CHAPTER - 7

PROBLEMS AND PROSPECTS OF LEASING INDUSTRY IN INDIA
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The primary objective of this chapter is to find answers to the following two questions: (1) What are the problems faced by leasing companies in India? and (2) What are the prospects of Indian leasing industry? We make an attempt to answer these two questions in the following sections. The conclusions are based on 28 lessors’ questionnaire responses and outcome of the indepth interviews with the executives of leasing companies. The former section deals with the problem areas of leasing and the latter section devotes to the prospects of leasing business in India.

PROBLEMS

The phenomenal growth of leasing companies, their lease business and its acceptance of leasing as a method of acquiring use of assets, however, has raised some problems. Increasing attention, therefore, needs to be given to the following problems of leasing companies in India. The main problems are as follows:

1. Resource crunch
2. Inadequate tax benefits and additional tax burden
3. Rigid procedure for import/crossborder leasing
4. Lack of proper and integrated accounting standards
5. Lack of legislation
6. Existence of cut throat competition
7. Lack of expertise in the management
RESOURCE CRUNCH

As seen in Chapter 4, the sources of finance available to leasing companies are (a) equity share capital, (b) reserves and surplus, (c) debentures, (d) long term loans, (e) public deposits, (f) bank loans and (g) inter-corporate deposits and other sources.

As of today, the investors seem to have lost the confidence in leasing companies about their performance and prospects. The present state of leasing company shares is in a very poor condition. These shares are quoted at an extremely lower price as compared to the book value and par value. Therefore, it is becoming difficult for the leasing companies to raise equity share capital in the existing conditions. It is also not possible for leasing companies to issue either fully convertible or partly convertible debentures because these are closely linked with the net worth and trading of equity shares in the market.

As discussed in Chapter 4, now banks are allowed to grant loans to leasing companies by way of cash credit or term loans not more than three times of their (leasing companies) net worth as per the RBI guidelines. For each transaction financed by bank, the maximum amount withdrawn will be restricted to 75 per cent of the asset cost at the time of acquisition. But the bank finance to leasing companies has two restrictions (1) bank finance will not be available for leases over a period of five years even though leasing companies enter into such leases and (2) finance will be available neither for "sale and lease back arrangements nor for
second hand assets". Therefore, leasing companies will not get more than three times of their net owned funds (NOF). For smaller and medium companies, it will be difficult to raise funds by way of bank loans.

The public deposits are the significant source of finance to the leasing companies. The RBI has amended the earlier Non-Banking Financial Companies Directives, 1977, effective from March 28, 1989. Two important provisions of those Directives are (1) minimum period for acceptance of deposits by equipment leasing companies has been increased to 24 months from 6 months and (2) the maximum period extended from 36 months to 60 months. However, the rate of interest for beyond 36 months deposits remains at 14 per cent per annum. Again this minimum period of two years, without a corresponding hike in interest rate, will create a problem to leasing companies. Only big and sound finance cum leasing companies or group companies may be able to raise funds by way of public deposits. The foregoing discussion indicates that there is going to be an acute shortage of raw material i.e., money in the case of leasing companies.

According to Mr. Ramakrishna Rao, Managing Director, Magnificent Leasing while the demand for leasing increased, raw material supply (resources) became a severe constraint. A few companies also had management problems, this being a specialised business. Mr. Ranina, a tax expert and chairman, Mazada Leasing, "all leasing companies are facing the problem of resource crunch. Most of the companies have not been able to raise any funds since 1986-87". Similarly our analysis of the responses of the
questionnaires showed that, four companies (14 per cent of the respondents) faced problem in raising share capital and long term debt and 8 respondents (29 per cent) in getting bank finance whereas 15 respondents (58 per cent) had problem in mobilising public deposits.

INADEQUATE TAX BENEFITS

Unfortunately the tax benefits which leasing companies enjoy in the developed countries are not available to the Indian leasing companies. The tax benefits such as the ones arising out of depreciation, investment allowance of deposit scheme etc., are not conducive to the growth and promotion of leasing companies. The official depreciation rates provided under Income Tax Act, 1961 differ from the depreciation rates provided under Indian Companies Act, 1956. Besides, the depreciation provided under the Income Tax Act, 1961 are much higher than the normal depreciation provided during primary lease period. Thus, there is a mismatch between legal depreciable life of an asset under Income Tax Act 1961 and Indian Companies Act 1956, during the primary lease term.

Besides, investment allowance (U/S 32A) was abolished from 1st April 1987 and in its place an Investment Deposit Scheme (U/S 32 AB) has been introduced. Under this scheme, the amount of deduction is limited to 20 per cent of the profit of eligible business or profession as per audited accounts. However, this scheme excludes certain categories of leasing. The latest position is that even this has been abolished as announced in the
Budget of 1990-91.

In addition to the above, the Finance Act. 1987 had introduced a minimum tax of 30 per cent of the book profits of a company. The leasing companies were brought within the orbit of this new tax provision. This also led to some uneasiness among the leasing companies in particular. Now this has been abolished as announced in the Budget 1990-91.

SALES TAX PROBLEM

Leasing companies are also facing the problem of sales tax. The 46th Amendment to Indian Constitution, which came into force from February 1983, has empowered the state governments to levy sales tax on the transfer of rights or to the use of any goods for valuable consideration. As a result, the legal position of finance lease is that it is a "deemed sale" under the Sales Tax Act. The governments of Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Madhya Pradesh, Orissa, Tamil Nadu, and West Bengal have already amended their Sales Tax Acts in accordance with the 46th Amendment to Constitution. Hence, the leasing companies are required to pay sales tax at higher rates at multi points on a lease transaction as leasing companies are not being allowed to use 'C' Forms. This makes leasing more expensive, and the cost of the asset acquired under lease finance becomes enhanced to the extent of sales tax paid by the leasing companies. This is bound to cripple the infant leasing industry.

In view of the burden created by sales tax, it is essential that
the Central Government should take immediate steps to formulate guidelines in order to ensure uniform legislation amongst various states. It would be reasonable to have a uniform sales tax act regarding leasing industry in order to bring in uniformity in its content and scope. Presently leasing companies are not permitted to use 'C' Forms. The facility of using Form 'C' should be extended to leasing companies. The sales tax on lease rentals not only reduces the viability of the industry but also creates a lot of inconvenience due to procedural inter-state problems and variations in lease agreements.

Shri Prabhu, Chairman, Canbank (Chairman’s Speech in 2nd AGM, 12 June, 1989), remarks that there are certain avoidable constraints restraining the lease finance from becoming a major source of corporate finance. The levy of sales tax on rentals by many State Governments makes leasing unattractive for lessees. The benefits of lease finance, in terms of accelerated modernisation and industrial growth are to that extent adversely affected. Yet another problem faced by leasing companies is in obtaining approval for issue of 'C' Forms by lessors under Central Sales Tax.

It is noticed from the analysis of the questionnaire responses that 100 per cent of the respondents suggested that Section 115 J of the Income Tax Act, 1961 and sales tax on lease rentals should be abolished with immediate effect. About three-fourths of the respondents expressed that the investment allowance and investment deposit scheme should be extended to the leasing
companies. The leasing companies would feel relieved since Section 115 has been scrapped.

RIGID PROCEDURE FOR IMPORT LEASING

In India, leasing industry has high potential in areas like import leasing or international leasing. Recently, a few leasing companies entered the arena of import leasing. The Government has laid down a lengthy, complicated and cumbersome procedure to comply with for leasing of imported equipment. Only a few selected leasing companies are permitted to do the import leasing business, those who have a minimum amount of Rs. one crore as paid up share capital and whose shares are listed in one of the recognised stock exchanges. Thus, leasing of imported equipment has been restricted to a meagre part of the industry. A number of respondents indicated the problems of import leasing and made the following suggestions.

a) Import of OGL items to be permitted without approval of the Joint Chief Controller of Imports and Exports (JCCI&E).

b) The Chief Controller of Imports and Exports (CCI&E) has to reduce the period for giving permission for import leasing.

c) Permission for sale and lease back of assets in overseas.
ACCOUNTING PROBLEM

As we have discussed in Chapter 6, Indian leasing companies are following a variety of lease accounting practices. Lessees are neither showing the leased assets on the asset side nor do they show the future lease rental obligations on the liabilities. Therefore, the lease transaction seems to be an off-balance sheet transaction in India. Lessors are showing leased assets as owned assets in their balance sheets, even though they lose the economic possession of assets by making finance lease.

The first flaw is reporting the lease income in the financial statements. It is evident from the examination of books that the accounting practices of various leasing companies have been far from uniform and consistent. The leasing companies are not amortizing the value of the leased asset during the primary lease period (period in which leasing companies recovered more than 95 per cent of the asset value). Instead of amortising the full equipment cost, leasing companies are debiting a small part of the leased asset's cost by way of straight line depreciation in the books of accounts. The depreciation rates are too lower than the rate of income recognition during the primary lease period. It means that the total cost of equipment is recovering in three years and in some leases within five years, whereas depreciation is being shown for more than 8 years, even though there would not be any income through the asset. Hence, in such a case, the basic accounting concept of matching the cost with revenue is totally ignored.
The second flaw would be regarding showing of the leased assets in the balance sheet. Different leasing companies have adopted variety of methods and there is no consistency in the presentation of accounts. It is interesting to note that the method of providing depreciation is also different from that of owned assets. Leasing companies are following written down value method of depreciation for owned assets and straight line method for leased assets.

In the light of these practices, the Institute of Chartered Accountants of India (ICAI), has issued a "Guidance Note on Accounting for Leases". (see Annexure 5 for the Guidance Note). Inter-alia, the following are the important requirements.

a) The assets leased out should be shown under 'Fixed Assets' separately as "Assets on Lease" and classified in the same manner as other fixed assets.

b) A matching annual charge representing the difference from the lease rentals and finance income is to be debited to the profit and loss account. This annual charge will consist of the minimum statutory depreciation as per the Compannis Act, and lease equalisation charge where the lease charge is in excess of said depreciation.

The recent amendment to the Companies Act, 1956, ensures that all the companies, including leasing companies, should follow accrual system of accounting. This will cause leasing companies
unnecessary hardship. The leasing companies will be required to treat unrealised/unrealisable lease rentals as income, even though there may be no chances of recovering some rentals. This will not show true and fair profitability of leasing companies. However, again there is disagreement in the treatment of depreciation allowances, possession of assets under Income Tax Act, 1961 and Indian Companies Act, 1956. Therefore, there is strong discontentment among the leasing companies regarding the accounting treatment in their financial statements. In this connection, the ELA has represented to ICAI, regarding the liability of leasing companies under the Income Tax Act, 1961, adverse effects on ratios in relation to funding, computation of tax credit, etc. The leasing industry feels that the ICAI did not provide adequate transition period for implementation of the Guidance Note.

LACK OF PROPER LEGISLATION

In fact, the only legal reference available to lessors and lessees is the Hire Purchase Act, 1972. Another act, which is available for them is Transfer of Property Act (Sections 105 to 117), which deals with only immovable properties. Even today, the leasing industry is following these acts in addition to the Sections 126 to 180 of the Indian Contract Act, 1872. Hence, it is obvious that there is neither a comprehensive and detailed leasing law nor government policy to guide the leasing business so far. Now it is the right time, for the Central Government to make efforts to pass an act known as "Indian Lease Act," to cover leasing business.
CUT-THROAT COMPETITION

Private sector leasing companies are facing the cut-throat competition from public sector leasing organisations like ICICI, IFCI, SBI Cap and Canbank. These are at a privileged position by way of getting funds at cheaper cost than the small private sector companies. Therefore, these public sector leasing organisations can quote less lease rentals than the private sector leasing companies. Public sector organisations already have good tie-ups with blue chip and big companies and public sector manufacturing companies. These have better terms and conditions than the private sector companies. Besides, keen and unequal competition exists even among the private sector leasing companies because of the oligopolistic nature of the leasing industry (as seen in Chapter 3). Some times, highly profitable and high tax companies may also create competition by offering lease finance in order to avoid the income tax through leasing as a tax planning device.

MANAGEMENT PROBLEM

Some of the leasing companies suffer from inadequacy of management. Without knowing the lease business, a large number of entrepreneurs had entered the leasing fray with others’ money. Management of leasing companies requires a different orientation as compared to the management of manufacturing and trading companies. The leasing companies need the people who have specialised knowledge and skill to evaluate and appraise the creditworthiness and soundness of the potential as well as existing lessees from time to time. The leasing companies need
to evaluate the lease rentals with variety of lease packages and options in order to cater the needs and requirements of different segments of the market.

The second issue relates to the composition of the board of directors of leasing companies. A scrutiny of the board of directors of leasing companies reveals that almost all the leasing companies boards are dominated by the retired banks' or financial institutions' chairmen/managing directors or chief managers. Moreover, the same person will be associated with many such companies. It is interesting to note that most of such directors do not have any financial stake in the leasing companies. The objective of promoters in including such popular figures is to attract instantaneous response to public issues, whereas, the retired executives are finding these offers as retirement benefits. Can we hope that these boards will provide due care and proper direction to the companies? Most of these directors do not have either time or willingness to devote attention to the regular and routine business. If these directors provide efficient and effective guidance and supervision, why some of the leasing companies have diversified into unrelated areas and a sizeable number has disappeared from the industry?

According to Mr. Vinay Sawhney, Chairman of the Worldlink Finance Ltd. (Chairman's Speech, in 3rd AGM March 28, 1989), the leasing industry in India has failed to make any significant contribution to the process of capital asset formation in the past few years.
due to (a) limited resource mobilisation capabilities, (b) restrictive bank support and (c) lack of trained manpower. He suggested that careful planning, systematic institution building, innovative approach and well thought out staff training programmes are the key to the ultimate success in leasing business. In the words of Shri Santhanam of Sundaram Finance Ltd. (Chairman’s Speech in 34 AGM 24 Sept, 1987), there has been keen competition in leasing business from the financial institutions and subsidiaries of commercial banks.

An analysis of responses on problem areas of leasing indicates that almost all the companies faced one or the other problem in the leasing market. They have referred to a number of factors affecting financial performance of their companies. The analysis is presented in Table 7.1.

**TABLE 7.1**

**DESCRIPTION OF PROBLEMS BY RESPONDENTS**

<table>
<thead>
<tr>
<th>Description of Problems</th>
<th>No. of Companies</th>
<th>Percentages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Competition is keen and intense</td>
<td>12</td>
<td>46</td>
</tr>
<tr>
<td>2. High interest rate burden</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>3. Lack of business opportunities</td>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>4. Defaults in rental payments</td>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>5. Sales tax on lease rentals</td>
<td>26</td>
<td>93</td>
</tr>
<tr>
<td>6. Income tax under Section 115 J</td>
<td>25</td>
<td>80</td>
</tr>
<tr>
<td>7. High cost of operation</td>
<td>5</td>
<td>19</td>
</tr>
<tr>
<td>8. Low margin/unprofitable rentals</td>
<td>4</td>
<td>15</td>
</tr>
</tbody>
</table>

As Table 7.1 shows that, about 90 per cent of respondents state that sales tax on lease rentals and Section 115 J of the Income Tax Act, 1961 have affected the financial performance of the
companies and about half of the respondents quote that competition is keen and intense. Only a few respondents cited other problem areas.

It is also noted from the analysis of the responses that about one-third of the leasing companies indicated that they have the marketing problems such as underquoting of lease rentals (rate war) by competitors, and special and innovative schemes of leasing divisions of financial institutions and subsidiaries of commercial banks. About one-third of respondents (9) expressed the need of the lease broker services to facilitate the marketing functions of lease and rest of them (three-fourths) stated no need for lease broker services.

As regards the policy issues, 20 respondents (70 per cent) suggested that the Central Government should take immediate steps to abolish the sales tax on lease rentals and Section 115 J of the Income Tax Act, 1961 in order to allow the industry to grow. (Section 115 J has been abolished in the Budget 1990-91). More than half of the companies suggested that leasing companies should also be allowed to avail of the investment allowance and investment deposit scheme. (However, these two were abolished in the Budget 1990-91). One-fifth of respondents stated the minimum period of public deposits to be reduced to six months as against current period of 24 months and a few also stated bank finance to leasing companies should be increased to five to six times of their net owned funds. A few companies suggested that the procedure for import leasing should be made simple. In the light
of the foregoing discussion, it can be concluded that the following are the major problems faced by the leasing companies:

1. high incidence of sales tax on lease rentals
2. cut-throat and keen competition
3. inability to raise resources on continuous basis, in case of both new and old companies due to varied reasons.
4. no legislation to guide, direct and control leasing companies and leasing business.
5. lack of trained and experienced manpower to leasing companies.

PROSPECTS

Despite a number of problems, the leasing business in India has its own growth potential and prospects. Equipment leasing is a new device which goes a long way in providing the necessary resources for maintaining the tempo of industrial growth. Leasing has acquired a special importance in economics of the developing countries particularly for financing the small and medium scale industries. Capital formation through leasing can help growth with minimum investment by the corporate enterprises.

Leasing has great potential in India in view of the fact that barely less than one per cent of total industrial investment is so far financed through leasing as compared to 30-40 per cent capital investment through leasing in the developed countries like the USA, the UK, and 10 to 20 per cent in Australia, Canada, Japan etc.

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The well managed and large resourceful leasing companies are going to see the better days with good profitability during the next few years. The leasing business continues to grow and flourish and the consumers, i.e., lessees (different segments of market) are growing in number and size. Even though overcrowding and fierce competition exist, these will be temporary. The leasing concept has received wide propagation and acceptance. Demand for leasing business continues to grow at a faster rate and there is adequate space for all. In spite of the problems discussed in the preceeding section, it is sure that leasing industry has come to stay in India and it has a bright and promising future. In the coming years, perhaps, the fastest and largest growth industry would be the leasing since the public sector organisations are actively involved in the industry not only as lessors but also as lessees.

Financial institutions are armed with much cheaper and comparatively vast funds in their hands for deployment in leasing. These bodies can, therefore, function as catalysts for market growth for leasing and their operations set the pace for leasing rates and therefore influences profitability levels in the business. Several financial bodies are joining the bandwagon notably subsidiaries of banks or financial institutions taking substantial amount of leasing from public sector units such as ONGC, Air India, Indian Airlines, Shipping Corporation, HMT, SAIL, BHEL, BEL, Vaydut, Coal India Ltd., and service oriented sectors like transportation and communication departments and
professions such as medical, consultancy, engineering etc. The entry of financial institutions and banks will serve to keep the market for leasing alive. This segment will create and expand the demand for lease finance. The financial institutions and subsidiaries of commercial banks on the one hand and the private sector leasing companies on the other hand, may have to play an important role in the development of leasing business. Recently, there was a proposal from Asian Development Bank (ADB) to set up a Rs.100 crore "Indian Leasing Industry Fund" which has been approved by the Central Government. The fund is to be jointly promoted by ICICI, UTI and ADB. The Indian public is likely to have a stake in the fund. The main objective of the fund is to provide long term loans to private sector finance companies (Business India, August 20 - Sept. 2, 1990, p.21).

Leasing companies are not only useful to big and medium industries but also these opened a new window for financing small and non-priority companies, professionals and consumers. Leasing companies have started making their contribution to the growth of consumer goods industries also. Leasing companies will get an additional inflow of relatively cheap funds from IDBI, IFCI, UTI, since they offer medium term loan at 14 per cent interest. The branch network of leasing companies are working in full swing and are exploring new markets for public deposits.

Leasing companies entering the business as a limited company do not require to get any industrial licence or any other licence. All that is needed is an approval of the Controller of Capital Issues (CCI) if a public issue is to be made. So leasing
companies could be promoted very quickly since there is no acquisition of land, building, machinery or any such sort. Besides, the cost of operations is also very low as compared to manufacturing industries.

Recent studies by the Reserve Bank of India (RBI) have indirectly confirmed that there is vast scope for investment in the private sector. Most of financial institutions have, at one time or other, faced resource constraints. Term lending institutions have felt that with limited resources at their disposal all borrowers cannot be satisfied. There is a shortage of loanable funds and there appears to be a big gap between the demand and supply of the funds required by the private borrowers for their expansion, replacement, modernisation, diversification etc. Thus, leasing industry could be expected to fetch one fourth of share in industrial investment in the near future. Presently, leases in India are generally small ticket leases. The equipment ordinarily leased are plants and machinery. Some of the important potential markets are heavy plant and machinery, ships, aircraft, satellites, data processing equipment, trucks, chemical plants, high tech equipment by means of import leasing, leveraged leasing and vendor leasing. Leasing has plenty of scope in the service sectors such as developing the transportation and communication industries in India.

Recently, the Motor Vehicles Act has been amended for incorporating the interest of the lessor in the Registration Certificate. This was long awaited demand of the industry and
government has recognised the importance of leasing industry in developing transport sector. This will help to increase the vehicle leasing for transport and non-transport industry. It is also expected that the electronic technological innovations will bring in the field of office automation and data processing create ample scope for leasing. These indicate that there is plenty of scope for doing leasing business in India.

Leasing is a service to the Indian industry as it provides funds and also taps the capital market. Leasing supplements the governments developmental plans by supplying the needful equipment to the industry. Economic conditions in India are favourable and the prospects for the leasing industry are bright, considering the eighth plan projections and flexible government policies towards the development of industry, modernisation and expansion of capabilities and the emphasis on technological upgradation. The Central Government has reacted fairly as far as monetary, fiscal and regulatory policy issues were concerned. The manner and direction of the growth will be to some extent affected by fiscal, monetary and economic policies, although leasing industry is not dependent on them. Leasing will thrive on whatever fiscal and monetary system may be adopted, provided only that it does not treat leasing disadvantageously (Clark, 1978. p.37).

Leasing is a growing industry. It is seen that leasing has grown, in the latter 1980s, and still growing and it is hoped that certainly it will grow in future. It is worth mentioning that though the leasing business will grow substantially, by the
same time all the existing private sector leasing companies do not find place in the market, only a few leaders from the private sector, besides the public sector leasing organisation, remain in the industry. The leasing industry needs full support, cooperation and encouragement from the government and a regulatory framework to control its mushroom growth and irregularities, to ensure its healthy growth.

It is expected that a substantial number of manufacturers of many types of equipment may set up their leasing operations either as an integral part of the parent company or through a subsidiary to sell their products. The future of the leasing industry is bright, particularly for the vendor leasing. As long as the leasing industry continues to be innovative, it will find a ready market for the services it has to offer.