



04

EVALUATION OF
IDB GROUP'S WORK
THROUGH
FINANCIAL
INTERMEDIARIES

LEASING AND FACTORING

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ABBREVIATIONS AND ACRONYMS

A2F	Access to finance
BCA	Business current accounts
CRA	Credit rating agency
DFI	Development finance institution
FI	Financial intermediary
IDB	Inter-American Development Bank
IDBG	Inter-American Development Bank Group
IIC	Inter-American Investment Corporation
LAC	Latin America and the Caribbean
L&F	Leasing and factoring
MIF	Multilateral Investment Fund
MSMEs	Micro, small, and medium-sized enterprises
NBFI	Non-bank financial intermediary
NPL	Nonperforming loan
ROA	Return on assets
ROE	Return on equity
SCF	Structured and Corporate Finance Department, IDB
SMEs	Small and medium-sized enterprises
TC	Technical cooperation
VAT	Value-added tax



I. INTRODUCTION

- 1.1 **This background paper on leasing and factoring (L&F) supports a more comprehensive evaluation of the work of the Inter-American Development Bank Group (IDBG) through financial intermediaries (FIs) in Latin America and the Caribbean (LAC).** From 2005 to 2014 – the period covered by a comprehensive evaluation recently conducted by IDB’s Office of Evaluation and Oversight (OVE) – IDBG funded 466 operations for LAC FIs. Of these operations, 43 aimed at expanding access to finance (A2F) for micro, small, and medium-sized enterprises (MSMEs) through lending transactions collateralized by either short-term receivables (factoring) or tangible assets other than real estate (leasing) (Table 1).

Table 1. L&F was significant in terms of the number of FI operations, but involved only about \$300 million in IDBG disbursements from 2005-2014

Approved	Amount: \$358 million (2% of FI portfolio); Number: 43 operations
Disbursed	Amount: \$321 million
By windows	IIC (93%), SCF (4%), MIF (3%)
Instruments	Senior loans (93%), guarantees (6%), equity (1%)
Types of FIs	NBFIs (99%), banks (1%)
Top countries	Colombia (25%), Chile (25%), Mexico (15%)

Source: OVEDA, as of December 31, 2014.

- 1.2 **IDBG had several initiatives to increase access to finance (A2F) using L&F.** L&F operations were mainly supported through the Inter-American Investment Corporation (IIC), and to a lesser extent through the Multilateral Investment Fund (MIF) and IDB’s Structured and Corporate Finance Department (SCF). The main initiatives using L&F during the period were (i) the IIC/MIF SME Finance Facility, approved in 2004 with the objective of developing partnerships with top financial institutions (including banks and L&F companies) to demonstrate the benefits of new products;¹ and (ii) IIC’s Financial Institutions Program, approved in 2005, which followed the Nuevo Leon Declaration’s goal of enhancing financing to small and medium-sized enterprises (SMEs) by mobilizing funds through eligible FIs, including L&F companies.² MIF also had an initiative to develop factoring in Central America.
- 1.3 **This background paper seeks to provide more detailed information on IDBG’s operations supporting A2F through L&F.** It covers the 43 FI operations supporting L&F, accounting for almost 1 out of every 10 FI operations IDBG approved during the evaluation period. This paper is not meant to be a full evaluation; instead, it highlights special aspects of IDBG’s L&F operations, placing them in the context of their markets and of specific barriers to the development of L&F finance in LAC. The findings are based on project, client, and market data gathered through document and literature reviews, interviews, and focus groups.

¹ IIC/MIF SME Finance Facility (CII/GN-201).

² Lending proposal for the financial institutions program towards fulfilling the Nuevo Leon Declaration goal (CII/GN-2010).

II. LEASING AND FACTORING RATIONALE

- 2.1 **L&F is often used as an entry point, allowing underserved beneficiaries such as MSMEs to access financing from FIs.** Given the shorter-term nature of factoring and the relative ease of unwinding leasing transactions, companies often use L&F as their first foray into accessing credit from FIs. L&F lenders have ready access to the collateral guaranteeing the loans—for factoring, by exercising their payment rights on the receivables sold by the borrowers; and for leasing, by repossessing the leased assets (e.g., vehicles or equipment), of which they retain legal ownership.
- 2.2 **Although usually limited in terms of funding, L&F can often overcome many of the barriers that typically limit A2F.** On the one hand, pure L&F providers, which are often non-bank FIs (NBFIs), have a clear disadvantage relative to banks by not being able to access client deposits as a source of low-cost, stable funding. On the other hand, however, L&F enjoys a number of advantages. First, because barriers to entry into the L&F industry—for example, regulatory requirements—are often lower, more intense competition is likely. Second, L&F lenders are often niche providers with a risk appetite to target underserved borrowers. Third, L&F FIs tend to develop specialized product know-how, often limited to a few product lines. Fourth, regulatory requirements are often limited because of lower prudential concerns about safeguarding depositors’ funds—that is, L&F providers may be subject only to anti-money-laundering provisions. Fifth, by incorporating new borrowers into the system, L&F providers help them build a credit history. (Annex I provides a brief review of how some of these barriers affect A2F.) A2F constraints and L&F characteristics are summarized in Table 2 and explained in the next section.

Table 2. L&F have advantages in relieving some A2F barriers for MSMEs, but also disadvantages in terms of the regulatory environment and FIs’ ability to access funding

Barriers to A2F for MSMEs	Advantages and disadvantages of L&F
Funding constraints for FIs	Disadvantage: L&F providers are usually NBFIs (at least initially)
Lack of competition among FIs	Advantage: Entry into L&F industry is easier than into banking
Lack of know-how by the FIs	Advantage: L&F operations are built on specialized, narrow know-how
High risk perceptions of clients	Advantage: L&F providers naturally focus on underserved clients
Borrower data costly to obtain	Advantage: L&F have stronger collateral and often start with less credit analysis
Weak regulatory environment	Disadvantage: L&F are affected by legislation gaps and weak law enforcement

Source: OVE.

A. Factoring

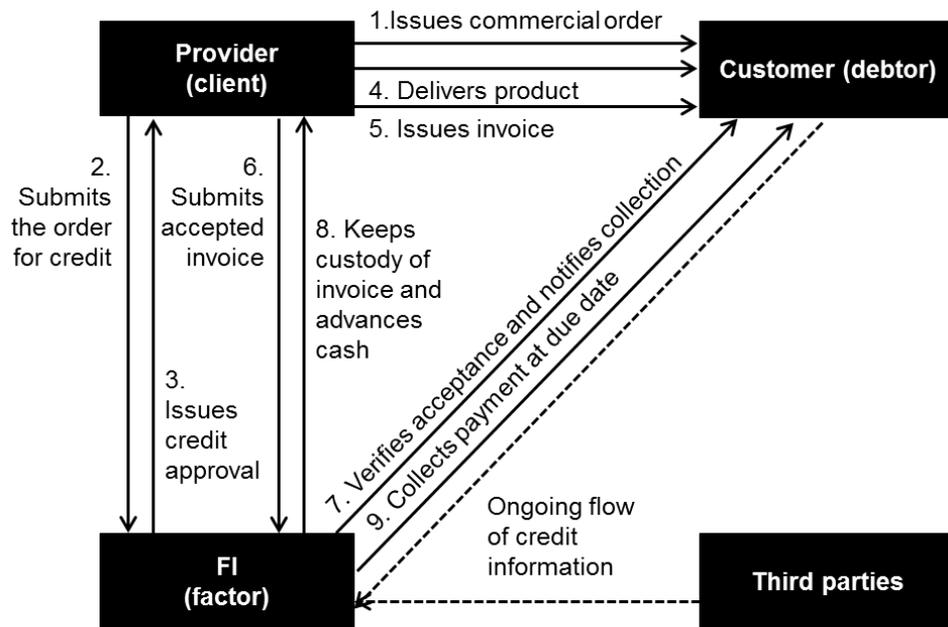
- 2.3 **Factoring is an asset-based finance mechanism in which companies (MSMEs) sell accounts receivable to a third party (factoring company) at a discount that covers interest and fees for the funds advanced to the borrower.**³ When a company provides a good or a service to a customer and

³ There are many definitions of factoring in the literature. A widely accepted definition is that of Factor Chain International: “Factoring is a complete financial package that combines working capital financing, credit risk protection, accounts receivable book-keeping and collection services. It is offered under an agreement between the so-called ‘factor’ and a seller.” (<https://fci.nl/en/about-factoring/index>)



agrees to receive payment at a later time, instead of waiting for payment to occur, it can immediately sell this asset (the right to collect the amount owed by this customer, also known as the final obligor or *debtor*) to a factoring company (or so-called *factor*), which can provide immediate cash. Usually the factoring company assumes ownership of the accounts receivable and collects the payment directly from the customer when due, retaining a fee for its services and interest for the time the funds were advanced to its *client* (see details in Figure 1).⁴ Factoring offers several financial benefits, including ready access to working capital financing, credit risk management, accounts receivable management, and collection services.⁵

Figure 1. A typical factoring transaction involves both funding and related services



Source: OVE, based on World Bank (2004)

- 2.4 **Factoring is based on the value of underlying assets instead of client creditworthiness, and therefore it relies less on credit information systems.** While traditional lending needs to determine a company's creditworthiness to assess viability and decide on the volume of lending, factoring uses information on the debtor's commercial risk to establish the value of the accounts receivable. Smaller enterprises can thus access financing more easily, as long as the invoices, checks, bills of exchange, or other factorable documents are those of creditworthy debtors.

⁴ Factoring starts when the client (borrower) issues a commercial order to its customer (debtor), which is a credit sale. The client submits the order for credit approval to the FI (factor), who issues a credit approval after processing credit information from the client, the debtor, and other sources (an ongoing process starting at approval and continuing during the operation cycle). After delivering products or services, the client issues an invoice to be accepted by the debtor. The accepted invoice is submitted to the factor, who verifies that services or goods were provided, notifies the debtor about the new payment collector, keeps custody of the invoice, and advances cash to its client. At the due date, the factor collects payment from the debtor.

⁵ Factoring differs from assignment of accounts receivable (or discounting), in which the buyer of the accounts receivable assumes ownership and management of the asset and its associated risks.

- 2.5 **Factoring provides immediate cash for working capital and tends to shorten the overall business cycle.** By releasing the capital tied up in accounts receivables, factoring provides immediate liquidity that can be used as working capital. Factoring also streamlines the whole business cycle, as it has the potential to shorten several stages of the production process. It can affect the management of inventories of raw materials and capital goods, investments for transformation into finished products, the sale of these products, and the collection of payment for the sales made. Using this practice also allows MSMEs to offer their products with financing, making them more appealing.
- 2.6 **Factoring also reduces the FI's credit-granting cost and the clients' (usually MSMEs') operating costs.** By outsourcing payment collection to the factor, MSMEs can focus its resources on its core business. The factor has specialized networks to collect and transport invoices, notify debtors, and collect payments.⁶ Likewise, regular loan approval and monitoring processes performed by FIs when granting a credit are now entirely focused on the debtor's payment capacity or commercial risk. Specialization and large scale allow factoring companies to cost-effectively perform these processes, especially when well-known debtors are involved.
- 2.7 **Factoring also reduces nonpayment risk, as the factor (who usually collects many payments from the same final obligor, usually larger companies using deferred payments) has better bargaining power regarding the collection of payment.** Factors have the required infrastructure to collect payments, and usually can also report unpaid invoices to credit bureaus—an incentive for debtors to pay on time.⁷ Factoring companies also reduce nonpayment risks by operating in national and international factoring networks as confirming and issuing agents for operations, with the specific function of collecting payments.
- 2.8 **There are also several financial and operational risks for FIs involved in the factoring business.** First, the FI bears the nonpayment risk of the debtor, so it needs to carefully assess the debtor, depending on the nature of the business (seasonality, market concentration, client concentration, etc.). Second, in many LAC countries invoices are not accepted as tradable certificates, and weak judicial systems do not allow factors to enforce unpaid claims. Third, invoices might not reflect a completed transaction (goods delivered and accepted with satisfaction), or might not have been confirmed by the debtor. Last, even though the FI notifies the debtor of its right to collect payments, payments could be made directly to the provider, posing a repayment risk to the FI.

B. Leasing

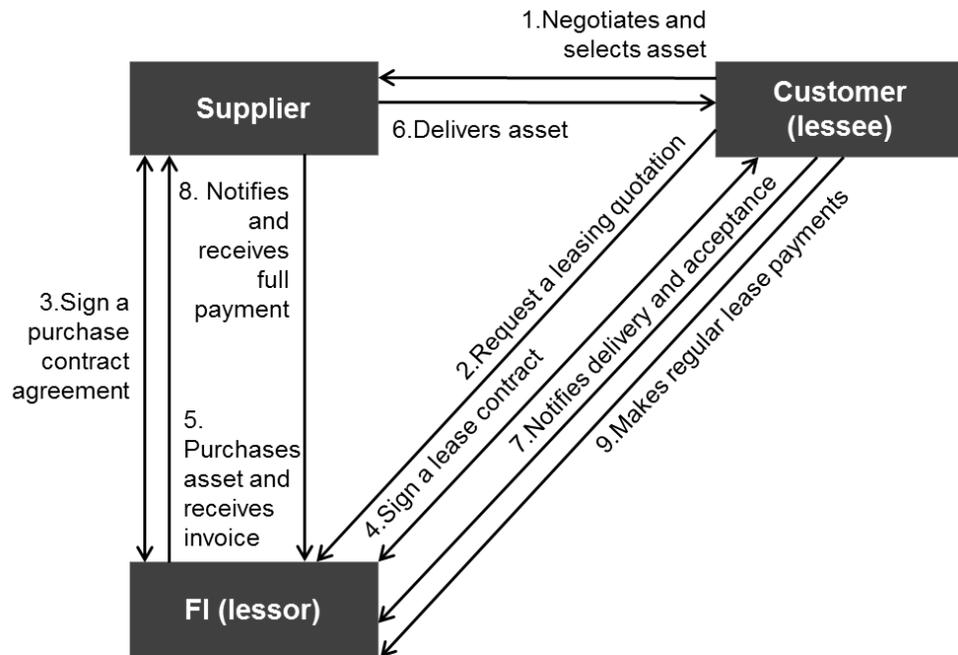
- 2.9 **Leasing is another form of asset-based finance in which companies rent an asset with the option of purchasing it after a period of time.** The financial institution (or *lessor*) provides a durable asset (machinery, equipment, vehicles, and other movable, tangible property) to the MSME (or *lessee*) to be used during

⁶ Klapper (2005).

⁷ For example, Chilean factoring companies may report on Equifax (www.equifax.com/, www.dicom.cl/) or Sinacofi (www.sinacofi.cl). Credit banks and other financial institutions can access these records, better manage risks, and start providing more comprehensive financial services to these small businesses.

a specified period in exchange for periodic payments (Figure 2). At the end of this period the lessee may either return the asset (operating lease), or buy it, at a certain, usually predefined, price (financial lease).⁸ It is customary for the lessor to provide services, such as maintenance, in addition to facilitating funding for purchasing the asset.

Figure 2. The typical leasing transaction also involves funding and other services



Source: OVE, based on IFC (2008)

- 2.10 **Leasing focuses on the client’s ability to generate income by using the leased asset.** The lessor retains legal ownership of the asset, and the transaction is therefore less reliant on the proper functioning of credit information systems. By providing income-producing assets, FIs do not need to focus solely on MSMEs’ credit risk. In addition, leasing can be a stepping-stone into the formal financial system for entrepreneurs and small businesses that build credit history based on leasing operations.
- 2.11 **Leasing provides a solution to legal environments with weak protection of creditor rights, since the asset ownership usually remains with the FI.** Leasing provides A2F to MSMEs that do not have assets that could be used as collateral for traditional lending. Furthermore, it is more secure, as it facilitates repossession of the asset, which the FI legally owns. This is particularly

⁸ In a typical leasing transaction, the lessee negotiates with and selects the needed asset from the supplier, and later requests a quotation from the FI (lessor). The lessor signs a purchase contract agreement with the supplier for the selected asset, and uses it to sign a lease contract with the lessee. After signing, the lessor purchases the asset from the supplier, who provides an invoice in return, transferring ownership rights to the lessor. The supplier delivers the leased asset to the lessee, who notifies the lessor about delivery and acceptance. After receiving notification, the lessor disburses to the supplier. The lessee makes the regular lease payment, and after the agreed term it may execute a buy option on the asset through a last payment. If the lessee does not execute the buy option, the lessor repossesses the asset and the contract is closed.

important in countries with weak regulation to protect secured lenders in case of default.

- 2.12 **Leasing often differs from traditional lending in the reporting of income/corporate profit tax and specific taxes, and often provides tax incentives for MSMEs.** Local laws affect the accounting of installments, interest payments (expenses), value-added tax (VAT), and depreciation rights. If a company purchases the asset outright, it is able to deduct only depreciation, and possibly interest. The different treatment of the legal ownership of the financed asset leads to a different application of taxes:⁹ if a company leases an asset, it often expenses the full periodic lease payment, thus reducing its taxable income base even more.
- 2.13 **Leasing may pose some challenges for MSMEs, also because of the different treatment of legal ownership of the financed assets.** First, tax laws may not let MSMEs benefit from fully deducting lease payments for tax purposes. Local regulation may also confuse legal and economic ownership in leasing, granting depreciation rights to the lessor instead of the lessee. Second, leased assets are usually not recorded on the lessee's balance sheet, obscuring the company's real financial situation. This could, for example, lead to overstating returns on capital employed and understating debt-to-equity ratios.

III. IDBG LEASING AND FACTORING PORTFOLIO OVERVIEW

- 3.1 **During the evaluation period (2005-2014), IDBG approved \$358 million and disbursed \$321 million through 43 L&F FI operations.** IIC and MIF approved 21 factoring operations, accounting for 46% of the L&F portfolio, and 22 leasing operations accounted for the remaining 54% (Table 3). The leasing operations were approved almost entirely by IIC,¹⁰ with one outlying guarantee operation approved by SCF. Leasing and factoring operations were mainly structured as senior loans (20 and 19, respectively) and to a lesser extent as equity investments (2) and guarantees (2). At the time of this assessment, 27 operations were completely disbursed and/or repaid in full, two had been cancelled, and 14 remained active (still disbursing).
- 3.2 **Of the FI portfolio under evaluation, L&F operations accounted for 10% of all projects and about 2% of the approval volume.** At the beginning of the period, under the Financial Institutions Program the IIC approved seven operations, with the main share of resources approved in local currency to leasing FIs in Colombia under a one-time swap operation. At the same time, MIF approved three operations in Costa Rica and Nicaragua to promote factoring in those markets and expand factoring toward other Central American countries. This support to provide A2F to underserved MSME beneficiaries accounted for 10% of approvals and 25% of disbursement in 2005, but rapidly decreased, reaching levels below 2% after the global financial crisis, and 3% at the end of the period (Figure 3). This trend was the result not only of the increased volume

⁹ Depending on local legislation, leasing operations may be exempted from specific taxes. For example, as of 2015 leasing operations in Chile were exempt from the stamp tax of 1%, to be increased to 1.44% by the new tax reform at that time under revision in the Congress.

¹⁰ IIC had started to support the leasing market in the 1990s in Colombia, and continued in the early 2000s, completing at least seven operations.



of FI operations using other products, but also of a decrease in the volumes of L&F approvals (Figure 4).

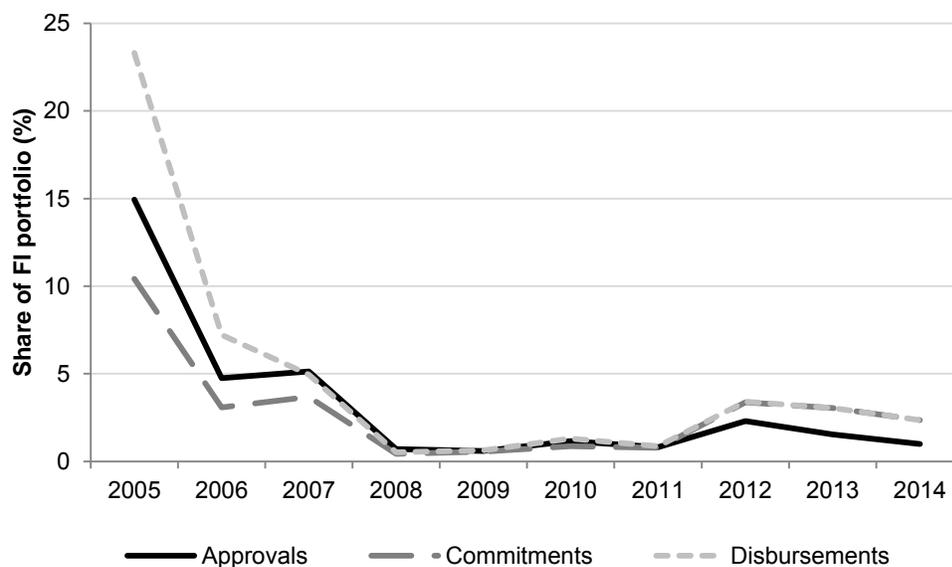
Table 3. L&F portfolio amounts

Windows and products	Number of projects approved	Approved amount (million) *	Disbursed amount (million) *
IIC	38	329	291
Factoring (dollars)	17	147	110
Leasing (dollars)	15	108	100
Leasing (local currency)	6	74	81
MIF - Factoring (dollars)	4	19	19
SCF - Leasing (local currency)	1	11	11
Leasing and factoring	43	358	321
Leasing	22	193	193
Factoring	21	165	128

* Approved amounts include renewals. Disbursed amounts may be greater than approvals for revolving credit lines and because of exchange rates.

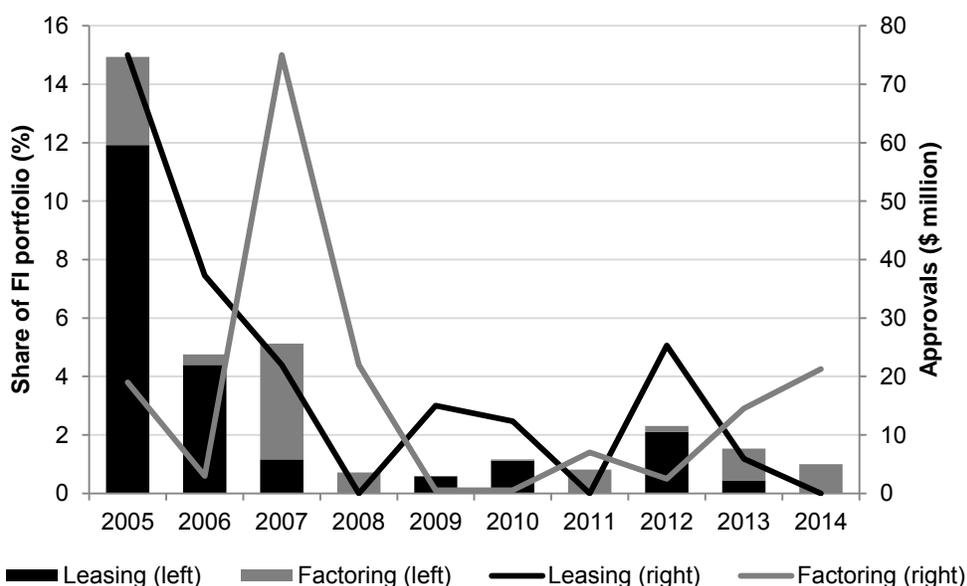
Source: OVEDA, as of December 31, 2014.

Figure 3. The relative importance of leasing and factoring dropped after the global financial crisis, when IDBG stepped up other types of support



Source: OVE, based on IDBG datawarehouse.

Figure 4. L&F had a vanishing prominence in both absolute and relative terms



Source: OVE, based on IDBG datawarehouse.

3.3 **IDBG supported L&F in seven countries and has continuing operations in three.** L&F operations were approved with FIs in Chile, Mexico, Costa Rica, Colombia, Nicaragua, Peru, and El Salvador.¹¹ Both leasing and factoring were supported in Costa Rica and El Salvador, while Chile and Nicaragua were exclusively chosen for factoring operations, and Colombia, Mexico, and Peru only for leasing. Even though Colombia was only targeted in 2005 and later left aside, mainly because of a regulatory constraint (Box 1), the IDBG apparently did not discard any of the L&F factoring markets it initially explored. Still the Bank remained mainly focused in Chile, Costa Rica, and Mexico.

Box 1. IDBG leasing operations in local currency

Foreign currency funding is not constrained in some LAC countries. For instance, Chile's system is based on freedom to carry out international exchange operations, with few restrictions. Under Chilean laws and regulations, the Central Bank of Chile only needs to be informed of loans in foreign currency, and authorizations are not needed for inflows or outflows of capital. There is no minimum term for the maturity of foreign currency loans.

However, in several LAC countries IDBG funding in US dollars poses a challenge to achieving its A2F objectives. In Colombia, under Regulation 8 of 2000 issued by the Central Bank, financial intermediaries could only receive foreign currency financing for the purpose of (i) carrying out authorized foreign currency credit operations, with a maturity equal to or less than that of the financing obtained; or (ii) carrying out foreign currency operations to cover derivatives positions. That financial regulation constrained IDBG's ability to finance Colombian FIs in US dollars.

Consequently, as part of its exploratory activities, the IIC identified clients' needs for local currency financing. By 2005 the IIC had financed five leasing companies for \$70 million in Colombian pesos under a one-time swap operation. The five projects were

¹¹ There were also three regional operations.

CO2350B-01, CO3506A-01, CO3505A-01, CO3735A-01, and CO3132B-01. The objectives were to provide medium-term funding and alleviate asset-liability mismatches in tenor, as well as to support the growth of the leasing market to finance MSMEs. After estimating the demand and coming to an agreement, the IIC issued a bond in the local market to obtain Colombian pesos and disbursed immediately to have an adequate match and minimize exchange rate risk. The market conditions allowed the IIC to obtain pesos with the same terms and at the same interest rate as it would use in lending. Similar operations were performed: project ME4019A-01 in Mexico for \$3.9 million in Mexican pesos and project PE1113A-02 in Peru for \$8 million (half in nuevos soles).

Although these operations achieved their objectives, local currency operations have been few because of unfavorable market conditions and risk concerns.^a IDBG's work in L&F has been limited by its not being able to provide funding in local currency.

^a Interviews with FIs and IIC staff.

- 3.4 **IDBG selected several specialized FIs to work in L&F but sustained longer-term partnerships with only a few.** IDBG did L&F operations with one banking FI and 24 specialized NBFIs. A bank in Costa Rica and leasing companies in Peru and Nicaragua later received support also for general SME lending. In terms of number of L&F operations, two Chilean leasing companies, two Costa Rican, and one Nicaraguan were the main IDBG partners,¹² and most had active operations as of the end 2014, especially due to pre-approved renewals by IIC. By approval volume, two Chilean leasing companies and a Costa Rican one were the main clients.¹³ The Costa Rican Bank, which also received funding for housing and trade products, and a leasing company in Costa Rica were the partners selected to introduce factoring in Central America.
- 3.5 **MIF first entered the factoring market in 2005,¹⁴ and later IIC took over.** MIF provided funding through equity, loans, and grants to support the factoring industry in Central America,¹⁵ and it mainly financed leading factoring FIs. It used grants to strengthen client FIs through capacity building and the development of specialized factoring products, expecting also to have demonstration effects on unregulated FIs. IIC initially focused on Chile and later also supported previous MIF factoring clients. Still, IIC had a different objective—promoting greater competition to reduce financing costs for MSMEs.

IV. RESULTS OF IDBG'S SUPPORT FOR LEASING AND FACTORING

- 4.1 **L&F operations had a high disbursement rate, alleviating the funding constraints of L&F companies.** Overall, only about 10% of their approval volume has not been disbursed, mainly because a few factoring operations remain active at the time of this review (Table 4). Because of pre-approved renewals of IIC operations, the amounts currently approved are 30% greater than those originally approved.

¹² Each had three or more approved operations in the evaluation period.

¹³ Each had approvals of more than \$30 million in the evaluation period.

¹⁴ MIF had not prepared this kind of financial operation before, except for an isolated leasing operation through a start-up leasing FI in 2004 to (i) finance capital goods for small enterprises through leasing transactions; (ii) strengthen the company's overall capital base; and (iii) deepen the Bolivian leasing market through demonstration effects (BO-M1001).

¹⁵ Operation RS-T1032.



Table 4. While there were no significant differences in disbursement rates across windows, factoring showed a lag in disbursements

Products and windows		Number of projects	Approved amount (million) *	Disbursed amount (million) *	Disbursement share (%)
Product	Factoring	21	165	128	77.6
	Leasing	22	193	193	99.8
Window	IIC	38	329	291	88.7
	MIF	4	19	19	99.0
	SCF	1	11	11	100.0
Total		43	358	321	89.6

* Approved amounts include renewals. Disbursed amounts may be greater than approvals for revolving credit lines and because of exchange rates.

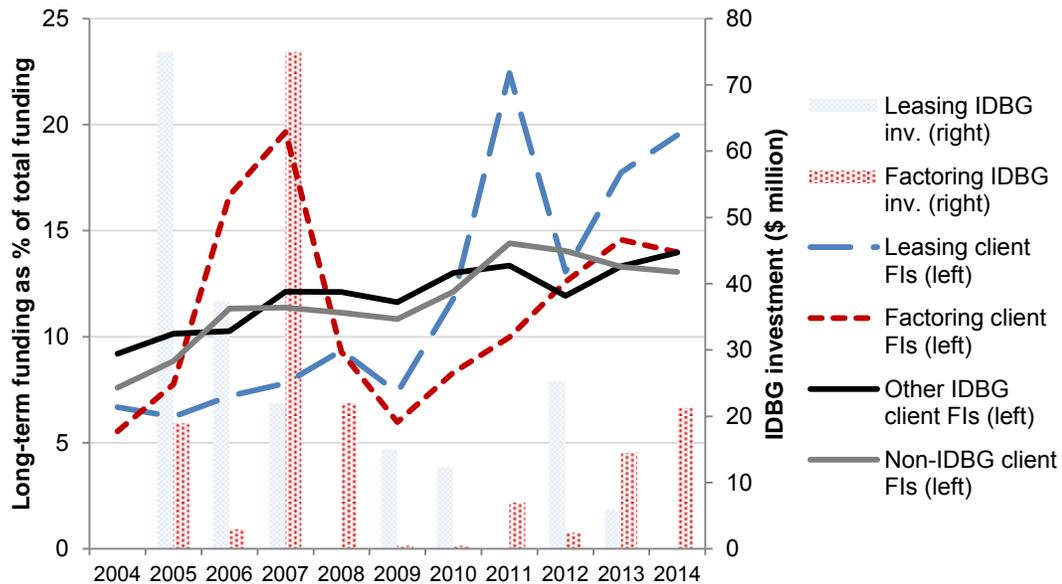
Source: OVEDA, as of December 31, 2014.

- 4.2 **IDBG funding also helped L&F FIs to match the tenor of their assets and liabilities.** The Bank provided funds to its leasing clients with an average tenor of 54 months, better matching the typical tenor of leasing transactions, which ranges from 36 to 60 months (depending on the leased good). IDBG also provided long tenors (36 months on average) for factoring operations, despite the typically shorter tenors of these transactions (3 months).
- 4.3 **Furthermore, IDBG’s leasing FI clients had a greater and more sustained increase in long-term funding.** IDBG’s FI clients for other products and non-IDBG clients maintained a similar steady average growth in their relative long-term funding (between 8% and 12%). Meanwhile, factoring FI clients had a steep growth immediately after the IDBG intervention, but it decreased rapidly with the global financial crisis. Leasing companies observed a more stable increase of long-term funds—about 5 percentage points above other FIs’ average long-term funding share (Figure 5). This sustained increase is hardly attributable to the IDBG, since leasing companies belonging to a larger financial or economic group also have access to international sources and local funding.
- 4.4 **Leasing FI clients’ increase in long-term funding is not fully attributable to the IDBG, which mainly worked with the larger and less risky NBFIs.** The main funding sources of L&F companies are typically promissory notes and local credit lines with pledged underlying assets of their portfolios. Larger FIs—particularly the leasing companies belonging to a larger financial or economic group—also have access to international sources and local funding. However, FI interviews reveal the importance of IDBG’s reputational effects in helping FI clients to raise funds from other development finance institutions (DFIs) and the local market.¹⁶

¹⁶ It could be argued that IDBG’s investment indirectly benefited smaller FIs. For example, after international funds became available in Chile, CORFO changed the focus of its programs toward smaller NBFIs, such as cooperative and savings banks that could not access other sources of funding, such as issuance of promissory notes bonds, and access to international funds.



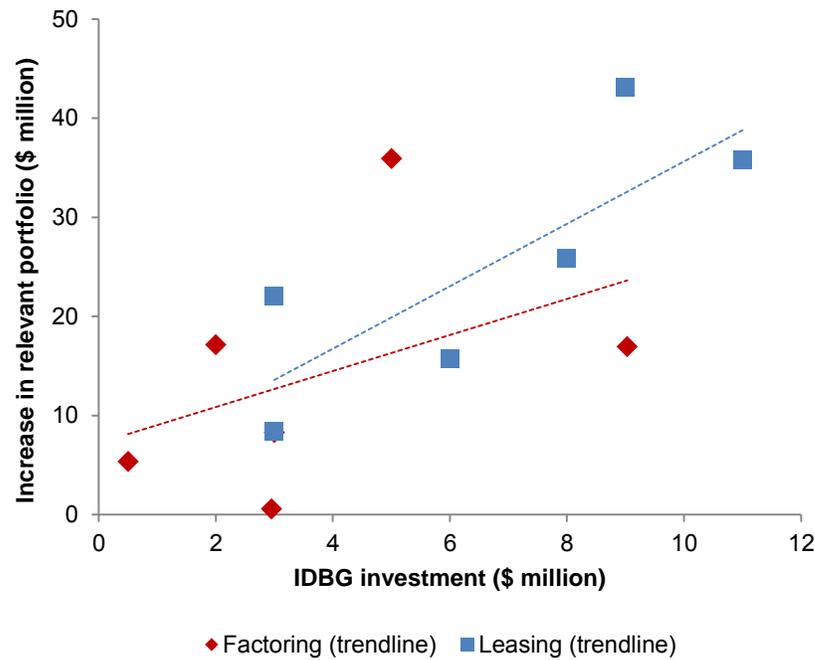
Figure 5. IDBG's leasing FI clients achieved a sustained increase in long-term funding, while factoring clients did not



Source: OVE, based on Bankscope information for 18 FIs in factoring and leasing.

- 4.5 **As with non-L&F FI operations, IDBG built a presence among LAC banks and NBFIs.** Except for a few IIC leasing operations, IDBG had rarely intervened in the LAC L&F markets before the evaluation period. At the beginning of the evaluation period, IDBG approved operations with 25 specialized FIs and built partnerships with some of them, promoting competition with well-established banks. NBFIs valued IDBG's network and reputation as a major benefit of working with IDBG. Through its work in the region IDBG was referenced as a quality standard, more for the reputation benefits of having the IDBG stamp (71%), than for its direct funding mobilization (29%) or know-how (29%). Supporting L&F operations also promotes competition in otherwise highly concentrated financial markets in LAC, particularly since L&F companies focus on clients typically not served by banks.
- 4.6 **Furthermore, IDBG's L&F investments were correlated with more than proportional increments in FIs' relevant portfolios, expanding A2F for MSMEs** (Figure 6). IDBG's L&F clients were mostly specialized NBFIs, and their relevant portfolios typically corresponded to their total portfolios. IDBG's investment almost always led to an increase in the relevant portfolios, not least because IDBG's funding was typically a significant share of the total portfolio. However, in a few cases, factoring companies became financial service companies, thus reducing the share of relevant portfolio during the evaluation period.

Figure 6. Leasing and factoring investments are positively correlated with relevant portfolio increases



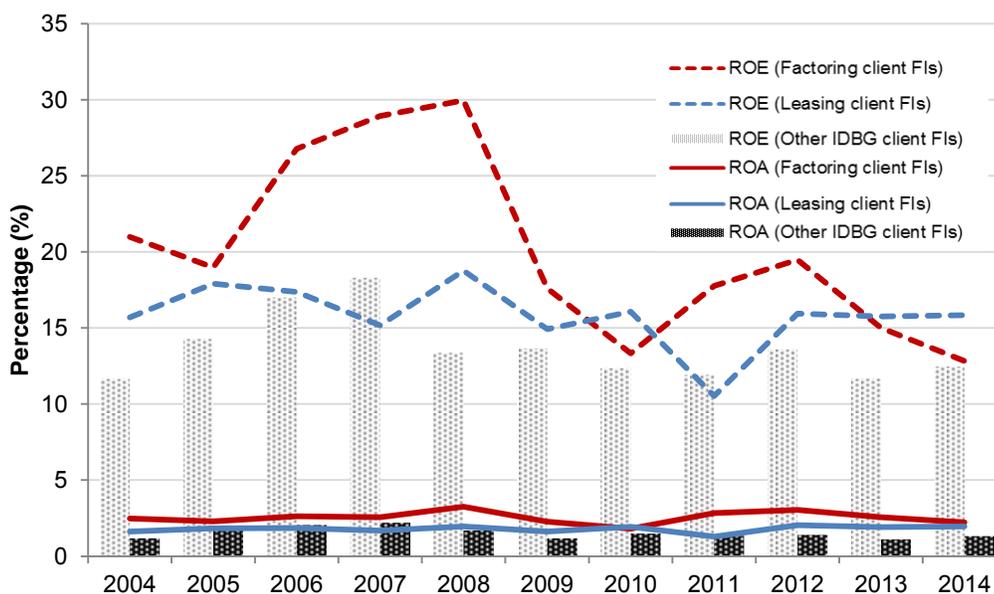
Source: OVE, own calculations.

- 4.7 **Goals in terms of beneficiaries were not fully achieved, but in any event the fungibility of money makes it difficult to assign specific subprojects to IDBG’s money.** The L&F operations focused on MSMEs as the eligible enterprises, and they set targets in terms of number of beneficiaries according to the average tenor and amount of L&F transactions. According to the reported lists of the eligible projects financed, about 60% of leasing operations reached or surpassed their targets, while only half of the factoring operations reached the intended beneficiaries. Furthermore, IDBG’s factoring support may have remained concentrated in a smaller number of MSMEs, which are typically related to a specific supply contract. Also, as IDBG provided long-term funding for factoring operations, the short-term nature of the transactions allowed several rollovers of resources. Still, since MSMEs with the largest clients are the most attractive for factoring FIs, MSMEs supplying smaller clients did not necessarily benefit from IDBG funding. In any event, it is important to point out that because of the fungibility of money, assigning specific leases or factoring clients to IDBG’s funding is unreliable, and the focus should be instead on whether the respective portfolios increased (in volumes and numbers of beneficiaries).
- 4.8 **IDBG also charged higher spreads for factoring operations, corresponding to their higher risk.** As L&F operations were approved for NBFIs, interest rates spreads were higher than for other FI operations. IDBG charged average spreads of 1.4% to second-tier banks, 2.6% to banks, and 2.9% to NBFIs. Leasing companies were charged an average spread of 1.8%, and factoring companies almost twice as much (3.2%). Correspondingly, factoring FIs had net interest margins from 7% to 9%, around twice those of leasing companies.

4.9 **IDBG's L&F clients had higher returns than other FI clients and non-IDBG clients, even though profitability was not an explicit target.** The return on equity (ROA) of factoring FI clients was higher (3%) than that of leasing clients (2%) and other product clients (1%). Similarly, return on equity (ROE) remained higher for factoring clients (20% on average) than for leasing clients (16% average) and other FI clients (12% average). Furthermore, profitability indicators for factoring were correlated with IDBG investments, while remaining more stable for leasing companies (Figure 7). Given that a key consideration in choosing clients is their financial performance, it may well be that IIC picked better-performing FIs, rather than that the investment influenced their performance.

4.10 **Portfolio quality has improved for leasing and deteriorated for factoring, but it stayed within the thresholds set by IDBG.** IDBG did not set objectives for portfolio quality, but it used financial covenants to limit deterioration in portfolio quality. Most of the L&F operations met these covenants. The nonperforming loan (NPL) ratio (impaired loans to gross loans) was very low for factoring operations at the beginning of the evaluation period, but has increased in recent years,¹⁷ whereas it has decreased for leasing (Figure 8). The NPL ratio of other FI clients has also decreased (slightly), and overall for IDBG's clients it has remained below the rest of LAC FIs.

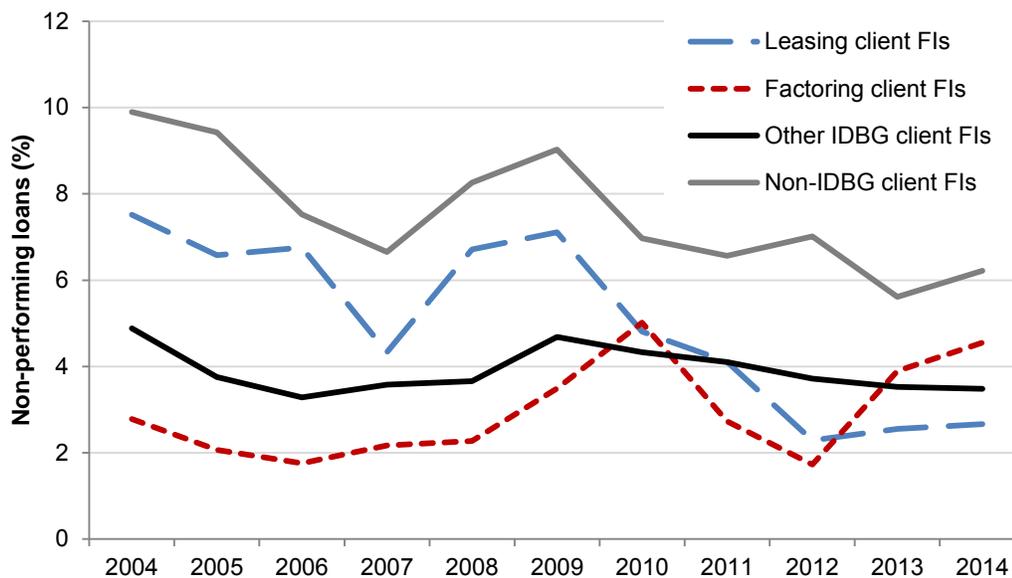
Figure 7. IDBG's L&F clients had even higher returns than those of other FIs.



Source: OVE, based on Bankscope information for 18 FIs in L&F.

¹⁷ This is an issue related not only to business, but also to regulation. For instance, because of the way financial accounting is done in Chile, factoring companies need to exhaust all payment options before being able to write off the debt and remove it from the balance sheet. If the collection goes to trial, it can take up to three years, and even if bad debt is already fully provisioned, the NPL would still be on the balance sheet with arrears of more than one year. This will increase the NPL ratio, and factoring companies in Chile may find it difficult to comply with that covenant.

Figure 8. Portfolio quality has improved or leasing, but for factoring it has deteriorated.



Source: OVE, based on Bankscope information for 18 FIs in L&F.

- 4.11 **IDBG also attempted to alleviate the A2F constraints that are due to weak regulatory environments and lack of depth in credit information by promoting factoring-specific regulatory frameworks.** The Bank accompanied its factoring operations in Central America with technical cooperation operations (TCs) to promote the use of factoring and enhance the regulatory environment. While in Costa Rica resources were not fully disbursed and no major regulatory improvement occurred during the evaluation period, the IDBG successfully supported the Nicaraguan market by promoting a law to allow the use of invoices as tradable certificates (Box 2).

Box 2. The rise and fall of IDBG's support to factoring in Central America

In 2004, after finding that Central America and Caribbean banks reported the lowest level of specialization in MSME financing, the IIC/MIF SME Finance Facility prepared a TC to analyze factoring services in LAC. With the support of the General Cooperation Fund of Spain, the TC RS-T1032 financed an analysis of the factoring market in Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. The ultimate goal of the project was to support the origination of operations to enhance the factoring regulatory environment and to provide training for the development of active factors, both conducive to increasing A2F for MSMEs.

The study led MIF to provide loans and accompanying grants with three objectives: (i) to support the development of invoice trade regulations, to create legal certainty and mitigate the regulatory risks of the business; (ii) to promote and raise awareness of the benefits of factoring for MSMEs; and (iii) to train MSMEs in the use of factoring. Three operations were approved in 2005: CR-M1005 and CR-M1004 in Costa Rica, and NI-M1005 in Nicaragua. In 2012, operation ES-M1039 was approved in El Salvador, which is still active. The total current approved amount was \$18.7 million.^a

IDBG's funds were on-lent in Costa Rica, but after the factoring market deformed, the selected FI clients abandoned the factoring product in the local market. Other FIs in the market had approved factoring lines, omitting the verification of deliveries and notification to debtors. Therefore, this product became a regular lending operation secured with unconfirmed and non-notified invoices—that is, risky and unsecured debt. Since this product did not have the cost of a duly responsible factoring operation, other FIs could offer a more competitive product than factoring FIs. New

clients started to request the same kind of product with more convenient terms from factoring FIs, and other FIs focused on traditional clients, limiting the growth of the market. Later, both types of FIs embraced the discounting product and abandoned factoring.

These operations in Costa Rica were credit lines renewable under the condition of expanding factoring services to two Central American countries (a renewal per country).^b Although these FI operations were successful in incentivizing and supporting expansion of factoring services, they were not profitable in the new markets because operational and regulatory risks materialized. FI clients' investments in Panama and El Salvador produced losses because of delinquent accounts. The inability to report nonperforming invoices and the costly legal enforcement of invoice payments incentivized final obligors not to pay.

The result of IDBG's support in Nicaragua was better, but is still too recent to permit an assessment of the project's full impact. The strategy of fostering the factoring industry in Nicaragua motivated not only the support to a NBF, but also two TCs: the first (NI-M1006) was approved for \$65,000 and completely disbursed, while the second (NI-M1007) was approved for \$60,000 but only disbursed 47%. Still, thanks to these TCs, a bill was prepared and later approved as Law 739 of 2010 (Ley de Factura Cambiaria), to regulate the negotiation and endorsement of invoices. At the same time, Law 740 of 2010 was approved to specifically regulate the factoring market, later detailed through Decree 10 of 2012. Through this support, Nicaragua became the first country of the group to have a specific regulation that provides a standard contract for the full scope of factoring operations, and consequently the due legal security. Still, the factoring product is not very well known in Nicaragua, and recourse factoring is predominant because weak enforcement of the law is expected.

^a Two other operations were not part of the scope of the evaluation. Project PE-M1033 was approved for \$1.07 million in 2006 for the establishment of a Fund in Peru, and later cancelled. The other, GU-M1038, was a stand-alone grant approved in 2011 in Guatemala for institutional capacity strengthening for \$482,000, which was almost completely disbursed.

^b The accompanying TC, CR-M1002, was approved for \$135,000, but only disbursed 15%. According to the interviews, the executing agency was not able to execute the funds to promote the factoring product in Costa Rica.

- 4.12 **Today in Costa Rica, El Salvador, and Chile, invoice discounting and factoring still have gaps in financial regulation.** Lack of regulation led FIs to use a recourse factoring agreement, establishing a credit line under which disbursements are made against received invoices that are only used as a repayment source after due notification to debtors, while a bill of exchange is used as a collateral for the MSME to bear the risk of insolvency or default. Hence, markets present factoring-specialized FIs competing with regulated FIs under incomplete regulatory frameworks to offer a distorted product, not as attractive and beneficial as the product studied in this background paper. (Annex II presents a more detailed summary.)
- 4.13 **However, leasing regulatory frameworks are fairly well developed in LAC and represent only a minor barrier to A2F.** Colombia and Peru have an explicit regulation for leasing operations, with a particular tax treatment rewarding the fact that the lessee is paying interest and taxes for a productive asset that it does not own. Conversely, in Costa Rica there are no specific leasing provisions that level the playing field between leasing companies and FIs offering traditional financial products. Mexico and El Salvador have specific regulations, but the incentives for the use of this innovative product have some limitations, particularly in the VAT and depreciation treatment. (Annex III presents a more detailed summary for all the leasing client countries.)



V. CONCLUSION

- 5.1 **IDBG correctly diagnosed that LAC had one of the lowest rates of credit availability in the world, and that this insufficiency – particularly critical for MSMEs – could be mitigated by asset-based lending products like L&F.** NBFIs, and particularly factoring NBFIs, cater to a market segment that is not regularly served by the banks. Smaller MSMEs often lack (audited) financial statements. This prevents traditional FIs from offering financial products to this segment, not allowing companies to build a credit history in credit bureaus. The absence of banking use and a standardized public risk profile increase the costs of assessing creditworthiness. Meanwhile, NBFIs, which are not subject to the same financial regulation as banks, view this as a market niche. They are better able to manage the MSMEs' different risk profiles, charge interest rates commensurate with the risk, and thus achieve attractive returns.
- 5.2 **The IDBG has supported L&F, but without extensive depth and continuity.** IDBG devoted only 2% of its FI portfolio to L&F, mostly through IIC. However, L&F operations did provide an important share of L&F FIs' relevant portfolio through long tenors, directly matching the FIs' assets. NBFIs' relevant portfolios may have increased competition, and IDBG's clients obtained high returns by working with MSMEs. IDBG's support was strong at the beginning of the evaluation period and then declined, particularly affecting factoring companies, which gradually returned to low shares of long-term funding and to low levels of portfolio quality.
- 5.3 **NBFIs do not have access to innovative financial products—not only funding from DFIs for L&F, but also access to capital market vehicles like investment funds through securitization of leasing portfolios and invoices.** IDBG could promote the creation of, or directly participate in, capital market vehicles like investment funds that can invest in bonds issued in the secondary market, first bought by DFIs to enhance their reputation. Those bonds could be secured by the portfolio of the L&F NBFIs. Leasing portfolios can be easily securitized, while factoring portfolios require segmentation. Because of the current regulation on invoice enforceability, only invoice factoring portfolios would be subject to securitization. The portfolio would also need to be segmented by types of debtors—for example, accounts receivable from public entities and companies.
- 5.4 **IDBG needs to provide local currency funds to meet the needs of L&F NBFIs and their beneficiaries.** Except for some dollarized markets such as Costa Rica and some particular sectors such as trade, foreign currency lending is inappropriate for NBFIs. IDBG attempted to mitigate this barrier through a few local currency operations in leasing. It could increase its additionality and development impact by offering local currency loans without having to resort to expensive swap markets.
- 5.5 **IDBG lacks a strategy to foster A2F for the underserved segment of MSMEs through L&F markets, and it would benefit from having one.** The broad A2F strategies have barely mentioned IDBG's intended work with innovative financial products. They have lacked results frameworks and have not fully incorporated the potential contributions of L&F operations in reaching the underserved MSME segment. IDBG should consider developing a strategy for promoting A2F to underserved MSMEs, encompassing different innovative financial products and giving due attention to measuring development results.

5.6 **An important pillar of this strategy would be supporting regulation that allows an L&F industry to develop as a complement to traditional banking.** IDBG used mainly L&F FI operations to foster A2F for MSMEs, but did not always accompany them with complementary activities to enhance the regulatory environment. Incomplete regulatory frameworks and weak law enforcement in the region have kept the markets from reaching their potential growth. Delinquent accounts remain the main threat to factoring, while market reputation and lack of product awareness have limited its growth. Market growth in leasing depends to a large extent on tax incentives, but the regulations of some countries have made leasing unattractive. There is also a need to enhance enforcement of creditors' rights and depth of credit information by promoting implementation of best regulatory practices and formalization of credit information systems and financial reporting. Much remains to be done to improve L&F regulations in LAC, and IDBG could have an important role in bringing about these improvements.

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ANNEX I. ACCESS-TO-FINANCE CONSTRAINTS

1. **Shallow credit information hinders establishing the creditworthiness of the potential beneficiaries or of the financed projects.** Credit bureaus and credit rating agencies (CRAs) usually do not capture credit information coming from NBFIs or utility companies, regardless the amount or type of reporting (performing or nonperforming loans). MSMEs' creditworthiness is more difficult to assess because of the absence of banking usage information such as business current accounts (BCA). Although LAC countries' credit information standards are good,¹ they could still have weaknesses in the areas of credit information systems and the legal framework's quality, coverage, and enforcement, so that there are no standardized public risk profiles or simple standardized financial statements for MSMEs.
2. **The selection and monitoring costs of potential borrowers make SME lending unappealing compared to corporate banking.** Low profitability, high administrative costs (such as information searching costs to establish the actual situation of MSMEs), and high risk profiles, which are characteristics of SMEs, imply smaller amounts, shorter tenors, and higher interest rates, making credit not appealing for either part. Cost-benefit analysis highlights high administrative costs as a non-negligible share of the amount of those microloans. Typically, investment officers face a high opportunity cost when assessing MSMEs, and monitoring poses the same issue. MSME loans use tailored contracts whose enforcement and proper management require extensive monitoring and flexibility.² The development of credit scoring models may be an alternative to assess the creditworthiness of the micro and small companies, particularly start-ups. For assessing creditworthiness, CRA information is also required; when it is not available, BCA may be the main substitute.³ Finally, while some information might be available through third parties, most valuable information is in BCA, which might not be available electronically, leaving room for concerns about veracity.
3. **The lack of real-estate collateral for investments hinders the hedging of MSME lending risks.** For the small group of MSMEs with immobile assets that can be used as collateral, the insufficient protection of legal rights affects the execution of guarantees and A2F. When MSMEs lack real estate properties to use as collateral, FIs abstain from lending or toughen their terms since they would face a larger risk. According to Dahan and Simpson (2008), in LAC, 95% of SMEs' assets are movable, and thus they require tougher legal protection. Yet in most LAC countries regulation does not allow (or does not offer the guarantees) to use movable property as collateral.⁴ For SMEs with immobile assets to use as collateral, a secured transactions legislation must create incentives for borrowers to honor loan contract terms by setting rules to (i) create an effective security system, (ii) clearly prioritize rights on collateral for upholding seniority claims, (iii) provide a cost-effective system to publicize rights on

¹ World Bank (2016)

² Field visits may substantially increase these costs when the MSMEs activities have a non-negligible Environmental and social risk level.

³ FCA and CMA (2014).

⁴ Love and Martinez (2015).

collateral, and (iv) guarantee its enforcement.⁵ Still, protection of creditors' and debtors' rights is weak,⁶ given that collateral laws are generally uncomprehensive and collateral registries are ineffective, hindering confidence among financial contracting parties about the creation and enforcement of property rights.

4. **Latent risks related to the low level of financial education⁷ of MSMEs remain, namely moral hazard (or failure of the borrower to repay after receiving the funds).** Financial education may pose moral hazard problems in enforcing repayment if contract design issues are identified. Because of the high monitoring costs, FIs might not be able to supervise MSMEs' willingness and ability (MSME performance) to repay. To reduce the amount of possible losses, credit rationing and low loan-to-value ratios are usually applied, hindering MSMEs' A2F and boosting costs as a share of lending.⁸

⁵ ADB (2014).

⁶ World Bank (2016).

⁷ Meaning that MSMEs are not familiar with or accustomed to financial practices and mechanisms, which can hamper the good use and management of the transferred funds.

⁸ FCA and CMA (2014).



ANNEX II. FACTORING REGULATION IN IDBG'S CLIENT COUNTRIES

1. **According to Klapper (2005), friendly factoring environments require minimum regulatory conditions for the market to emerge and subsist.** Desirable elements include not only specific regulations, but financial supervision, special tax regimes or treatment, and other aspects such as reputation and accessible sources of information. 1 Two regulatory elements in particular stand out: the legal guarantees to endorse (credit assignment) and enforce (payment collection) the underlying asset.
2. **However, the factoring markets of the IDBG's client countries are characterized by a low degree of regulation and development.** As the 2006 study developed under the TC RS-T1032 stated, factoring in Central America is a recent market (started in the 1980s) with uneven developments among countries. In most countries, factoring is developed in an informal environment, without regulation or financial supervision, leading to inadequate risk management and bankruptcy cases. By 2014 few regulatory upgrades had been implemented.
3. **Factoring-specific regulation is available only in Nicaragua.** In Costa Rica,² El Salvador,³ and Chile, as well as in Nicaragua before the issuance of a factoring legislation, factoring markets emerged by using supplementary regulation on the assignment of credit rights. Factoring was therefore made operable under an atypical contract,⁴ with a weak background to support the different economic purpose of the factoring operation, which affected the enforcement of the underlying asset and the contract. After 2010, Nicaragua became the first country of the group to have a specific regulation,⁵ providing a model contract for the full scope of factoring operations, and consequently the due legal security.
4. **In all four countries, direct enforcement or executive collection of invoices and other receivables is mandated by law.** Proper enforceability is provided by laws that allow resorting to an expedited process before judicial authorities to enforce payment of accounts receivable. Typical regulations state that after the buyer has accepted and

¹ Another desirable element to make the product more financially appealing is the development of electronic invoice regulation, relevant in making factoring services more competitive by reducing operating costs related to custody and mailing, among other benefits.

² According to the report of Roca Junyent Advocats - Grupo DFC (2006), the local association of factoring companies (Cámara Costarricense de Empresas de Factoreo, or CCEF) presented the bill 14687 in 2002. The initiative responded to the evidence of operative risks (such as fraud due to altered invoices or double discounting by presenting multiple copies to two or more factors) and to the necessity of factoring-specific regulation. By 2005 the bill was about to undergo the due legislative process, but it never did. In 2013 there was another attempt to take the bill through the legislative process, but according to the CCEF the proponent withdrew it, claiming it was obsolete after 10 years. Eventually, a new bill was prepared (No. 19072) and as of mid-2015 it was undergoing the due legislative process.

³ In 2013 a bill regulating factoring operations was prepared by the Ministry of Economy (<http://www.laprensagrafica.com/preparan-ley-para-agilizar-pago-a-pymes>). The project has not yet undergone the due legislative process.

⁴ Among the various classifications of contracts, the main one used to define the issue of non-specific regulation is the distinction between typical contracts, i.e. those with a specific statutory regulation, and atypical contracts, those orphans of specific regulation. Atypical contracts may be performed under the general principle of autonomy and freedom of agreement. Contract parties observe the agreement, mainly governed by the provisions in the document, and for other matters not covered in the agreement they resort to other related contracts or jurisprudence.

⁵ Law 740 of 2010 was approved to regulate the factoring market, later detailed through Decree 10 of 2012.

signed the invoice, the invoice acquires its direct enforceability and becomes an accepted bill of exchange, so that sellers can start an executory process with a hearing including both parties. If the buyer has no valid non-payment reasons or fails to appear, the judge makes a record that is enforceable, possibly declaring an embargo on the buyer's goods.

5. **Equally important, invoices are assignable and negotiable in all countries.** However, they are endorsable only in Chile and Nicaragua. In Chile⁶ and Nicaragua,⁷ invoices must have a specific copy for assignment or executive collection process. After they are signed by the buyer, acknowledging delivery and acceptance, they are assignable solely with the signature of the grantor, verified by a public notary before notification to the buyer. Costa Rica and El Salvador have the legal figure of the currency bill, which itself is executive but in practice is not much used because of issues in the regulation. In Costa Rica, the law recognizes invoices as securities, but the formal requirements for implementation are very strict.⁸ In El Salvador, buyers retain the invoice after delivery and provide a receipt, commonly known as “quedan,” which is not legally endorsable.
6. **Except in Nicaragua, factoring-specialized FIs are not subject to financial supervision.** Since factoring companies typically do not take deposits, there are no strong arguments for government regulation and supervision.⁹ Still, the whole industry could benefit from better supervision and by encouraging factoring companies to use the same accounting standards as supervised FIs. Regulation could also oblige factoring companies to take into account both clients' and debtors' risk profiles for provisioning for bad receivables, while allowing tax deductions using provisions. However, NBFIs are not regulated in Costa Rica, El Salvador, and Chile. Only in Nicaragua, after Law 740 of 2010, have factoring NBFIs been supervised by the *Superintendencia de Bancos y de Otras Instituciones Financieras*, and they are obliged to report their factoring operations and financial statements to guarantee adequate risk management.

⁶ Since Law 19983 of 2004 (Ley de Cesión de Facturas), invoices are endorsable upon fulfilling the requirements on information, stamp, and other physical features. Law 20323 of 2009 modified Law 19983 to facilitate the operation of factoring.

⁷ Law 739 of 2010.

⁸ Roca Junyent Advocats - Grupo DFC (2006).

⁹ World Bank (2004).



Annex Table 1. Summary of the main regulatory features affecting factoring in IDBG's factoring country clients

Country	Factoring-specific regulation	Usable underlying assets	Direct enforcement of receivables	Endorsement / assignment of receivables	Recourse factoring	Non-recourse factoring	Supervision	Publication of financial statements
Costa Rica	No. Atypical contract. In 2002 the CCEF presented bill 14687, but it never underwent due legislative process. A new bill was prepared (bill 19072) and as of mid-2015 was undergoing due legislative process.	Invoice	Yes. Commercial Code, article 460. Still, the debtor needs to sign the invoice for it to have an expedited and direct process of enforcement before judicial authorities.	Not endorsable in practice. Although it may be endorsed according to Commercial Code 460 bis, 490-494-Law 14684 of 2002 (see also Civil Code, articles 1101-1116), requirements are not met. Still, it is negotiable and then assignable (through a notary public).	Not regulated. Still, it usually operates with recourse as a discount contract with a bill of exchange.	Not regulated but used	Not supervised by Superintendencia General de Entidades Financieras	No
El Salvador	No. Atypical contract. The Law of Banks (article 51) allows banks to discount invoices, checks, and other documents (Commercial Code, Art. 999 and Art. 1129). In 2013 the Ministry of Economy prepared a bill to regulate the market, but it did not undergo the legislative process.	Invoice, check, bill of exchange	Yes. There is an expedited and special process before a Commercial Judge (Legislative Decree 774 of 1999).	Not endorsable in practice. (Legislative Decree 774 of 1999). For invoices to be transferrable they require acknowledgement of receipt by buyers, which is certified by a non-endorsable receipt, known as <i>quedan</i> . However, buyers retain the invoice after delivery.	Not regulated. Still, it usually operates with recourse as a discount contract with guarantees on the client's receivables and complementary guarantees.	Not regulated but used	Not supervised by Superintendencia del Sistema Financiero	No
Chile	No. Atypical contract. Law 20190 modified the Law of Banks (Law 3 of 1997) to allow banks and FIs to establish branches to operate factoring services.	Invoice, check, bill of exchange	Yes. (Law 19983 of 2004. Modified by Law 20323 of 2009).	Yes. Endorsable with notification to the debtor (Law 19983 of 2004).	Not regulated. Still, it usually operates with recourse as a discount contract with a bill of exchange.	Not regulated and rarely used	Not supervised by Superintendencia de Bancos e Instituciones Financieras (SBIF). Still, the SBIF has issued regulations for factoring companies	No
Nicaragua	Yes. Law 740 of 2010 - Factoring Law Decree 10 of 2012 - Regulation of the Factoring Law	Invoice, check, bill of exchange	Yes. (Law 739 of 2010).	Yes. Endorsable with notification to the debtor (Law 739 of 2010).	Yes (Law 740 of 2010).	Regulated and used (Law 740 of 2010).	Yes. Law 740 of 2010. Supervised by the Superintendencia de Bancos y de Otras Instituciones Financieras (SIBOIF)	Yes. Factoring companies report their operations and FS to SIBOIF

Source: OVE, based on information from factoring associations, FI interviews, Junyent Advocats - Grupo DFC's study (2006), and Acesa's Report (2007) "Redacción y Promoción de la nueva Ley de Factura Cambiaria."

ANNEX III. LEASING REGULATION IN IDBG'S CLIENT COUNTRIES

1. **The success of a local leasing market is considerably affected by country legislation, particularly fiscal regulation.** According to the IFC Leasing Manual, a sustainable leasing sector depends on a regulatory framework that levels the playing field with traditional financial products. For leasing to succeed, clear rights and responsibilities of the parties need to be established through specific regulation to remove potential contradictions in the existing legislation. Non-judicial repossession mechanisms and financial supervision and licensing are also desirable. Still, the fiscal benefits from leasing are the reason borrowers use leasing finance: to have the economic rights of using a productive asset while not having the legal ownership. IDBG's client countries had issued favorable leasing regulations in the past, promoting outstanding growth, but tax-benefit regulation has been partially dismantled.
2. **Leasing-specific regulation has been issued for most of the IDBG's leasing client countries; Costa Rica is the only market in which leasing operations use an atypical contract.** In Colombia, leasing was recognized as a financial activity and later regulated in 1993.¹ In El Salvador the government issued Decree 884 of 2002 specifically to regulate leasing operations. In Peru leasing has been covered by a specific regulation since 1984. Likewise, Mexico follows the basic operation rules for leasing operations included in 1984 in the general law of credit operations and a leasing-specific chapter, included in 2006. However, Costa Rica² does not have a leasing-specific regulation and is still operating under lease contracts and buy-option contracts, as defined in the Civil Code.
3. **A deduction of the full lease installments³ from corporate profit tax is allowed in most of IDBG's leasing client countries, except for Costa Rica.** In 1995 the Colombian regulation defined a special tax regime for leasing operations. In 2006 the law allowed MSMEs to use financial leasing with the treatment and benefits of operating leasing for determined types of assets, implying the double benefit of keeping assets off the balance sheet and deducting 100% of the installments from corporate profit tax declarations. However, this benefit for MSMEs ended in 2012. In El Salvador, Peru, and Mexico,⁴ the regulation established that all taxes derived from the economic use of the leased assets were due by the lessee. Still, the lessee can deduct the full lease installment from the corporate profit tax declaration. In Costa Rica there is no particular treatment of corporate profit tax for leasing operations.
4. **Colombia, El Salvador, and Peru have special VAT treatment for leasing operations.** While MSMEs may deduct the VAT of assets financed through traditional lending, the ownership of the leased asset by the lessor implies a different tax

¹ Decree 1997 of 1988, and Decrees 913 and 914 of 1993.

² In 1996, bill 12762, "Ley reguladora de los contratos de leasing," was presented for the legislative approval process, with the purpose of establishing the leasing contract as a different legal figure from the traditional contracts, and granting a specific tax regime for these operations. This bill was not approved.

³ Typically, borrowers can deduct interest only from the tax base. Leasing offers an argument for a different treatment: since the lessor keeps ownership of the leased assets, they are off the MSME's balance sheet; therefore, the whole lease payment by the MSMEs (composed of principal, interest, and other services) could be deducted from the gross income (tax base), making both profit and corporate profit tax lower.

⁴ Under the Decree issued on July 18 modifying the laws of corporate profit tax and VAT, among others.

treatment.⁵ In Colombia, since 1992 lessees were authorized to discount the paid VAT from their income tax declaration, while the VAT for financial leasing installments was eliminated. In El Salvador, lessors must pay the VAT when purchasing assets to be leased, and transfer the tax amount in the installments charged to the lessee. Those VAT shares can be computed in VAT declarations. In Peru, leased goods are not charged with VAT when leased assets are not used for activities subject to VAT. In Mexico and Costa Rica there is no VAT special treatment for leasing operations.

5. **Because of the lessee's economic rights to the leased asset, the depreciation rights are also be granted to the lessee in all IDBG's leasing client countries, except El Salvador.** In Colombia, Costa Rica, Peru, and Mexico, depreciation rights are conceded to the lessee, which can discount depreciation in the corporate profit tax declaration. In El Salvador, although the lessee is accountable for the economic use and duties of the leased asset, the lessor has the benefit of discounting depreciation from tax declarations.
6. **Financial supervision is mandatory in Colombia, Mexico, and Peru.** As factoring companies, leasing companies do not take deposits, leaving no strong arguments for government regulation and supervision. Still, the whole industry could benefit from supervision. In Colombia, since 1989, leasing companies are subject to financial supervision and therefore their operation should comply with the same regulations as banks. In Mexico⁶ and Peru, the general regulation provided recognition and financial control to leasing companies. In Costa Rica and El Salvador, leasing companies are not supervised. However, in Costa Rica leasing companies are indirectly regulated when they are part of a regulated financial group. This is important because in Costa Rica almost all private banks have their own leasing company.⁷

⁵ In most countries, banks do not charge VAT on their services (IFC, 2009), and are therefore not registered for VAT declaration and cannot issue invoices detailing VAT. Since VAT is normally charged on financed assets and in bank leases legal property goes through the FI, banks are unable to reclaim paid VAT and cannot pass it onto the MSMEs as a tax. Therefore, they pass it on as a cost, limiting the ability of the MSMEs to deduct it from the VAT payment, and increasing the total cost of the financed asset. NBFIs, which are governed by a different VAT regime, can issue invoices including VAT due, avoiding this shortcoming.

⁶ León (1989).

⁷ CR3838A-03, Board Approval Document (2012).

Annex Table 2. Summary of the main regulatory features affecting leasing in IDBG's factoring country clients

Country	Leasing-specific regulation	Corporate profit tax	VAT	Depreciation	Supervision and publication of financial statements
Colombia	Yes. In Colombia, leasing was recognized as a financial activity in 1988 (Decree 1997) and regulated in detail in 1993 (Decreets 913 and 914, specifying key aspects of the leasing contract). Also, Decree 836 of 1991 implies that leasing is a different operation from credits, credit sales, and leases.	Yes. A 2006 law (paragraph 3 of Law 1111 of 2006, adding article 127 -1 to Estatuto Tributario) allowed MSMEs (as defined per Law 905 of 2004) to use financial leasing with the treatment and benefits of operating leasing, implying keeping assets off the balance sheet and deducting 100% of the installments from income tax declarations. This benefit for MSMEs ended in 2012.	Yes. Since 1992 (Law 6 of 1992 and Decree 1250 of 1992) lessees were authorized to discount the paid VAT from the income tax declaration, while VAT for financial leasing installments was eliminated.	Yes. Regulation allowed depreciating leased goods during the execution of the contract (Decree 2913 of 1991).	Yes. Under Law 74 of 1989, finance leasing companies are subject to the Superintendencia Bancaria and therefore their operation should comply with the same regulations as banks. Furthermore, Law 35 grants leasing companies the title of credit institutions, under the figure of commercial finance companies.
Costa Rica	No. The Civil Code has provisions allowing leasing operations (Código Civil Libro IV, Título V. "Del Arrendamiento de Cosas", articles 1124 a 1155, Capítulo III, articles 1161 and subsequent regarding leases of mobile assets). In 1996, bill 12762, "Ley reguladora de los contratos de leasing," was presented for due legislative approval process, but was not approved.	No particular treatment of corporate profit tax	No particular treatment of VAT	Yes. Depreciation rights were conceded to the lessee, which can discount depreciation in the corporate profit tax declaration (Decree 32433-H of 2005).	No. Not regulated specifically by Superintendencia General de Entidades Financieras or the Consejo Nacional de Supervisión del Sistema Financiero, except when they are part of a regulated financial group, in which case they are indirectly regulated.
El Salvador	Yes. The Government of El Salvador issued Decree 884 of 2002 to specifically regulate leasing operations.	Yes. Decree 884 of 2002 (article 14) established that all the taxes derived from the economic use of the leased assets were due by the lessee. Still, the lessee can deduct the full lease installment from the corporate profit tax declaration.	Yes. Lessors must pay the VAT when purchasing assets to be leased and transfer the tax amount in the Installments charge to the lessee. Those VAT shares can be computed in VAT declarations (Decree Law NP 825 of 1974).	Yes. Although the lessee is accountable for the economic use and duties of the leased asset, the lessor has the benefit of discounting depreciation from its tax declarations (Decree 884 of 2002, article 15).	No. Not regulated specifically by Superintendencia del Sistema Financiero.
Mexico	Yes. Ley General de Títulos y Operaciones de Crédito - Capítulo VI (1984), updated with a leasing chapter through the Decree of July 18, 2006.	Yes. The lessee is considered the leased asset owner for fiscal matters, and hence is entitled to deduct the full installments from the corporate tax declarations.	No particular treatment of VAT	Yes. The lessee is entitled to deduct depreciation from its tax declarations.	Yes. Supervised by the Comisión Nacional Bancaria y de Valores.

Country	Leasing-specific regulation	Corporate profit tax	VAT	Depreciation	Supervision and publication of financial statements
Peru	<p>Yes. Leasing operations are defined and regulated (Legislative Decree 299 of 1984). Law 27394 modifies article 18 of Decree 299. Legislative Decree 915 of 2001 specifies the area of application of Law 27394.</p>	<p>Yes. For taxation purposes, leased assets are considered the lessee's assets and must be included on its balance sheet (Decree Law 299, article 18). Lease installments are considered as income for the lessor and a deductible expense for the lessee (article 19).</p>	<p>Yes. Leased goods are not charged with VAT when leased assets are not used for activities charged with VAT (Decree Law 299, article 17).</p>	<p>Yes. The lessee is entitled to discount depreciation from its tax declarations (Decree Law 299, article 19)</p>	<p>Yes. Regulated under the authority and control of the Superintendencia de Bancas y Seguros (SBS)</p>

Source: OVE, based on information from leasing associations, FI interviews, and the ALTA report.

ANNEX IV. LAC LEASING AND FACTORING MARKETS

1. **MSME factoring in LAC is dominated by NBFIs, while leasing is dominated by banks.** According to a survey conducted by the IDBG and the Latin American Federation of Banks in 2012, among 106 banks in 20 LAC countries, 50% offer an invoice factoring product and 44% a factoring product through a different underlying asset. More than two-thirds of the large banks offer this service, while less than half of small and medium-size banks offer it. However, only 3% of the banks actually offer this service to micro and small enterprises. Except in Brazil, banks rarely operate in this market. Furthermore, factoring banks are not focused on MSMEs. For leasing, 50% of the banks offer a leasing product, and 6% of those not currently providing this service planned to provide it. The Multilatinas (Itau, Bancolombia, Grupo Aval) are still leading the leasing market, thanks to the growth of the main financial groups, while European groups (BBVA, HSBC) have had mixed results.
2. **Chile and Costa Rica are the most important factoring markets in LAC.** According to Factor Chain International statistics,¹ Chile is the LAC country with the most important factoring market in terms of local GDP (10%), followed by Costa Rica (5%), while El Salvador and Nicaragua are at the lowest level, with Uruguay and Bolivia (less than 1%). Still, Chile is only the third (\$24b) and Costa Rica (\$2b) the sixth largest markets in the region. Brazil has the highest turnover (\$32b) followed by Mexico (\$25b). The other markets with an important size are Colombia (\$9b) and Peru (\$8b)² (Annex Figure 1).
3. **Colombia and Peru are the countries with the greatest leasing penetration.** According to statistics gathered by the Alta Group³, in absolute terms Brazil is the leading leasing market in South America (\$20b), followed by Colombia (\$15b), Mexico (\$12b), Peru (\$9b), Chile (\$6b), and Argentina (\$2b). Although in Central America statistics are not consolidated, it is known that Costa Rica is one of the leaders of the subregion.⁴ With respect to GDP, Peru and Colombia have a penetration of about 4%, while for Brazil and Mexico this industry represents only about 1%. Chile, the fifth largest country, with a penetration of 2%, is followed both in absolute and relative terms by Argentina, Venezuela, Ecuador, and Bolivia (Annex Figure 2).

¹ The Factor Chain International report is a partial compilation of factoring statistics; its use in this document is for reference purposes and is not intended to give a complete view of the factoring market in LAC.

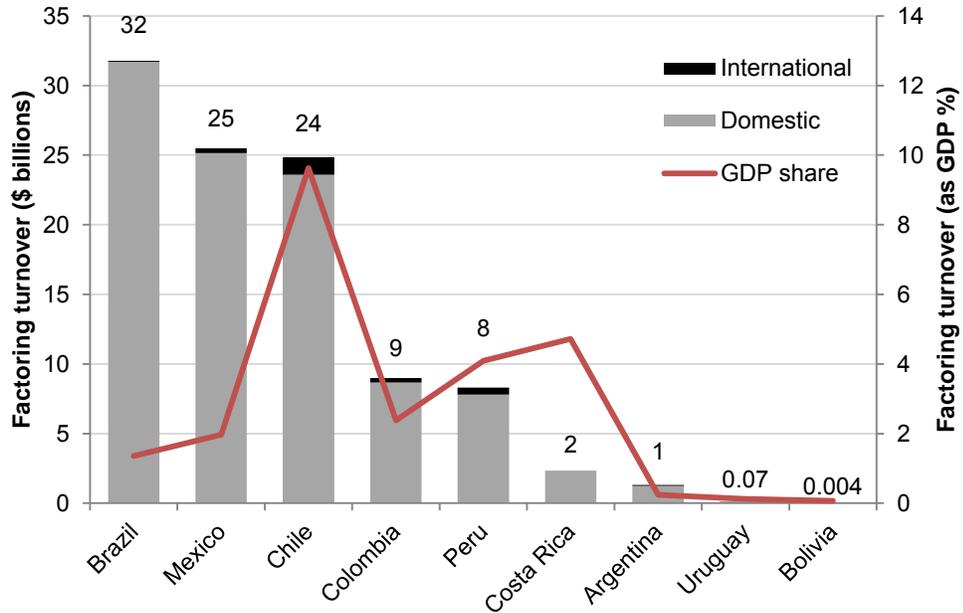
² According to FI interviews in Chile, Peru has become an attractive market for factoring, and factoring FIs from Chile have started to invest in this country.

³ The Alta Group report is a partial compilation of leasing statistics; its use in this document is for reference purposes and is not intended to give a complete view of the leasing market in LAC.

⁴ The Alta Report 2015.

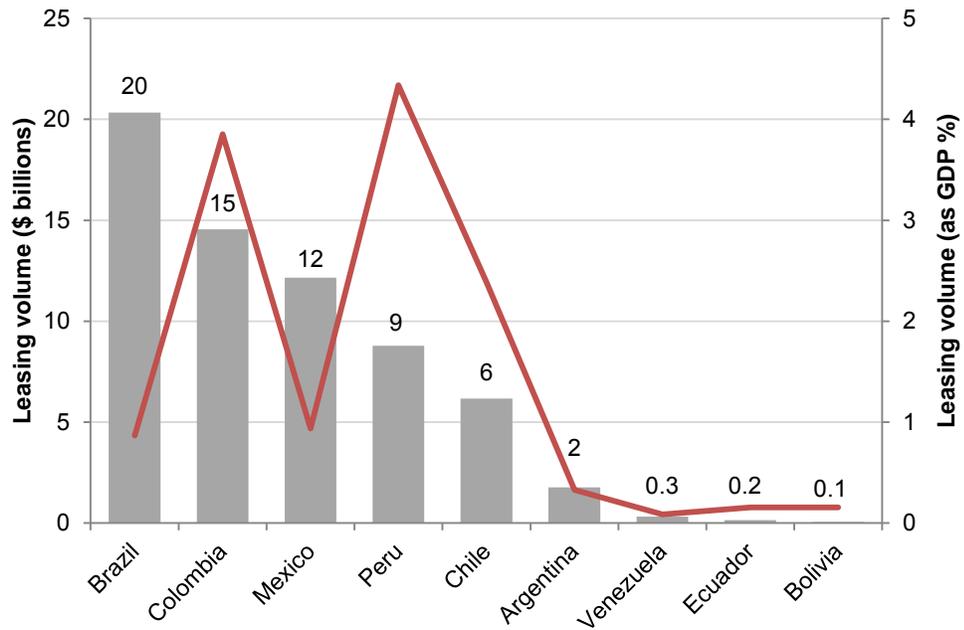


Annex Figure 1. While Brazil has the highest absolute factoring turnover, Chile has the most important factoring turnover in GDP terms



Source: OVE, based on Factor Chain International information.

Annex Figure 2. While Brazil is the leading leasing market in LAC, Colombia and Peru are more important in terms of leasing volumes as a share of GDP



Source: OVE, based on statistics compiled by the Alta Group.

