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STATE POLICY ON LEASING OPERATIONS

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INTRODUCTION

As known, leasing is a system of relations encompassing the elements of a bank loan, lease and investment. Leasing is a long-term (in most cases) financial agreement between the lessor (owner of a leasing) and the lessee (user of a leasing). According to a lease agreement, the lessor must acquire the ownership of property from the seller for a temporary utilization and ownership of a lessee.¹ Leasing is a form of special entrepreneurial activity of a utilization of industrial equipment, machines, new technologies, buildings and structures.

In other words, leasing is a kind of service involving a purchase of a property for the purpose of leasing it for a certain period, following the order of a consumer. Leasing has become one of the ways to invest in economy in most of the developed countries. That is to say, 25-30% of investment in developed countries are realized through leasing, as around 80% of final products are produced with rented equipment. Combining a system of relations encompassing the elements of a bank loan, lease and investment, leasing is one of the main financial tools that supports entrepreneurship development. Leasing is extensively used in a renewal of fixed assets in developed countries as a long-term financing mechanism.

The opportunity of renewal of fixed assets during short period with less costs by small and medium entrepreneurs is a key advantage of leasing. The support of industrial development and revitalization of performance of industrial enterprises through leasing is extensively implemented in Russia, Turkey and the members of European Union. Based on recent experience, the leasing method has been

¹Azerbaijan Leasing Companies Association, <http://azerbaijanleasing.com/>

the main external financing source of nearly half of small and medium sized enterprises operating in European Union.

Agricultural equipment, medical equipment, construction equipment, industrial equipment, passenger, cargo and other transport vehicles, commercial equipment and other movable and immovable property can act as a subject of a leasing.

1. LEASING IN AZERBAIJAN

The history and development of leasing in our country can be divided into two phases. The first law on leasing in Azerbaijan was adopted in 1994 (this was the first law on leasing among CIS countries). However, the development of leasing commenced in 2003 in Azerbaijan. During the period 2003-2008, the portfolio of leasing companies demonstrated at least twofold increase annually. The growth in leasing market in Azerbaijan slowed in 2008, due to the repeal of certain privileges previously granted to the sector. While in 2008, the amount of portfolio of leasing market reached 200 million USD, it fell by at least 20% in 2010-2011.²

Currently, leasing relations in Azerbaijan are regulated via Civil Code (chapter 38, article 747-751) and Tax Code (article 123.1 and article 140)³ of the Republic of Azerbaijan. The Law on leasing (adopted in 1994) has been canceled after enlarging the abovementioned article of Civil Code. The existing legislation does not cover articles on other types of leasing - operating leasing and re-leasing.

Article 123.1 of the Tax Code refers to taxes deducted from the payment source of legal entities engaged in financial leasing. Article 140

¹Azerbaijan Leasing Companies Association, <http://azerbaijanleasing.com/>

²Taxes Newspaper. <http://vergiler.az/art-view/67/>

³<http://www.taxes.gov.az/modul.php?name=qanun&cat=3>

of this Code is about financial leasing. This article provides a regulatory basis for rights of lessor and lessee, interest rates to be paid and specifies when property leasing is considered a financial leasing. Additionally, the notion of leasing is also indicated in the article 164.1.25 of the Code, which states that, fixed assets that are objects of lease agreement are exempt from import duty.

The Civil Code of the Republic of Azerbaijan includes regulations on lease agreement, its subjects and objects. According to the Civil Code, there are two forms of leasing - internal or external. At the same time, subleasing is also regulated by this Code, and requires written consent of a lessor. Based on the Civil Code, the legal form of leasing operations is either a lease agreement signed between a lessor and lessee together with a sales and purchase agreement signed between a lessor and seller, or tripartite agreement among them in line with the article 747-5.2 and other articles related to leasing. In addition, this Code also includes regulations on rights and duties of parties of a lease agreement, the ownership relations in leasing, leasing payments, the accounting of a leasing.

Leasing market is relatively underdeveloped in Azerbaijan compared to banking and insurance sectors. The analysis of leasing market and the meetings held with the participants of leasing market show that, the lack of financial resources is considered one of the main challenges in this sector. Leasing organizations, which have comparatively better financial situation, are subsidiaries of banks. The scope of operations of leasing companies, their small portfolios and low capitalization level are not attractive for foreign investors. Even, the number of leasing companies getting financial resources from their founder banks is insignificant. Consequently, the financing of leasing companies becomes expensive and they cannot offer competitive conditions for their customers - lessees. That is to say, currently the average interest rate in leasing market is higher than 18%, depending on the product. Because of this indicator, leasing sector

loses customers to the banking sector. The lessor passes the leased equipment to the lessee with a margin of 3-5%, depending on the kind, the cost, and the possibility of resale of an equipment. Due to interest rates of bank loans (12-22%) and other conditions, leasing companies cannot compete with banks.

The sustainable economic growth and industrial development in Azerbaijan create huge potential for expansion of leasing market. Currently, there are 20 companies specialized in leasing operations or presenting their products for leasing.

Leasing businesses operate as a special sphere of entrepreneurial activities. If the utilization of leasing expands, it may act as a strong impulse for manufacturing production, reorganization of Azerbaijani economy and filling the market with high-quality products. The effectiveness of lease agreements is manifested through an intensified investment process, better financial position of lessee company, increased competitiveness of small and medium enterprises.

Azerbaijan Leasing Companies Association (ALCA) was established in 2005 within the framework of the Project on Development of Leasing in Azerbaijan by International Financial Corporation (IFC). There are 11 leasing companies under the ALCA. The Association actively worked until 2008. After 2008, there was stagnation in the operations of the Association similar to the overall leasing sector in the country. The website of the Association is not updated and some of the pages are not served.

Following the decision by the Central Bank in 2013, the provision of credits by commercial banks outside the area of a bank is prohibited. This decision created opportunities for leasing companies then. The absence of an authority controlling the operations of leasing companies, the repeal of the respective law in 2003, that is to say, gaps in the existing regulation, no license requirement in establishing a leasing company and the simplicity of process increased inter-

est of many entrepreneurs in leasing. At the same time, the development of construction, healthcare and other sectors in the country led to improved leasing products.

Since 2013, a number of household appliances stores and automobile dealers applied to leasing companies, even some of them established their own leasing companies. Based on some sources, during those years the number of leasing companies rose rapidly by several times. In 2014, a warning in a written letter format was sent to companies engaged in consumer leasing by the Ministry of Taxes stating “Individuals who want to obtain a car through leasing firstly must open TIN and submit a declaration of income”. Although this letter was an advisory basis lacking legal basis, this warning had a serious impact on the operations of companies engaged in consumer leasing and consequently, leasing process in automobile dealers discontinued.

The February and December devaluations of 2015 led to a complete suspension of operations of many leasing companies. Currently, the leasing companies operating in the market are engaged in collection of leasing payments and do not conduct active leasing operations.

2. MAIN LEASING COMPANIES OPERATING IN AZERBAIJAN

The state-funded “Agroleasing” OJSC has the leading position in the leasing market of Azerbaijan. “Agroleasing” OJSC is principally engaged in leasing of agricultural equipment and the volume of its leasing operations in 2015 amounted to 57,6 mln. AZN. Due to the lack of official data collection on other leasing companies, there is no adequate data. Based on the research in this area, the volume of leasing transactions in the country was approximately equal to 200 mln. AZN in 2015. The share of total leasing operations in GDP constituted less than 0.5% during the reporting period. It should be noted that, this indicator varies between 2-6% in developed industrialized countries. Considering the share of leasing transactions in GDP in developed countries, it can be concluded that, leasing market in Azerbaijan can potentially expand by 3-4 times.

During the preparation of this paper, the economic developments in the country had also affected leasing companies, as a result, several leasing companies discontinued or minimized their operations. According to the data available for the end of 2016 and the beginning of 2017, almost none of leasing companies applied could lease equipment valued at 30 thousand AZN. The lack of financial resources is stated as a main underlying reason.

“AGROLEASING” OPEN JOINT-STOCK COMPANY

“Agroleasing” Open Joint-Stock Company was established based on the order of the President of the Republic of Azerbaijan dated October 23, 2004. Since 100% of its shares were owned by the state, the Company was controlled by the Ministry of Economic Development. Based on the order by the President dated July 21, 2009, ownership of “Agroleasing” Open Joint-Stock Company was transferred to the Ministry of Agriculture.

Based on the article 1.4 of a regulation on regional markets of “Agroleasing” Open Joint-Stock Company dated November 22, 2005, “Agroservice” networks were established under these 9 supply bases.

On June 8, 2006, self-financed Agroservice branches of “Agroleasing” Open Joint-Stock Company started their operations in 61 districts of the Republic of Azerbaijan following the decision (No 331) of the Ministry of Economic Development. Besides, there was a significant role of Baku Central Supply base of the Joint Stock Company, and inter-regional supply bases based in Ganja, Shirvan, Ucar, and Khachmaz in extending the scope of operations in agroservice rendered to natural and legal persons engaged in agricultural production. Currently, the same bases conduct the arrangement, acquisition, pre-sale preparation and sale of combines, tractors, excavators and other agricultural equipment brought to the Republic by “Agroleasing” OJSC. Fertilizer logistics bases were founded in 2008 in Shaki and Sabirabad, in 2009 in Shamkir and Khachmaz and in 2010 in Jalilabad and Barda.

The main objective of the establishment of “Agroleasing” OJSC is to overcome the shortage of agricultural equipment in the country and to provide these equipment to the farmers with special conditions. The following Presidential orders in 2007, 2008 and 2009 expanded the scope of its functions.

According to the rules approved with a decision of the Cabinet of Ministries, “Agroleasing” OJSC should lease the techniques and equipment purchased at the expense of a state budget to natural and legal persons. Based on the conditions, a lump-sum payment of 20% of the total cost of the product should be paid, while the remainder should be repaid in 10 years (depending on the cost). The Company

should also purchase fertilizers, breeding cattle and productive seed varieties and sell them to farmers at discounted prices.⁴

ANSAR LEASING

“Azerbaijan Leasing Company” Ltd was founded by the Islamic Corporation for the Development of the Private Sector and officially registered in December 12, 2008. The trademark of company is “ANSAR LEASING” and the volume of its regulatory capital constitute 5 million AZN. The enterprise is mainly engaged in financial leasing services. Being guided by Shariat rules, the company intends to achieve a key position in leasing market of Azerbaijan. Operating under Shariat rules enables to protect the rights of customers and win their sympathy.

The mission of the company:

- To meet the needs of customers for leasing products through financial leasing operations based on modern technology and world-class systems and procedures.

The vision of the company:

- To be the leading sharia compliant leasing provider in Azerbaijan through hard work of professional staff and innovation. To win the sympathy of leasing purchasers.⁵

“MCB Leasing” CJSC

“MCB Leasing” Closed Joint Stock Company was established as closed joint stock company in October, 2009. The company has substantial share capital, major part of shares is owned by “MCB Bank Limited” based in Islamic Republic of Pakistan, other part belongs

⁴<http://agrolizing.gov.az/az/menu/199>

⁵<http://www.ansar.az/az/about-us/>

to the natural person who is a resident of the Republic of Azerbaijan. “MCB Bank Limited” is included under the group of companies called “Nishat Group”. The companies included under this group operate in textile, cement production, insurance, financial services, electric power generation, paper production and other sectors.

The Company’s achievements within the short period have attracted interest of the shareholder and share capital was increased to 1.7 million AZN in October 2012. The main objective of the Company is to offer wide range of financial leasing products to small and medium enterprises (SME) operating in profitable and competitive sectors of Azerbaijani economy.

“MCB Leasing” CJSC offers leasing products mainly for businesses. “MCB Leasing” CJSC offers lease of all kinds of vehicles, construction machinery, equipment and real estate to SMEs as well as corporate customers to meet their business requirements.⁶

“Qafqaz Leasing” OJSC

“Qafqaz Leasing” OJSC is a leasing company established in October 30, 2007. The Company presents leasing services for developing different fields of economy. The main customers of the Company include small and medium-sized entrepreneurs, as well as low-income people group, therefore its products have been adapted for this group.⁷

⁶<http://www.mcbleasing.az/index.php/az/irk-t-haqq-nda111>

⁷“Qafqaz Leasing” OJSC. <http://www.qafqazleasing.com/>

3. INTERNATIONAL EXPERIENCE

Short history of leasing

There is no unanimous agreement among historians regarding the period of creation of leasing. According to one point of view, leasing, as a financial instrument, was first used in Babylon and Ancient Egypt around 2000 BC. The oldest leasing document is dated back to 550 BC, to Roman Empire.

According to historians, the next oldest written source on the issue is from 1066. King William leased ships from Norman ship-owners to use in the conquest of Britain. Yet another official lease agreement took place around 1248, for weapons and equipment to be used in Crusades.

Two companies, British Railway Wagons and Bell telephone company from USA, claim the first ever application of official rent or lease agreement.

The current use of the term originates in United States of America. Henry Shofeld, who established the first leasing company in railroad sector in 1952, is considered the founder of American financial leasing. After he realized the advantages and potential of leasing operations, he continued his activities in this area and established the famous “United States Leasing Corp” (currently “United States Leasing International Inc.”). Leasing in Europe began to develop at the end of 1950s and the beginning of 1960s.

Leasing worldwide

Currently the share of leasing in investment in developed industrial countries is 30%, while the share of leasing operations in GDP is in the 2-6% range. Main portion of the global leasing market is concentrated in “USA-Western Europe-Japan” triangle. Lessees in West-

ern Europe are comprised of specialized leasing companies operating under banks and their subsidiary institutions.⁸

The volume of global leasing market in 2016 was around 1 trillion USD. Annual growth of the market was 6.5%. The dynamic growth of the leasing market is more evident if we take into consideration that global economic growth in the same period was 2.76. North America is ahead of other regions in terms of the volume of leasing market. United States is still the leading country in the market. The volume of leasing market in this country reached 374.3 billion USD.⁹

Leasing operations are an important part of business activities in USA. Rapid growth of leasing companies providing various services, modification of lease agreement conditions have led to development of new leasing methods. Subsequently these leasing companies got the name of finance-lease associations. They assist the producers by leasing their products, by financing their contracts and by risk-sharing.

Leasing services market of USA outperforms markets of both Western and Eastern Europe and post-Soviet countries in term of its volume and level of development. Wide use of leasing in developed countries is explained by favorable economic situation and systemic support to business development. Tax discounts are not applied to leasing activities in most cases, yet leasing is considered more favorable relative to other capital investments since leasing costs are in-

⁸Ministry of Industry and Economy of the Republic of Azerbaijan. The report on facilitation of purchase of equipment by industrial enterprises through leasing agreements. <http://senaye.gov.az/content/html/3580/attachments/D%C3%BCnyada%20avadanl%C4%B1q%20v%C9%99%20texnikan%C4%B1n%20lizin%C9%99%20il%C4%B1nmas%C4%B1%20haqq%C4%B1nda.pdf>

⁹<http://www.whiteclarkgroup.com/videos/global-leasing-report-2017-summary>

cluded in the operating costs of the final product. Development of leasing a country is stipulated by the following criteria:

- Normative legislative base;
- State regulations;
- Macroeconomic situation, condition of investment market;
- Bank interest rates, tax burden, inflation etc.;
- Adopted financial reporting standards.

There are no special legislative acts regarding lease agreements in some European countries (e.g. United Kingdom, Germany, and Denmark). These countries treat leasing as a part of commercial law. However, France, Portugal, Sweden and several other countries have specific laws relating to leasing, which define rights of lessees and lessors and their relation to leasing object.

Leasing operations constitute a significant part of fixed asset renewal in Europe and especially Germany. There are around 2000 leasing companies in Germany. 150 of these dominate the majority of the market, the remaining part consists of small and medium companies. Two associations represent the companies of this sector. Large companies (with equity exceeding 1 million euros) are in Federal Association of German Leasing Companies (Bundesverband Deutscher Leasing Gesellschaften) and represent 86% of all leasing operations.

Legislation of France, Belgium and Italy is based on the principle of economic ownership, while the legislation of United Kingdom, Ireland, Netherlands and USA is based on legal ownership. There are examples of both principles in legislations of some Western Europeans countries.

The sale of the property at pre-specified price (option) is an important condition upon the end of lease agreement in Belgium, France

and Italy. On the other hand, this is not included in the leasing-sale agreements in United Kingdom, Ireland, Netherlands and USA. Furthermore, in USA leasing is considered a financial instrument like a credit or similar loans.

Meanwhile, lease agreements in Germany and Switzerland include a special option, whereas lessor remains the owner of the property in case of lease agreement, but the ownership is transferred to lessee on the date of the agreement in case of fixed term purchase agreement.

There is no license requirement for leasing operations in the most countries. Despite this, the share of leasing in total investment in developed countries is around 30%.

Leasing is an important tool for investment policy in most countries. Overall, volume of leasing agreements and turnover of leasing operations is one of the indicators of development level of the country.

4. PROBLEMS OF LEASING MARKET IN AZERBAIJAN

Leasing companies in Azerbaijan are established with participation of both domestic banks and foreign capital. Actually, managers prefer foreign capital, since it is both cheaper and have a longer maturity. However, currently leasing companies are facing serious capital problems. On the one hand, the access to domestic capital sources are becoming highly restricted, and, on the other hand, their capitalization levels does not allow them to attract foreign capital.

It should be noted that, Azerbaijan **have not joined Ottawa** Convention on International Financial Leasing. This reduces the interest of foreign investors in the market and creates serious problems in creating necessary trust of foreign investors in leasing operations in Azerbaijan. Countries participating in the Convention recognize the importance of removing certain legal impediments to the international financial leasing of property, while maintaining a fair balance of interests between the different parties of the transaction.

Yet another problem is that, leasing companies, unlike banks and other non-bank credit institutions **have not joined Central Credit Registry** under Financial Market Supervisory Authority. Certainly, this impedes prevention of risks relating to failures to pay by lessees. That is why it is essential to ensure the CCR membership of leasing companies. It is necessary for leasing companies to have an access to information on non-performing loans via CCR, as the ratio of such loans in bank portfolios is on the rise.

Another impediment to the development of leasing market is the absence of **incentives and exemptions**. Since the main sources of financing for leasing companies are banks, these companies cannot provide funding to their customers with better conditions than banks, which, in turn, impedes their development and restricts their ability to attract new customers.

Accelerated depreciation of lease objects is another serious issue. The abolishment of accelerated depreciation that was previously implemented with two coefficients have created a serious impediment to the development of the sector. Accelerated depreciation is an essential factor in asset renewal in leasing sector. That is why, there is a pressing need for a more advanced tax legislation of leasing operations.

Future development of leasing sector demands sound statistical database. Currently, the lack of any statistical data on leasing operations impedes even the most general analysis of the sector.

Another issue is the lack of experts. To eliminate this problem it is essential to improve the preparation of specialized experts in higher education institutions.

5. ADVANTAGES AND DISADVANTAGES OF LEASING

As was discussed above, leasing is long-term renting of movable and non-movable property. This includes vehicles, equipment, buildings etc. Leasing allows the purchase of the property with the remainder of the value. Usually, the value of the lease object at the end of agreement term nears zero, so no extra payment is required for the transfer of ownership. There are number of advantages and disadvantages of leasing for lessor and lessees. Some aspects of leasing that are advantageous for lessee can be a disadvantage for the lessor. We can group these advantages and disadvantages as following:

Advantages of leasing:

- Relative ease of documentation; usually it is much easier and faster to lease a property than to purchase it on loan. Leasing company requirements regarding solvency of customers are a lot looser than that of banks.
- Leasing can be the only option for companies that want to obtain equipment or vehicles, but do not have assets to put as collateral. In addition, leasing can be more cost-effective, allowing entrepreneurs to use resources more efficiently and invest in their companies.
- Parties of lease agreement can agree to schedule leasing payments of the lessee according to specifics of his business. For example, farmers can pay make seasonal payments.
- Lessor can optimize his tax payments by acquiring his assets through leasing. In other words, usually leasing payments are included in operating costs of the company, which decreases the company's profit and, thus, the profit tax. While in case of bank loans, company includes only interest payments in their income statement. Furthermore, lessees are also exempt

from property tax, since the ownership of the property remains with the lessor.

- Termination of lease agreements is a lot easier than termination of loan contracts. Lease agreements can be terminated at any time, like a rent contract. However, it is required to sell the collateral and pay the interest until that to close bank loans.
- The change of lease object is easily carried out. For example, if the leased property do not satisfy the needs of the company, then it can switch it to another property through lease agreement.

Disadvantages of leasing:

- Firstly, we should note that interest on leasing agreements are usually higher than bank loans. We can treat this as the main disadvantage of leasing. However, leasing can be more efficient for the lessee if it optimizes his tax payments.
- Another issue with lease agreements is that entrepreneur does not have the ownership of the property. Usually, entrepreneur refrains from investing in the property since he does not fully own it.
- Requirement of a down payment is considered a disadvantage of the leasing. Although leasing is the rent of the property, lessor usually demand a down payment.
- Another problem is the need for double documentation of property in lease agreements. Usually the lease object is registered as a property of lessor at the onset of the agreement and is transferred to the ownership of the lessee at the end of term.

6. RECOMMENDATIONS FOR THE DEVELOPMENT OF LEASING IN AZERBAIJAN

The growth rate of ongoing technological development in the world has increased the pace of change of technological parks. Consequently, there is an emerging need for a creation of new opportunities to renew technological parks. Therefore, an expansion of technique-equipment park with new and modern equipment in line with the development practice of foreign countries can contribute to increasing industrial production, reducing repair and maintenance costs of outdated equipment, improving financial consequences of an operation, and ultimately lead to higher gross domestic product.

Leasing can be used as a modern and efficient investment instrument in purchasing new techniques and equipment, as well as, in renewal of outdated techniques and equipment. In modern development stage of national economy, a facilitation of conditions for leasing techniques may act as form of state support to industrial sector in the Republic of Azerbaijan.

The issues of an increasing number of leasing companies in Azerbaijan and their specialization are becoming topical. There is a pressing need in this respect considering the importance of non-oil development in country's economy. That is to say, the services of domestic leasing companies can be utilized in various state projects on the development of non-oil sector.

In this regard, vast perspectives are emerging in leasing. Since higher technological equipment of residents of these parks can be formed and later modernized through leasing. Moreover, the sale of products to be produced there could be conducted via leasing. That is why, it is important to take into account the leasing business poten-

tial in development programs, organization and operations of techno and agro parks.

Main recommendations for the development of leasing in Azerbaijan include the followings:

- To adopt a Law of the Republic of Azerbaijan on leasing. Currently, the lack of a single law impedes the creation of favorable situation for the development of leasing in our country.
- To adapt the normative-legal base on leasing to the requirements of new law, to create opportunities for implementation of various forms of leasing.
- To study the expedience of VAT application to leasing payments, to make necessary decision considering leasing is comparatively less attractive than bank loans.
- To apply incentives and exemptions to leasing operations.
- To take necessary steps to join Ottawa Convention on International Financial Leasing.
- To take necessary steps to support the capitalization of leasing companies.
- To apply accelerated amortization methods to leasing operations.
- To establish and develop a statistical accounting system of leasing operations.
- To make necessary decisions so that leasing companies can join Centralized Credit Registry (CCR).
- To implement necessary measures in higher education institutions for training skilled personnel on leasing operations.

Note

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