

MARKET INQUIRY INTO THE SME LEASING SECTOR IN KENYA

Competition Authority of Kenya

10 April 2019

Note: Detailed information requests were sent to market participants. These were essential for the Inquiry to establish a complete and accurate picture of Kenya's leasing market given the significant lack of quantitative data about leasing in Kenya. However, the responses were often incomplete and inconsistently presented despite follow-up requests being made. This means that the Inquiry report has had to rely on indications and estimates which were made by market participants in interviews and submissions. Although requested, interviews of only a small number of leasing customers were possible, which limits the information on demand-side issues. The substantive findings and recommendations of the Inquiry are principally drawn from interviews with market participants and review of the relevant legislation and are generally unlikely to be affected by the quantitative data. Certain information submitted confidentially has been redacted from this report and is indicated <CONFIDENTIAL>.

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Acronyms

CAK	Competition Authority of Kenya
CBK	Central Bank of Kenya
KRA	Kenya Revenue Authority
LAK	Leasing Association of Kenya

MSME Micro-, Small- and Medium-sized Enterprise

SME Small- and Medium-sized Enterprise

VAT Value Added Tax

Summary

This report is carried out on behalf of the Competition Authority of Kenya under its inquiry into the leasing market announced by Notice No. 2546 in Vol.CXX-No.35 of the Official Gazette of 16 March 2018. The law firm Macmillan Keck Attorneys & Solicitors was engaged to advise and assist the CAK in conducting the Inquiry and, together with economics firm Acacia Economics, have produced this report.

The opportunity of SME leasing

This report focuses on barriers to the expansion of leasing for SMEs and possible distortions of competition in this market. Leasing offers a useful alternative to purchasing an asset, particularly for small businesses. Leasing avoids the cash outlay of a purchase, preserving cash for other uses which may generate a higher rate of return. Leasing avoids the lessee incurring a loan from a bank and so overcoming the barrier of lack of credit history and the burden of debt on a balance sheet. Furthermore, the leased asset itself may be used as strong collateral where there are weak creditors' rights.

Leasing reduces risk, filling an important gap in the market, having the ability to provide medium-term equipment financing to a wide range of businesses, some of which may not have had access to such financing from another source. Leasing also provides an opportunity for informal businesses to make use of formal mechanisms for asset finance and develop a record of financial transactions which can enable them to use other financial products in future. This aids the development of the financial sector more generally, with all the associated knock-on benefits.

Kenya's leasing market

Kenya's leasing market is dominated on the demand-side by Government and large corporate customers. It has a variety of leasing companies, some independent leasing companies, some affiliated with particular suppliers of goods, and some banks (or owned by banks). It also largely comprised of vehicle leasing. There is very little leasing to SMEs or of assets other than vehicles. This is a central concern of the Inquiry as the rationale for leasing is to lower risk in order to provide for the financing of assets for businesses such as SMEs to which credit is typically rationed.

The markets for each of the different types of asset-based finance are relatively concentrated. While this could give rise to competition concerns, the problem of the SME leasing market appears to be less a matter of market dominance or collusion among participants with market power and more a lack of commercial incentive for banks and lessors to invest in and develop the SME leasing market. In particular, the incentive to collude is to charge higher prices for goods and services to customers who *are* being served, through agreeing not to compete. While there may be private coordinated arrangements which have not been uncovered by the Inquiry, these would affect the pricing of finance to the existing customers (Government and large corporate customers) and is not a reason for the lack of leasing finance for SMEs. In any event, the Inquiry did not identify signals of collusion, other than noting that the industry is relatively concentrated and operates in a relatively tight knit business community.

The challenge of SME leasing

SME leasing presents high transactions costs and so low marginal returns. Large corporate or government customers may agree to lease numerous assets at a time under a single framework contract, but SMEs are more likely to lease one asset at a time. Large customers present huge efficiencies of scale and/or scope for leasing companies, saving customer relations, legal and other costs. They have or can get the expertise to understand asset management. However, SMEs do not present economies of scale or scope. They lack understanding of leasing and so require the legal, fiscal and accounting treatment of leasing to be explained to them one-by-one. The resulting high transaction costs presented by SMEs undermines the attractiveness of the market.

At the same time, SME leasing has historically been viewed as risky due to lack of credit history information and uncertainty over lessor rights in case of default. Some of these risks have been addressed in recent legislation (the Moveable Property Security Rights Act) which improves management of credit risk, as well as credit reporting practices and rules that improve credit assessment. However, other major problems remain unaddressed in the legal and regulatory framework, as well as fiscal and accounting treatment. As SME leasing already presents a challenging business model, these other factors represent a major impediment.

Impediments to development of Kenya's SME leasing market

The report identifies four problem areas:

- **financial risk**, in particular, the inability to price financing (by banks) for leases against risk due to the interest rate cap (see section 5);
- **fiscal and accounting disincentives**, in particular, the unavailability of VAT exemptions for leasing of assets where the purchase of such assets would be VAT-exempt (see section 6);
- **information weaknesses**, in particular, the lack of market data and understanding among SMEs of a complex product and the fiscal and regulatory environment (see section 7); and
- **legal and regulatory framework problems**, where barriers to growth of SME leasing are found in uncertainties, inconsistencies and gaps in the various laws (see section 8).

Recommendations

To establish medium- to long-term legal certainty in the leasing sector, we recommend making numerous changes to existing laws, which could be done in a new Leasing Act that establishes a clear framework for leasing, clarifies various terms and their legal effects, harmonising these with terms used in the VAT Act and Income Tax Act, and clarifies how the Moveable Property Security Rights Act and Consumer Protection Act apply to leases.

Such an Act could also ensure lessors are protected from third party claims in finance leases, that lessors are treated as beneficiaries in supply agreements, protect lessors from removal of moveable collateral from Kenya, and related improvements. These matters could be addressed in a new leasing law that collects basic provisions relating to leasing and, together with the Moveable Property Security Rights Act in particular, sets out a coherent framework for how leasing works.

It would be vital that a new Leasing Act results in clear treatment of the various types of asset-based finance (rather than sowing confusion by only addressing operating and finance leases) and fits appropriately with rights and processes established in the Moveable Property Security Rights Act in particular.

We also recommend establishing obligations in law requiring leasing companies (including banks engaging in leasing) to report their leasing activities in a standardised manner to enable effective analysis and monitoring of the market on an ongoing basis, whether to the CBK, Treasury or in due course a new Financial Markets Conduct Authority. We also recommend that the Government (whether through CBK or Treasury) solicit support from a body such as International Finance Corporation or a consultant to assist LAK to develop leasing template documents, but that there be no attempt to impose standardised documentation on the sector.

We also have the following recommendations:

Financial risk

- When considering the ongoing regulation of interest rates, take into account the adverse impact on the leasing market of the current policy.
- Clarify asset repossession provisions of the Consumer Protection Act, Auctioneer Act and Moveable Property Rights Act.

Fiscal and accounting

- Revise the application of VAT so that it does not apply to lease payments for assets which, if purchased, would not be subject to VAT.
- Engage with the Leasing Association of Kenya (LAK) and accounting profession to bring about a consensus view of the impact of new accounting standards for operating leases, IFRS 16 and IFRS for SMEs.
- Clarify the application of VAT to finance lease payments and the definitions relating to leasing and VAT.
- Review the impact of VAT withholding by KRA-registered parties.
- Making available to leasing the fiscal benefits under the Income Tax Act available to purchasing, such as accelerated depreciation on heavy machinery, review certain aspects of the Income Tax (Leasing) Rules, and permit accelerated depreciation on assets, particularly where this is applied to purchases.

Information weaknesses and market stimulation

- Collect and publish data on demand for equipment and leasing with a view to demonstrating the market opportunity for the leasing sector.
- Engage in outreach to SMEs in order to explain the workings and benefits of leasing. This would include preparing a clear and concise guide to legal, accounting and tax issues, and could be accompanied by workshops.
- Engage in a targeted, coordinated SME leasing stimulus initiative, including an information campaign to a particular SME market segment, for example agricultural equipment, aligning SMEs with lessors, supported by development finance, subsidies, fiscal exemptions and guarantees.

Legal and regulatory framework

- Revise the existing Hire Purchase Act to remove its application to sole traders and leasing transactions useful for SMEs.
- Introduce new legislation as described in first part of this *Recommendations* section.

1 Introduction

1.1 Background

This report is carried out on behalf of the Competition Authority of Kenya (CAK) under its inquiry (we will call it the ‘Inquiry’) into the leasing market announced by Notice No. 2546 in Vol.CXX-No.35 of the Official Gazette of 16 March 2018. The law firm Macmillan Keck Attorneys & Solicitors was engaged to advise and assist the CAK in conducting the Inquiry and, together with economics firm Acacia Economics, have produced this report.

1.2 Nature of the CAK’s authority

The CAK’s authority to conduct a market inquiry is derived from the Competition Act. The CAK is mandated to carry out inquiries into matters relating to competition and protection of consumers, study the effects of government policies and legislation and regulatory authorities on competition and consumer welfare, and investigate impediments to competition. A market inquiry under the Competition Act is not an ‘investigation’ by the CAK.

1.3 Approach

This report assesses the legal and regulatory environment of the Kenyan leasing sector with a view to identifying barriers to entry and growth and other distortions of competition, taking into account certain legal, regulatory, accounting and taxation issues raised. It focuses on leasing of equipment (e.g., motor vehicles, medical and agricultural equipment) to small and medium sized enterprises (SMEs), and for these purposes we have included sole traders. However, growth in the leasing market to SMEs will likely be part of the growth of the larger market, and so we have not restricted our recommendations to the SME leasing market.

This report does not review every aspect of the Kenyan legal and regulatory environment for leasing, or its accounting and tax treatment. Nor does it propose comprehensive improvements to the legal and regulatory regime, or accounting and tax treatment, that such a review might generate. This report, rather, focuses on barriers to the expansion of leasing for SMEs and possible distortions of competition in this market. It is primarily concerned with what will lead to development of a vibrant, competitive leasing market for SMEs rather than hinder it. Improvements to the legal and regulatory regime that are not expected to have a significant impact on competition and growth generally, or for SMEs, are thus given less detailed attention.

There is a strong rationale for the focus on SMEs. Information is intrinsic to the extension of finance. Market failures arising from imperfect information may undermine a lender’s ability to assess risk, resulting in companies with good investment plans not being granted the credit they require. Typically, information about SMEs is more imperfect than on larger and well-established companies. This means that SMEs are more likely to face rationing of credit. Instead of reflecting what may be higher risk lending in higher interest rates, the lender may not be able to make an assessment and so may simply refuse credit. Under imperfect information, higher interest rates may simply select out less risky borrowers, leaving higher risk borrowers with potentially higher returns (adverse selection) and persuade existing borrowers to take more risks to earn higher returns but also with a great likelihood of failure and default (moral hazard).

Leasing presents an opportunity to reduce the risk to a lender because the lender is better able to repossess the asset in case of a default. Leasing thus has the potential to unlock finance for investment in vehicles, plant and equipment by companies, and especially SMEs. It does, however, depend on lenders still being able to exercise discretion in setting interest rates and other charges to tailor products to specific market niches, their financial flows and risk profiles.

This report discusses provisions that might be incorporated or better reflected in the Kenyan legal and regulatory environment, and ways in which the markets could be improved. It is primarily focused on supply-side insights due to a lack of available information on the demand side.

1.4 Sources and limits of information

The Inquiry gathered information from a range of sources, including a review of existing literature, studies and legislation and interviews with leasing companies, banks active in the leasing sector, leasing customers, the Leasing Association of Kenya (LAK), and the Treasury.¹

Information requests were sent to banks, leasing companies, equipment manufacturers and customers in June 2018. Responses were received in July from leasing companies Alios, Rivieres, Zohari, Ryce and Simba; banks CBA and Cooperative Bank; and, customer EABL. The responses were not sufficiently detailed in terms of the data provided which was generally not disaggregated. In addition, answers to the qualitative questions were sometimes unclear. Therefore, follow-up information requests were sent in early September to the companies which had responded and an excel template was developed in order to clarify the data sought. Subsequently, responses were received from Equity Bank, Kenya Commercial Bank, Barclays Bank, NIC Bank, Diamond Trust Bank, Isuzu, General Electric Health, Vaell, Rentco and RentWorks. An additional submission in response to the follow-up information request was received from Alios, and data spreadsheets were received from Isuzu, Alios, DTB, KCB, Vaell, E-Lease and Ryce. No responses were received from Star Rental, Achellis, Tsusho and Chase Bank, and the Rentworks response did not provide any data.

Data on the leasing industry in Kenya is not readily available, even at the level of the total volume and value of lease transactions. The information request aimed to collect data from leasing providers on volumes and values of leases split out by type of lease, type of client (corporate, SME or individual) and type of asset (new vehicles, used vehicles, construction equipment, agricultural equipment and other) for the past five years. Detailed data on interest rates, other fees, source and cost of funding and lease duration was also requested.

Table 1 provides an overview of the data received. The data returned was incomplete in a number of respects, despite follow-up information requests. Several firms did not break down the lease volumes and values by type of client and/or type of asset. In addition, some firms did not provide data for some years, particularly the earlier years in the period. A small number of firms did not provide any data. This presented a challenge in drawing accurate inferences from the data and meant that some data had to be excluded from the analysis of certain issues, particularly where changes over time were tracked. We have indicated in the report where we have had to exclude data for a particular company and what impact this may have had on the overall analysis given the size and importance of the company and the segment(s) in which they operate.

Table 1: overview of data on leases

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In addition to missing data, in some cases significant anomalies were noted between the data submitted and estimates which had been provided in the earlier interviews. This cast some doubt on the accuracy of the data submitted. We have drawn attention to these where relevant in the analysis below but we have been unable to reconcile them in some cases.

Finally, in some instances the data provided was unclear, for example in terms of the unit of measurement of the values provided, and we have had to make assumptions based on the most plausible interpretation of the data. Again, we have noted these instances where they impact on the analysis.

¹ The Inquiry team met with representatives of ‘captive’ leasing companies (Tsusho Capital and Simba Leasing), Achellis Limited, NIC Bank, Vehicle and Equipment Leasing (VAELL), Ryce Motors, Diamond Trust Bank, Kenya Commercial Bank, Rentworks EA Ltd., Rentco EA Ltd., Office of Attorney General, Rivieres Finance Ltd, Unilever EA Ltd., Bollere Africa Logistics, East Africa Breweries Limited, Leasing Association of Kenya and consultant Edna Kihara.

However, a substantial number of providers did provide their views on measures that should be introduced to encourage growth in the leasing sector, although not in any detail. Their views are shown in

Table 2. The various suggestions are analysed throughout this report.

Table 2: Respondents' view on measures for growth in the leasing industry

Company	Regulatory challenges, uncertainties and improvements	View on measures for growth
<i>Pure leasing companies</i>		
<<CONFIDENTIAL>>	Lack of regulations Can be difficult to set residual value for specialised equipment Leases fall under Companies Act which is not as comprehensive as the HP Act	Formalisation of the industry Consumer education Tax incentives Tax guidelines
<<CONFIDENTIAL>>	Current regime is adequate	Concern that IFRS 16 will kill operating lease product
<<CONFIDENTIAL>>	Banks should not compete at both levels of the value chain Position on ownership and repossession not clear VAT exemptions not applied	Increase access to funding Clear law on VAT
<<CONFIDENTIAL>>	Better regulation Regulator with leasing knowledge	Better marketing Tax benefits
<<CONFIDENTIAL>>	There is no tax benefit directly to leasing companies There should be protections for leasing firms in the event of default by clients (SMEs)	Government should provide protection for leasing companies in the case of default by SMEs
<<CONFIDENTIAL>>	No information	Consumer education Government funding
<i>Banks</i>		
<<CONFIDENTIAL>>	No information	Specialised equipment valuers to give reliable valuations Registry of default assets for sale to make it easier to dispose of assets Review of IR cap to allow banks to price according to risk
<<CONFIDENTIAL>>	Lack of clarity in the legal/regulatory environment – guidelines and a leasing law would help Lack of central register for leased assets Need to license and monitor leasing companies	Remove IR cap Consumer education Improved vehicle registration process More active and aggressive LAK
<<CONFIDENTIAL>>	Clear legal, tax and accounting framework required Banks should be allowed to offer operating leases Definitions are not clear in accounting rules	Improved regulatory environment Consumer education
<<CONFIDENTIAL>>	Standalone leasing Act required for clarity Clear legal and accounting framework required	Improved awareness Comprehensive leasing Act Clarity on legal and accounting framework

Company	Regulatory challenges, uncertainties and improvements	View on measures for growth
<<CONFIDENTIAL>>	MPRSA has had great benefits for SMEs	Improved marketing and awareness More leasing companies Government participation in the market Government guarantees
<<CONFIDENTIAL>>	SME awareness of leasing benefits low Difficulty of obtaining tax rebates Need for standard contract terms	Comprehensive leasing Act Tax benefits Government participation in the market Quotas to SMEs for government business Training and awareness creation
<<CONFIDENTIAL>>	No information	Government entities pay suppliers on time Corporate support for SMEs
<i>Captive leasing companies</i>		
<<CONFIDENTIAL>>	No information	Government guarantees for leasing to SMEs
<<CONFIDENTIAL>>	Inconsistent tax requirements - fringe benefits tax for non-commercial but not commercial Withholding tax on govt vehicle leases VAT charged on VAT exempt products High finance costs Need to harmonize tax provisions	Tax benefits Consumer education Flexibility to exit contracts

Source: submissions by leasing providers

1.5 Obstacles and recommendations

In light of submissions from market participants and others interviewed, analysis of the laws and regulations, and consideration of international practice, this report examines various impediments to the growth of the Kenyan SME leasing market and makes recommendations as to their removal or reduction. After providing background on leasing markets in general in section 2, and on Kenya's leasing market in section 3, we consider competitive dynamics and theories of harm in the SME leasing market in section 4.

Finding that there do not appear to be competition problems as such, but rather a number of disincentives to enter and grow in the market, we examine the key areas that are impeding growth in the market. We follow four themes:

- **financial risk**, in particular, the inability to price financing (by banks) for leases against risk due to the interest rate cap (see section 5);
- **fiscal and accounting disincentives**, in particular, the unavailability of VAT exemptions for leasing of assets where the purchase of such assets would be VAT-exempt (see section 6);
- **information weaknesses**, in particular, the lack of market data and understanding of a complex product and the fiscal and regulatory environment (see section 7); and
- **legal and regulatory framework problems**, where barriers to growth of SME leasing are found in uncertainties, inconsistencies and gaps in the various laws (see section 8).

This report includes various recommendations, some of which are of fundamental importance to the leasing sector's growth. We refer to these as immediate priority recommendations, and they largely concern the weak economic incentives to pursue SME leasing under the current legal and regulatory

framework. They concern high transaction costs, high default risk, high regulatory risk, information weaknesses, and VAT and income tax treatment that disincentivises leasing compared with purchasing assets.

Other recommendations concern improvements that ought to be made over the medium- to long-term, but are not expected to transform the sector's performance immediately or as directly as the immediate priority recommendations. They include revising the legal and regulatory framework to improve its coherence, among other things. We refer to these as medium/long term recommendations.

The recommendations in this report are as follows:

	Immediate priority recommendations	Medium/long term recommendations
Financing	<p>Pricing risk: the interest rate cap</p> <p>Section 5.3. For Kenya’s SME leasing market to grow, it will be essential for lessors to have access to financing from banks that is not subject to the interest rate cap and for leasing companies to be able to price effectively to higher risk groupings. We recommend that when considering the ongoing regulation of interest rates, the Government take into account the adverse impact on the leasing market of the current policy.</p>	<p>Managing risk: collateral, repossession and disposition</p> <p>Section 5.2. We recommend clarifying how the repossession provisions of the Consumer Protection Act and the disposition provisions of the Auctioneer Act relate to similar provisions in the Moveable Property Rights Act, whether by interpretative guidance (e.g., issued by the Attorney General’s office) or by legislative amendment.</p>
Fiscal and accounting	<p>VAT exemptions</p> <p>Section 6.1. We recommend considering revising the application of VAT so that it does not apply to lease payments for assets which, if purchased, would not be subject to VAT, probably best in the form of an exemption as is the case with the supply of goods. This would require modifying the VAT Act, likely in an annual budgeting process.</p>	<p>VAT exemptions</p> <p>Section 6.1. We recommend clarifying the application of VAT to finance lease payments. We also recommend clarifying the definitions relating to leasing and VAT as part of a broader set of reforms to improve the coherence of definitions and the accounting and fiscal treatment of leasing activities.</p> <p>Withholding of VAT</p> <p>Section 6.2. We recommend reviewing the impact of the 6% VAT withholding by KRA-registered parties with a view to whether the KRA’s fiscal objectives outweigh the burden this imposes on lessors.</p>
	<p>Accounting standard IFRS 16</p> <p>Section 6.4. We recommend that the Government (perhaps through Treasury) engage with the LAK and accounting profession to bring about a consensus view of the impact of IFRS 16 and IFRS for SMEs.</p>	<p>Income tax treatment</p> <p>Section 6.3. We recommend making available to leasing the fiscal benefits under the Income Tax Act available to purchasing, such as accelerated depreciation on heavy machinery. We also recommend reviewing the distinction in the Income Tax (Leasing) Rules between leases that involve a transfer of title as opposed to the accounting approach that is based on the economic risk and reward of the asset. The leasing sector would also benefit from permitting accelerated depreciation on assets, particularly where this is applied to purchases. Whether these should be applied must be considered in the context of the wider fiscal objectives of the KRA.</p>

	Immediate priority recommendations	Medium/long term recommendations
<p>Information weaknesses and market stimulation</p>	<p>Market data</p> <p>Section 7.1. We recommend that Government collect and publish data on demand for equipment and leasing with a view to demonstrating the market opportunity for the leasing sector.</p> <p>We recommend that the CAK monitor carefully the LAK efforts to gather data from its membership, procure market analysis and share the results among its members in order to ensure that it does not amount to or lead to anticompetitive conduct. The CAK should alert the LAK to prohibitions on horizontal coordination and be available to provide guidance if requested.</p>	
	<p>Education and outreach</p> <p>Section 7.2. We recommend that Government, in collaboration with the LAK and perhaps with international technical assistance, engage in outreach to SMEs in order to explain the workings and benefits of leasing. This would include preparing a clear and concise guide to legal, accounting and tax issues, and could be accompanied by workshops.</p>	
	<p>Market stimulation</p> <p>Section 7.3. We also suggest that the Government engage in a targeted, coordinated SME leasing stimulus initiative. This would combine various features discussed in this section. An information campaign would explain leasing (the legal nature of the financial product and its accounting and fiscal treatment) to a particular SME market segment, for example agricultural equipment. This could be done through dissemination of explanatory brochures and promotional events in farming communities, and</p>	

	Immediate priority recommendations	Medium/long term recommendations
	<p>would significantly decrease the transaction costs faced by leasing companies in explaining leasing to individual SMEs. Such outreach would be carried out in coordination with the LAK and its members, who would be prepared to provide leases of equipment for SMEs. Such outreach would also be more effective if initially supported by development finance, subsidies or fiscal exemptions to provide incentives on both the lessor and lessee side. It could be combined with Government guarantees and other collateral support for SME leases that reduce the credit risk that SMEs present. Such an initiative could be expected to open the SME agriculture equipment leasing market, and then be built upon in other sectors.</p>	
<p>Legal and regulatory</p>	<p>The Hire Purchase Act</p> <p>Section 8.3. We recommend revising the Hire Purchase Act to remove its application to sole traders and leasing transactions useful for SMEs. This could be done in one of several ways:</p> <ul style="list-style-type: none"> --the maximum hire purchase price in the Act could be reduced, e.g., to KSh 500,000 or 1 million; --the maximum hire purchase price could be reduced to a similar amount where the asset is to be used in connection with a business; --hire purchase agreements for assets to be used in connection with a business could be excluded entirely from the scope of the Act; or --the definition of “hire purchase agreement” in the Act could be revised to exclude finance leases (or, to be clear, leases in general). 	<p>Improving the legal framework</p> <p>Section 8.3. We recommend making numerous changes to existing laws, which could be done in a new Leasing Act that establishes a clear framework for leasing, clarifies various terms and their legal effects, harmonising these with terms used in the VAT Act and Income Tax Act, and clarifies how the Moveable Property Security Rights Act and Consumer Protection Act apply to leases. Such an Act could also ensure lessors are protected from third party claims in finance leases, that lessors are treated as beneficiaries in supply agreements, and related improvements. In addition, a framework permitting leased goods to be moved within the region subject to application of firm lessor rights in the destination country would enable leasing to be part of the regional economic integration underway.</p> <p>These matters could be addressed in a new leasing law that collects basic provisions relating to leasing and, together with the Moveable Property Security Rights Act in particular, sets out a coherent framework for how leasing works. It would be vital that a new Leasing Act results in clear treatment of the various types of asset-based finance (rather than sowing confusion by only addressing operating and finance leases) and fits appropriately with rights and processes established in the Moveable Property Security Rights Act in particular.</p>

Immediate priority recommendations	Medium/long term recommendations
	<p>Regulating leasing</p> <p>Section 8.4. We recommend establishing legal obligations in law for leasing companies (including banks engaging in leasing) to report their leasing activities in a standardised manner to enable effective analysis and monitoring of the market on an ongoing basis, whether to the CBK, Treasury or in due course a new Financial Markets Conduct Authority. Firms could also be required to notify the relevant agency of the fact that a company is engaging in leasing activities at such time as the value of its leases exceeds a minimum threshold in the prior financial year.</p> <p>We also recommend that the Government (whether through CBK or Treasury) solicit support from a body such as International Finance Corporation or a consultant to assist LAK to develop leasing template documents, but that there be no attempt to impose standardised documentation on the sector.</p>

2 Background on leasing markets

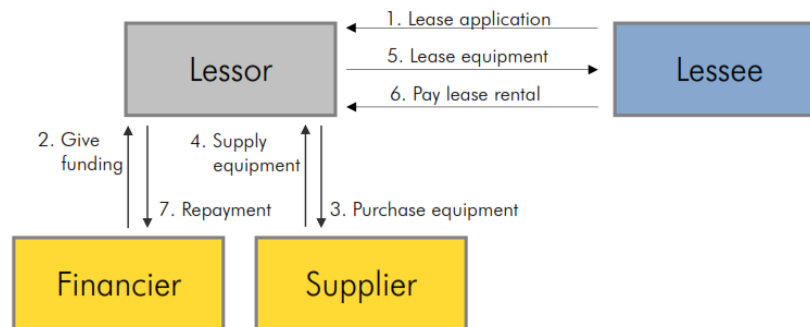
2.1 The nature of leasing

According to the International Finance Corporation (IFC), “in its simplest form, leasing is a means of providing access to finance and may be defined as **a contract between two parties wherein one party (the lessor) provides an asset for use to another party (the lessee) for a specified period of time in return for specified payments.**”² This is similar to the definition used for accounting purposes.³

Leasing serves as a form of asset financing where the lessor purchases an asset and the lessee pays to use the asset, effectively separating the legal ownership of an asset from the use of the asset. The lessor’s purchase is often financed by a loan or credit facility from a bank or other financial institution, the repayment of which is funded from the lease payments from lessee to the lessor, as illustrated in Figure 1.

At the end of the lease period, ownership of the asset may pass to the lessee, or the asset may be returned to the lessor. Leasing is used to finance the use of various kinds of equipment such as vehicles, IT equipment, construction equipment and property.

Figure 1 Leasing mechanism.



Source: IFC (2009), based on Izumi

Leasing can be distinguished from short-term hire, which may be for anything from a day to a year, but, in any case, a period considerably shorter than the economic life of the asset. In some cases, there may be an evolution from short-term hiring to leasing, as occurred for example in Kenya’s agricultural sector.⁴ This evolution is important in the maturing and deepening of the financial sector in providing credit for productive investment.

The development of leasing finance, as with the financial sector more generally, depends on information and incentives in order to be able to assess risk. Effective leasing finance is critical for relaxing the self-financing constraint that businesses with profitable opportunities may face. Of concern in Kenya, as in other countries, is that SMEs are more likely than larger and more established businesses to be credit rationed due to information asymmetries.

² IFC (2009). ‘Leasing in Development: Guidelines for Emerging Economies’. Available [here](#).

³ The common financial accounting definition of ‘lease’ is “an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.” International Accounting Standard 17. IFRS for SMEs uses the same definition. Similarly, IFRS 16 defines a lease as “a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.” IFRS 16, Appendix A, Defined terms.

⁴ Interview, <<CONFIDENTIAL>>.

This has been borne out by the overall picture provided by Kenyan leasing companies in this Inquiry. The interviews and responses to information requests indicate a relatively developed market for ‘blue chip’ and multinational clients, especially for vehicles, and an undeveloped set of offerings for SMEs and the types of equipment required by these businesses. The focus therefore needs to be on improved incentives and a clearer framework for the extension of leasing finance to SMEs to address what is effectively a market development challenge.

2.2 Leasing and economic development

Kenya is in a process of economic transformation. Not only is there substantial investment and growth in services, not least digital financial services, but the country is pursuing a course of industrialisation, bringing more stages of production, manufacturing and assembly within Kenyan borders. Key objectives of the country’s national policies, including the President’s ‘Big 4’ of food and nutrition security, affordable housing, enhancing manufacturing, and universal health coverage, all depend on capital equipment. To the extent that SMEs and other businesses that may not have the wherewithal to purchase the capital equipment required to contribute to these sectors, progress on the Big 4 objectives is likely to be greatly enhanced by use of leasing, among other forms of asset finance.

Generally, but particularly also in Kenya at its current juncture, leasing offers a useful alternative to purchasing an asset, particularly for small businesses. Leasing avoids the cash outlay of a purchase, preserving cash for other uses which may generate a higher rate of return.⁵ Businesses generally make money from using equipment rather than owning it, and leasing allows them to use the cash flows generated from their activities to pay for the use of the equipment.⁶

Leasing avoids the lessee incurring a loan from a bank. As a result, acquiring financing is less dependent on a business’ past credit history or asset base, which makes it especially useful for new businesses and SMEs, which often have limited assets and history.⁷ SMEs in developing countries often face even greater difficulties in accessing finance due to under-developed financial markets and high levels of perceived risk.

One of leasing’s main benefits compared to other asset finance methods is that the asset itself may be used as collateral, and cash flows arising from use of the asset used to fund payments. In an environment where rights of collateral and repossession are uncertain, there is higher risk in lending to smaller and new firms. Leasing offers a solution to these difficulties with many of the same benefits as other forms of asset finance. It therefore fills an important gap in the market, having the ability to provide medium-term equipment financing to a wide range of businesses, some of which may not have had access to such financing from another source (see Figure 2).

Leasing may also avoid the recording of the lease on the balance sheet, which would typically increase the business’ corresponding level of indebtedness (although some leases are, and others will for some entities in the future be, recorded on the balance sheet, as discussed in sections 2.3 and 6.4).

Leasing also has advantages in jurisdictions where there are weak creditors’ rights, as it allows the legal ownership to remain with the lessor, making it possible to provide financing in circumstances where it may otherwise be too risky to do so.⁸

⁵ IFC (2011). ‘Global leasing toolkit. An Introduction. Available [here](#).

⁶ IFC (2011).

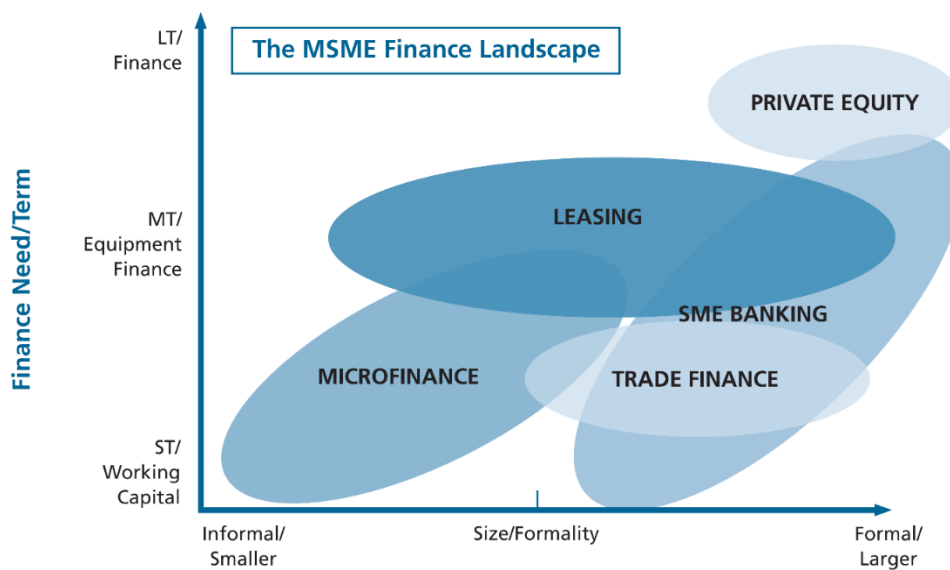
⁷ IFC (2009).

⁸ IFC (2009).

There may also be tax benefits through deducting lease payments from operating expenses during the period when they are paid, which may differ from the deduction of interest on a loan and depreciation of an asset that is purchased.

In sectors that experience rapid technological development, some leases (operating leases) may allow the lessee to benefit from advances and improvements in technology, replacing an outdated asset under a new lease, compared to holding the asset for its full life. Similarly, where assets are special-use (e.g., particular machinery or a forklift truck) rather than generic (e.g., cars), the lessee may prefer not to have the economic responsibility, administrative burden and legal liability for disposition at the end of the economic life of the asset. By leasing, lessees can focus their management on their core business, leaving asset management to the leasing companies. The suppliers of the equipment are also concerned with the effective demand and ability to purchase of their customers. Leasing finance relaxes the financing constraint and can stimulate demand in the context of a growing economy.

Figure 2 MSME Finance landscape



Source: IFC (2009)

Leasing also provides an opportunity for informal businesses to make use of formal mechanisms for asset finance and develop a record of financial transactions which can enable them to use other financial products in future.⁹ This aids the development of the financial sector more generally, with all the associated knock-on benefits.

Through providing businesses with access to asset finance for equipment, leasing can accelerate levels of industrialisation and local production which generates employment and boosts economic growth. It can also facilitate greater levels of infrastructure deployment.¹⁰ In a dynamic and growing economy, as Kenya is, there are concerns regarding the ability of smaller business to grow to become medium in size. Access

⁹ IFC (2009).

¹⁰ IFC (2009).

to credit for investment in productive assets is a critical aspect and market failures in the provision of credit is part of what has been observed as the phenomenon of the 'missing middle'.¹¹

2.3 Finance and operating leases

There are two main types of lease agreement:

- **finance leases**, where the lessor transfers to the lessee substantially all the risks and rewards incidental to ownership; and
- **operating leases**, where the lessor does not transfer to the lessee substantially all the risks and rewards incidental to ownership.

Figure 3 Assessment of type of lease



With a finance lease, the ownership of the asset will typically pass to the lessee at the end of the lease and the lease payments will typically repay the entire cost of the leased asset plus interest.¹² With an operating lease, the lessee will not have ownership rights at the end of the lease period. Operating leases can be more expensive than borrowing to purchase or finance leases because the lessor leases the equipment for a fixed monthly amount, and also assumes the residual value risk of the equipment.

Operating leases provide firms with a range of benefits, including lower up-front expenses (as a down-payment is not always required), cash flow benefits, tax deductible lease payments and ease of upgrading of equipment.¹³ Operating leases may include maintenance of the equipment or vehicle which enables the lessor to keep track of the condition of the asset and ensure it is being properly maintained to protect its value.

Whether a lease is a finance or an operating lease is not a question of form but of the substance of the transaction. For instance, under International Accounting Standard 17, which concerns accounting for leases, a lease will normally be classified as a finance lease if:

- (a) the lease transfers ownership of the asset to the lessee by the end of the lease term;*
- (b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;*
- (c) the lease term is for the major part of the economic life of the asset even if title is not transferred;*

¹¹ See Alibhai, S.; Bell, S.; Conner, Gi. 2017. What's Happening in the Missing Middle?: Lessons from Financing SMEs. World Bank, Washington, DC

¹² IFC (2009).

¹³ Submission by <<CONFIDENTIAL>> (undated).

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

FSD Africa offers a similar breakdown with a set of four criteria, so that a lease is a finance lease if any of the following statements is true:

- transfer of ownership occurs at the end of the lease;
- there is a purchase option in the lease;
- the lease term accounts for more than 75% of the asset’s life; or
- the present value of the lease payments amounts to over 90% of the starting asset value.¹⁴

The relevance of the difference between finance and operating leases is in their accounting treatment. A finance lease is accounted for as a sale/purchase of an asset, with financing (a loan) that is paid off over a period of time whereas an operating lease is basically an expense of the business. As a result, the balance sheet and income statement treatments are different for each:

- **Balance sheet:** Under a finance lease, the asset (more precisely, the right-to-use it) is usually treated as an asset of the lessee which can then claim depreciation allowances against taxable income. Under an operating lease, the asset is treated as the property of the lessor and an ‘off balance sheet’ item for the lessee.¹⁵
- **Income statement:** Under a finance lease, the lessee will record the interest portion of the lease payments as an expense, whereas under an operating lease they will record the whole lease payment as an expense.

Table 3. Accounting treatment of finance and operating leases

	Finance lease	Operating lease
Balance sheet	Sale/purchase of the asset Right-to-use the equipment recorded as an asset of the lessee Lessee books the lease payment obligations as indebtedness	Asset is treated as property of the lessor, who has fiscal depreciation allowances
Income statement	Lessee may apply depreciation	Lease payments treated as operating expenses

In many respects, a finance lease with an option to purchase the asset at the end of the term is similar to a hire purchase agreement, in which title to the asset passes with the last instalment. Indeed, they are often accounted for similarly. For instance, IAS 17 explains:

The definition of a lease includes contracts for the hire of an asset that contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

¹⁴ FSD Africa (2017). ‘Agricultural Leasing Market Scoping Study for Sub-Saharan Africa’. Available [here](#).

¹⁵ IFC (2009).

Indeed, the Kenyan Income Tax (Leasing) Rules define a hire purchase agreement as a form of lease:¹⁶

'hire purchase' means a contract under which the lessor agrees to lease the assets to the lessee for a specified period of time, with the intention of transferring ownership on the expiry of the lease;

We discuss hire purchase agreements in detail in section 6. They differ from instalment sales, in which title to the asset passes at the time of purchase with payment made in subsequent instalments.

As will be discussed in section 6.4, there is some confusion as to the treatment of operating leases for SMEs under the incoming accounting standard IFRS 16, which may undermine the attractiveness of such leases. Conversely, as will be discussed in section 8.3.2, the Hire Purchase Agreement, as currently in force, presents a significant disincentive to provide finance leases for various equipment to SMEs as the rights and obligations are heavily weighted in favour of the consumer/lessee.

3 Kenya's leasing market

3.1 Introduction

Estimates of the total value of the leasing sector in Kenya vary substantially, reflecting the weakness of the data available on leasing. One estimate placed the total value of leases, together with other asset-based finance products, at KSh 46bn.¹⁷ Estimates from the responses to the information requests are of a higher magnitude, around KSh 54bn. Of this, by far the largest value is the leasing finance provided by banks and their leasing subsidiaries with around KSh 46bn, with specialist leasing companies around KSh 5bn and captive leasing companies (generally linked with motor vehicle suppliers) at around KSh 3bn. Some of these estimates may reflect double-counting as the specialist and captive leasing companies are partly financed by banks.

The value of leasing finance compares with total credit extended by the banking sector in Kenya of around KSh 2,492bn¹⁸, or between 1.8-2.1% of this total.

The leasing sector is varied and comprises different categories of leases, including finance, operating, hire purchase and asset-based finance leases. Of these, the largest in value terms is hire purchase finance, although several companies did not provide a proper breakdown.

The companies taking out leases range from the Kenyan subsidiaries of the largest multinationals in the world to small-scale farmers and entrepreneurs. By far the largest category of products leased is motor vehicles (trucks and cars), with agricultural equipment, other machinery, office equipment and even fittings (such as supermarket fittings) also being provided under leasing arrangements. This means that leases can represent both high and lower value products.

¹⁶ Income Tax (Leasing) Rules 2002, Section 2.

¹⁷ This was provided by <<CONFIDENTIAL>>, March 2018.

¹⁸ Gross loans as reported in Central Bank of Kenya, <<CONFIDENTIAL>>.

3.2 Types of customers

In Kenya, most leasing is for multinational companies, large domestic enterprises ('blue chip' clients) and government departments. Few leasing companies and products have targeted SMEs, although many of the leases categorised as hire purchase may be for small sole-proprietor businesses.

Corporates: Large companies like East African Breweries Limited (EABL), and multinational companies such as Coca Cola, Nestle and Total, have been significant users of leasing over the years in Kenya. This is in part due to the fact that Kenya's leasing providers have focused on larger users.

Government: The leasing market also enjoyed a substantial demand-side stimulus from increased use of leasing by the Government, starting in 2014 when the Government leased 3,000 vehicles. This demonstrated the viability of leasing as a financing mechanism and established demand that attracted an increase in supply of leasing providers. Several players subsequently entered the market.¹⁹ The Government budgeted KSh 8.1 bn (about US\$ 81 million) in the 2017-18 fiscal year for leasing police vehicles alone.²⁰ The purpose of Government's entry as a leasing customer was to improve economic efficiency in asset management, ensuring that assets were not wasted but put to good use, as well as to reduce the cash outlays of outright purchases.²¹

The Government did not enter the leasing market as a monolithic customer, but rather several different Government agencies and county Governments ran their own lease tenders to meet their respective requirements. Some were more aggressive than others. A balance of substantial public sector demand with some distribution of decision-making appears to have kept the leasing market on its toes while keen to pursue a major business opportunity.

SMEs: There appears to be little serious interest in provision of leasing finance to the SME market as of 2018. Almost all market participants interviewed in the Inquiry explained that they have viewed the SME market as too risky to be attractive. Based on the responses to the information requests, only a very few firms extend a substantial proportion of their total leasing finance to SMEs.

Of the nine companies which provided data disaggregated by customer type, only six reported leasing to SMEs at any point between 2014 and 2017.

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We discuss risk assessment, management and pricing in section 5. While important steps have been taken to improve risk assessment (discussed in section 5.1) and risk management (see section 5.2), there are serious difficulties in pricing finance for risk (see section 5.3). This is closely related to the returns that may be made from SME lending under the interest rate cap currently in place. While the interest rate cap does not apply to lease rental payments and charges, it applies to debt incurred to finance the assets to be leased. Leasing firms indicated that customers expected rates on leases to be in line with the cap. The sector also faces the risk that the Government may extend the cap to leasing finance. These factors together present a major challenge to financing leasing in Kenya today.

In addition to presenting a higher risk profile, some respondents suggest that SMEs do not come intuitively to leasing in Kenya, tending to prefer to have ownership of their assets. This preference for

¹⁹ Interview with <<CONFIDENTIAL>>.

²⁰ See BDO, Review of 2017-18 Budget, Finance Bill 2017 & Tax Changes, available at www.bdo-ea.com.

²¹ Interview with Treasury.

ownership is likely due to the control it affords in an uncertain market, unfamiliarity with leasing, and concern about the cost of leasing. Less accustomed to pursuing bank lending, SMEs may also be less focused on the objective (that larger companies may have) of avoiding capitalising the assets on the balance sheet, another important driver of the leasing market. According to market participants, many SMEs in Kenya have not yet understood the potential benefits of leasing as opposed to owning, viewing leasing as being an expensive option. We discuss this in relation to information barriers to growth in the market in section 7.

3.3 Types of providers

There are generally three types of institutions that offer leasing services:²²

- *independent leasing companies* (led by <<CONFIDENTIAL>>), which as discussed later are split into two key categories, of pure leasing and captive leasing;
- *banks*, which offer leasing on their own balance sheets through in-house leasing or lending units, or may also acquire leases and receivables under leases, or lend to lessors (e.g., <<CONFIDENTIAL>>); and
- *subsidiaries of banks* cleared by the Central Bank to enter into leases, typically financed by their parent banks (e.g. <<CONFIDENTIAL>>).

Although relatively small, Kenya's leasing sector comprises a variety of all of these players.

Banks:

Several Kenyan banks are engaged in the provision of leasing. This includes <<CONFIDENTIAL>>. Leasing may be provided through a subsidiary (such as <<CONFIDENTIAL>>) or in conjunction with independent financing companies. Banks are predominantly focused on financial leasing which can be provided by financing independent leasing companies which assume the agreements initially struck by independent leasing companies and title to the asset, or by buying the receivables under the lease but not the title. Banks' subsidiaries also may enter into leases directly.

There is some variation in the target markets and approaches across banks. For example, <<CONFIDENTIAL>> appears to be more directly targeting leasing to the SME and retail sector than others.

Independent leasing companies:

Independent leasing companies may be 'pure' leasing companies that lease a variety of goods and brands without particular affiliation to any one vehicle or equipment supplier, or 'captive' leasing companies with long term relationships with (including being owned by) one or more suppliers.

Pure leasing company <<CONFIDENTIAL>>, for instance, built its position from a short-term rental market, such as for cars or farming equipment (for which demand is highly seasonal), developing over time into longer term leases for a wide variety of equipment, with yellow machinery being the largest in 2018. It also leases production plant and equipment, vehicles, furniture, IT equipment and software.

Captive leasing companies are more restricted in their asset types, constrained by their brand affiliations, and generally focus on vehicles. For example, <<CONFIDENTIAL>>.

Some of the leasing companies work in close partnership with banks to finance the leases, while others use their own capital (which has a lower financial cost than a loan) to acquire the assets to be leased. While banks and bank-affiliated leasing companies may have access to large balance sheets and attractive financing terms for the acquisition of the assets to be leased, independent leasing companies have the

²² IFC (2009).

advantage of operating in a less regulated environment, particularly as they do not require a banking licence to operate.

The relationship between banks and leasing companies:

Leasing companies are often effectively intermediaries channelling finance from banks to SMEs, and add value in three important ways:

- ***Credit risk:*** Leasing companies have potentially significant familiarity with the lessees, with whom they will often develop long term relationships on which they build an information base which is part of their core competitive competence. This reduces the risk of default through poor credit decisions. It also allows leasing companies to judge better whether to wait out a period of late payments or to repossess the assets.
- ***Asset value:*** They will also have greater familiarity with the leased assets and what they are used for. This enables them to reduce risk of loss of value during the lease and to increase the value (or reduce the cost) of disposition at the end of the lease or life of the asset. Some companies reported that they aim to make their profits from the excess of the disposition price over the residual value in the lease.
- ***Value-added services:*** They often add various services to the lease, such as maintenance and service of the asset, and insurance. These are often offered by captive leasing companies linked to vehicle suppliers with networks of dealers. Maintenance and service may be an important means of preserving the value of the asset on disposition at the end of the lease.

A lease may be a:

- ***dry lease***, where the lessee only pays the vehicle rental charge and procures insurance, service and maintenance and other services separately;
- ***wet lease***, where the lessor also provides insurance, maintenance and service; or
- ***partial lease***, where the lessor provides insurance only.

A lessor providing wet leases will be well positioned to monitor risk to the asset through regular contact with the lessee and mitigate this risk through provision of service and maintenance. As competition in the leasing market develops, with banks increasingly providing commodity retail leasing services, lessors may focus on providing the value-added services of service and maintenance for leases entered into by banks or bank subsidiaries. There are signs of this occurring in Kenya. Banks that provide leasing finance will often collaborate with service providers that can provide service and maintenance of the asset. However, there is also the potential for expansion of leasing into specialist niches such as machinery and equipment outside of vehicles, where leasing companies with in-depth knowledge of the customers can build an offering.

Overall, banks dominate in the provision of finance leases, hire purchase finance and other asset-based finance (Figure 4). Banks offer up to 90% funding for finance leases. Clients therefore pay a deposit of between 10% and 40% when they take out such a lease.²³ Similarly, banks are responsible for almost all of the hire purchase finance; the other asset-based finance deals were due to just two banks, <<CONFIDENTIAL>>, in 2017.

²³ Submission by <<CONFIDENTIAL>>.

Independent leasing companies are focused on operating leases, as shown in Figure 4, although the majority of operating lease finance in value terms in 2017 was also provided by banks. Indeed, the operating lease finance by banks was due to a single bank (<<CONFIDENTIAL>>).²⁴

Operating leases, which are more often provided by a leasing company, do not typically require a large deposit. Lessors finance the acquisition of assets either from bank lending or from their own capital. Financing from their own capital may be less costly than borrowing but is constrained by the level of capital of the leasing company and its shareholders. When borrowing, they may do so against their general balance sheet or specifically in relation to a lease being financed. For example, <<CONFIDENTIAL>> explains that it typically takes 80-90% funding from the bank and provides 10-20% of the funding from internal sources.²⁵ <<CONFIDENTIAL>> similarly receives around 80% of funding from banks and uses internal funds and shareholder funds for the balance.²⁶

Based on the eight companies which provided lease values disaggregated by type of asset, by far the largest asset category appears to be new vehicles (Table 5). Values for used vehicles, construction and agricultural equipment are small. The “other” category accounts for all other types of assets including IT equipment, office furniture and shop fittings. The large jump in this category in 2017 is driven by a very large increase in operating lease values reported by <<CONFIDENTIAL>> driven by one lease transaction and does not reflect an overall shift.²⁷

Figure 4: Lease values by type of lessor, 2017

<<CONFIDENTIAL>>

Table 4: reported lease values for different asset types (Ksh, billions), 2014 -2017

<<CONFIDENTIAL>>

3.4 Types of lease

Data was sought from leasing companies in Kenya on the volume and value of lease transactions, disaggregated by type of lease, type of client (corporate, SME or individual) and type of asset (new vehicles, used vehicles, construction equipment, agricultural equipment and other) for 2014 to 2017.

The data returned was incomplete in a number of respects even after follow-up requests. Several firms did not break down the lease volumes and values by type of client and/or type of asset. In addition, some firms did not provide data for some years, particularly the earlier years in the period. A small number of firms did not provide any data. This presented a challenge in drawing accurate trends and inferences from the data. Table 1 above provided an overview of the data received, while Annex 1 provides a more detailed description of the data provided by firm, and the gaps. However, almost all the major participants did provide data, even if not necessarily fully disaggregated or for all the years in the period.²⁸

By analysing the data provided by firms which had complied with the request over the period, we assess the patterns by type of lease (Figure 5). There is considerable year-to-year volatility in the value of new

²⁴ <<CONFIDENTIAL>> recorded a very small number of leases with very high values. We were unable to clarify and confirm this data. If accurate, it may reflect provision of finance by <<CONFIDENTIAL>> to specialist leasing companies, effectively double counting this finance.

²⁵ Submission by <<CONFIDENTIAL>>.

²⁶ Submission by <<CONFIDENTIAL>>.

²⁷ It may also be the result of mis-reporting of data by <<CONFIDENTIAL>>.

²⁸ <<CONFIDENTIAL>> did not provide data, along with <<CONFIDENTIAL>>.

leasing finance extended, with major changes sometimes due to a single firm. This means caution must be exercised in making inferences from the data. The value of hire purchase leases, which is the largest single category and extended almost entirely by banks, dropped substantially after the increase in 2015. Table 1 indicates that the number of hire purchase leases also dropped significantly to 2017.²⁹

The value of finance leases, also extended by banks, increased around four-fold between 2014 and 2016, then remained static from 2016 to 2017. Asset-based finance also increased in 2017. However, the increases in these two categories were not enough in absolute terms to outweigh the decline in hire purchase finance and bank leasing finance from 2015 to 2017, based on the responses received.

Figure 5: Value of leases, 2013 – 2017, only data for firms providing data for all years

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The value of operating leases fell sharply from 2014 to 2015, which reflects data provided by the main independent leasing companies. This may reflect a shift into finance leases from operating leases and a greater relative role for banks and their leasing subsidiaries in leasing finance. A variety of factors may explain this pattern, as explored below. These include the growing role of banks in leasing, the unfavourable VAT treatment of operating leases and more limited availability of financing following the interest rate cap in 2016. However, in 2017 the value of operating leases trebled. This was entirely due to the operating lease finance reported by one bank, DTB, which had previously had a negligible presence in operating lease financing.

3.5 Key processes and lease features

The respondents provided details of the process of credit assessment which they undertake prior to entering into a lease agreement. As will be discussed further in section 4.1, most in 2018 reported using credit reference bureaus as a source of information on customers.

The credit assessment process for obtaining a lease is quite similar to that for other forms of financing. The descriptions provided by the leasing providers included the same main points. The key components of the assessment are:

- *Character of the lessor* – assessed using credit reference bureau checks, financials and account statements, cashflow modelling and tax compliance;
- *Amount* – the value of the lease and repayments;
- *Margin* – the interest and fees the bank will receive;
- *Purpose* – the objective of the lease and purpose for which the equipment will be used;
- *Insurance/collateral and a view on the secondary market* – how easy it will be to dispose of the asset in the event of default or at the conclusion of the lease;
- *Experience of the lessee* – period of operation, existing assets, management experience and internal processes; and
- *Industry type and risks.*

Lease durations vary according to the type of equipment being leased. Equipment with a shorter lifespan such as IT equipment will typically be leased over a shorter period (around 36 months), while other types of heavy plant and machinery with much longer lifespans will be leased over a longer period (up to 84

²⁹ This is especially notable as Table 1 includes data for all firms, and not just those completing the information request for each year from 2014 to 2017. More firms responded in 2017 and yet the number of HP leases extended in that year was recorded as <<CONFIDENTIAL>>.

months).³⁰ Vehicles may be leased over up to 60 months, but second hand vehicles will typically be leased over a shorter period.³¹ The data submitted by stakeholders suggests that the most common duration is 48 months, except for used vehicles (Figure 7), but this is based on a small sample size as not all companies provided information.

Finance leases and hire purchase leases have a longer average duration than operating leases (Figure 6). This may be due to the prevalence of used vehicles in the operating lease segment, which generally are leased over a shorter period.

Figure 6: Average duration by type of lease, 2018

<<CONFIDENTIAL>>

Figure 7: Average duration by asset type, 2017

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The experience of companies varies substantially in terms of the repossessions which they have had to undertake, although overall the rate of repossessions has been low (Table 6). This is especially the case with respect to operating leases where several respondents report having had no repossessions in recent years. Three respondents reported that the number of repossessions has increased over time or spiked in the last year. It is unclear what has caused this. In one case (KCB) this has been focused on a particular sector, supermarkets, where there have been very challenging trading conditions.

Table 5: Number of repossessions reported by respondents

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Only one respondent noted challenges with making repossessions. The difficulty of repossession at the lower end is the reason RentWorks reported for not having substantial lending to SMEs and individuals.³² The low rate of repossessions and lack of concern about repossessions may simply reflect firms' orientation towards larger and multinational clients. The ability to readily repossess in case of default is therefore still an important issue to consider if firms are to be encouraged to expand leasing finance to SMEs.

3.6 Leasing Association of Kenya

3.6.1 Industry cooperation

The Leasing Association of Kenya (LAK) has about 40 members, about half of which are banks, with the remaining being leasing companies, equipment providers, consultants and advisers. This varied membership has a disparate set of interests. This, and the small scale of the market, are given as reasons why the LAK remains a small organisation without a dedicated secretariat.

The LAK has generally focused on advocacy, knowledge sharing and training. Its mandate includes:³³

- a) Creating awareness of leasing benefits in Kenya through topical seminars, workshops, conventions and research studies targeted at various stakeholders.
- b) Lobbying and advocacy for regulatory reforms to improve/ increase use of leasing in the country.

³⁰ Submission by <<CONFIDENTIAL>>.

³¹ Submission by <<CONFIDENTIAL>>.

³² Submission by <<CONFIDENTIAL>>.

³³ See lak.co.ke.

- c) Training and capacity building for leasing professionals.
- d) Self-regulation and control of ethical behaviour among industry players.
- e) Enhancing corporate social responsibility as part of the association's efforts to contribute to the overall wellbeing of society beyond leasing.

The LAK has carried out various training events for its membership and for customers, as well as training in leasing law and accounting among professionals. In the advocacy area, the LAK's notable lobbying successes include:

- the removal of a 3% withholding tax that applied to leases;
- the opening of CRB reporting to leasing companies; and
- the Government's initiative to lease rather than purchase vehicles.

The LAK has coordinated submissions to the Government on tax matters, such as seeking exemptions on stamp duty for leases, calculation of wear and tear allowances by lessors, and removing anomalies that result in leases being taxed in a manner that results in them being costlier than asset purchases (we make a similar point regarding VAT exemptions, below).

Any trade association that meets regularly to discuss how its members conduct business risks the exchange of information and other communication and agreements, explicit or tacit, that may amount to collusion in fixing prices or volumes, sharing markets and other anticompetitive practices. According to LAK members interviewed, they do not share volume or pricing data, but focus on advocacy, lobbying, education and training. There may still be concerns that the association provides a forum for sharing information which may be anti-competitive as part of these roles, however, the Inquiry did not receive sufficient information about the communications among LAK members to take a view on this.

3.6.2 Self-regulation and consumer protection

In its self-regulatory work, the LAK adopted a Code of Conduct³⁴ in February 2017, setting out standards of good practice for members to achieve in all aspects of their businesses. It aims to assure the end user of services of the highest levels of professionalism and integrity when using any of the services provided by members, but without affecting “the contractual relationship negotiated and agreed in the ordinary course of members business activities between members and their customers or other third parties.”

The Code of Conduct covers a range of conduct matters such as: fair and transparent and needs-oriented treatment of customers; bribery; responsible marketing and advertising; written disclosures of costs, charges, terms and conditions to customers, including complaints and early settlements. The LAK also undertakes in the Code of Conduct to conciliate between complaining customers and members. In addition, members are required to undertake some know-your-customer (KYC) measures to protect against fraud and money laundering, and to respect certain customer data protection and confidentiality standards (with exceptions for reporting to the CRBs). Many of these are already addressed in law, but do have the benefit of drawing members' attention to a certain standard of conduct.

Whether the current regulatory context, let alone the Code of Conduct, is sufficient consumer protection is not the focus of this report, which concerns the challenges to the growth of the market oriented to SMEs in particular. While confidence and trust in leasing providers may be important for demand for leasing to grow, the level of understanding of leasing among SMEs and the lack of appetite among leasing companies for the hitherto high-risk SME segment appear to be more significant barriers to the development of leasing.

³⁴ A Mandatory Code of Conduct for Members of the Leasing Association of Kenya, Approved by a resolution of the Board of Directors on 23 February 2017.

4 Competitive dynamics and theories of harm

We discuss in this section 4 the competitive dynamics of the Kenyan SME leasing market, considering potential indications of a lack of competition and theories of harm. After discussing relevant markets (section 4.1), we consider whether pricing data available suggests a competition problem (section 4.2), and whether there is a risk of harm from market concentration (section 4.3), coordination among market participants (section 4.4) or barriers to entry into the market (section 4.5). We conclude with some observations on competitive dynamics as banks enter leasing markets (section 4.6).

Ultimately, we find little reason to think that the SME leasing market suffers a lack of competition due to market concentration or collusion. Rather, it appears to be underserved because the commercial incentive to pursue the market have not been inviting enough, whether for independent leasing companies or banks.

4.1 Relevant markets

The focus of this Inquiry is on the obstacles to expanding leasing finance to SMEs and not in the main on possible anti-competitive conduct. Although the latter would of course merit attention and action, this is an inquiry and not an investigation (as mentioned in section 1.3). This Inquiry is therefore concerned primarily with the aspects of competition policy that involve actions to stimulate competition for an apparently underserved market segment, rather than competition law enforcement. This is appropriate as the main concern, which is further reinforced in our assessment, is the under-developed nature of the market for SME leasing finance. As such, a rigorous market definition is not required for the purposes of defining possible dominance and substantial market power. In any case, sufficient data has not been provided to develop rigorous market definitions.

A broad analysis of the relevant markets is, however, helpful in understanding the characteristics of demand and supply. This exercise involves considering the decisions by firms extending leasing finance, and the alternatives on the demand side for those requiring financing for vehicles and equipment.

International experience provides important indications as to the appropriate market definition for leasing, while recognising the specific context of leasing in Kenya. This experience points to the importance of understanding segmentation of the markets according to the types of leases and the assets being purchased, which implies segmenting the demand side of the wider market.

For example, the European Commission has defined separate product markets for operating and finance leases. This arises from their distinct business models, different offerings (for example, in relation to ownership) and risks.³⁵ Certain decisions have further delineated the product market in terms of asset types (such as segmenting markets for vehicles of a particular tonnage). They have however noted that there is some supply-side substitution between asset types and customer sizes.³⁶ This depends on the leasing company (which may be different from the provider of the finance) being able to readily use the same capabilities to evaluate risk for different assets and potential groups of lessees. This risk involves the strength of the business use to which the asset will be put, as well as the ease of resale of the asset in the second-hand market.

Similar market delineations are likely relevant to the Kenyan leasing sector. In particular, there are important differences between leasing to large and multinational corporations, mainly vehicles which can

³⁵ See for example, European Commission COMP/M.5217- GEFA/PEMA, COMP/M.6763 - VWFS/ PON Holdings B.V./PON Equipment Rental and Lease; COMP/M.6436 – Volkswagen Financial Services / D'ieteren/ Volkswagen D'ieteren Finance JV.

³⁶ European Commission Case M.7944 – Credit Mutuel/ GE Capital's Factoring and equipment financing business in France and Germany.

be readily re-sold, and leasing plant and equipment to SMEs through operating leases, where the equipment is specific to their business needs. For example, agricultural machinery requires a different evaluation from medical equipment for doctors.

For these reasons, we analyse operating leases separately from other categories of leases. In operating leases, the independent leasing companies compete partly on their knowledge of particular market segments. They source finance from the banks but the banks have not shown an interest in directly extending leasing in segments about which they know little.

4.2 Pricing

Lease agreements have various associated charges. The interest rates are the single largest charge and, according to interviews, consumers focus on this and compare the rates offered with those from banks. While the interest rate cap does not apply to lease payments, lessees nevertheless have expected the rates charged to have been in line with the cap.

In addition, there are a range of other non-interest charges. These can include set-up charges such as approval fees and asset registration charges, as well as additional charges such as insurance, tracking services, and asset service and maintenance charges.³⁷ Fees (such as processing fees or facility fees) may also take the form of a percentage of the value of the asset.³⁸

In general in Kenya, average interest rates of leases (weighted by volume of transactions) appear to have fallen over time (consistent with the application of the interest rate cap) while fees have increased slightly or stayed the same (Figure 8). Average interest rates are higher for finance leases than operating leases, and higher fees seem to be charged for finance leases as well. Interest rates for hire purchase leases and asset-based finance are similar to operating leases but fees are higher. Interestingly, the types of leases which are bank driven (see Figure 3) tend to have much higher fees than operating leases which are offered mainly by leasing companies. This is despite the fact that interest rates charged for operating leases tend to be lower or similar to the interest rates charged for the bank-led leases.

Overall, however, the pricing data available to the Inquiry did not suggest there is a competition problem in the market, and we draw attention to the notes to the figures which indicate the relatively few responses to the information requests. Better responses would have allowed greater understanding of this area.

Figure 8: volume-weighted average interest rates and additional fees, 2014 - 2017

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Figure 9: value-weighted average interest rates and additional fees, 2014 – 2017

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4.3 Market structure

One theory of harm in a competition analysis might relate to the existence or risk of significant market power, and of this being used to foreclose the market to rivals, or impose higher prices, poorer quality or otherwise worse conditions on consumers than would prevail in a competitive market. While the market's performance is poor, we did not find evidence that this arises from such competition problems.

³⁷ Submission by <<CONFIDENTIAL>>.

³⁸ Submission by <<CONFIDENTIAL>>.

The markets for the different leasing products are quite concentrated, even before further segmentation by asset type and size and activity of the lessees (Table 6). However, some companies did not provide data and so caution must be exercised in interpreting Table 6 and the shares of market segments.

Table 6: Market shares by value and volume, by lease type, 2017

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Concentrated markets in themselves do not necessarily imply that there is a competition problem. Where there are not significant barriers to entry and growth, the threat of competition from new providers (including those in adjacent leasing markets) may impose competitive discipline on the market. The Inquiry did not find reason to think that concentration in the Kenyan leasing market is the cause of the weak SME leasing sector. Nor did we find signs of collusion, although the Inquiry was not investigating any allegations of collusion (see section 4.4). Rather, the sector is underserved, apparently because under current regulatory and fiscal conditions (see sections 5 through 7), the commercial opportunity it presents (particularly in light of the risks and high transaction costs) is insufficient to attract leasing providers in significant scale.

4.4 Potential coordination among market participants

While the available information indicates that the market segments are concentrated, it does not provide signals of collusion, especially with regard to leasing finance to SMEs. The most obvious point, worth emphasising once more, is that there are very low levels of leasing finance to SMEs and that market failures and other constraints mean that the incentives to extend finance to SMEs are poor. This contrasts with the general incentive to collude which is to establish and maintain high profit margins through agreeing not to compete – where customers are being served from which supra-competitive margins can be earned.

Even with the relatively poor data, it further appears that the market shares in leasing finance have been very variable over time rather than the stable shares that would be expected from collusion. There is some segmentation within the leasing markets, as noted above. However, given the low levels of market development, this could be expected and is not necessarily indicative of any form of market division arrangement. While there are barriers to entry (see section 4.5), there has been entry and the market facilitation steps we recommend here would further open up leasing markets. The similar pricing is to be expected given the interest rate caps and this cannot be taken as being a sign of collusion.

In addition, terms and conditions do vary. Moreover, the product itself is not homogenous but varies on a range of dimensions including the asset being financed, the duration, the risk of the lessee and the arrangements regarding taking over ownership and the terms thereof.

These all make it difficult to reach and sustain a broader collusive agreement, other than simply an agreement on fixing certain charges, which could be reached but of which we have not found any evidence. As we discussed above, the industry organisation, the Leasing Association of Kenya, is active in promoting the sector through lobbying government as well as discussing among its members how best this can be achieved. However, no evidence was uncovered to indicate that the LAK is a forum for collusion.

³⁹ Although <<CONFIDENTIAL>> has extended into other areas, as discussed below.

⁴⁰ Interview with <<CONFIDENTIAL>>.

4.5 Barriers to entry

High barriers to entry and growth constrain potential competition from new and smaller firms. These barriers relate to hurdles that need to be overcome to be an effective competitor. In the provision of leasing finance, the barriers depend on the type of leasing. Finance leases, hire purchase and asset-based finance are essentially banking products in Kenya. While there are significant regulatory barriers to banking, the additional obstacles to banks providing leasing finance are not substantial.

The provision of operating leases is a more niche capability requiring knowledge of the customer segment and links with the suppliers. The ability to source finance is a critical requirement. However, the relatively small number of providers of operating leasing targeted at SMEs appears to be less due to barriers to entry, and more related to the nature of the SME market segment itself. In particular, providers face challenges of building the necessary capabilities to evaluate risks, and lack a supportive regulatory regime to incentivise leasing finance in face of the inherent market failures associated with imperfect information and risk in the SME segment (see sections 5 through 7).

In addition, in the case of SMEs, leasing presents high transactions costs and so low marginal returns. Large corporate or government customers may agree to lease numerous assets at a time under a single framework contract, but SMEs are more likely to lease one asset at a time. Large customers present huge efficiencies of scale and/or scope for leasing companies, saving customer relations, legal and other costs. They have or can get the expertise to understand asset management. However, SMEs do not present economies of scale or scope.

They lack understanding of leasing (as discussed in section 7) and so require the legal, fiscal and accounting treatment of leasing to be explained to them one-by-one. The resulting high transactions costs presented by SMEs undermines the attractiveness of the market.

In addition, the Kenya market faces significant financial risks (discussed in section 5), fiscal and accounting barriers (discussed in section 6), and legal and regulatory framework problems (discussed in section 8). Together, these impede entry and growth of SME leasing.

4.6 Other competitive developments

Independent leasing companies often lead the way in terms of the development of a market for leasing in developing countries, and this has been the case in Kenya, with Vaell and Rentworks being early entrants. However, leasing markets also often develop to become ultimately dominated by banks and bank-affiliated leasing companies which have better access to finance.

Banks may establish subsidiaries to engage in leasing, doing so with the clearance of CBK, but only <<CONFIDENTIAL>> have taken this step (we understand that <<CONFIDENTIAL>> also has approval but at time of interviews in mid-2018 it had not yet launched leasing).

As banks extend downstream from providing finance into providing leases, they compete with the financing part of the independent leasing companies' business. As a result, a bank that might have provided financing to several leasing companies may cease to do so, privileging its own leasing operation. Thus, one leasing company in Kenya observed that while in the past more than 10 banks would finance the independent leasing companies, this has diminished as the banks have themselves entered the market. Successful independent leasing companies are often acquired by banks as the market develops.⁴¹

These developments are not necessarily anticompetitive or a reason to expect diminished competition or higher prices. Banks bring certain transparency, efficiency and innovation benefits into the financing part

⁴¹ IFC (2009).

of the market. Lease payments typically cover the rental payment, which represents the implicit cost of repayment of and interest on the principal of the loan, as well as any service and maintenance, as well as insurance.

As the market has developed in Kenya, lessors have faced increasing pressure from large customers to provide transparent information about the build-up of the pricing. This includes separating out not only the service and maintenance, insurance and lease payments, but also showing the principal and interest component. This trend towards greater transparency imposes competitive pressure on leasing companies in competition with banks that are also providing leases, as well as among the leasing companies for the prices and terms and conditions of service and maintenance and insurance. Some large customers indicated that pricing and transparency have improved as the market has developed.⁴²

Other indications of competition are in diversification into broader product ranges. For instance, Simba is moving into agricultural equipment, such as tractors for agriculture franchises, as well as potentially the smallholder farmer market. It has also been leasing small Turkish branded generators. On a larger scale, <<CONFIDENTIAL>> has entered hotel fit-out leasing, for example at the <<CONFIDENTIAL>>. As Kenya industrialises, further opportunities are anticipated in leasing of processing machinery and packaging.⁴³

5 Financial risk barriers

The equipment leasing market for Kenyan SMEs is inherently risky and subject to high transaction costs. SMEs often do not have any significant formal borrowing history or reliable financial statements. As a result, there is typically considerably less available credit information about SMEs than larger entities. SMEs' smaller scale also makes them disproportionately vulnerable to larger economic forces. Their poorer access to financial facilities may also result in a weak ability to absorb temporary economic shocks. Furthermore, leased assets are typically moveable, and while this may make repossession easier, it also raises risk of loss of the asset, thus undermining the value of collateral. As a result, Kenyan leasing companies have tended to view the high level of risk as the main barrier to increasing leasing to SMEs.⁴⁴

As in any financial market, the ability to assess, manage and price risk is fundamental to development of the market. Where risk is higher, as with SMEs, a weak ability to assess, manage and price it effectively will impede healthy development of the market:

- **The ability to assess risk** depends on availability of credit information.
- **The ability to manage risk** depends on effective collateral and repossession security rights, and the ability to dispose of the repossessed asset.
- **The ability to price risk** depends on the ability to increase and reduce the price of finance according to the risk profile of the lessee.

The Kenya Government has sought to address the challenge of risk *assessment* by developing credit reference bureaus (CRBs) and leasing companies' participation in them, as discussed in section 5.1. Today, leasing companies increasingly report data to the CRBs, giving them access to the credit assessments. Some market participants referred to this as a 'game changer' in credit assessment leading to

⁴² Interview with <<CONFIDENTIAL>>.

⁴³ Interview with <<CONFIDENTIAL>>.

⁴⁴ For example, <<CONFIDENTIAL>>.

more leasing, however, as noted above, leasing finance extended to SMEs has nevertheless declined over the same period.

The Government has also taken important steps to improve the *management* of default risk. The introduction in 2018 of an electronic collateral registry, discussed in section 5.2, considerably reduces legal risk relating to security and repossession. This is an important step, together with the changes in credit reporting, supporting extension in leasing to SMEs in the years ahead.

However, the *pricing* of risk has been fundamentally undermined by the interest rate cap. While lessors can charge higher lease prices to reflect the level of risk, this is not effective if the underlying financing for higher risk business is not available or lease pricing is carried out in the shadow of the interest rate cap. Thus, as discussed in section 5.3, the cap on Kenyan interest rates appears to be off-setting the beneficial advances in credit assessment and risk management, reducing access to finance for higher risk transactions, including financing of SME leases. The market participants interviewed unanimously emphasised that, in a market prevented from pricing transactions against risk, they had little interest in pursuing SMEs.

One option for reducing SME credit risk would be for the Government to provide support by way of guarantee for SME lease payments and other collateral. We discuss this in connection with market stimulation in section 7.3.

5.1 Assessing risk: credit reporting

The Credit Reference Bureau Regulations, 2013, require that all banks and other institutions licensed under the Banking Act report both positive and negative credit information on consumers to Kenya's three credit reference bureaus.⁴⁵

Creditors that are not subject to reporting requirement, which would include lessors and other non-banks that provide finance for leases, have no obligation to submit any credit reference information to the bureaus. However, these 'third parties' are permitted to submit positive and negative credit reference information to credit reference bureaus if they are approved by the CBK and obtain the consent of a customer.⁴⁶

Indeed, some lessors in 2018 were reporting, though only negative credit data (i.e., delinquent payments) and not positive data (i.e., compliant lease payments). This became more effective as the leasing companies took a more standardised approach to the format of their data reporting. As a result, the leasing companies receive data from the CRBs, enhancing their credit assessments of prospective and current lessees. Of the lessors surveyed (banks and leasing companies), all but one reported that they (or banks on their behalf) make use of the CRB and that its usefulness is improving as more information is reported over time.⁴⁷

The Regulations require banks and other entities that intend to submit negative information to the bureaus to give 30 days' prior notice to the customer, allowing the customer an opportunity to dispute the

⁴⁵ Section 18.

⁴⁶ Section 23.

⁴⁷ Note that one respondent did not answer the question.

accuracy of the information.⁴⁸ Customers also have the right to access their credit reports from the bureaus and dispute the accuracy of information in a report.⁴⁹

All market participants agreed that these are valuable developments, enabling them to better assess risk of their customers. The credit reporting system is not yet perfect, but is undergoing improvements, as the CAK found in its banking inquiry in 2016-7, and this is to be welcomed in the leasing context.

5.2 Managing risk: collateral, repossession and disposition

5.2.1 Risk and security rights

An important risk for lessors relates to recovery of the asset in case of default in payments by the lessee. Lengthy proceedings to recover the asset result in idle time, and potential risk to the condition and value of the asset itself.

In the Inquiry, lessors did not generally indicate significant problems with repossession where lessees defaulted on their leases. In part, leasing is a relationship business, where the lessor will hope to make the lessee a repeat customer that returns for new or renewed leases for its asset requirements. In many cases, the lessor will prefer to wait out late payments (or renegotiate) rather than seize assets that it has to place elsewhere. In addition, leasing finance has predominantly been to blue chip local businesses and multinationals, for vehicles, which present lower or more manageable risk of default.

Where repossession becomes necessary, it may require the incurrence of costs, including to pay for police to accompany the repossession agent. But only a small number of repossessions tend to be contested (one market participant estimated 5%), and no market participant suggested that the process is too cumbersome or slow.

Nevertheless, a robust process for repossession is a vital dimension of any leasing system, and will affect the risk premium that lessors will place on the already-high-risk SME market.

Security for indebtedness or other obligation may be made by granting collateral over assets. In the case of a lease, the lessor typically has a right to repossess the leased asset, but other assets could also be offered as collateral. Kenya has struggled with effective collateral in the past, and so introduced the Movable Property Security Rights Act⁵⁰ which came into force in May 2017, followed shortly thereafter by the associated regulations in June 2017.⁵¹ The Act will clearly constitute a vital pillar in the robustness of any equipment leasing market, and its recent enactment and implementation by the Office of the Attorney General should represent a major stride in the development of the leasing market. The Act

⁴⁸ Section 25.

⁴⁹ Section 35. The Regulations have been subject to judicial challenge based on violation of the constitutional rights of consumers. However, the High Court of Kenya recently issued a judgment confirming that the Regulations do not violate the Constitution, including, among other provisions, the rights to privacy under Section 31 of the Constitution. *Barbra Georgina Khaemba v Cabinet Secretary, National Treasury and Attorney General*, Republic of Kenya, In the High Court of Kenya at Nairobi, Constitutional and Judicial Review Division, Petition No. 516 of 2014, Judgment dated 11 March 2016.

⁵⁰ Movable Property Security Rights Act No. 13 of 2017.

⁵¹ Movable Property Security Rights (General) Regulations, 2017.

contributes to the Government's Kenya Vision 2030 objective of building an efficient and globally competitive financial services sector.⁵²

5.2.2 Electronic registration of security rights over collateral

The Movable Property Security Rights Act provides a means for obtaining legal certainty and enforceability for securities. In particular, it requires securities over movable property⁵³ to be registered under the Act in an electronic Collateral Registry in order to be effective collateral⁵⁴, having priority over a liquidator, administrator or third parties. Without such protection, a debtor's liquidator, administrator or other creditors might take control of and dispose of the debtor's assets before the creditor asserting the security right. It provides for a Registrar to deal with such registration processes. It thus addresses the very credit risk concerns that typically arise in relation to equipment leases.

The Act and the associated Regulations set out the nature of and evidence for security rights, and the process for creating and registering security rights in specific movable assets through electronic filing in the Collateral Registry (Figure 10 illustrates part of the registration form). It provides also for how the rights, obligations and priorities of third parties, including consensual and non-consensual creditors in security rights over movable assets, will be determined, as well as enforcement of the rights of a security right holder.

⁵² Other laws relevant to this goal are the Financial Services Authority Bill, 2016 and the Nairobi International Financial Centre Bill, 2016. The Movable Property Security Rights Act repeals the Chattels Transfer Act (Cap. 28) and the Pawnbrokers Act (Cap. 529). It also amends several sections of the Agricultural Finance Corporation Act (Cap. 323), The Stamp Duty Act (Cap. 480), the Hire Purchase Act (Cap. 507), the Business Registration Services Act (Act No. 15 of 2015), the Companies Act, 2015 and the Insolvency Act, 2015 to align the provisions of these statutes with the Act.

⁵³ "Movable assets" are broadly defined as tangible assets (meaning all types of goods including motor vehicles, crops, machineries and livestock) and intangible assets (including receivables, choses in action, deposit accounts, electronic securities and intellectual property rights).

⁵⁴ "Collateral" is defined as a movable asset that is subject to a security right or a receivable that is subject to an outright transfer.

Figure 10 Excerpt from initial collateral security registration form

A. Type of Collateral

- Motor vehicle
- Livestock
- Crops
- Documents of title
- Intellectual property
- Securities
- Negotiable instruments
- Bank accounts
- All present and after acquired property
- Future proceeds
- Household items
- Furniture
- Stock in trade
- Inventory
- Consumer goods
- Others

B. Description of Collateral (including serial number if any):

.....

.....

.....

5. Period of effectiveness:.....(days/months/years)

6. Maximum amount secured:.....(currency)

The Act provides for an electronic facility for searching the Collateral Registry according to the grantor of security rights and according to the collateral, enabling potential lessors and lenders to identify the assets already secured, and to identify what security rights have been granted over a debtor’s assets.

Many market participants interviewed in this Inquiry referred to the introduction of the registry and confirmed its usefulness in reducing risk of repossession and disposition for value in the event of lease default. Of those who made written responses, ten confirmed that they use the registry and find it useful while four do not use it and three did not answer the question. Respondents pointed out that leasing providers do not yet have access to the full system as the project has been implemented in phases, starting with the commercial banks and deposit-taking microfinance institutions. It is expected that leasing companies will be next to receive full access, although there are questions about how effective communication about the timing and nature of this access has been.⁵⁵

5.2.3 Enforcement of security rights

The new Act creates powerful rights, although there may be some uncertainty about how these affect provisions in laws already in force.

Under the Consumer Protection Act, where the lessee has paid two thirds or more of the payment obligation under the lease, the supplier’s (i.e., the lessor’s) remedy of repossession may only be enforced

⁵⁵ Follow up submission by <<CONFIDENTIAL>>.

by leave of the High Court.⁵⁶ The Act applies to transactions with ‘consumers,’ a term that is broadly defined as ‘persons’ dealing with suppliers, and would apparently include sole traders.⁵⁷ The protection apparently applies to both operating and finance leases.⁵⁸

Repossession of assets pursuant to a law or a written contract (which would include a lease) is deemed to be the business of ‘auctioneering’ under the Auctioneers Act.⁵⁹

The Moveable Property Security Rights Act in 2017 introduced new provisions relating to repossession and disposition of collateral. It is not entirely clear to the Inquiry how these relate to the provisions of the Consumer Protection Act and Auctioneers Act, which it did not repeal.

The Moveable Property Security Rights Act provides for the registration of security rights over moveable property where the assets are used to secure a payment or for performance of an obligation. In the case of a lease, this would be the lease payments. Under the Act, ‘financial leases’ (which are defined⁶⁰ along the lines of what is typically understood as a finance lease) are treated as security rights, and operating leases probably are too.⁶¹ We understand that lessors and lessees are in practice registering their leases in the new Collateral Registry in order to create security rights in the leased assets as collateral, protected under the new Act.

The new Act does not apply to enforcement of security rights under hire purchase agreements⁶², which include finance leases to sole traders where title is or may be transferred and the total hire purchase price is Ksh 4 million (about US\$ 40,000) or less. However, other finance leases, such as to incorporated entities and even leases to sole traders where the total hire purchase price exceeds Ksh 4 million, appear to be subject to the new Moveable Property Security Rights Act.

⁵⁶ Section 20 of the Consumer Protection Act No. 46 of 2012 provides: “(1) Where a consumer under a future performance agreement has paid two-thirds or more of his or her payment obligation as fixed by the agreement, any provision in the agreement, or in any security agreement incidental to the agreement, under which the supplier may retake possession of or resell the goods or services upon default in payment by the consumer is not enforceable except by leave obtained from the High Court. (2) Upon an application for leave under subsection (1), the court may, in its discretion, grant leave to the supplier or refuse leave or grant leave upon such terms and conditions as the court considers advisable.”

⁵⁷ The term ‘person’ could in some circumstances even mean a legal person that is not an individual. Although this appears unlikely, we have not been able to ascertain whether this is possible in this circumstance.

⁵⁸ Under the Consumer Protection Act, ‘lease’ is defined as “a consumer agreement for the lease of goods, other than a consumer agreement for the lease of goods in connection with a residential tenancy agreement, and ‘lessor’ and ‘lessee’ have a corresponding meaning”. This does not actually define what a lease is, but merely excludes residential tenancy leases for the purposes of the Act, which concerns consumer goods.

⁵⁹ Section 2(2) of the Auctioneers Act No. 5 of 1996.

⁶⁰ Section 2 provides: “‘financial lease’ means a lease under which at the end— (a) the lessee automatically becomes the owner of the asset that is the object of the lease; (b) the lessee may acquire ownership of the asset by paying no more than a nominal price; or (c) the asset has no more than a nominal residual value.”

⁶¹ Section 4(1)(b) provides that the Act “applies to security rights in moveable assets, including [various types of security right, including financial leases] *and any other transaction that secures payment or performance of an obligation*” (emphasis added).

⁶² Section 65(4) provides: “If the security right has been created under a hire purchase agreement, the secured creditor may enforce its rights only in accordance with the Hire Purchase Act.”

The new Act permits the secured creditor (here, the lessor) to exercise any right provided in its security agreement with the debtor (here, the lessee).⁶³ Further, a secured creditor (lessor) is entitled to obtain possession of the collateral if the grantor (lessee) has consented in the security agreement to the secured creditor obtaining possession, in which case no court application is required, or the grantor does not object.⁶⁴ Overall, the post-default rights appear to be exercisable without applying to court.⁶⁵

This would appear to contradict the Consumer Credit Act provision cited above, which requires the creditor to apply to a court if the lessor has paid more than two thirds of the payment obligation.

The new Act also permits the secured creditor (here the lessor) to dispose of the collateral, including by auction.⁶⁶ Whether the Auctioneer Act provisions still apply to require the lessor to hold an auctioneer licence is not addressed, so one must suppose that they do.

No market participant raised the relationship between the Consumer Credit Act and the Auctioneer Act on one hand with the Moveable Property Rights Act on the other as being problematic in practice, or as reducing their appetite for pursuing the leasing business. Nevertheless, it would be helpful to clear away any ambiguity, whether by amendment or in the meantime providing interpretative guidance.

Recommendation (medium/long term)

We recommend clarifying how the repossession provisions of the Consumer Protection Act and the disposition provisions of the Auctioneer Act relate to similar provisions in the Moveable Property Rights Act, whether by interpretative guidance (e.g., issued by the Attorney General’s office) or by legislative amendment.

5.2.4 Priority lien

Lessor risk also must take into account the legal provisions addressing the situation where a creditor of the lessee (or even the lessor) obtains a lien or similar right against the leased asset under insolvency laws, laws governing enforcement of judgments, or other laws. The lessor will be protected if it is clear that a third-party creditor takes any lien over the asset subject to the rights and remedies of the parties to the lease. This includes ensuring that the creditor of the lessee cannot impair the lessor’s security interest rights in the leased asset. In turn, it also includes ensuring that the rights of a creditor of the lessor are subject to the lessee’s rights of use and possession.⁶⁷

⁶³ Section 65 provides: (1) After the failure of the debtor to pay or otherwise perform a secured obligation, the grantor and the secured creditor may exercise any right—(a) under this Part; (b) provided in the security agreement; or (c) provided under any other written law.”

⁶⁴ Section 71 provides: “[A] secured creditor is entitled to obtain possession of the collateral [if...] (a) the grantor [of the security right] has consented in the security agreement to the secured creditor obtaining possession, in which case no court application is required [or] (b) the grantor ... does not object].”

⁶⁵ Section 66 provides: “A secured creditor may exercise its post-default rights by application to a court or in accordance with this Part, without applying to a court.”

⁶⁶ Section 72. The section provides that the secured creditor may ‘buy’ the collateral, but this appears to be an error and in the context can only mean ‘sell.’

⁶⁷ These goals are addressed in Article 8 of the UNIDRIOT Model Law: “Except as otherwise provided by the law of [this State]: (a) a creditor of the lessee and the holder of any interest in land or personal property to which the asset becomes affixed take subject to the rights and remedies of the parties to the lease and cannot impair any interest arising under the lease; and (b) a creditor of the lessor takes subject to the rights and remedies of the parties to the lease.

Under the Moveable Property Security Rights Act, priority of security rights is according to time of registration.⁶⁸ The Act addresses various dimensions of this, including timing, security right over the proceeds of the asset, treatment of comingled goods, and disposition of the asset subject to the security right.⁶⁹

Lessees are protected against creditors of the lessor, i.e., the lessor's secured creditor may not interrupt the lessee's enjoyment of the asset.⁷⁰ Security rights over equipment that secure future payments of the purchase price, for example in an instalment sale, have priority over other security rights.⁷¹ Specifically, the security rights of a seller or lessor that secure future payments take priority over other security rights.⁷²

Altogether, although the Inquiry has not been able to resolve in the course of its work the uncertainties above, the Moveable Property Security Rights Act introduces a very robust set of rights and procedures for lessors, including matters that might typically be found in a leasing act.

5.2.5 Secondary market risk

A number of respondents noted that there is risk associated with the need to dispose of assets in the event of default and repossession or at the end of an operating lease. Thin markets for second hand equipment make it difficult for lessors and financiers to assess the likely resale value, and therefore to accurately price the risk involved in the lease transaction. They also increase the likelihood that the sale of the asset will not cover the costs involved in providing the lease. For this reason, one leasing provider noted that marketable and movable assets (for which the secondary market is likely to be better) are better suited to operating leases while bespoke and non-movable assets are better suited for financial leases where the ownership of the asset passes to the lessee at the end of the lease period.⁷³

A number of respondents noted the quality of secondary markets as a factor they take into account during a credit assessment. This is consistent with the overwhelming orientation of leasing to vehicles, which as a general-purpose asset tend to have a more liquid secondary market than other equipment that may be more specialised (e.g., agricultural or medical equipment). However, if leasing to SMEs for machinery and equipment is to take-off and alleviate the self-financing constraint facing SMEs for their investment needs, then the constraints of thin secondary markets for equipment needs to be recognised. This suggests

⁶⁸ Section 38.

⁶⁹ Sections 39 – 55.

⁷⁰ Section 45(5) reads: “The rights of a lessee of tangible collateral leased in the ordinary course of the lessor's business are not affected by the security right, provided that, at the time of the conclusion of the lease agreement, the lessee does not have knowledge that the lease violates the rights of the secured creditor under the security agreement.”

⁷¹ Section 47.

⁷² Section 47 provides: “An acquisition security right in consumer goods, equipment, inventory, or intellectual property has priority as against a competing non-acquisition security right created by the grantor, provided that a notice with respect to the acquisition security right is registered with the Registrar before the grantor obtains possession of the asset or acquires a right in intellectual property. Section 48 provides: “An acquisition security right of a seller or lessor has priority over a competing acquisition security right of a secured creditor other than a seller or lessor.” Section 2 defines ‘acquisition security right’ as “a security right in a tangible asset or intellectual property, which secures the obligation to pay any unpaid portion of the purchase price of the asset or other credit extended to enable the grantor to acquire it to the extent the credit is used for that purpose.”

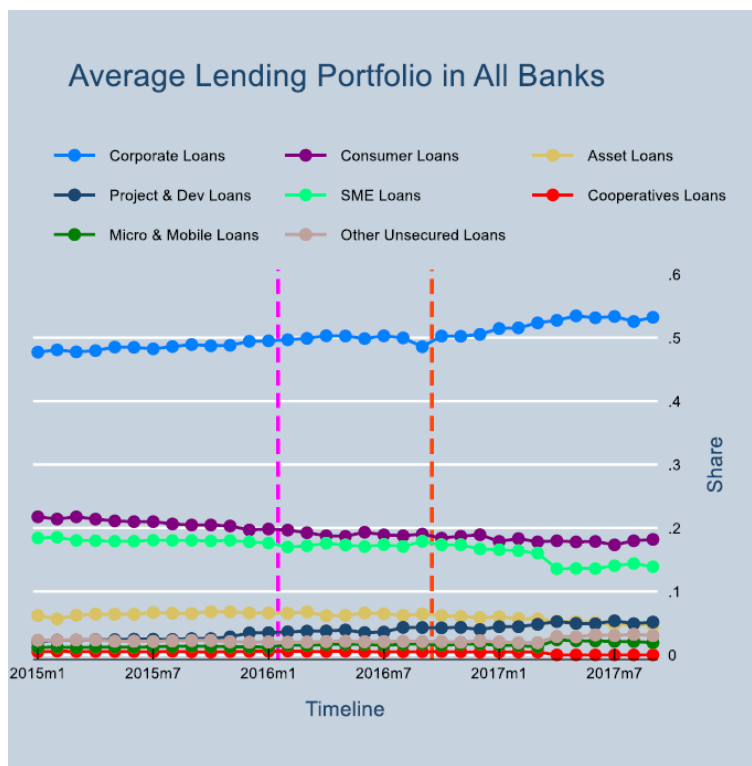
⁷³ Submission by <<CONFIDENTIAL>>.

that further incentives on the supply-side to attract leasing companies to expand in these higher risk segments would be appropriate, as discussed further below in section 7.

5.3 Pricing risk: the interest rate cap

The interest rate cap imposed by the Central Bank of Kenya in the Banking Amendment Act 2016 reduced interest rate margins between deposits and loans. This policy has been controversial, with some claiming that it has slowed economic growth,⁷⁴ particularly through its impact on rationing finance to the SME sector. The World Bank, for example, has found that the caps led to a decline in aggregate lending, an increase in non-performing loans and a marked decline in lending to SMEs as shown below (Figures 11 and 12).⁷⁵ The CBK estimated that the contribution to GDP growth by SMEs declined by 1.4 percentage points in 2017 as a result of the rationing, leading to a real GDP decline of 0.4%.⁷⁶

Figure 11: Average lending portfolio in all Banks



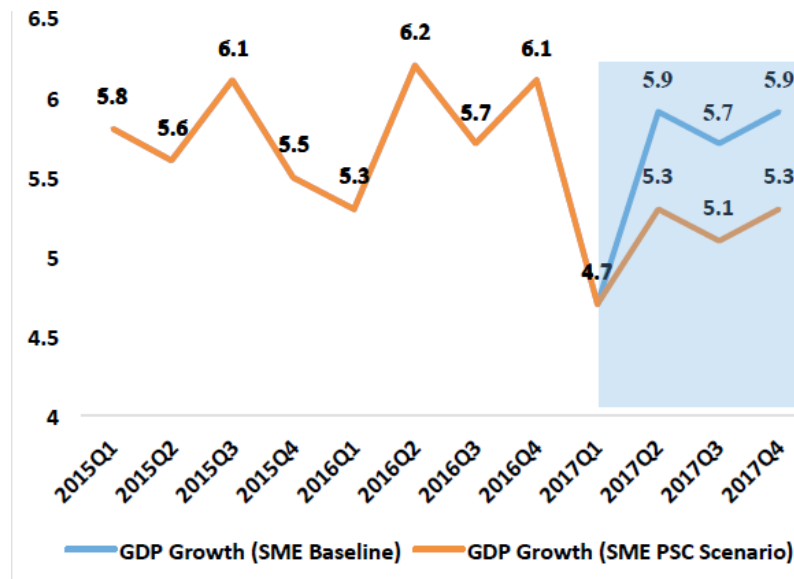
Source: World Bank (2018)

⁷⁴ For example, sales of vehicles dropped by over 20% during 2017 according to the Kenyan Vehicle Manufacturers Association, part of a general slowdown attributed to a combination of lack of access to finance and the two presidential elections held during the year. See e.g., <https://af.reuters.com/article/africaTech/idAFKBN1FK1GP-OZABS>. It is unclear how much of the slowdown is attributable to the interest rate cap and how much to the period of political uncertainty. Sales are reported to have started growing again in early 2018.

⁷⁵ Safavian, M and Zia, B. “The Impact of Interest Rate Caps on the Financial Sector”, World Bank Group Policy Research Working Paper 8393, April 2018, available [here](#)

⁷⁶ Central Bank of Kenya, “The Impact of Interest Rate Capping on the Kenyan Economy”, Draft Paper, March 2018, available [here](#)

Figure 12: Impact of rationing out MSMEs on Growth



Source: CBK (2018)

Lease prices are not subject to the interest rate cap and so, in theory, one might expect leasing companies to be at liberty to price for risk through increasing lease pricing for higher SMEs. One possible outcome would be switch into leasing finance for SMEs from other forms of bank credit to these companies. This does not appear to have occurred from the data provided by respondents. Instead, SME leasing finance appears to have declined, along with other finance to SMEs.

There are a number of possible explanations for this. First, as we discuss below, other regulatory and taxation measures have disincentivised leasing finance. Furthermore, a range of considerations relating to poor understanding and awareness of leasing need to be addressed.

Second, the ability of leasing companies to make leasing available for their customers depends on their ability to obtain the finance in the first place. While some leasing companies fund their operations from their own balance sheets and from shareholders, much leasing depends on banks to finance the acquisition of the assets. Bank finance may be provided by loan to the lessor to acquire the asset to lease to a given customer in a specific transaction, or by providing a credit facility to a lessor to enable it to finance its asset portfolio. Either way, bank financing is a cornerstone of the leasing market. While loan finance from banks for leasing companies has become cheaper under the interest rate cap (as some respondents reported), the banks cannot price loans higher where there is higher perceived risk and so are more likely to ration credit. The constraint on banks' ability to price loans higher to reflect higher risk has likely turned them away from higher risk transactions in the Kenyan economy generally, reducing availability of lending for both asset purchases and lessors.⁷⁷

Third, while respondents to the CAK's information request highlighted the different impacts of the interest rate cap (see Table 8), the main independent leasing companies emphasised the disincentive to lend to SMEs. Where respondents noted positive effects, this did not reflect the challenges facing the extension of leasing to SMEs for machinery and equipment. For example, <<CONFIDENTIAL>>noted

⁷⁷ According to some market participants, the constraints on purchasing and leasing has resulted in some increase in demand for short-term rentals, benefitting pure leasing companies like Vaell who continue to provide short-term rentals. In other words, the demand for equipment is having to be met in another, potentially less efficient, way. Interview, <<CONFIDENTIAL>>.

lower cost of funds, yet <<CONFIDENTIAL>>extends leases mainly for second hand cars and <<CONFIDENTIAL>>has almost no leasing activity. While <<CONFIDENTIAL>>also noted that the cap lowered the cost of funds, the in-depth interview with <<CONFIDENTIAL>>highlighted the challenges in practice with the ability to price for higher risk segments. The largest and most established pure leasing companies which provided information (<<CONFIDENTIAL>>) both noted the challenges from the interest cap. <<CONFIDENTIAL>>noted that the reduced interest rates had resulted in additional bank fees being charged and in a lack of credit, particularly for individuals and SMEs.

Table 7: Respondents' view on interest rate cap

<<CONFIDENTIAL>>

This begs the question as to why the leasing providers cannot continue to charge higher effective interest rates and charges related to risk, especially where they have their own capital base. In this regard, the leasing providers reported that lessees seek transparency on finance charges and do not expect to be charged more than the capped interest rate. In addition, there has been uncertainty as to whether the cap would be extended to leasing in which case rates might have to be reduced on existing as well as new leases. Ultimately, the cap both reduces the incentive to lend to riskier segments, in which SMEs are clearly one, and introduces uncertainty.

The banks were unsurprisingly more troubled by about the cap. Various challenges were cited including lowered revenues and margins, the difficulty of pricing risk appropriately, and lower levels of lending, especially to SMEs. Unfortunately, the data collected was not sufficiently disaggregated to enable us to isolate trends in leasing to SMEs and individuals, and so we were unable to test these claims. However, the banks' arguments are consistent with the broader lending trends illustrated above.

Concern about the overall investment climate evidenced by strong consumer protection efforts, of which the interest rate cap is perceived to be part, has (according to market participants) even led to some withdrawal from adjacent markets such as instalment sales (in which title to the asset transfers at sale with payment made in subsequent instalments) due to risk of further price regulation, even although these fears appear to be unfounded.⁷⁸

While clearly this Inquiry is not focused on the regulation of banking, nevertheless, the regulation of interest rate pricing appears to have had a significant adverse effect on the leasing sector. While the sector did not grow as hoped before the interest rate cap was introduced, it does appear that no other reforms are likely to have a positive effect on the leasing market, particularly for SMEs, so long as the cap remains in place. The sector is viewed as too high risk, for which finance is unavailable at prevailing margins. Despite indications that the government intended to lift the interest rate cap, the Kenyan parliament voted instead in August 2018 to extend it.

Recommendation (immediate priority)

For Kenya's SME leasing market to grow, it will be essential for lessors to have access to financing from banks that is not subject to the interest rate cap and for leasing companies to be able to price effectively to higher risk groupings. We recommend that when considering the ongoing regulation of interest rates, the Government take into account the adverse impact on the leasing market of the current policy.

⁷⁸ Banks have picked up some of the instalment sale market where SMEs brought strong credit profiles, while SMEs lacking strong enough credit profiles have simply been unable to finance vehicle acquisition, whether by purchase or lease.

6 Fiscal and accounting barriers

6.1 VAT exemptions

A common policy intervention to stimulate the leasing industry involves adjusting tax laws so that they are both clear, and neutral in that they provide a level playing field between leasing and other forms of financing. One issue identified internationally relates to whether VAT is claimable by the lessee given the purchase is not in the name of the lessee. Where VAT cannot be offset it may render leasing more expensive compared to bank finance. Other ways in which VAT can affect the development of the leasing market concern whether it is exempt for the importation of equipment for leasing, and whether there is a difference in how VAT is charged for a financial or operating lease. Other interventions involve removal of VAT entirely.⁷⁹

The Kenyan Government, through the KRA, has provided various tax incentives to support particular sectors of the economy and SMEs. The standard VAT rate under the VAT Act is 16%⁸⁰ but some goods and services are exempt. For instance, the supply of goods such as agricultural equipment (e.g., tractors), energy equipment (e.g., electricity generators), medical equipment (e.g., scanners, dentist chairs), various plant and machinery, and many other things required by businesses, are VAT-exempt.⁸¹ Various services are also VAT-exempt, such as certain financial, medical, agricultural and transportation services.⁸² Various other goods and services are not VAT-exempt but attract a zero rate of VAT.⁸³

In addition to these exemptions and zero ratings that apply to the supply of particular goods and services, many (probably most) SMEs are not registered to charge VAT on their supply of goods and services because their annual revenues from supply of taxable goods and services fall below the KSh 5 million threshold for registration.⁸⁴

A SME that is not required to charge VAT that purchases VAT-exempt goods will thus neither pay VAT to the seller from which it buys its inputs nor charge VAT to the buyers of its outputs. Furthermore, if the

⁷⁹ Some have recommended waiving VAT on lease payments in emerging markets as they are substitutes for term loans to ensure a fairer playing field. Some reforms have tried to address this. For example, in Uzbekistan there is no VAT on lease payments, and no VAT or customer fees levied on goods for the purpose of leasing.

⁸⁰ VAT Act No. 35 of 2013, as amended.

⁸¹ VAT-exempt goods are listed in Part I of the First Schedule to the VAT Act.

⁸² VAT-exempt services are listed in Part II of the First Schedule of the VAT Act.

⁸³ The zero-rated goods and services are listed in the Second Schedule to the VAT Act. No VAT is payable on the supply of both exempt and zero-rated goods and services. The difference between VAT-exempt and zero-rated goods and services is that the suppliers of zero-rated goods and services can reclaim their input VAT (i.e., they are allowed credits for the VAT they pay on inputs), while suppliers of exempt goods and services cannot reclaim their input VAT (and indeed may not be registered for VAT in the first place). Section 7(1) of the VAT Act provides, "Where a registered person supplies goods or services and the supply is zero rated, no tax shall be charged on the supply, but it shall, in all other respects, be treated as a taxable supply." Section 17(1) of the VAT Act in turn provides, "[...] [I]nput tax on a taxable supply to [...] a registered person may [...] be deducted by the registered person [...] from the tax payable by the person on supplies by him in that tax period [...]"

⁸⁴ Section 34(1) of the VAT Act provides: "A person who in the course of a business [...] has made taxable supplies or expects to make taxable supplies [...] or is about to commence making taxable supplies [...] the value of which is [or is reasonably expected to be] five million shillings or more in any period of twelve months [...] shall be liable for registration under this Act [...]"

SME borrows to purchase its inputs, it will not pay VAT on interest because charges for credit are VAT-exempt.⁸⁵

However, VAT applies to operating lease payments. A lease is treated as a supply of services rather than supply of goods, and so exemptions for supply of goods are not available. While as mentioned above, there are VAT exemptions for some services, they are not available for leases of equipment that would be VAT-exempt if supplied as a good. As a result, the lessee will pay VAT on the lease payment. For example, the farmer who buys a tractor will pay no VAT on the purchase price or interest for a loan taken out to pay for it, but the farmer who leases the tractor will pay VAT on the lease payments.

This means in effect that the lessee pays VAT on both the asset value and the financing cost, i.e., the interest implicit in the lease. In simplistic terms, the underlying financial cost of the loan in the case of a purchase may be compared in the case of a lease with the underlying cost of financing the asset to be leased as the lease payments will be set to cover the cost of the loan incurred by the lessor to purchase the asset. Purchase and lease transactions are merely structured differently as to nature of the payment obligation, treatment of title to the asset, and benefit of the residual value of the asset. However, because VAT applies to lease payments (and these cover the principal and interest implicit in those lease payments), the lease structure presents a higher cost for the farmer than a purchase where no VAT would be payable on principal or interest.

In some cases, a business may be able to offset this input VAT paid against VAT collected on goods sold during the period. However, this is not possible where the goods (e.g., farm produce, to continue our example) are VAT-exempt or where the lessee (e.g., a farmer) is not registered under the VAT Act. As mentioned above, many SMEs are not VAT-registered, so do not charge VAT that would offset the VAT cost they incur under the lease. The result is a higher cost of leasing than purchasing, all other things being equal.⁸⁶ Several respondents to the CAK's information request made this point.⁸⁷

The application of VAT to leases for equipment that, if purchased, would be VAT-exempt, appears to be anomalous and, according to market participants, poses a substantial (16%) additional cost for capital equipment that is important to development of leasing in a large part of the Kenyan economy where leasing might otherwise grow. This includes doctors, dentists, farmers and various manufacturing businesses. Unfortunately, the application of VAT (where it would be exempt in the case of purchases) raises a cost barrier to leasing, the very financing mechanism that could otherwise lower the barrier for SMEs to acquire assets they are unable to finance. There are indications that the Government is open to review how VAT applies to leases in order to address such issues.⁸⁸ We also note that there were

⁸⁵ Section 1(h) of Part II of the First Schedule of the VAT Act.

⁸⁶ Of course, all other things are rarely equal. The lessor may have access to finance at lower cost than the farmer, for example because the lessor presents a better credit risk than the farmer or the lessor benefits from interest rate discounts due to the scale of its borrowing, or because it uses its own capital which has a lower cost to it than borrowing from a bank. If so, under competitive conditions, the lessor might be expected to pass the lower cost through to the farmer in lower lease payments. This may offset some of the additional cost to the farmer of the VAT payable on the lease. The Inquiry did not have sufficient data to assess the degree to which this may be the case, but many of the Kenyan market participants interviewed indicated that the charging of VAT on leases of assets that would be VAT-exempt if purchased increased the relative cost of leasing to SMEs. Alternatively, the SME may simply not have access to loan finance; indeed, one of the benefits of leasing is precisely that it makes available a form of finance where bank lending is not available. So leasing subject to VAT may not be more expensive than borrowing that is not possible in the first place, but it is nevertheless more expensive than the policy of VAT exemptions would appear to intend.

⁸⁷ Submission by <<CONFIDENTIAL>>.

⁸⁸ Interview with Treasury.

differences in understanding regarding the application of VAT to categories of leases and that clarification is needed in this regard.

There appear to be different understandings of application of VAT to finance lease payments.⁸⁹ It is not clear whether finance leases are treated as supply of a good akin to a purchase, and whether finance lease payments are thus viewed as repayment of a debt and interest or the service of a lease. Clarification of this, while not necessarily fundamental to stimulate the SME leasing market (which is likely to be driven more by operating leases), is strongly desirable.

Recommendation (immediate priority)

We recommend considering revising the application of VAT so that it does not apply to lease payments for assets which, if purchased, would not be subject to VAT, probably best in the form of an exemption as is the case with the supply of goods.⁹⁰ This would require modifying the VAT Act, likely in an annual budgeting process.

Recommendation (medium/long term)

We recommend clarifying the application of VAT to finance lease payments. We also recommend clarifying the definitions relating to leasing and VAT as part of a broader set of reforms to improve the coherence of definitions and the accounting and fiscal treatment of leasing activities.

6.2 Withholding of VAT

Some market participants expressed concern about the arrangements for withholding of VAT. The KRA has designated certain entities as withholding agents, such as Government bodies, banks, insurance companies and other financial institutions, hospitals, cooperative societies and certain large companies. Withholding agents are required to withhold payment of the 6% portion of the 16% of VAT payable to suppliers on the price of goods and services, and remit that 6% to the KRA. For instance, where a large firm like EABL leases a vehicle from a lessor at a notional price of Ksh 100,000 per month, it will pay Ksh 110,000 to the lessor (of which Ksh 10,000 is VAT) and will withhold Ksh 6,000 VAT, which it will remit to the KRA. The KRA, through its i-Tax platform, then sends an acknowledgement to the supplier. The 6% VAT is applied against the supplier's VAT debt for that month.⁹¹

⁸⁹ Some sources say financial services are VAT exempt but others say no difference between operating and finance leases from a tax perspective. See for example, <https://www2.deloitte.com/content/dam/Deloitte/ke/Documents/tax/Direct%20and%20Employee%20Tax%20Bootcamp.pdf>.

⁹⁰ The objective could be accomplished either by VAT exemption or zero rating. Zero rating would have the advantage that it would also allow the lessor to claim back VAT paid on acquiring the asset, which would allow a lower cost to be passed through to the lessee. This may not be a concern for equipment that is imported and not subject to VAT. However, as Kenya's industrialisation policy develops assembly of equipment and vehicles, VAT may be payable by lessors acquiring the assets. For instance, firms like Associated Vehicle Assemblers (AVA) and Kenya Vehicle Manufacturers (KVM) now assemble vehicles for Volvo, VW, Toyota and Mitsubishi. See https://www.volkswagenag.com/en/news/2016/12/Volkswagen_Fahrzeugfertigung_Kenia.html However, the approach to VAT on leases of particular goods will likely appropriately follow the approach to VAT on the supply of such goods by purchase. The Government may wish to consider whether at any stage there would be merit to all such goods being zero-rated instead of exempt.

⁹¹ For example, the leasing of vehicles to the Kenya Police Service was subject to 6% withholding tax, so the Treasury withholds that amount when paying the lease payments.

A problem arises where the supplier does not have VAT debt and wishes instead to claim back the funds from the KRA. It is thus more applicable to leasing companies that are primarily financial service providers that never have VAT inputs. The delays (and, indeed, apparent absence) of VAT refunds has adversely affected cash flow where their withholding VAT credits exceed their output VAT because no credits are available for refund. This has resulted in a large receivable on the balance sheet of at least one market participant, and undermined its leasing business. Three respondents to the CAK's information request noted that VAT refunds take too long or are never paid.⁹²

The extent to which the withholding of VAT poses a problem to the Kenyan leasing sector is not clear. Some lessors apparently have built up large receivables from the KRA on their balance sheet with little prospect of seeing the reimbursement. This is not unique to the leasing sector and it was not a widely expressed concern. Furthermore, any harm to the leasing sector must be weighed against wider fiscal policy objectives of the KRA in improving the collection of VAT. This Inquiry is not charged with advising on the wider fiscal policies of Kenya, and thus can only recommend that these concerns be taken into account effectively when considering those policies.

Recommendation (medium/long term)

We recommend reviewing the impact of the 6% VAT withholding by KRA-registered parties with a view to whether the KRA's fiscal objectives outweigh the burden this imposes on lessors.

6.3 Income tax treatment

The removal of tax barriers generally can stimulate the leasing industry. In some countries, regulation on the calculation and levying of profit tax included a reduction in tax, elimination of tax breaks for most forms of capital investment, changes to the calculation of depreciation, and removal of restrictions on deducting expenses, and permitting lessees to record VAT paid as a tax deduction.⁹³

A key issue that often arises in fiscal treatment of leases is whether depreciation and lease payments can be deducted from taxable income, which party can deduct it, and whether accelerated depreciation should be allowed. A 'form' based approach allows the deduction of depreciation for all lease contracts, which encourages leasing and enhances investment.⁹⁴ A 'substance' approach may allow deduction of depreciation only if the economic reality meets certain conditions in the tax legislation to qualify as a true lease.

In Kenya, a lessor's rent is taxable income. Specifically, gains or profits (which include rent) received from a right granted to another person for use or occupation of property (i.e., a lease) are taxable income under the Income Tax Act.⁹⁵

There are differences between how leases are accounted for and how they are treated for tax purposes. Income from operating and finance leases are taxed in the same manner as one another except where a finance lease includes a transfer of title to the asset, in which case it is treated as a hire purchase transaction. The definition of finance lease excludes the situation where there is a transfer of ownership,

⁹² <<CONFIDENTIAL>>.

⁹³ E.g., Russia introduced all of these reforms.

⁹⁴ Nair, A, Kloeppinger-Todd, R, Mulder, A. "Leasing: An underutilized tool in Rural Finance." World Bank Agriculture and Rural Development Discussion Paper 7, available [here](#).

⁹⁵ Sections 3(2)(a)(iii) and 6(1) of the Income Tax Act of 1974

which is sometimes the case in finance leases.⁹⁶ Where title does transfer, or is ‘effectively’ transferred, such a transaction is not treated as a lease for income tax purposes but as a hire purchase. The Kenyan Income Tax (Leasing) Rules⁹⁷ provide:

Where the Commissioner is of the opinion that a lease contract was entered into with the intention of transferring ownership, or where the substance of the contract effectively transfers ownership, the provisions of the Act on assessment and payment of tax in respect of a hire purchase transaction shall apply to such transaction.

Likewise, a lessee’s lease payments are treated as deductible expenditures for income tax purposes.⁹⁸

Interest is taxable income under the Income Tax Act.⁹⁹ Likewise, interest payments are a deductible expenditure for the lessee’s income tax purposes (but payment of the principal of the loan is not).

In short, under leases that do not involve a transfer of title, the lessor can deduct depreciation of the asset and interest on the loan, and the lessee can deduct the lease payment, from taxable income. Where there is a transfer of title, the lessor will deduct the interest on the loan and the lessee will deduct the depreciation and implicit interest on the loan but not the lease payment, although there is some ambiguity in this regard.

Similar issues as those discussed in relation to VAT (see section 6.1) arise in relation to income tax. In particular, in Kenya various capital allowances are available for certain classes of assets. This includes wear and tear allowances for various assets including tractors, vehicles and certain forms of furniture and equipment. In addition, investment deductions are allowed for certain forms of machinery for manufacture.¹⁰⁰ Such deductions are not available as an expense in the case of leasing, where lease payments are deducted over the course of the lease. This favours the purchase of such assets over leasing. Just as with VAT, ensuring that leasing enjoys benefits similar to those afforded to purchases would increase the incentives to adopt leasing – and this for assets that are particularly well suited to leasing.¹⁰¹

⁹⁶ Income Tax (Leasing) Rules, Section 2, made under the Kenyan Income Tax Act has the following definitions: “‘lease’ means a contract by which a person owning assets grants to a lessee the right to possess, use and enjoy such assets for a specified period of time in exchange for periodic payments; [...] ‘operating lease’ means a contract under which the lessor agrees to lease the assets to the lessee for specified periodical payments where the title to the assets and the risks and rewards associated with ownership substantially remain with the lessor; [...] ‘finance lease’ means a contract which the lessor agrees to lease assets to the lessee for a specified period of time where the risks and rewards associated with ownership of the assets are substantially transferred from the lessor to the lessee, but with the title to the assets always remaining with the lessor.”

⁹⁷ Section 9.

⁹⁸ Section 15(2)(t) of the Income Tax Act.

⁹⁹ Section 3(2)(b).

¹⁰⁰ See, for example, PWC Worldwide Tax Summaries Kenya Corporate Deductions, available [here](#) and the PKF Kenya Tax Guide 2016/2017, available [here](#)

¹⁰¹ Depreciation appears to not be allowed, but wear and tear and capital allowances do appear to be allowed. See <https://www.pkf.com/media/10028435/kenya-tax-guide-2016-17.pdf> and <http://www.kra.go.ke/publications/publicationguidetoinvest.html>. It is also not clear whether the different in fiscal treatment of leases according to whether title is transferred, as opposed to who bears the economic risk of the asset (as is the approach in accounting) poses an undue burden on the sector.

Recommendation (medium/long term)

We recommend making available to leasing the fiscal benefits under the Income Tax Act available to purchasing, such as investment allowances on heavy machinery. We also recommend reviewing the distinction in the Income Tax (Leasing) Rules between leases that involve a transfer of title as opposed to the accounting approach that is based on the economic risk and reward of the asset. The leasing sector would also benefit from permitting accelerated depreciation on assets, particularly where this is applied to purchases. Whether these should be applied must be considered in the context of the wider fiscal objectives of the KRA.

We also recommend clarifying the definitions relating to leasing in the Income Tax Act as part of a broader set of reforms to improve the coherence of definitions and the accounting and fiscal treatment of leasing activities (see section 8).

6.4 Accounting standard IFRS 16

6.4.1 Accounting for operating leases

Finance leases are accounted for as if they were purchase of the assets and incurrence of debt. The requirement is to record on the balance sheet:¹⁰²

- the right-of-use of the leased asset at fair value, which is recorded either under property, plant and equipment (PPE) or as its own line item; and
- a lease liability representing its obligation to make lease payments, determined as the present value of the lease payments using the interest rate implicit in the lease as the discount rate.

These lease assets and liabilities are initially measured on a present value basis. The lessee will also have to recognise in the profit and loss account the:

- depreciation of the right-of-use asset, usually on a straight-line basis; and
- interest on the lease liability.

In the statement of cash flows, the lessee will separate the total amount of cash paid into principal (presented within financing activities) and interest (presented within either operating or financing activities).

One of the benefits of operating leases is that they avoid recording the asset, or the right-to-use the asset, and the associated lease payment liability on the balance sheet (as would be required in a purchase or a finance lease). This avoids increasing the debt on the balance sheet, which may reduce the firm's ability to take on other debt.

However, the accounting rules will change when IFRS 16¹⁰³ will be applied from January 2019 in Kenya. IFRS 16 requires a lessee to recognise assets and liabilities for leases having a term of more than one year, except for low value assets, such as personal computers and small items of furniture. The determination of what qualifies as a low value asset may depend on the context. One market participant indicated that it expected assets below US\$ 5,000 not to be recorded on the balance sheet.¹⁰⁴

¹⁰² “The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The initial lease asset equals the lease liability in most cases.” IFRS Foundation, at <https://www.ifrs.org/issued-standards/list-of-standards/ifrs-16-leases/>.

¹⁰³ IFRS 16 is available at www.ifrs.org.

¹⁰⁴ Interview with <<CONFIDENTIAL>>.

Thus the accounting advantages of operating leases will be lost for those reporting under IFRS. Some large companies may even prefer to shift from operating leases to short term hiring in order to avoid the adverse impact on the balance sheet, or simply borrow the funds from banks, purchase the assets, and obtain maintenance and service separately from service providers.

For those to whom it applies, IFRS 16 will make the portion of lease payments that represents the underlying interest rate on the loan used to acquire the asset more transparent to lessees. This may enhance lessee's ability to compare leasing with direct bank loans, improving consumer experience and possibly enhancing competition. However, this removes one of the important attractions of operating leases, particularly for larger companies that seek to minimise the impact on the balance sheet.

There was significant concern among market participants about the impact of IFRS 16. Some predicted that the operating lease market will suffer significantly from a loss of demand as a key benefit is lost, possibly resulting in a shift to finance leasing.¹⁰⁵ One bank said it 'sounded the death knell for operating leases.' Others disagreed, taking the view that off-balance sheet financing was not as large a driver of operating leases in Kenya as in other markets, and that operating leases were chosen in Kenya more for affordability reasons, i.e., where lessees cannot afford to purchase an asset. Others suggested that the impact of IFRS 16 on SMEs would be significant, as it would further reduce their ability to borrow. Most market participants, however, had not reached a clear conclusion on how IFRS 16 would work, and were concerned that different accounting firms were giving different advice (and indeed that there were differences among accounting firms' approaches in different countries).

The written responses to the CAK's information request were also mixed in terms of their predictions of the impact of IFRS 16. Some suggested that IFRS 16 will make operating leases less attractive, particularly to corporates while others noted that it has the potential to cause significant changes to financial ratios for companies with a large number of operating leases. One leasing company stated that the operating lease product will not survive following the implementation of IFRS 16.¹⁰⁶

IFRS 16 will apply to the next financial year. Lessors whose financial years commence in April will not have to apply it until the 2019-2020 financial year. This allows them time to adapt. However, many lessees use the calendar year and will have to apply it to the 2019 calendar financial year.

6.4.2 IFRS 16 and IFRS for SMEs

The position may be less problematic for SMEs than perceived. The accounting standard IFRS for SMEs is applied in Kenya. The Institute for Certified Public Accountants of Kenya (ICPAK) formally adopted IFRS for SMEs in 2009 and provides a specimen set of accounts using the standard on its website. The IFRS for SMEs accounting standard is not modified by IFRS 16, and so SMEs reporting under IFRS for SMEs will continue to distinguish between operating and finance leases in their financial statements. IFRS for SMEs is permitted (i.e., not required) in Kenya for SMEs.¹⁰⁷ Thus SMEs appear to be unlikely to be adversely affected by the introduction of IFRS 16 for the foreseeable future.

Uncertainties in the application of IFRS 16 (and its non-application to SMEs under IFRS for SMEs) are not best addressed by regulation but by consensus in the accounting profession. It is thus desirable for the leasing market as a whole that the Kenyan accounting profession reach consensus on how IFRS 16 will apply, and to disseminate the position for SMEs. It would be regrettable if the negative perception of IFRS 16 were to diminish interest in leasing when SMEs should remain unaffected. Such consensus can

¹⁰⁵ Interview with <<CONFIDENTIAL>>.

¹⁰⁶ Submission by <<CONFIDENTIAL>>, undated.

¹⁰⁷ See <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/kenya/>.

be cultivated under the leadership of policy makers, such as the CBK or the Treasury, for example, in coordination with the LAK.

It may be that even if SME's are not affected directly by IFRS 16 they will nevertheless be affected by a reduced interest among lessors in providing operating leases because larger customers will no longer enjoy the accounting benefits traditionally associated with them. The SME market may not be large enough alone, and may be too risky, for lessors to cultivate products only for them that they do not already provide to larger customers. Until there is greater clarity on the accounting treatment of IFRS 16 in Kenya and its impact on SMEs, it is difficult to ascertain what can be done in this respect.

Recommendation (medium/long term)

We recommend that the Government (perhaps through Treasury) engage with the LAK and accounting profession to bring about a consensus view of the impact of IFRS 16 and IFRS for SMEs.

7 Information weaknesses and market stimulation

Ready information is vital for a market to grow and is especially important in financial services where assessment of risk is such a vital part of firms' decisions to extend products and services. The information includes quantitative data about the market, data on performance and credit risk records, and explanatory information that facilitates understanding the working of market working, the applicable regulations and the products and services offered. We address each of these below.

7.1 Market data

Markets attract investors where they can more easily assess demand and possible returns. One difficulty the Inquiry faced was the dearth of data on the market, whether in terms of values or volumes, both of leasing but also generally acquisition of equipment that could be the subject of leasing or purchase.

The Kenya Motor Industry Association prepares regular statistics on the vehicle market, including new vehicle sales, categorized by make, class and model, as well as regularly up-dated prices, providing members access to the details and publishing broad summaries and trends for public information. Drawing together and publishing data on trends in the acquisition (purchase or lease) of a wider range of equipment used in manufacturing, medical, agricultural and other sectors, would help investors assess the potential for entering or growing the leasing market.

Fuller market data on demand for equipment and leasing would also provide a firmer footing for the Treasury's policy-making. In addition, it would support the CAK's monitoring of the market for anticompetitive conduct and any emerging dominance. Information should not be gathered on leasing exclusively, it should also cover instalment sale, hire purchase and other types of asset finance. The types of data that would be useful would be market participants' portfolios broken into volumes, values and types of asset finance transactions by asset class and customer segmentation. This will complement the improvements in credit reporting and in the movable asset register.

IFC has attempted in the past in other countries to develop data on leasing markets, and might be approached to support the Treasury or other agency with such work. The LAK could also be enlisted, though with an expanded secretariat to support the work. Resources for such efforts could be provided from increased membership fees, which are particularly low (annually Ksh 50,000), and possibly funding from the Government for providing the public good of market data, as well as technical assistance from organisations such as IFC.

The leasing companies can be required to provide data on a regular basis (quarterly) to the Central Bank of Kenya, Treasury or future Financial Markets Conduct Authority to ensure that the development of

leasing finance is properly tracked along with other means by which finance is extended to SMEs (see section 8.4.3).

We understand from comments of the LAK representatives made on presentation of this report in March 2019 that the LAK members have agreed to collect data about their activities (book size, asset class and other data) and provide them to a university which would be requested to prepare market analysis. We do not have further information about what kind of data would be compiled or how it would be used. It appears that the LAK members intend the market analysis to be made available to members contributing their data, i.e., on a basis of reciprocity.

This may be a positive development because it recognises the need for industry data. At the same time, it creates risk of coordination and information exchange among competitors that could ultimately lead to market division, price fixing or other anticompetitive conduct. Just as importantly, the approach is insufficient for the purposes of informed policy making. It is vital that a Government agency obtain reliable, detailed data and not merely industry participants.

Recommendation (immediate priority)

We recommend that Government collect and publish data on demand for equipment and leasing with a view to demonstrating the market opportunity for the leasing sector.

We recommend that the CAK monitor carefully the LAK efforts to gather data from its membership, procure market analysis and share the results among its members in order to ensure that it does not amount to or lead to anticompetitive conduct. The CAK should alert the LAK to prohibitions on horizontal coordination and be available to provide guidance if requested.

7.2 Education and outreach

Several market participants indicated that the level of customer understanding remains a significant barrier to leasing, particularly among SMEs. It is true that the variety of potential transaction structures, and the different treatment between finance leases and operating leases for accounting purposes, and potentially different treatment again for VAT and income tax purposes, makes leasing particularly complex. This complexity is not unique to Kenya, indeed is common internationally and is difficult to eliminate, and may be mistaken for uncertainty and incoherence. Although this is unsurprising, it can be addressed through education and outreach efforts.

The LAK has chiefly concentrated its efforts in this area but could do more. The LAK's incentives to do so for SMEs are not strong. Thus there are steps that the Government could take to support this for example by preparing a clear, simple guide to leasing. This would describe the various forms of leasing and their accounting and tax treatment, focused on SMEs. This could be prepared, for example, by the Treasury or other suitable agency in collaboration with the LAK. It could be accompanied by workshops to which potential leasing customers would be invited, and announcements to draw attention to the guide and workshops.

The other key interested parties in extension of credit are the economic groupings who are being held back from investment and the suppliers of the equipment they require. Consideration should be given to prioritising sectors for concerted action around leasing finance. For example, at the centre of Kenya's sustained economic growth is improved productivity on the part of farmers, including small and medium farmers. This requires greater use of agricultural machinery and vehicles to transport product to market. A partnership should be explored between the suppliers of agricultural machinery and the relevant associations of farmers, together with leasing companies to design and market appropriate leasing products.

At a general level, while product explanation for customers is normally appropriately driven by providers in search of business, the LAK today is not particularly large and the overall information environment for

potential customers is a public good which the Government can usefully play a leadership role in developing. Technical assistance from IFC might be enlisted to support with such endeavours.¹⁰⁸

Recommendation (immediate priority)

We recommend that Government, in collaboration with the LAK and perhaps with international technical assistance, engage in outreach to SMEs in order to explain the workings and benefits of leasing. This would include preparing a clear and concise guide to legal, accounting and tax issues, and could be accompanied by workshops.

7.3 Market stimulation

The Government's use of leasing has been mentioned as an important stimulus to the sector. If other conditions are right, then ongoing Government demand should continue to draw in leasing providers, with off-shooting benefits for SMEs. There appear to be further things the Government could do in this area. Firstly, for some departments, the first round of vehicle leases are coming to an end. Conducting new tenders for further vehicles would continue to stimulate the market. In addition, there are market segments, such as medical equipment, where the Government chose to lease to multinational suppliers rather than from the Kenyan market. It will be valuable to explore how these could be arranged through Kenyan lessors.

In addition, clearer structures for central and county Government leasing may help provide a clearer view of the market opportunity for lessors. This would include greater transparency of county finance so that lessors have confidence that central funds have been duly allocated and county Governments will be in a position to fulfil their lease obligations. Such rules were not developed in the Public Financial Management Act 2012, but could be introduced by amendment.

Other ways to stimulate demand would be to encourage use of leasing in connection with subsidies, so that organisations receiving support from Government might receive leases or improved funding where used for leases. In addition, Government could provide guarantees and collateral for SME leases in strategically significant parts of the economy which stand to benefit particularly from leasing products and where there are significant opportunities of economic growth.

It is important to locate initiatives for stimulating the provision of leasing finance in the context of the provision of credit for different sectors of the economy. For example, key drivers of growth in Kenya are agricultural and construction machinery. These have different characteristics such as the seasonality of farmers' requirements for harvesting machinery which need to be taken into account in the potential initiatives for expanding leasing finance. Information needs to be gathered and shared regarding potential lessees, the assets they require and the returns from the productive activities using these assets to lessen the information asymmetries at the heart of financial sector development. This is part of the initiative proposed in section 7.2 above. Advances in digital technologies provide important opportunities in lowering the costs of information collection and sharing.

Recommendation (immediate priority)

We recommend that, insofar as leasing serves the Government's wider objectives of asset financing and management, it renew its leasing of assets, extending these into areas beyond vehicles, and

¹⁰⁸ Various countries have benefitted from technical assistance. This assistance can be aimed at three groups of stakeholders, potential and current lessors, government officials as well as accountants and lawyers that deal with leasing. This can be provided through publications, workshops etc on accounting, tax and legal issues related to leasing. For example, IFC has provided this assistance in Russia and Central Asia. Nair, A, Kloeppinger-Todd, R, Mulder, A. "Leasing: An underutilized tool in Rural Finance." World Bank Agriculture and Rural Development Discussion Paper 7, available [here](#).

strengthening the structures of funding such leases, and encourage leasing as a means of allocation of some subsidies.

We also suggest that the Government engage in a targeted, coordinated SME leasing stimulus initiative. This would combine various features discussed in this section. An information campaign would explain leasing (the legal nature of the financial product and its accounting and fiscal treatment) to a particular SME market segment, for example agricultural equipment. This could be done through dissemination of explanatory brochures and promotional events in farming communities, and would significantly decrease the transaction costs faced by leasing companies in explaining leasing to individual SMEs. Such outreach would be carried out in coordination with the LAK and its members, who would be prepared to provide leases of equipment for SMEs. Such outreach would also be more effective if initially supported by development finance, subsidies, or fiscal exemptions to provide incentives on both the lessor and lessee side. It could be combined with Government guarantees and other collateral support for SME leases that reduce the credit risk that SMEs present. Such an initiative could be expected to open the SME agriculture equipment leasing market, and then be built upon in other sectors.

8 Legal and regulatory framework issues

A number of market participants explained in their submissions in response to the CAK's information request that areas of the existing leasing regulatory environment are overly complex, lacking in clarity and confusing (see

Table 2 on page 11). This is consistent with widespread calls for greater awareness, marketing of leasing and an improved regulatory environment. We have found also in the previous sections that there are indeed numerous points of confusion that should be clarified in the existing legal and fiscal treatment of leasing in Kenya.

The number and complexity of problematic issues is such that they can only be resolved through legislation – by amending existing laws or introducing an entirely new law overhauling the existing laws relating to leasing.

The optimal approach to legal reform will depend on what it seeks to accomplish. To reach a view on how best to approach legal and regulatory reform, we begin by summarising in section 8.1 key areas of legal and regulatory reform often applied in other countries to develop leasing sectors. We then introduce in section 8.2 the laws that comprise Kenya's existing legal and regulatory framework for leasing. We consider various specific weaknesses of this existing legal and regulatory framework and recommend changes in section 8.3. Lastly, we consider in section 8.4 the broader question of what regulation and institutional oversight is appropriate to introduce to the Kenya leasing sector at this time.

8.1 International practice in developing enabling environments

Internationally, there have been a range of policy interventions aimed at enhancing the competitiveness of leasing markets. These have particularly been promoted by projects led by IFC and the World Bank. Reforms may aim to encourage leasing by making it more financially attractive through reform of taxation (see section 6). Reforms may also include projects that relate to firm or individual level support to lessors or leasing companies through technical assistance, financing and assistance in launching new ventures (see section 7). Thirdly, reforms may improve the enabling environment by enhancing the legal framework for leasing, and regulation of leasing markets (discussed in this section 8).

Domestic legal frameworks can often inhibit leasing due to contradictory laws or the absence of a clear legal framework. Since the legal framework for leasing is integral in determining how the market

functions, leasing markets can be stimulated through enhanced transparency and a legal framework that enables a better leasing environment. Large benefits from improving the enabling environment have been shown in some countries.¹⁰⁹ This does not necessarily mean an over-arching legal framework for leasing is required as this can mean increasing the regulatory burden and inhibiting the growth of the sector. But it does mean that the provisions need to be coherent and effective in providing the economic incentives for effective leasing business.

Internationally, legal and regulatory issues that have been identified as obstacles to a vibrant leasing market in other countries include:¹¹⁰

- lack of leasing-specific legislation;
- lack of clarity over the definition of leasing and legal implications;
- contradictions between different elements of a country’s legislative framework, for example contradictions between Civil Codes and Tax Codes;
- legislation that prevents the enforcement of leasing contracts;
- lack of clarity over whether lessors hold the title to leased assets;
- lack of clarity over whether third parties can hold a security position in leased assets or have a claim to them;
- difficulties in a lessor taking possession of leased asset in the case of defaults without costly and time-consuming court procedures, etc.; and
- definitions and legal implications of finance leases that are not specified in the legislation.

While reforms that have been carried out have been specific to the legal framework and the context of various markets, the key themes in such reforms include the following:¹¹¹

8.1.1 Clarifying the rights and responsibilities of parties to the contract

It is sometimes useful, though not always necessary, to have lease-specific legislation. The form of legislation that optimally comprises a country’s legal and regulatory framework, including whether leasing-specific legislation or amendments are required, depends very much on the context. IFC notes¹¹² that:

In countries with developed legal infrastructure and contract laws, the leasing industry can rely on the legal framework to establish and run its operations. Otherwise, a special leasing law is required to fill the gap.

¹⁰⁹ The Russia Leasing Development Group (RLDG) project for example has been estimated to have changed leasing volumes from a few hundred million to over US\$2 billion in the five years during which reforms were implemented, while in Panama changes in the legal framework increased volumes from US\$11-15 million to over US\$200 million in 2001. Nair, A, Kloeppinger-Todd, R, Mulder, A. “Leasing: An underutilized tool in Rural Finance.” World Bank Agriculture and Rural Development Discussion Paper 7, available [here](#). In numerous countries (such as the Kyrgyz Republic, Tajikistan and Tanzania) leasing-specific legislation has been introduced to fill legislative gaps. In others amendments have been made to regulations in Civil Codes.

¹¹⁰ IFC Advisory Services, “Leasing in Development: Guidelines for Emerging Economies” International Finance Corporation 2007, pp 26, available [here](#).

¹¹¹ IFC, “G20 SME Finance Policy Guide”, October 2011; Al-Sugheyer, B and Sultanov M, “Leasing in the Middle East and Northern Africa Region: A preliminary assessment”, World Bank, October 2010 available [here](#).

¹¹² Al-Sugheyer, B and Sultanov M, “Leasing in the Middle East and Northern Africa Region: A preliminary assessment”, World Bank, October 2010, pp12, available [here](#).

In many cases, leasing laws have assisted in enabling the industry by addressing definitional issues and legal gaps as well as addressing complexities in the three-party arrangement that characterises many leases. In countries where leasing reforms have been implemented, the new laws and amendments that have been designed often define leasing activity, a leased asset, and parties to the leasing transaction and outline their responsibilities and roles.¹¹³

Such measures can improve security and therefore lower investment risks. For example, a country's existing laws may prohibit use of the leased asset as collateral. Clarity over roles is especially relevant for three party leasing transactions. In most instances the three-party finance lease arrangement means that a lessee may not have a direct contractual relationship with the supplier of goods, preventing them from taking direct action against the supplier (for example, in the event of the supply of defective goods). Clarifying reforms may enable lessees to take action against suppliers where required but prevent both the lessee and lessor from taking action for the same defect. This is the case in Tanzania after a reform of the Financial Leasing Act of 2008.¹¹⁴ Other issues that can be clarified include third party liability.

8.1.2 Ensuring legal consistency across acts and codes

Where specific leasing legislation is enacted, it will be important to ensure that there are no conflicts with other key pieces of legislation. In particular, tax legislation may require alteration. In Jordan attempts to enable the leasing environment through tax exemptions were not recognized by the Tax Authority as it was not addressed in the tax legislation.¹¹⁵

8.1.3 Creating registries of leased assets

Many countries require registration of leasing contracts which imposes an administrative burden. However, reforms in various jurisdictions now require a lessor's interest in assets to be recorded in a collateral registry. Various countries internationally have been working on reforms relating to collateral registries.¹¹⁶

8.1.4 Streamlining repossession mechanisms

One feature of leasing is that the asset can be repossessed in case of payment default, which reduces the need for additional collateral and reduces risk of lending. However, the security benefit of collateral is reduced if repossession is costly or time-consuming. Mechanisms for repossession are key elements of a good leasing environment. In many countries, legislation requires that in the event of a default the lessee may voluntarily return assets without incurring a penalty. In case of disputes, there should be a framework for a non-judicial process with a short time-frame. As such, several reforms relate to streamlining processes for repossession, particularly in instances when it is not contested. For example, in Uzbekistan prior to legal reforms, the law required court proceedings for repossession. After reforms the new law simply requires a court-issued repossession notice, which absent contestation allows repossession within 30 days. Romania also now allows for non-court repossession for non-contested cases.

¹¹³ For example, in Yemen after the development of a 2007 leasing law.

¹¹⁴ <https://www.ifc.org/wps/wcm/connect/819eb58048e521779470bc849537832d/TanzaniaLeasingHandbook2006.pdf?MOD=AJPERES>, <https://www.clydeco.com/insight/article/financial-leasing-in-tanzania>

¹¹⁵ Al-Sugheyer, B and Sultanov M, "Leasing in the Middle East and Northern Africa Region: A preliminary assessment", World Bank, October 2010 available [here](#).

¹¹⁶ Al-Sugheyer, B and Sultanov M, "Leasing in the Middle East and Northern Africa Region: A preliminary assessment", World Bank, October 2010 available [here](#).

8.1.5 Treatment of lessees and lessors under bankruptcy

It is necessary to have clarity over the rights of lessees and lessors under bankruptcy of either party, e.g., whether leased equipment can be attached when a lessee is bankrupt. Jordan and Yemen have specified this in their laws for example.¹¹⁷

8.2 Overview of the existing Kenyan leasing framework

Kenya has no single ‘leasing act’ that collects together in a coherent single law the provisions relevant to leasing. The Hire Purchase Act does aim to be a comprehensive law addressing many aspects of one branch of leasing, i.e., hire purchase transactions, but these are only one among other forms of leases. The Hire Purchase Act is also limited to non-corporate entities and transactions where the total purchase price does not exceed Ksh 4 million.

This does not mean that there is no framework. There are today in Kenya several laws relevant to leasing, involving various institutions, that together comprise the framework, only not in a single law:

- **The Hire Purchase Act** effectively regulates not only ‘pure’ hire purchase transactions but also the terms and conditions of finance leases with an option to take title of the asset made to sole traders where the total purchase price is Ksh 4 million or below.
- **The Consumer Protection Act**, among other things, regulates repossession of moveable assets upon default, in particular where the lessee has paid more than two-thirds of the total price.
- **The Moveable Property Security Rights Act** established an electronic Collateral Registry for moveable property, and a Registrar to register security rights.
- **The Insolvency Act**¹¹⁸ deals with treatment of assets upon insolvency, including (after amendment by the Moveable Property Security Rights Act, security interests which includes collateral provided for leases), and provides for various roles of different bodies in administering bankruptcies, insolvencies and liquidations.
- **The Auctioneer’s Act**¹¹⁹ regulates the disposition of repossessed assets and licenses auctioneers.
- **The Competition Act** includes prohibitions on collusion, abuse of dominance and other anticompetitive conduct, as well as prohibitions on misleading and false representations, unconscionable conduct and other consumer protection provisions, and established the CAK with responsibility for pursuing such matters.
- **The Income Tax Act** addresses how lease payments will be treated as taxable income of the lessor and deductible expense of the lessee, as well as how depreciation and wear and tear allowances will apply, among other matters, and is administered by the KRA.
- **The VAT Act** applies to the supply of goods and services, but with some exemptions for particular assets supplied as goods, and is also administered by the KRA.
- **The laws of contract** address the entering into and interpretation of lease agreements, including formation of contract, misrepresentation and fraud (by leasing providers, financiers and customers), and the court system addresses disputes among contracting parties.

¹¹⁷ Al-Sugheyer, B and Sultanov M, “Leasing in the Middle East and Northern Africa Region: A preliminary assessment”, World Bank, October 2010 available at http://siteresources.worldbank.org/INTMNAREGTOPPOVRED/Resources/MENAFlagshipLeasing12_20_10.pdf

¹¹⁸ Insolvency Act No. 2 of 2015.

¹¹⁹ Auctioneer’s Act No. 5 of 1996.

This mesh of different legal sources comprises the framework within which banks, leasing companies, other financial service providers and lessees choose how to finance asset acquisition. As indicated, they involve a number of different agencies with different roles.

These laws are supplemented by accounting standards (such as IAS 17 and the incoming IFRS 16, as well as IFRS for SMEs) that apply to whether and how lease transactions will be booked as assets and liabilities on balance sheets, and depreciation, amortisation and lease payments on income statements.

The key question is whether the existing framework is coherent and supportive of a vibrant leasing sector or not. Some of the key impediments to leasing in Kenya have been addressed, e.g., reduced risk through improved credit assessment and risk management, as discussed in section 5. Others remain in place, such as limits on pricing risk as discussed in section 5.3, and fiscal and accounting barriers, as discussed in section 6. However, there are clearly also various areas of incoherence and gaps in the legal provisions that require to be addressed, as discussed next in section 8.3, and then a question whether a more extensive regulatory regime is appropriate, as discussed in section 8.4.

8.3 Improving the legal framework

A legal and regulatory framework comprises a law (or collection of laws and regulations made under such laws) that sets out rights, obligations and procedures that must be followed in carrying out the relevant business. Regulators are bodies with the function of monitoring markets, intervening with regulation when appropriate, and enforcing laws and regulations using legal powers, as well as requiring reporting and monitor conduct. We discuss the law itself in this section, and the need for regulation in section 8.4.

A lease is a contract, which means that the rights and duties are established by agreement between parties. In abstract, a mere contract does not require anything more than contract law, dispute resolution and enforcement to work. However, to function as intended, leases depend on certain of their negotiated rights being given particular force, which requires legislation. This is particularly the case with lessors' rights over assets in case of default, where the lessor needs rights not merely against the lessee but also against third party creditors of the lessee. These can largely be established only by law that bind such third parties.

In Kenya, these key rights have now been established and uncertainties addressed in the Moveable Property Security Rights Act discussed in section 5.2. Thus some of the most important elements that one might look for in leasing legislation have been relatively well addressed in this new law.

The existence of poorly devised law can significantly undermine the prospects for leasing, in particular if it does not establish the necessary rights, but also if such law creates confusion regarding leasing rights and obligations, undermining confidence in how and whether contracts will be enforced as intended, and how they will be treated for fiscal and accounting purposes. This is the case in Kenya.

The current legal and regulatory framework for leasing in Kenya lacks coherence, and includes various inconsistencies in the use of terminology. Various reforms would improve the coherence of the framework and would provide a more readily understandable framework. This section summarises these areas of incoherence, inconsistency and gaps.

Such reforms should be kept in perspective: The Inquiry identified in sections 5, 6 and 7 important factors directly undermining the economic incentives of leasing providers and banks. Addressing these would have a larger and more immediate impact than improving the coherence of the legal and regulatory framework. Revising the legal framework without addressing such other fundamental problems of economic incentives is unlikely to make a significant difference. Nevertheless, the changes identified below should be made to improve the coherence and completeness of Kenya's laws relating to financial services and property. Doing so will strengthen confidence among lessors and lessees, and so remove one of the barriers to leasing. Addressing the Hire Purchase Act (see section 8.3.2) is particularly important.

While we discuss the income tax and VAT laws, we are not providing advice on optimal treatment of fiscal policy. Nevertheless, areas where it appears that improvements could be made are discussed below.

8.3.1 Harmonising terminology and definitions

The use of different terms and definitions relating to leasing, including the Hire Purchase Act, the Moveable Property Security Right Act, the Consumer Protection Act, the Income Tax Act and the VAT Act leaves market participants, their accountants and fiscal advisers (and probably fiscal authorities) with uncertainty about the rights and obligations applying to legal definitions of leasing activities, how these should be accounted for, and how they will be taxed.

For instance, the Income Tax (Leasing) Rules under the Kenyan Income Tax Act¹²⁰ includes definitions that differ from the Hire Purchase Act.¹²¹ Uncertainty in the application of VAT to finance lease payments has similarly been identified,¹²² as has registration of leases in light of the definitions used in the new Moveable Property Security Rights Act.¹²³

Kenya's leasing market participants would all have greater certainty if terms and definitions were to be aligned, giving greater clarity on accounting and fiscal treatment, greater business certainty, and so a stronger foundation for market entry by new players and greater investment in the sector.

We understand also that a bill regulating conduct in financial markets is being contemplated, which would create a new Financial Markets Conduct Authority responsible for regulating financial products and services provided to retail financial customers. Based on the information previously available, such customers were expected to include individuals and micro and small and medium enterprises¹²⁴ and (although it is not clear) some financial products and services regulated under the proposed Act may include leases that amount to credit agreements.¹²⁵ If so, then such a body will have some consumer protection function in relation to leasing. This needs to be clarified, and if it proceeds, it will be important that the new Act adopts terminology on leasing that is consistent with the other legislation discussed in this report.

8.3.2 The Hire Purchase Act

Legal reform is clearly and urgently needed to remove the application of the Hire Purchase Act to SME leasing, and indeed if the Act is to be retained, to restrict it to small consumer goods.

Kenya's Hire Purchase Act, based on the English statute of 1964, regulates hire purchase agreements. These are defined as "an agreement for the bailment of goods under which the bailee may buy the goods or under which the property in the goods will or may pass to the bailee."¹²⁶ Bailment typically means the transfer of possession and control of property from one person to another.

A hire purchase agreement in economic reality includes a finance lease that includes an option for the lessee to purchase the asset at the end of the lease. In both, the hirer and lessee have possession of the asset and enjoy the risks and rewards incidental to ownership. Indeed, it seems likely that most finance

¹²⁰ See footnote 96.

¹²¹ See section 8.3.2 of this report.

¹²² See section 6.1 of this report.

¹²³ See section 5.2.2 of this report.

¹²⁴ Draft Financial Markets Conduct Bill, 2018, Section 2.

¹²⁵ See the definition of 'amount of credit' in Section 2, and sections 71 and 85.

¹²⁶ Hire Purchase Act No. 42 of 1968, Section 1.

leases with an option to purchase would be treated as hire purchase agreements under the definition above.

The Hire Purchase Act only governs agreements with consumers and individual traders, applying where the hirer is ‘not a body corporate.’ It also applies only to agreements where the hire purchase price (“the total sum payable by the hirer under a hire-purchase agreement in order to complete the purchase of goods”) is Ksh 4 million or less.¹²⁷ When this maximum was introduced in 2007¹²⁸, it was the equivalent of about US\$ 60,000. It is now equivalent to about US\$ 40,000. It was previously only Ksh 300,000, equivalent to about US\$ 4,500 in 2007.

The large increase in transaction value covered by the Act would have protected consumers purchasing larger items such as cars, though some have suggested that the increase in the maximum amount was not so much to widen consumer protection as to fund the hire purchase agreement registry. In any case, it now sweeps in sole traders running a business, such as farmers, doctors, dentists and others acquiring agricultural equipment, medical scanners, dentist chairs and operating equipment. Many assets acquired by sole traders will be within this Ksh 4 million amount.

The Act requires a hire purchase agreement to be registered with the Registrar of Hire Purchase Agreements within 30 days. If it is not registered, it is unenforceable against the hirer or any security granted by the hirer, or against any guarantor,¹²⁹ preventing the owner from recovering the goods from the hirer. The benefit of this registration requirement is unclear.

Under the Hire Purchase Act, if two thirds of the hire purchase price have been paid, then the owner may only recover the goods (e.g., if the hirer defaults) by recourse to the courts.¹³⁰ While the law suit is pending, the owner may recover the goods if the hirer has failed to pay two instalments of the hire purchase price, but must hold the goods until the law suit is concluded (i.e., may not sell or hire them to anyone else). The agreement may not provide that the owner may enter the hirer’s premises to recover the assets.¹³¹

The Act requires hire purchase agreements to contain various provisions that largely protect the hirer, such as a right to terminate early and return the goods, implied warranties that cannot be excluded, prohibition on acceleration in case of default¹³² and other provisions. Early termination is disincentivised by requiring the hirer to bring his or her total payments up to 50% of the hire purchase price if this has not already been paid.¹³³

A person is required to be licensed to carry on a hire purchase business, i.e., the business of entering into hire purchase agreements.¹³⁴

These provisions are generally relatively weighty, being particularly protective of purchasers and relatively inflexible in prescribing what must be, and what may not be, in a hire purchase agreement.

¹²⁷ Hire Purchase Act No. 42 of 1968, Section 3(1).

¹²⁸ Statute (Miscellaneous Amendments) Act No. 7 of 2007.

¹²⁹ Section 5(4).

¹³⁰ Section 15(1).

¹³¹ Section 7(a).

¹³² Section 29(a). However, acceleration of an instalment is permitted if the default of the instalment is one tenth of the hire purchase price or more.

¹³³ Section 12(1).

¹³⁴ Sections 2 and 18(1).

Market participants in Kenya indicate that they are such a major disincentive to leasing to SMEs that they typically avoid structuring transactions with sole traders as hire purchase transactions under the Hire Purchase Act at all. Because the Hire Purchase Act's definition of a hire purchase agreement is broad enough to include finance leases with an option to acquire title to the asset, lessors therefore tend to avoid offering sole traders finance leases with the possibility of acquiring title. Instead, the preference has been to resort to chattel mortgage financing for sole traders, where the trader takes out a loan to purchase the asset and pledges the asset as collateral for the loan.

Altogether, the current breadth of the Hire Purchase Act effectively results in exclusion of sole traders from a segment of the leasing market that has significant potential for them.

8.3.3 Lessor protection from third party claims

A common legal protection for lessors relates to claims by third parties.¹³⁵ Defects in, or use of, leased asset may cause damage to third parties, including personal injury or property damage. The lessor in a finance lease may hold title to the asset but is essentially a conduit between the supplier of the good and the lessee. It is reasonable to exclude the lessor from liability because its function is only to finance the lessee's right to possess and use the asset.

Such provisions will often exempt the lessor in a finance lease from liability for damages to a third party suffering as the result of a defect in, or through use of the leased asset relating to its role and actions as lessor and owner of the asset. Such protections may also be extended to the provider of finance. Depending on the lessor's responsibilities with respect to asset maintenance and service under an operating lease, protections against third party claims (particularly resulting from the lessee's use of the asset) could also be extended to lessors in operating leases.

The Inquiry has not found any suggestion that the lack of such a provision is at this time is a hindrance to growth, but as the possibility of larger law suits grows and as Kenya seeks to develop a sophisticated financial services sector, such protections will likely be among the necessary elements to include.

8.3.4 Lessee as beneficiary of supply agreement

Some finance leases, and even some operating leases, involve a tripartite contractual relationship among lessor, lessee and supplier of the asset (the bank providing finance may also be added to this, depending on the structure). This is more often the case of 'captive' lessors who work closely with suppliers, particularly in the vehicle sector.

In some cases, however, the lease agreement is kept separate from the supply agreement, with the result that the lessor has a purchaser relationship with the selling supplier, and the lessee has a leasing relationship with the lessor, but there is no contractual relationship between supplier and lessee.

In a tripartite relationship, the lessee will have a direct contractual claim against the supplier in case of defects in or non-delivery of the leased asset. Where the lease and supply agreements are independent contracts, the lessee may have no claim against the supplier, particularly if the jurisdiction has a strong doctrine of privity of contract.

¹³⁵ UNIDROIT Model Law, Article 9 reads: "In a financial lease, the lessor when acting in its capacity of lessor and as owner within the limits of the transaction, as documented under the supply agreement and the lease, shall not be liable to the lessee or third parties for death, personal injury or damage to property caused by the asset or the use of the asset."

Some leasing laws therefore provide a direct line of liability from supplier to lessee, effectively giving the lessee the same rights against the supplier as the lessor.¹³⁶ This also relieves the lessor of responsibility for pursuing the supplier on behalf of the lessee if the supplier breaches the supply contract. This may go further by specifically requiring the lessor to assign its rights under the supply agreement to the lessee if the lessee so requests, and deeming this to occur by operation of law if the lessor fails to do so.¹³⁷ The lessor should have an interest in doing so in order to avoid responsibility for matters it does not control, including the lessee's selection of supplier and specifications for the asset, but the law may helpfully require it. This can go further, and provide that modifications to a supply agreement that was approved by the lessee will not modify the lessee's rights without the lessee's consent, and if its consent is not given, the lessor assumes the supplier's obligations.¹³⁸

The absence of such provisions in Kenya has not been raised as an impediment to growth of the leasing market, but it could become one over time as the sector develops, and so in due course it will likely be helpful to adjust the law accordingly.

8.3.5 Cross-border movement of collateral

Considerable efforts are currently underway to integrate the economies and infrastructure of East Africa, and Kenya participates in the Common Market for Eastern and Southern Africa (COMESA) and the East African Community (EAC). Opening up the leasing market may include permitting lessors to lease to firms outside Kenya, and vice versa, enabling leased goods to cross borders while providing secure rights for lessors regarding such goods when they are in other countries. There are likely benefits to negotiating the introduction of reciprocal legislation with countries in the region to provide lessors strong, harmonised protections across the region.

In addition, in Kenya, the Hire Purchase Act, which as explained above applies to certain finance leases for sole traders, protects lessors against removal of goods from Kenya without the seller's consent. This is made an offence. In addition, and more importantly, the lessor has the right to bring a suit on an *ex parte* basis to prevent removal, as well as various related rights. Putting aside whether it is appropriate to extend the criminal law element, the overall leasing framework would be strengthened by a better framework for the transfer of collateral across borders.

8.3.6 Definition of finance lease for income tax purposes

The definition of 'finance lease' in the Income Tax (Licensing) Rules¹³⁹ excludes agreements by which the title to the asset is ultimately transferred to the lessee. There would be merit to reviewing the tax

¹³⁶ Article 7(1) of the UNIDROIT Model Law provides: "In a financial lease, the duties of the supplier under the supply agreement shall also be owed to the lessee as if the lessee were a party to that agreement and as if the asset were to be supplied directly to the lessee. The supplier shall not be liable to both the lessor and the lessee in respect of the same damage."

¹³⁷ Article 7(2) of the UNIDROIT Model Law provides: "At the request of the lessee, the lessor shall assign its rights to enforce the supply agreement to the lessee. If the lessor does not, the lessor is deemed to have assumed the duties of the supplier."

¹³⁸ Article 7(3) of the UNIDROIT Model Law provides: "The rights of the lessee under this Article with respect to a supply agreement that was approved by the lessee shall not be affected by a variation of any term of such agreement unless consented to by the lessee. If the lessee did not consent to such variation, the lessor is deemed to have assumed the duties of the supplier to the lessee that were so varied to the extent of the variation."

¹³⁹ Section 2.

implications if the Rules were revised to align with the customary meaning of a finance lease, which may include transfer of title.

8.3.7 Lessor's deduction for wear and tear

The lessor's entitlement under the Income Tax (Licensing) Rules¹⁴⁰ to deduct wear and tear of the leased assets is currently bluntly formulated as treating the assets as part of the lessor's business. There may be merit to aligning the wear and tear with the amortisation of the asset for the calculation of the lease rental. Allowing greater wear and tear allowances for manufacturing investments may, for example, stimulate financing to that sector. Special wear and tear allowances for lessors could be used to reduce costs of investment. Such allowances could be used as a means of compensating for the downward pressure on lease pricing resulting from the interest rate cap.

8.3.8 Clawback of deductions upon acquiring the asset under a finance lease

Under the Income Tax (Licensing) Rules¹⁴¹, the clawback of income tax deductions made by a lessee upon termination where the lessee acquires the asset, notwithstanding that the lessee may depreciate the amount recovered based on the applicable wear and tear deduction may disincentivise some lessees from taking up finance leases. There appear to be good reasons to remove this clawback, as it may not generate significant revenue for the KRA yet may impede the growth of the leasing sector.

8.3.9 Electronic commerce and communications

The Moveable Property Securities Act introduces an electronic Collateral Registry and electronic filing procedures, and has the effect of greatly facilitating both the establishment of securities against payment obligations and verifying the availability of assets for such securities. This is a welcome shift to use of information and communications technology to serve legal needs.

None of the existing Hire Purchase Act or other relevant laws provide for electronic dimensions of transactions. This may be addressed in contracts themselves (e.g., in relation to valid communications between parties) or in general ecommerce legislation. The sector is likely to benefit over the long term in efficiency and productivity from aligning the legal regime with modern information and communications technology.

A policy framework to promote leasing finance to SMEs should include steps to realise the benefits from digitalisation of the economy to reduce transactions costs and open-up the extension of leasing services much more widely.

8.3.10 Sharia financed leases

There is significant potential for Sharia financing to be used in leasing in Kenya, as there is a substantial Muslim population. There may be benefits from recognising sharia financing explicitly in legislation that already refers to financing of leases, including in the Moveable Property Security Rights Act, as well as the Income Tax Act and VAT Act.

8.3.11 Additional rights

Various other legal provisions could be helpful, although not apparently urgent, to include in the legal framework for leasing. These could include establishing a right of lessors to sell and assign leases unless

¹⁴⁰ Section 4(a)(i).

¹⁴¹ Section 8.

the parties agree otherwise. As this is already occurring in Kenya, such a provision may not be necessary in law, but would prevent doubt on the matter.

Recommendation (immediate priority)

We recommend revising the Hire Purchase Act to remove its application to sole traders and leasing transactions useful for SMEs. This could be done in one of several ways:

- the maximum hire purchase price in the Act could be reduced, e.g., to KSh 500,000 or 1 million;
- the maximum hire purchase price could be reduced to a similar amount where the asset is to be used in connection with a business;¹⁴²
- hire purchase agreements for assets to be used in connection with a business could be excluded entirely from the scope of the Act; or
- the definition of “hire purchase agreement” in the Act could be revised to exclude finance leases (or, to be clear, leases in general).

Recommendation (medium/long term)

We recommend making numerous changes to existing laws, which could be done in a new Leasing Act that establishes a clear framework for leasing, clarifies various terms and their legal effects, harmonising these with terms used in the VAT Act and Income Tax Act, and clarifies how the Moveable Property Security Rights Act and Consumer Protection Act apply to leases. Such an Act could also ensure lessors are protected from third party claims in finance leases, that lessors are treated as beneficiaries in supply agreements, and related improvements. In addition, a framework permitting leased goods to be moved within the region subject to application of firm lessor rights in the destination country would enable leasing to be part of the regional economic integration underway.

These matters could be addressed in a new leasing law that collects basic provisions relating to leasing and, together with the Moveable Property Security Rights Act in particular, sets out a coherent framework for how leasing works. It would be vital that a new Leasing Act results in clear treatment of the various types of asset-based finance (rather than sowing confusion by only addressing operating and finance leases) and fits appropriately with rights and processes established in the Moveable Property Security Rights Act in particular.

8.4 Regulating leasing

As shown in section 8.2, the legal framework in place today comprises various sources of law and institutions, and section 8.3 identified various elements that should be addressed to improve its coherence. A related question is the degree to which leasing should be regulated on an ongoing basis. This should be considered in light of the broader regulatory agenda for leasing, including the objectives and form of potential regulation and possible role of an appropriate regulatory institution with specific responsibility for supervising and regulating the leasing sector.

¹⁴² An example of such an approach is Section 2 of the Competition Act’s restriction of the definition of ‘consumer’ to “any person who purchases or offers to purchase goods or services otherwise than for the purpose of resale, but does not include a person who purchases any goods or services for the purpose of using them in the production or manufacture of any goods or articles for sale.” This could be improved, as it is unclear whether a person who purchases goods or services for the purpose of using them in the provision of services is a consumer or not. Another approach could be that taken in the draft Financial Markets Conduct Bill, which would exclude from the definition of ‘retail financial customer’ the case where a financial product or service is “provided in connection with the conduct by the person of a micro enterprise or a small enterprise as defined under the Micro and Small Enterprises Act.”

Regulation involves a regulator monitoring the sector for which it is responsible, identifying market failures that require to be corrected by obligating market participants to do certain things or prohibiting them from doing certain things. Regulation is thus not so much a necessary precondition for a service to exist, but rather conditions the functioning of the market to address market failures.

There are broadly two types of relevant regulation that could call for a regulator to engage in monitoring, regulating and enforcement activities:

- **prudential regulation** that concerns the stability of the financial system; and
- **conduct regulation** that concerns how providers interact with customers and one another.

A regulatory institution will typically be responsible for making and adapting rules to refine such regulation, supervising the market and compliance, and carrying out enforcement activities. Depending on its remit, it may also be responsible for identifying areas for further improvements to law and policy, and championing the development of the sector. We discuss these various dimensions of regulation below.

As will be seen, we found strong reason to believe that certain reporting obligations are very important to enable better understanding of supply and demand in the market, the dynamics of competition, and so better policy making for the leasing sector. At the same time, we did not find there to be a strong reason to think that adding constraints to the leasing market at this time will help it grow, particularly in the case of SME leasing. The problem is not so much market failures requiring regulatory remedies as the lack of a market in SME leasing at all, and introducing regulatory obligations is likely only both to increase the cost to providers as well as their perception of regulatory risk in face of uncertainty about where a regulator will intervene in the future.

8.4.1 Prudential regulation

Prudential regulation is generally designed to reduce and mitigate risk. The degree to which prudential regulation would be beneficial for the leasing market depends on the degree to which regulation is necessary to address actual or perceived risk (whether for systemic protection or market confidence), and the degree to which such regulation may hamper development.

Examples of prudential regulation for leasing companies include reserve ratio requirements, minimum capital requirements, low allowable leverage ratios, single party exposure limits, and limits on non-shareholder capital funding.

Prudential regulation for leasing has two dimensions: whether leasing companies should be prudentially regulated and, conversely, whether prudentially regulated entities (such as banks) should be allowed to engage in leasing. The latter dimension has already been addressed by allowing banks to engage in leasing on their own balance sheets or through subsidiaries. The Inquiry did not find any particular problem with the status quo in this regard.

In the financial sector (particularly banking), prudential regulation can enhance credibility, generate trust among customers, and so assist growth in the market in the early stages. Additionally, it can prevent the loss of public confidence from the failure of leasing companies.

A key disadvantage of prudential regulation is its potential stifling effect on growth. Growth may be impeded by increasing the barriers to entry and an ongoing burden on financial management. This could also hamper the evolution of the industry from a loan substitute to a more specialised service. It could dissuade lessors from taking on higher risk clients (in particular SMEs and microenterprises).

Some, such as IFC, have taken the position that companies that do not obtain public deposits should not be prudentially regulated and, in many countries in which leasing reform has been a focus, supervision of

leasing companies has been limited.¹⁴³ This has fostered a more entrepreneurial approach to leasing, while ensuring that the risks from leasing finance are still guarded against where the provider of funds are banks and other deposit-taking institutions.

Generally, the Inquiry did not find reason to think that additional prudential regulation of leasing is necessary in Kenya at this time, or that any anticipated benefits from strengthening consumer confidence would outweigh the potential stifling effect of greater regulation. Furthermore, there is a significant risk that introducing a new regulator for leasing companies would focus market participants on influencing the regulator in order to optimise regulatory conditions and mitigate regulatory risk (gaming), which could distract market participants from commercial pursuit of leasing business opportunities.

8.4.2 Conduct regulation

Consumer protection and other conduct regulation

In addition to prudential regulation, a regulator may regulate market conduct. This could focus, for example, on requiring leasing providers to provide leasing on certain terms and conditions prescribed by the legislature or regulator, to disclose certain information to consumers before contracting with them, and to provide them with dispute and complaints processes.

Such requirements are typically established to protect consumers against poor standards and stronger bargaining power of providers, supplementing existing laws of contract. Contract law typically (including in Kenya) addresses pre-contracting disclosures through rules about fraudulent misrepresentation in the contracting process, and relies on dispute resolution through the court system or arbitration.

The Inquiry did not find reason to believe that developing consumer protection rights further at this time would lead to growth in the leasing for SMEs. Several market participants indicated that consumers often do not assert their rights, which suggests that consumer education is more immediate need than any additional consumer rights. Indeed, to the extent that any finding could be made in this regard, the hesitation about leasing to SMEs suggests that further consumer protection at this time might impede the development of the SME leasing market at this time.

Misconduct of leasing providers has not been identified as having been a significant problem or impeded growth in leasing. While some cases of fraud have occurred, the Inquiry did not receive information suggesting that these have been of a scale or nature so grave as to make conduct a major impediment to sector development. To the extent that misconduct has been a problem, it is likely prudent to monitor how the LAK's new Code of Conduct is implemented, including whether the LAK applies in practice the various complaints and dispute processes it envisages.

Rather, growth appears to have been impeded on the supply side by disinterest of leasing providers in the SME market due to its high risk. Now that such risks have been reduced by recent reforms (see sections 5.1 and 5.2), supply side growth now appears to be impeded by the interest rate cap. On the demand side, potential customers may lack of familiarity with and understanding of leasing, but this appears to be more an information weakness than a matter of customer mistrust or lack of confidence in, or of delinquent conduct by, leasing providers. The measures discussed in section 7 would, we believe, have a stronger impact than new legislation – or at least should be tried first.

¹⁴³For example, in Russia reforms on leasing mean that there are no prudential regulations on leasing companies. Furthermore, registration and licensing is not required as leasing companies do not hold public deposits. This has been seen to increase entry and enhance competition in the environment. USAID, “Leasing: A potential tool for SME expansion and rural financial sector deepening: A study of Russia”, Microreport #46, 2006 available [here](#). In Tanzania, leasing companies require a licence but are not subject to supervision. In Jordan minimum capital requirements for lessors were abolished.

Standardising lease agreements and practices

In addition to strengthening the protections of consumers, conduct regulation may also be used to establish standard terms, which may also raise acceptable standards of conduct, together building confidence among customers. In Kenya, one key difficulty facing SMEs (and individual consumers) with leasing has been understanding what is a complex financial product with implications for cash flow management, accounting and taxation. According to some market participants, this has been one factor that has suppressed demand for leasing.

It is possible that the establishment of a regulatory framework with an active regulator could have some positive standardising and confidence enhancing effects. However, prescribing the manner in which leasing providers must or must not carry out their business is appropriate where other market-based approaches are unlikely to succeed, and the intervention of the legislator or regulator is necessary. In light of the weak development of the sector, this point does not seem to have been reached in Kenya.

It was suggested by some stakeholders that the publishing of standardised lease agreements with standard terms and conditions would assist transparency and customer understanding. Respondents to the CAK’s information request raised a range of arguments, both positive and negative, in relation to standardisation. These are summarised in Table 9. Key benefits expected are transparency, greater understanding and reduced transaction costs. This should be weighed against the loss of flexibility and potentially innovation and creativity.

Table 8: Benefits and costs of standardising lease agreements

Benefits	Costs
Ease of marketing Transparency Improved access to funding (due to better understanding by financiers) Improved clarity Easier litigation Ease of doing business/reduced transaction costs Enhanced customer protection Standardized expectations Improved ethical practices in the industry	Loss of innovation and creativity Over-regulation Loss of flexibility and customisation – different customer segments/assets have different needs Increased compliance and training costs Dynamic market will mean frequent changes are required

Source: responses to CAK information request

From a consumer protection perspective, transparency around a baseline set of terms may be beneficial in ensuring that lessees understand their rights and obligations and may also give small leasing companies protection by ensuring that they can easily include clear and enforceable provisions in terms of repossession, dispute resolution etc. These aspects may be positive for competition and for the growth of the market. On the other hand, enforcing a mandatory set of standard conditions would not allow leasing providers to tailor leasing solutions to different clients and market segments, and may lead to a reduction in competition in terms of innovation and product design.

To the extent that the variety of approaches to lease documentation impedes sector growth, it appears to be because it creates an additional burden on suppliers, particularly banks financing leasing providers. This appears to be the type of problem that market participants would be better positioned to solve than legislators or a regulator. Banks financing leasing companies would appear to have substantial leverage to require leasing companies to follow standardised agreements.

The costs and risks of developing some standardised agreements are likely far less for leasing providers and banks than delegating it to a regulator. The incentives of leasing providers and banks to do so appear to be sufficiently aligned to overcome any collective action problem if some initiative and leadership is provided. To the extent that inertia or lack of resources are an impediment, this could be addressed by some focused support to the LAK from the Government or international expertise such as offered by the International Finance Corporation.

One bank, which would often find itself in the position of financing leases, and so having to review the various lease terms and conditions of the different lessors, urged standardisation through legislation. It suggested that the market is ill-served by the variety of different lease documents used, which is a burden for banks financing transactions arranged by multiple lessors. Such documents require to be reviewed by lawyers, which is costly and time-consuming.

However, it is not clear that this calls for legislative intervention. If there is a need to harmonise the legal documentation, this can be achieved through a consultative process between participants (lessors and banks). But even this may not be advisable, as the existence of different legal terms and conditions may allow lessors to innovate in the terms and conditions they offer to attract lessee customers as well as banks to finance the leases they arrange. This differentiation is important where market segments have different characteristics.

Thus, if the current variety of legal documents appears to be somewhat messy, this is often the nature in relatively young markets. Efforts to harmonise terms and conditions also create risks of diminishing competition, and even of coordinated anticompetitive behaviour through fixing of prices and other terms and conditions, and bid rigging in tenders by Government and large companies for vehicle and other leases.

More importantly, it is not clear that Government, by legislating standard terms and conditions for leases, would be the optimal body to determine the economic relations between lessors and lessees. At this stage of the market's development, particularly as there are now prospects for growth arising out of the still-recent improvements in credit assessment, collateral registry and potential lifting of the interest rate cap, there appear to be significant benefits to allowing market participants to continue to develop their own products according to their perceptions of the opportunities and risks of the market. Engaging in a significant regulatory effort to set in place a common framework at this time risks centring attention on regulation that may not provide the benefits it might be hoped to generate.

A middle ground solution may be appropriate whereby non-mandatory lease agreement templates could be made available, but where leasing providers are permitted to make alterations to the standard approach in order to tailor the solution to the client. This would enable easier comparisons across providers without binding the market to a fixed standard contract. Such templates could be developed in close collaboration with the LAK, making it clear that they are not required either by law, regulation or the Association to be adopted.

8.4.3 Market monitoring and policy development

Beyond the clearly needed legal changes discussed in section 8.3, the approach to regulation recommended above is light handed. It focuses on establishing rights and obligations that will make leasing a more effective financial product and not adding prudential or conduct regulation that has not been shown to be required to address market failure.

In this light, the nature and scale of the legal obligations applicable to leasing companies do not appear to merit the creation of a new regulatory body specifically focused on licensing, rule-making, compliance supervision and enforcement.

However, there are important gaps in the institutional framework that do merit providing greater clarity on responsibility for sector analysis and development. There are clearly important roles for public institutions to play, particularly in relation to:

- gathering data on and monitoring the development of the market (the sector faces severe information weaknesses as discussed in section 7 and evidenced in section 3);
- developing policy to stimulate the sector and improve performance; and
- shepherding changes to the taxes and laws discussed in this report, as well as ongoing proposals to refine legislation.

There are public agencies dealing with leasing in Kenya. At a policy level, when it comes to monitoring the sector and considering the need for future regulation, the Treasury already takes a policy interest in the sector and is well positioned to propose new legislation if necessary. However, it lacks data about the market, and it is not clear whether the Treasury is the best champion of the leasing sector. Then the various bodies mentioned in section 8.2 have their respective responsibilities. However, none of these other than the CAK has an overarching responsibility to review conduct in the sector, but it is not clear what a regulator would do that these bodies do not already do.

For these reasons, we believe that it is important to establish legal obligations for leasing companies (including banks engaging in leasing) to report their leasing activities in a standardised manner to enable effective analysis and monitoring of the market on an ongoing basis. The goal would be to enable the appropriate body to form a good view of the types and volumes of leases, assets and providers in the sector, and their evolution.

The details of the reporting obligations should be determined after consultation with market participants, ensuring that they are sufficient to support informed policy making but not unreasonably burdensome on providers. This would address matters such as the substance, format and regularity of reporting, as well as transparency or confidential treatment. The same body which would determine the details of the reporting requirements should receive such reports and have responsibility for developing policy and liaising among the tax authorities.

The Central Bank of Kenya or the Treasury would at this time be best placed for this role, but an alternative in the future could be the Financial Markets Conduct Authority, if and when it is established. As mentioned in section 8.3.1 of this report, we understand that a new bill on financial markets conduct is being contemplated to establish such an authority, whose responsibility for financial products may extend to certain leases provided to retail financial customers. If so, then such a body may also be better placed to carry out the market monitoring and policy development activities recommended. It would potentially also be able to apply principles to leases that are similar to those for other financial products and services. It will also be important to ensure that the new Act adopts terminology on leasing that is consistent with the harmonisation process recommended in section 8.3.1 of this report.

8.4.4 Notification regime

In many regulated sectors, a requirement to report on activities (as discussed in section 8.4.3) is often linked to a licence. Indeed, the continued right to operate in many regulated sectors depends on a licence, and non-compliance with prudential regulation (discussed in section 8.4.1) and conduct regulation (section 8.4.2) may result in revocation of the licence. There can be some other advantages to introducing a licensing regime, such as the establishment of a publicly sanctioned formal status that may build trust among consumers, and so foster demand. Thus licensing may have various purposes, including:

- to control market entry, vetting the experience, capital, business plan or governance of a new entrant;
- as an enforcement mechanism; and
- as a means of building trust among consumers.

Today in Kenya, a licence is not required to engage in leasing except inasmuch as the provider of the lease is already a bank that requires a licence, or is providing hire purchase, in which case a licensing requirement does apply (see section 8.3.2).

We are not proposing a licensing regime for leasing companies:

- There does not seem to be any strong reason to require an authority to vet companies before they enter the market, at least not a reason the benefit of which exceeds the potential hindrance to market entry and growth.
- Establishing a licensing regime principally to enforce laws and regulations is a heavy-handed approach to regulation. Creating a licensing regime principally for this purpose would increase barriers to entry where the objective is surely to reduce them.
- Nor have we found that consumer distrust of unlicensed leasing companies is the problem holding back the leasing sector in Kenya – rather it is the unattractiveness of the regulatory environment.

Nevertheless, some mechanism for reporting obligations is appropriate, particularly as firms will need to know whether their activities fall within the category that is subject to the reporting requirement. There are likely benefits to having a notification regime whereby firms engaged in leasing (defined broadly to include finance and operating leases, hire purchase and asset backed finance, as well as pure and captive leasing companies) must notify the authorities that they are engaging in this activity. It would be wise to impose this only where the value of their leases in a given financial year has exceeded a minimum specified threshold level, and to set this at a sufficiently high level only to apply to firms providing a substantial number of leases.

Recommendation (medium/long term)

We recommend establishing legal obligations in law for leasing companies (including banks engaging in leasing) to report their leasing activities in a standardised manner to enable effective analysis and monitoring of the market on an ongoing basis, whether to the CBK, Treasury or in due course a new Financial Markets Conduct Authority. Firms could also be required to notify the relevant agency of the fact that a company is engaging in leasing activities at such time as the value of its leases exceeds a minimum threshold in the prior financial year.

We also recommend that the Government (whether through CBK or Treasury) solicit support from a body such as International Finance Corporation or a consultant to assist LAK to develop leasing template documents, but that there be no attempt to impose standardised documentation on the sector.

Annex A – Market participants

Table A1. Kenya's leasing market participants

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Annex B – Values of leases

Values of leases, Ksh (millions)

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