

<sup>200</sup> J. Milnes Holder (1987) pp.260 – 262.

<sup>201</sup> Especially involving cheques or bills where a bank lends money in anticipation of payments received under the cheques or bills as and when they mature usually on a short term basis not exceeding 90 days

is likely to be reduced by any right of set off the third party may have against the borrower.<sup>202</sup>

The tri-partite nature of the lease financing structure and in particular reliance on a lessee to repay a loan advanced to the lessor exposes itself to the challenge of privity of contract. Lease financing incorporates two distinct transactions. The first is the loan transaction between the bank and the lessor and the other transaction being the leasing arrangement between the lessor and the lessee. These two transactions are merged by way of assignment by the lessor of its rights under the leasing arrangement to the bank and the sale of receivables by the lessor to the bank to secure the loan. In the event of default of the loan, the bank finds itself in difficulties of enforcing the security from the lessee considering that the bank would not have had any contact with the lessee except through information received courtesy of the lessor. Though the lessor is never a party to any borrowing, the banks and the lessor who are the only party to any borrowing rely and expect payments to be made by the lessor towards satisfying the loan repayments. Banks therefore have to entirely rely on the goodwill and management by the lessor as management of the lease transaction is well beyond the banking business permitted under the Banking Act.

The tripartite nature of lease financing also needs to be considered in the context of consideration as an element of a valid contract. In English Law of Contract, a promise must have consideration and the consideration must move from the promisee.<sup>203</sup> For a promise to be valid in law, it must seek something in return.<sup>204</sup> It is impossible to execute a legal assignment of a future debt, but in equity such assignments, if made for valuable consideration, are treated as contracts to assign, of which specific performance will be granted. Thus a lender is fully protected, provided that he gives notice to the future debtor and obtains an acknowledgement.<sup>205</sup> Banks have opted to adopt the equitable assignment

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<sup>202</sup> J. Milnes Holder (1987) pages 326.

<sup>203</sup> Atiyah, (1986) *Essays on Contract* Oxford: Clarendon Press, p. 179 et seq. See also *Tweddle v Atkinson* [1861] EWHC QB J57.

<sup>204</sup> *Currie v Misa* (1875) LR 10 Ex 153; (1875-76).

<sup>205</sup> J. Milnes Holder (1987) pages 328.

option in adopting the assignment of future debts in the absence of the legal possibility in light of lack of consideration.

These potential legal challenges have restricted banks to offer lease financing to only high net worth, blue chip and multinational companies where the risk of default is low. The small and medium enterprises and other start up companies stand no chance of being incorporated in the lease financing transactions in the absence of a clear legal structure comfortable to banks.

It is in light of the above challenges that some banks in their efforts and zeal to secure the financing resort to additional measures such as joint registration between the bank and the lessor where motor vehicles are part of the assets. The problem with joint registration of motor vehicles is that such an arrangement brings itself within a hire purchase transaction. The Hire Purchase Act is the substantive Act governing hire purchase transactions and joint registration of ownership of vehicles is a recognised security under the Hire Purchase Act.<sup>206</sup> There are other aspects of hire purchase that separate it from lease financing and purporting to apply hire purchase security in a lease financing transaction in isolation lends itself to legal challenges. Moreover, such joint registration removes the assets (in this case vehicles) from any form of pledge as registration connoted ownership and a bank cannot pledge its own assets to secure its financing to a third party (in this case the Lessor). Pledge of moveable assets are legally recognised under the Chattels Transfer Act for individuals and the Companies Act in form of specific debenture for Companies. It is argued therefore that joint registration jeopardises the vehicles pledged as security and it will be curious to see how the bank will go about it in realising the vehicles pledged to the bank as security in the event of default. The study argues that the bank should either take full ownership of the vehicles and lease them (assuming this is permitted under banking business) or have the vehicles fully owned by the lessor who can instead pledge them to the bank by way of specific debenture to buttress its security position.

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<sup>206</sup> Section 5 of the Hire Purchase Act whereupon all hire purchase agreements are also required to be registered within 30 days of execution.



Existing statutes dealing with bank securities all buttress the importance of registration of securities in a specific registry established under statute.<sup>207</sup> The importance of registration not only makes the security enforceable but also allows any third parties intending to deal with a company that has borrowed to appreciate the company's financial status and indebtedness. Securities under lease financing as currently structured are novel and still developing. Notably is the assignment of future debt and sale of receivables which form the main basis of a lease financing. Under the Companies Act, security taken by way of floating debenture does include the option of appointing a Receiver Manager as well as taking a charge over book debts (receivables).<sup>208</sup> In the absence of registration of security the instruments creating the security are likely to be void.<sup>209</sup> Consequently, in the absence of registration of securities by banks under lease financing, it is a reasonable expectation that in the event the lessor had issued a floating debenture that has been registered, the bank in relying on its unregistered securities is likely to be considered an unsecured creditor.

Moreover, the bank in relying substantially on future debt as its main security does not shield it from disputes on outstanding balance(s) between the lessor and the lessee which can lead to counter claims and/or offset of the said amounts between the lessor and the lessee. This is one situation that banks abhor to find themselves in considering the large amounts disbursed in light of the shaky nature of the joint registration of motor vehicles as already considered. From the foregoing, it is evident that the nature and enforceability of security under lease financing as currently structured is inadequate and needs proper addressing and streamlining to address the challenges pointed out.

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<sup>207</sup> Hire Purchase Registry, and Chattels Registry falls under the Registrar General, Companies Registry falls under the Registrar of Companies whilst Motor Vehicle Registry is headed by the Registrar of Motor Vehicles all of whom are established under the respective statutes.

<sup>208</sup> Sections 347, 348 and 96(2)(e) of the Companies Act.

<sup>209</sup> Section 13 of the Chattels Transfer Act.

### 3.2.3 Independent Leasing companies

The role of independent lessors in the development of lease financing cannot be gainsaid. Banks continue to form partnerships with independent leasing companies as each seeks to establish itself in the emerging lease financing market to offer leasing products. For instance, a leading leasing company Vehicle and Equipment Leasing has signed an agreement with various banks exceeding ten, with about six of them already having started offering the leasing product.<sup>210</sup> The arrangement effectively allows the bank to tap into the already established clientele of the leasing company spread across the different segments being manufacturing, horticulture, mining, technology and international and donor organisations.

Currently, there exist no statutory provisions to address or control the activities of independent leasing companies. With the overwhelming effect on the banking business afforded to banks by independent leasing companies, for example trading in assets and management of the lease transaction on behalf of the banks, there is need to evaluate whether to regulate the said companies. Regulation could be in form of capitalisation, competence of the key personalities behind the said companies and even licensing in the wake of the prominence given to consumer protection under the Constitution of Kenya.<sup>211</sup> Central Bank of Kenya as the regulator of banks and financial institutions is yet to make any policy directive relating to the activities of such independent leasing companies despite their continued increasing presence in the country. Similarly, the Ministry of Finance under which the banking and financial services sector under which the independent leasing companies fall have yet to see the need to issue any policy directive on the activities of the independent leasing companies.<sup>212</sup>

Other jurisdictions like Tanzania, as shall be seen in the subsequent chapter, have put in place legislation to specifically address and regulate the independent leasing companies.

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<sup>210</sup> Kenyan banks sign deal to offer leasing services available at [http://www.africanmanager.com/site\\_eng/detail\\_article.php?art\\_id=14980](http://www.africanmanager.com/site_eng/detail_article.php?art_id=14980) (accessed on 20<sup>th</sup> August 2013).

<sup>211</sup> Article 46.

<sup>212</sup> The Minister in charge of Finance is empowered under section 52 of the Banking Act to make regulations.

Leasing companies in Kenya have argued against regulation of their activities.<sup>213</sup> It can be fairly inferred that independent leasing companies do offer financial services and can therefore be expected to fall within the realm of licensing and regulation by Central Bank of Kenya. However, the Central Bank of Kenya admits to not having licensed any other non banking financial institution.<sup>214</sup>

### 3.3 The case for legislative intervention

Where leasing is at an early stage of its development, with a limited level of understanding as to its impact, there may be need to regulate and supervise leasing activities.<sup>215</sup> The goal is to engineer a leasing environment that addresses the needs of lessors and lessees, and encourages the continued development and sustainability of the leasing sector.<sup>216</sup>

The Banking Act of the laws of Kenya is an act of Parliament to amend and consolidate the law regulating the business of banking in Kenya and for commercial purposes<sup>217</sup> The Central Bank of Kenya as the statutory regulator is yet to direct or advise banks on lease financing transactions.<sup>218</sup> This connotes that the various lease financing models are presumed to be in compliance with the requirements of the Banking Act. Nothing could be further from the truth.

This study acknowledges that the Banking Act was amended vide Act No.57 of 2012 allowing the Central Bank to prescribe what else could amount to banking business by definition. To date and despite the growing nature of lease financing transactions in Kenya, the Central Bank of Kenya is yet to formally extend the definition of banking business to cover lease financing. Be that as it may, lease financing as banking business

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<sup>213</sup> Magan Jugurnauth 2014 at p.61.

<sup>214</sup> [www.centralbank.go.ke](http://www.centralbank.go.ke)

<sup>215</sup> International Finance Corporation (2005), *Leasing in Development Lessons from Emerging Economies*, p.33.

<sup>216</sup> Ibid p.21

<sup>217</sup> Short title of the Act.

<sup>218</sup> Power of the Central Bank of Kenya under section 33 of the Banking Act.



goes beyond the mere definition. It extends to the important issues of securities for the lending which is beyond the scope of the Central Bank of Kenya, such matters requiring to be addressed by statutes and not merely regulations. Current banking business activities lend recourse to other statutes (being not less than seven examined under this study) on matters of bank security including the formation of registries and registration regimes. Other jurisdictions like Tanzania have taken time to legislate specifically on lease financing.<sup>219</sup>

Supervision of leasing institutions would be necessary only when specific regulations have been established for the leasing institutions. In such a case, existing supervisory institutions, such as banking supervisor agencies, may be able to perform such supervision.<sup>220</sup> There are two main types of regulation for non-bank lessors; minimum capital requirements and licensing of leasing activity.<sup>221</sup> Each type of regulation calls for different considerations.<sup>222</sup> A leasing license usually does not contain many requirements that a license for securities or banking operations contains and therefore, in most cases, it is nothing but some type of “registration procedure.”<sup>223</sup> This allows leasing companies the flexibility to adapt to the changing market situation or otherwise they fall into a non-competitive position.<sup>224</sup>

The Central Bank of Kenya does not have the power to legislate beyond the issuance of regulations and this study thus argues that there is need to consider putting in place a proper regime to cover lease financing activities. The framework that is developed may not solve all national issues, but should serve as a basis for developing operations that may not have previously existed or enable the continued improvement of the leasing sector.<sup>225</sup>

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<sup>219</sup> Through the Financial Leasing Act, No.5 of 2008.

<sup>220</sup> International Finance Corporation, *Leasing in Development Lessons from Emerging Economies*,(2005) p.32.

<sup>221</sup> Ibid p.33.

<sup>222</sup> Ibid pages 33 – 35 where the considerations have been aptly discussed.

<sup>223</sup> Ibid p.35.

<sup>224</sup> Ibid.

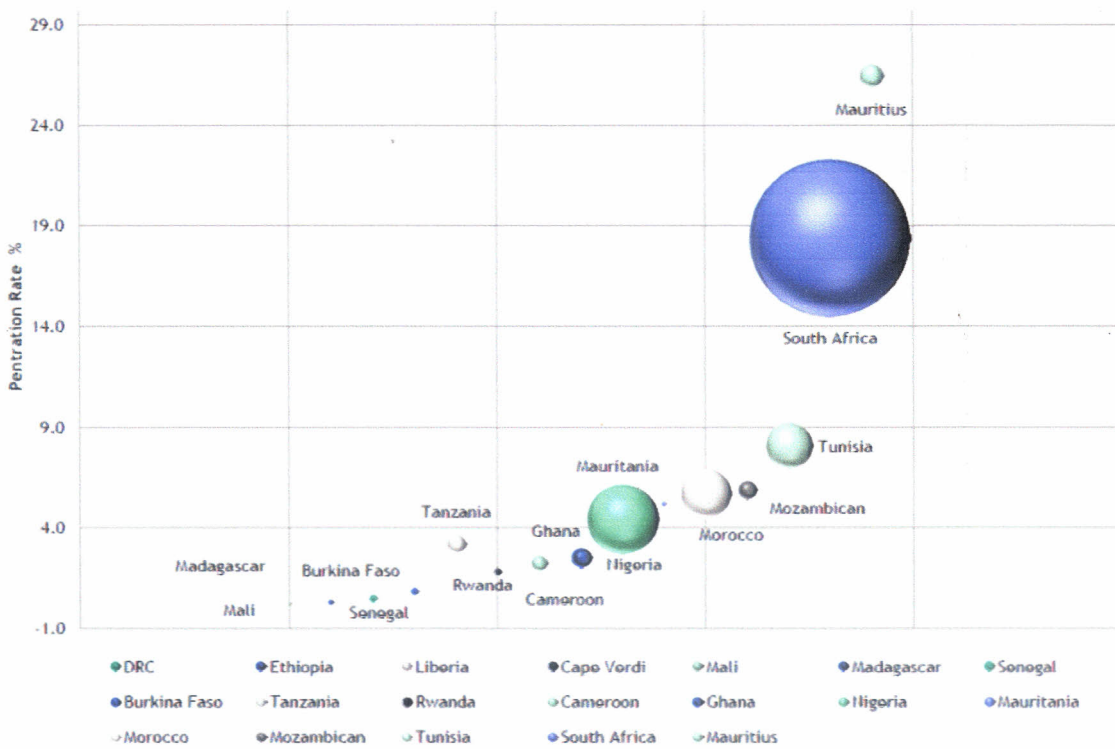
<sup>225</sup> Ibid.p.21.

## CHAPTER FOUR

### COMPARATIVE STUDY –LEGISLATIVE FRAMEWORK IN TANZANIA AND SOUTH AFRICA

With the exceptions of Egypt, Morocco, Tunisia, Nigeria and South Africa, the leasing market is in its nascent stages in Africa, with penetration rates ranging from 1 to 5 percent (against a global average of 20).<sup>226</sup> As any other industry in its infancy stage, leasing is characterized by absence of favourable operating environment since the taxation, regulation and legal regimes are not yet adapted to the sector’s requirements.<sup>227</sup> Kenya has been recognised as one of the most promising economies, not only in the East Africa region but across the continent, due to its market-based policies that enable growth of the various sectors, including financial services; and the Government’s progressive role of fostering public-private sector engagement.<sup>228</sup>

*Fig. 4.1 Penetration ratio vs leasing volumes in Africa Region 2008<sup>229</sup>*



<sup>226</sup> <http://www.mfw4a.org/nc/access-to-finance/sme-finance-leasing.html>

<sup>227</sup> Ibid.

<sup>228</sup> <http://www.kba.co.ke/images/stories/KBA%20Consumer%20Education%20March%202014.pdf>

<sup>229</sup> Riadh Naouar (2014) at p.19

From figure 4.1 above, it is evident that Kenya does not rank in Africa in terms of the penetration ratio or leasing volumes. South Africa on the other hand takes an overwhelming lead. In East Africa, Tanzania has been recognised as a player in terms of penetration ratio and leasing volumes in Africa ranking at slightly less than 4%. In keeping with the recognition therefore, this chapter seeks to highlight the existing legislative framework particularly in Tanzania which is an emerging case nearest to Kenya, and South Africa as the epitome of leasing in Africa with a penetration rate of approximately 20%. The chapter shall also look at the general international regime in the context of cross border leasing.

#### 4.1 CASE STUDY: TANZANIA

Lack of legal and regulatory framework necessary for the development of lease financing operations is one of the limitations that prevent most of the local banks in Tanzania from venturing into lease financing.<sup>230</sup> The Tanzania Consumer Advocacy Society believe that there should be proper protection on interests of financiers, the government and customers as well as clearly laid out rules and regulations such as the rights that were not present in Tanzania.<sup>231</sup> Without a proper legal framework, financial institutions and service users operate in fear creating a chance for banks and other financial institutions to give loans with fear.<sup>232</sup> It is against this backdrop that it was deemed necessary to have specific legislation to amend other laws affecting leasing and its development in

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<sup>230</sup> Eric Torokal (2009) "Lease Financing and Tanzania's Economy" *Business Times March 7 – 13, 2008* published in Tanzania Consumer Advocacy Society accessed at <http://tanzaniacustomer.blogspot.com/2009/05/lease-financing-and-tanzanias-economy.html> on 14th May 2015.

<sup>231</sup> According to Bernard Kihyo, Executive Director Tanzania Consumer Advocacy Society quoted in Eric Torokal (2009) The Tanzania Consumer Advocacy Society is a private voluntary, non-partisan and non profit making organization that was registered as a company limited by guarantee in July 2007 under the Companies Act of 2002. The Society has been providing an advocacy platform that would allow consumers' voices to be heard, raise consumers' awareness of their rights, and build consumers' ability to claim their rights, as well as make markets accountable and more responsive to consumers' needs and interests.

<sup>232</sup> Ibid.



Tanzania.<sup>233</sup> In this chapter, the study considers an overview of the following legislations relating to lease financing - The Banking and Financial Institutions Act No.5 of 2006 and the Banking and Financial Institutions (Financial Leasing) Regulations, 2011 and the Financial Leasing Act No.5 of 2008 for comparative purposes with the Kenyan legislative situation.

#### **4.1.1 The Banking and Financial Institutions Act No. 5 of 2006**

The Banking and Financial Institutions Act No.5 of 2006 is an act of parliament to *inter alia* provide for comprehensive regulation of banks and financial institutions.<sup>234</sup> This Act defines banking business as “the business of receiving funds from the general public . . . and to use such funds, in whole or in part, for loans or investments for the account of and at the risk of the person doing such business.”<sup>235</sup> This definition of banking business is fundamentally similar to that given under section 2 of the Banking Act of the laws Kenya.

Part V of the Banking and Financial Institutions Act of Tanzania provides for activities and Investments. In particular, section 24 thereof provides for permissible activities that a licensed bank or financial institution may engage either directly or through a separately incorporated subsidiary as determined by the Bank of Tanzania. This is what may have informed certain banks in Kenya who have incorporated subsidiaries through which lease financing is undertaken by those specific banks as was discussed in chapter three of this study.

Of interest to this study is the express permission of financial leasing activities by the legislation.<sup>236</sup> Though the Act does not define financial leasing, the same is defined under the Banking and Financial Institutions (Financial Leasing) Regulations, 2011. This is in contrast to the Banking Act of the laws of Kenya which is silent on lease financing as

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<sup>233</sup> This was done through program managed by the International Finance Corporation under the he Swiss State Secretariat for Economic Affairs (SECO)-IFC Tanzania leasing program as explained by Moyo Violet Ndonge as quoted in Eric Torokal (2009).

<sup>234</sup> Long title to the Banking and Financial Institutions Act.

<sup>235</sup> Section 3 on interpretation.

<sup>236</sup> Section 24(1) (c).

banking business or at all with the Banking Act of Kenya containing express restrictions in certain aspects of trading and investments as discussed in chapter three of this study.

#### **4.1.2 The Banking and Financial Institutions (Financial Leasing) Regulations, 2011**

These regulations are made pursuant to section 71 of the Banking and Financial Institutions Act. They apply to all financial leasing operations by banks and financial institutions or its subsidiaries as well as financial leasing companies.<sup>237</sup> Financial leasing company is defined as a non-deposit taking entity which is licensed by the Bank of Tanzania to carry out financial leasing operations.<sup>238</sup> The principles to be adhered to in the regulation of lease financing operations including promotion of sustainable financial leasing companies and instillation of good corporate governance and accountability by shareholders, directors and managers.<sup>239</sup> The regulations permit both banks and non banks to engage in lease financing provided that they obtain licensing by the Bank of Tanzania. In particular, banks licensed by Bank of Tanzania are expressly permitted to engage in lease financing.<sup>240</sup> Part III of the regulations deal with the application for licensing setting out the requirements processes leading to the grant of license and commencement of business by financial leasing companies. Operations of lease financing are subject to supervision by the Bank of Tanzania<sup>241</sup> while the organisation, ownership and minimum capital of leasing companies is also provided for.<sup>242</sup> Part VIII of the regulations deal with the classification and provision of lease assets by the bank in line with prudential guidelines.

From the foregoing, it is evident that Tanzania has appreciated and embraced the existence of independent leasing companies. The regulations are largely aimed at regulating the activities of such independent companies alongside other banks and financial institutions. In conclusion, the Banking and Financial Institutions Act and the regulations made thereunder contain provisions that mainly allow banks and independent

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<sup>237</sup> Regulation 2.

<sup>238</sup> Regulation 3 on interpretation.

<sup>239</sup> Regulation 4 (a) and (b).

<sup>240</sup> Regulation 5(2).

<sup>241</sup> Part IV.

<sup>242</sup> Part V.

leasing companies to engage in lease financing by providing a statutory framework for the licensing and conduct of lease financing operations by entities engaging in lease financing. Apart from the provisions relating to asset classification and amortisation, the Banking and Financial Institutions Act and the regulations made thereunder do not provide for the specific lease financing product as offered to the consumers by the banks which is the focus of this study. The crafting of suitable banking products to the public has been left to the banks and financial institutions and the markets.

#### **4.1.3 The Financial Leasing Act (Act No 5 of 2008)**

The International Finance Corporation worked closely with several leasing companies during the drafting phase of this law and has continued their work with capacity building, including developing and presenting training programmes and seminars using international leasing experts and practitioners to present the information and share their knowledge with interested parties.<sup>243</sup> The Financial Leasing Act (the Act) sets out the legal framework for lease financing transactions. The Act applies both to mainland Tanzania as well as to Tanzania Zanzibar.<sup>244</sup> It also applies to any financial lease of an asset if the asset is within the United Republic of Tanzania, the lessee's centre of main business is within Tanzania or the lease financing transaction provides Tanzanian law as the governing law for the transaction.<sup>245</sup>

Under the Act, 'asset' means all property that is non-consumable, used in the trade or business of the lessee and includes personal property, immovable property, trademarks and copyrights, computer software, capital goods but does not include shares, investment securities, financial instruments, government bonds and securities or any other moveable of immovable asset whose free circulation in the United Republic of Tanzania is restricted by law.<sup>246</sup> This study finds it curious that immovable property whose legal regime is separate and comprehensive is considered as part of assets under lease

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<sup>243</sup> International Finance Corporation, (2009) *Leasing in Development Guidelines for Emerging Economies* p.27

<sup>244</sup> Section 2(1).

<sup>245</sup> Section 2(2).

<sup>246</sup> Section 3.



financing. The definition of 'lessor' under the Act to *inter alia* mean a person legally registered or licensed to engage in financial business is sufficiently inclusive to extend to banks and other financial institutions apart from independent leasing companies.<sup>247</sup>

Part II of the Act<sup>248</sup> mandates a lessee to comply with the provisions of the Act for the lessee to use any leased asset for business operation. The lessee is required to identify and choose a supplier of an asset for the purpose of enabling the lessor to acquire such asset from the supplier for leasing to the lessee.<sup>249</sup> This is to ensure that the lessee specifies the asset without relying primarily on the skill and judgment of the lessor.<sup>250</sup> For avoidance of doubt, this legislation recognises and acknowledges that a lease financing agreement is a special contract that constitutes neither a rental, a sale, a rental-sale, a hire-purchase, a sale with preservation of property rights, nor a credit sale by payments made in instalment all of which operations are excluded from the scope of the existing laws.<sup>251</sup> The capacity to contract and formation of lease financing contracts remains regulated under the law of contract.<sup>252</sup>

The Act offers protection of assets under lease financing to secure the rights and interests of the lessor in the transaction. These include the irrevocable nature of the lessee's duties to the lessor,<sup>253</sup> obligation to pay rent and the lessor's obligation to repossess the asset for non payment of rental instalments.<sup>254</sup> Leased assets are excluded from assets of any receivership or pool of assets to be disposed of by the creditors of the lessee.<sup>255</sup> The lease agreement is effective and enforceable according to its terms between the parties and against purchasers of the asset and creditors of the parties.<sup>256</sup> The lessor's title is given prominence and prevails over claims by third parties including creditors of the lessee

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<sup>247</sup> Section 3.

<sup>248</sup> Formation of Lease Agreement.

<sup>249</sup> Section 4 (2) and (3) respectively.

<sup>250</sup> Section 5(1) (a).

<sup>251</sup> Section 5(2).

<sup>252</sup> Section 6(2).

<sup>253</sup> Sections 9 and 12 especially 12(3).

<sup>254</sup> Section 13.

<sup>255</sup> Section 13(2).

<sup>256</sup> Section 15.

(except as against a purchaser in good faith for value of the asset under a non-registered lease).<sup>257</sup>

Assignment of the lease agreement by a lessor is permitted under the Act provided the intention to assign is communicated to the lessee in writing. The lessor may also assign its rights on the rental receivables under the lease without requiring prior information to the lessee.<sup>258</sup> The practice by some Kenyan banks as evidenced in chapter three in accepting assignments of rental receivables as security for lease financing seems to be predicated upon the Tanzanian legal provisions, there being no express legislative framework in Kenya to cover such practice.

In protecting the assets as security for banks, the Act provides that any action by a third party (owing to the tripartite nature of some of the lease financing transactions) claiming right to the asset (for instance as a financier) shall be brought against the lessor.<sup>259</sup> Moreover, the lessee is prevented from creating any charge or encumbrance over the leased asset during the term of the lease, and if so created, the charge or encumbrance shall be void and the creditors of the lessee shall not be entitled to enforce the charge or encumbrance of the leased asset.<sup>260</sup> A notable provision of the Act that seeks to protect third parties including banks is part V which provides for the registration of lease agreements and leased assets. Just like the Charges and Debentures, Hire Purchase or Chattels Registries, the Minister is required to designate a registry for registration of assets under lease agreements which registry shall be made open for the public.<sup>261</sup> Accordingly, parties to a lease agreement are required to register assets under the lease agreement with the register of financial lease agreements.<sup>262</sup> A registered asset under a financial lease agreement serves as a notice to third party purchasers of leased assets of existing interests in the leased asset.<sup>263</sup>

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<sup>257</sup> Section 16.

<sup>258</sup> Section 14.

<sup>259</sup> Section 17.

<sup>260</sup> Section 19.

<sup>261</sup> Section 21.

<sup>262</sup> Section 21(2).

<sup>263</sup> Section 21(3).

This Act is by far an attempt to make substantive provisions in appreciating the peculiar nature of lease financing, an emerging bank product. The Act has sought to codify the nature of the lease financing transaction, defined the obligations and also recourse. In essence, the Act contains provisions that protect all the parties including third parties, the banks and the general public through availability of a registry for inspection.

#### 4.1.4 Conclusion

Although Tanzania has taken major efforts to reform the banking and financial institutions sector over the last two decades, the issue of consumer protection has remained virtually untouched by the reforms.<sup>264</sup> This situation has led to increasing abuse of good business practices by many of the financial institutions and banks, as well as a lack of transparency in dealing with customers.<sup>265</sup> Only one institution, the Tanzania Consumer Advocacy Society, is in process of building foundations for consumer protection efforts. The Bank of Tanzania, which has the mandate to supervise the banking and financial industry as a whole, has no straightforward consumer protection guidelines.<sup>266</sup> Rural Tanzanians have little access to financial services. Nearly one third have no access at all; 29% use non monetary means to transact and 28% use informal financial service providers. Only 4% use semi formal providers, while just 8% have access to a bank account or insurance policy.<sup>267</sup>

In the year ending June 2014, the Bank coordinated the preparation of the National Financial Inclusion Framework, which was launched in December 2013 as a guide towards improving the level of financial inclusion in the country.<sup>268</sup> The Bank also licensed *inter alia* one financial leasing company in a bid to increase access to financial services.<sup>269</sup> By the end of the year 2008, the leasing market volume had grown to around

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<sup>264</sup> Tanzania Consumer and Advocacy Society, 2012 <http://www.tcas-tz.org/tanzania-financial-reforms-fail-on-consumer-protection/>

<sup>265</sup> Ibid.

<sup>266</sup> MFTransparency. Promoting Transparent Pricing in the Microfinance Industry, County Survey: Tanzania accessed at [mftranparency.org](http://mftranparency.org)

<sup>267</sup> MicroNed, 2(011), Tanzania <http://www.micro-ned.nl/nl/countries/tanzania> accessed on 11th June 2015

<sup>268</sup> Bank of Tanzania,(2014) *Directors Report and Financial Statements for the year ended 30<sup>th</sup> June 2014* p.4.

<sup>269</sup> Ibid.



USD100 million or 3% penetration in financing investment in the Tanzanian economy. This compares to around USD20 million or 1% penetration in 2005.<sup>270</sup>

## 4.2 CASE STUDY: SOUTH AFRICA

South Africa has an advanced banking system, backed by a sound regulatory and legal framework which aims to secure systemic stability in the economy, ensure institutional safety and soundness, and promote consumer protection.<sup>271</sup> It is by far the most developed country in lease financing.<sup>272</sup> There are eleven primary statutes and regulations that govern the banking industry in South Africa.<sup>273</sup> For purposes of this study, reference shall be made to the Banks Act 1990, the Inspection of Financial Institutions Act 1998 and the National Credit Act 2005. The study shall also consider the Financial Services Board Act 1990.

### 4.2.1 The Banks Act (Act No.94 of 1990)<sup>274</sup>

The aim of this legislation is to provide for the regulation and supervision of the business of public companies taking deposits from the public; and to provide for matters connected therewith.<sup>275</sup> Under the Act, the business of a bank is defined to include the utilisation of money, or of the interest or other income earned on money, accepted by way of deposit for the granting by any person acting as lender in such person's own name or through the medium of a trust or nominee, of loans to other persons; for investment and for the financing, wholly or to any material extent, by any person of any other business activity or any other activity which the Registrar of Banks has, after consultation with the

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<sup>270</sup> International Finance Corporation (2009), *Leasing in Development Guidelines for Emerging Economies* p.27

<sup>271</sup> <http://www.polity.org.za/article/global-legal-insights-banking-regulation-1st-edition-south-africa-chapter-2013-07-11>.

<sup>272</sup> As per figure 4.1 of this study.

<sup>273</sup> the Banks Act 1990; the South African Reserve Bank Act 1989; the National Payment Systems Act 1998; the Inspection of Financial Institutions Act 1998; the Currency and Exchanges Act 1933; the Financial Intelligence Centre Act 2001; the Financial Advisory and Intermediary Services Act 2002; the Mutual Banks Act 1993; the Co-operative Banks Act 2007; the National Credit Act 2005 and the Consumer Protection Act, 2008.

<sup>274</sup> <http://www.acts.co.za/banks-act-1990/>

<sup>275</sup> Preamble.

Governor of the South African Reserve Bank, by notice in the *Gazette* declared to be the business of a bank.<sup>276</sup> The aspects of the conduct of the business of a bank are covered under the Act. Banks are expected to hold all their assets in their own name excluding, any asset *bona fide* hypothecated to secure an actual or potential liability; in respect of which the Registrar has, on application of the bank concerned approved in writing that such asset may be held in the name of another person; or falling within a category of assets designated by the Registrar by notice in the *Gazette* as a category of assets which may be held in the name of another person.<sup>277</sup>

#### 4.2.2 The National Credit Act 2005

The National Credit Act 2005 (NCA) regulates consumer credit and improved standards of consumer information, prohibits certain unfair credit and credit marketing practices; as well as reckless credit granting. It also provides for debt reorganisation in cases of over-indebtedness, regulates credit information and provides for registration of credit bureaux, credit providers and debt counseling services.<sup>278</sup> The Act establishes the National Credit Regulator (NCR) as a regulator and with the enforcement of compliance with the NCA.<sup>279</sup> The Act requires the regulator to promote the development of an accessible credit market, particularly to address the needs of historically disadvantaged persons, low income persons, and remote, isolated or low density communities. The NCR is responsible for the regulation of the South African credit industry.<sup>280</sup> It is tasked with carrying out education, research, policy development, registration of industry participants, investigation of complaints, and ensuring the enforcement of the Act.<sup>281</sup>

Under the Act, a credit provider in respect of a credit agreement to which the Act applies means *inter alia* a party who extends credit under a credit facility; the lender under a

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<sup>276</sup> Section 1 (definitions).

<sup>277</sup> Section 78(1) (d).

<sup>278</sup> <http://www.polity.org.za/article/global-legal-insights-banking-regulation-1st-edition-south-africa-chapter-2013-07-11>.

<sup>279</sup> Section 12.

<sup>280</sup> Sections 13 to 18.

<sup>281</sup> <http://www.ncr.org.za/about>.

secured loan and the lessor under a lease.<sup>282</sup> A Lease is defined to mean an agreement the terms of which temporary possession of any moveable property is delivered to or at the direction of the consumer, or the right to use any such property is granted to or at the direction of the consumer; payment for the possession or use of the property is made on an agreed or determined periodic basis during the life of the agreement or deferred in whole or in part for any period during the life of the agreement; interest, fees or other charges are payable to the credit provider in respect of the agreement, or the amount that has been deferred; and at the end of the term of the agreement, ownership of that property either passes to the consumer absolutely or passes to the consumer upon satisfaction of specific conditions set out in the agreement.<sup>283</sup>

Part C of Chapter 6 of the Act provides for debt enforcement by repossession or judgment. The credit provider is allowed to invoke dispute resolution mechanisms, give notice to the consumer before resorting to court process or even repossess the assets for sale.<sup>284</sup>

#### **4.2.3 The Inspection of Financial Institutions Act 1998<sup>285</sup>**

This Act was enacted to provide for the inspection of the affairs of financial institutions; the inspection of the affairs of unregistered entities conducting the business of financial institutions; and for matters connected therewith. The Act defines an unregistered person to mean a person, partnership, company or trust inspected not being registered or approved as a financial institution but carrying on the business of a financial institution. If the registrar has reason to believe that a person, partnership, company or trust which is not registered or approved as a financial institution, is carrying on the business of a financial institution, he or she may instruct an inspector to inspect the affairs, or any part of the affairs, of such a person, partnership, company or trust.<sup>286</sup> Such inspection may be done for the purposes of implementation of any agreement, *communiqué* or memorandum

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<sup>282</sup> Section 1.

<sup>283</sup> Section 1.

<sup>284</sup> Section 129.

<sup>285</sup> Act No.80 of 1998.

<sup>286</sup> Section 3(2).



of understanding contemplated in section 22(2)(b) of the Financial Services Board Act, 1990.<sup>287</sup>

#### **4.2.4 The Financial Services Board Act 1990<sup>288</sup>**

The purpose of this Act is to establish the Financial Services Board to supervise compliance with laws regulating financial institutions and the provision of financial services. The functions of the board include advising the Minister on matters concerning financial institutions and financial services and to provide, promote or otherwise support financial education, awareness and confidence regarding financial products, institutions and services.<sup>289</sup> The Act defines a financial service to mean any financial service rendered by a financial institution to the public or a juristic person and includes any service so rendered by any other person and corresponding to a service normally so rendered by a financial institution.<sup>290</sup> It is worth pointing out that the provisions of this Act do not affect the operations of any bank under registered in terms of the Banks Act 1990.<sup>291</sup> The Act however prevails in respect of other legislation that conflicts or is inconsistent with the provision of the Financial Services Board Legislation.<sup>292</sup>

#### **4.2.5 Conclusion on the South African experience.**

In the period ending 30<sup>th</sup> June 2014, there was reduced growth in installment sale credit and finance leases in major banks in South Africa, which grew by 5.2% (compared to the 6.6% growth seen for the six months to December 2013).<sup>293</sup> There was also a rise in Non Performing Loans. The drivers contributing to the rise in combined Non Performing Loans on a rolling six-month basis was isolated to two product segments – card debtors

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<sup>287</sup> Section 3A.

<sup>288</sup> Act No.97 of 1990.

<sup>289</sup> Section 3.

<sup>290</sup> Section 2.

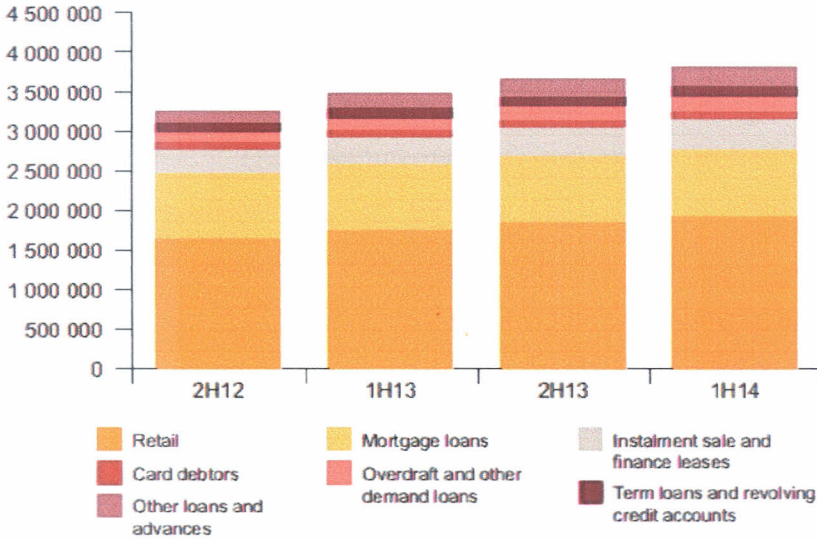
<sup>291</sup> Section 28(1).

<sup>292</sup> Section 28(2).

<sup>293</sup> PricewaterhouseCoopers (the South African firm) (2014) “*Stability amid uncertainty South Africa – Major banks analysis, PwC analysis and report of major banks’ results for the reporting period ended 30 June 2014*” dated 16<sup>th</sup> September 2014 at p.17. Consistent with industry data, a slowdown in retail vehicle sales occurred within the existing environment of rising vehicle prices. Rising prices in this sector are largely attributable to a weaker rand exchange rate, which limits the ability of vehicle suppliers and dealers to maintain favourable prices and attractive financing options, given the high import costs associated with the vehicle industry in South Africa.

(which saw Non Performing Loans rise by 38.1%) and installment sale and finance leases (with NPL growth of 14.3%).<sup>294</sup>

Figure 4.2 Retail Advances per product by major banks in South Africa.<sup>295</sup>



From the figure below, it can be noted that there has been an increase in instalment sale and finance lease from the year 2012 to 2014. Similarly, major Banks in South Africa do recognise lease financing as a separate product in terms of retail advances. South Africa and Morocco have been the only two African countries in the top 50 leasing market every year since 1989.<sup>296</sup> This can be attributed to the existing sound legal and regulatory framework noted above aspects of which are worth consideration by Kenya. It is argued by this study that South Africa's legislative framework is advanced to the extent that it is no longer concerned with the basic of definition of bank products or regulation of lease financing companies and products but rather consumer protection and the greater bank industry. This is an ultimate position that Kenya should strive to attain in future.

<sup>294</sup> Ibid at p.18

<sup>295</sup> Ibid.

<sup>296</sup> Teresa Barger, Irving Kuczynski (1996) *IFC – Leasing in Emerging Markets* p.9

### 4.3 CROSS BORDER LEASING

Just like many other aspects that occur across border including trade, there exists cross border leasing. Cross-border leasing often attracts considerable attention.<sup>297</sup> Internationally, assets that are leased on a cross border basis are typically limited to assets that are actually used across borders, such as airplanes, certain rail equipment, ships, and transport vessels.<sup>298</sup> The main international instruments dealing with cross border leasing are the International Institute for the Unification of Private Law (UNIDROIT) Convention on International Financial Leasing and the UNIDROIT model law on leasing. There also exists the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment, signed in Cape Town.

The International Institute for the Unification of Private Law (UNIDROIT) is an independent intergovernmental Organisation with its seat in the Villa Aldobrandini in Rome. Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States and to formulate uniform law instruments, principles and rules to achieve those objectives.<sup>299</sup> On occasions, the UNIDROIT Secretariat has been approached by Governments seeking UNIDROIT's assistance in the development of leasing legislation. The States Parties to the UNIDROIT Convention on International Financial Leasing are, moreover, almost all either developing countries or countries in transition.

The UNIDROIT Convention on International Financial Leasing<sup>300</sup> regulates only cross border leases,<sup>301</sup> but supersedes national legislation in all countries that have signed up

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<sup>297</sup> International Finance Corporation, (2005) *Leasing in Development Lessons from Emerging Economies* p.60 The reasons are explained as follows. First, it often involves particularly expensive capital assets, such as aircraft. Second, the tax implications can be highly complicated. Finally, it is often (incorrectly) associated with foreign investment. In principle, no special incentives should be required, and in practice they rarely are. If the import or leasing of certain assets is desirable, it should be encouraged directly and not through cross-border leasing.

<sup>298</sup> Ibid. p.61. Most other types of assets are simply leased domestically. In practice, relatively small amounts of equipment are financed on a cross-border basis worldwide, although the amounts are significant in certain industries.

<sup>299</sup> <http://www.unidroit.org/about-unidroit/overview>

<sup>300</sup> <http://www.unidroit.org/fr/leasing-ol-2/leasing-anglais>



to the convention of cross border leases. The Convention provides that financial leasing is a three party arrangement involving the lessor the lessee and the supplier<sup>302</sup> and applies to transactions in relation to all equipment save that which is to be used primarily for the lessee's personal, family or household purposes.<sup>303</sup> The Convention was in recognition of the importance of removing certain legal impediments to the international financial leasing of equipment, while maintaining a fair balance of interests between the different parties to the transaction.<sup>304</sup> Those engaged in running the projects of the International Finance Corporation for the development of leasing industries in such countries have invariably taken the rules contained in the UNIDROIT Convention as the model for the leasing laws to underpin such new leasing markets.

The UNIDROIT model law on leasing targets developing countries and countries in transition that require a legal framework to foster the growth of their nascent leasing industry.<sup>305</sup> The model law does not apply to a lease or a supply agreement for large equipment unless the lessor, the lessee and the supplier have otherwise agreed in writing.<sup>306</sup> The model law provides for effects of a lease, performance, default and termination. It is worth pointing out that the model laws are made in respect of leasing transactions without mentioning the lease financing aspect. The study appreciates that lease financing can only develop and be undertaken where leasing as a business model exists.

#### **4.4 CONCLUSION ON THE COMPARATIVE STUDY**

As discussed earlier in this study, some aspects of the practice by banks in Kenya have been modelled along the Tanzanian framework. This is in the area of use of subsidiary banks in Kenya and the recognition of assignment of receivables as security to secure the financing. However, unlike Tanzania, there is no express legal backing to support the

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<sup>301</sup> Article 3 which provides that the lessor and the lessee have their place of business in different states.

<sup>302</sup> Article 1(1)(a).

<sup>303</sup> Article 1 (4).

<sup>304</sup> Preamble to the Convention.

<sup>305</sup> Paragraphs 1 and 2 of the Preamble. See also <http://www.unidroit.org/leasing-model-law-2008-overview>.

<sup>306</sup> Article 3(2).

bank's similar activities in Kenya. Lease financing is expressly recognised as a banking business complete with the protection of assets under a lease transaction as security for the lending. The Bank of Tanzania recognises leasing as a way of increasing financial inclusivity being an issue that the developing economies such as Kenya seek to develop. Leasing as a business model is equally given legal recognition under the Financial Leasing Act Tanzanian legislation does also recognise the independent leasing companies some aspects of which are regulated. The Bank of Tanzania therefore has the express legislative mandate to regulate and promote leasing and lease financing transactions generally. This study postulates that some aspects of the Tanzanian legislation need to be adopted as we strive to develop the industry in Kenya bearing in mind that Kenya has a bigger economy than Tanzania.

Lease financing in South Africa is recognised as an independent banking product that continues to grow in excess of 5% as was evidenced in figure 4.2 on retail advances by major banks in South Africa. With increase in non performing loans it is imperative that emphasis be placed on the securitisation of the loans in the wake of potential need to realise the securities. Currently and owing to the non developed nature of Kenya's legal regime, lease financing is limited to high net worth and blue chip companies with a low risk of default hence less penetration. The South African legal framework is advanced for our adoption. South Africa is moving towards consumer protection as opposed to laying the basic structure of rights and obligations which Kenya is at present. This makes the Tanzanian experience more of the immediate concern for emulation by Kenya. The South African framework is a demonstration of where Kenya can be in future.

This study therefore takes into account the above case studies in coming up with the recommendations.

## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATIONS**

#### **5.1 CONCLUSION**

Leasing continues to become a popular business model in Kenya both for private companies and more recently the government. The members of Leasing Association of Kenya continue to sensitise the market towards adoption of leasing. Consequently, and in light of Kenya's vision 2030 objective to have a vibrant financial market, banks have continued to adapt in order to cater for this emerging market while expanding financial inclusivity. With the help of independent leasing companies, banks have devised various products which can be largely deemed to amount to lease financing as was discussed in Chapter three.

As was covered in chapter two, lease financing is a distinct financing transaction in relation to current lending transactions by banks. In chapter three, the study noted that lease financing is currently undertaken by banks in the realm of the current legislative framework. The study noted several legal issues that arise from the current bank practice on lease financing including the possibility of engaging in prohibited trading of assets, whether lease financing is covered under the definition of banking business, the question of securities formation and enforcement. The possibility of stretching the existing legal framework to cover the emerging area of lease financing was considered and the framework was found inadequate. In considering the existing framework from a regulatory perspective, it was apparent the Central Bank of Kenya as the regulator does not have powers to legislate on substantive legal aspects. Similarly, to enhance the securitisation process, there is need to have a substantive legal framework to address the securities formation and enforcement whilst protecting the bank and other third parties. In addition, the study considered the place of independent leasing companies in lease financing transactions and the need for minimal regulations so as not to stifle the development of leasing.



A comparative study revealed the existence of better legislative framework in Tanzania and South Africa some aspects of which are already being undertaken in Kenya without the accompanying legislative framework. In Tanzania for example, the Banking and Financial Institutions Act expressly provides for lease financing as part of the banking business. The Bank of Tanzania on the backdrop of the legislative framework has made regulations to specifically address lease financing. In addition, progressive legal frameworks appreciate and provide specifically for a registration regime of assets comprising security. South Africa specifically recognises lease finance as a bank product separate from the traditional types of lending more common with the products offered by banks in Kenya.

In summary, the study has revealed that the existing legislative framework on lease financing is inadequate. Whereas some existing legislation particularly those relating to regulation can be stretched to cover aspects of lease financing, there is still need to come up with a specific framework to address the unique nature of lease financing. This is in line with other existing legislations like the Hire Purchase Act, Chattels Mortgage Act that exist to address specific bank products. The legislative framework from other jurisdictions considered by this study, UNIDROIT model law on leasing and International Finance Corporation guidelines for emerging economies can be taken into consideration in coming up with the necessary legislation for Kenya. Public participation by the stakeholders (especially banks, the regulator and independent leasing companies) cannot also be ignored in line with the provisions of the constitution. It is expected that over time, banks should be able to finance lease transactions of big magnitudes such as those that are undertaken by the government, both national and county and other large institutions.

## **5.2 RECOMMENDATIONS**

This study recommends the amendments to existing laws and the Banking Act in particular and enactment of new laws as specifically set out hereafter.

### **5.2.1 Amendments**

The following amendments are recommended to the Banking Act Cap.488 of the Laws of Kenya:-

- a) The definition of the term 'banking business' as provided under section 2 of the Banking Act should be amended to specifically include 'lease financing' as part of the permitted activities.
- b) a new definition for the word 'lease financing' should be introduced under section 2 of the Banking Act with its definition indicated as 'as defined under the Leasing Act.' This study has elsewhere recommended the enactment of a new statute known as the 'Leasing Act.'

These amendments would readily address the uncertainty of lease financing falling under prohibited activities set out in part III of the Act. Moreover, the Central Bank of Kenya as the regulator of banks would now have a full basis of coming up with regulations and/or prudential guidelines to specifically address lease financing operations under the realm of banking business. It is hoped that the Central Bank of Kenya would eventually make the necessary regulations specifically aimed at regulating lease financing as a banking business in line with the existing needs of the banking industry from time to time.

### **5.2.2 New legislation**

The study proposes the enactment of a new statute known as the Leasing Act. This new Act will be the substantive Act that would provide and consolidate the legislative framework and structure for leasing as a business model. This Act would in essence define leasing and lease financing, provide the respective obligations of parties to leasing bearing in mind the tripartite nature of leasing to include banks as the financiers and independent leasing companies. Of importance to banks would be the creation of the registry to facilitate the registration of lease financing agreements and assets taken as security as well as the enforcement of such securities in the events of default. In addition, the Act would contain general provisions with regards to independent leasing companies with the aim of affording a subsequent opportunity to the Central Bank of Kenya and/or

the necessary Ministry as the regulator(s) to supervise and regulate the activities of the independent leasing companies. At this nascent stage of development of leasing in Kenya, very minimum regulation is recommended to allow the leasing sector to grow and be accessible particularly by the Small and Medium Enterprises and according to the market needs.

### **5.2.3 Public Sensitisation**

Lease financing can only be effective once the leasing model is appreciated and embraced in the Kenyan market. Currently, leasing as a business model is still in its embryonic stage thereby affecting the development of lease financing. This is evident from the furore generated by the leasing of medical equipment as undertaken by the national government for the use by county hospitals where the governors and members of public are reported not to understand the nature of a leasing transaction. This study proposes that there be sufficient sensitisation of leasing and lease financing to enable increased uptake not only by the national and county government and other government entities and state corporations but also by small and medium enterprises. However, the sensitisation can only be best undertaken with the existence of a clear legal framework.

It is therefore proposed that the policy makers to consider setting up a task force incorporating the necessary stakeholders to develop the necessary policy, legislation and regulations incorporating the constitutionally mandated public participation.



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