

Recent developments in equipment leasing

An article published in the September 1980 Bulletin described the growth of leasing during the 1970s.⁽¹⁾ The present article describes subsequent developments, drawing on discussions with the leasing industry,⁽²⁾ as well as published statistics.

- *The rate of growth of leasing, in real terms, has slowed sharply over the last two years.*
- *The clearing banks dominate the leasing industry and their capacity to do new business has been reduced recently by slower growth of profits.*
- *Nevertheless, leasing continues to finance an increasing share of fixed investment.*
- *The industry has become more flexible in the range of assets leased and terms of contracts.*
- *Rental rates have fluctuated less than interest rates.*

At the end of 1981, the Bank took over, from the Department of Industry, the responsibility for collecting and compiling official statistics on capital expenditure by companies which lease out capital goods. A supplementary note to this article updates earlier Department of Industry statistics.

Introduction

This article, like its predecessor,⁽¹⁾ is mainly concerned with finance leasing. In contrast to an operating lease, which is akin to hiring, a finance lease (or full payout agreement) is one in which an asset is leased out for a fixed, contractual period (known as the primary period) during which its full cost is recovered by the lessor. It is a method of financing the use of capital assets in which the user (lessee) normally selects, and the lessor buys and retains title to, capital assets, with the lessee paying rent over a fixed period which usually approaches the useful life of the asset being leased. At the end of the primary period, the asset might be sold, with a share of any proceeds being passed to the lessee as a rebate of rental. Alternatively, the lease might continue, at the lessee's option, into a secondary period, in which the rental would usually be nominal.

The fundamental reason for the growth of leasing has been the low level of companies' taxable profits. As a result of this, when first year capital allowances against corporation tax were increased substantially in 1970, and raised to 100% in 1972 with the phasing-out of investment grants, a sharp impetus was given to leasing. Companies with insufficient taxable profits could not take advantage of the new allowances. But lessors with taxable profits were able to purchase and lease capital equipment, to obtain the benefit of tax allowances, and hence to defer their tax liabilities until rental payments were received from lessees. Tax benefits to lessors, which effectively reduced their costs,

could be passed on to lessees, in whole or in part, in lower rental payments, and lessees with little or no taxable profits could thereby obtain cheaper finance than if they had purchased fixed assets by borrowing. The introduction of stock relief in 1975 gave an additional stimulus to leasing by reducing industrial and commercial companies' taxable profits still further.

Another factor in the rapid growth of leasing in the 1970s may have been that leasing commitments do not have to be disclosed in companies' balance sheets. But this is unlikely to have been significant recently. Many lessees record the amount of such commitments in notes to their accounts.⁽³⁾

Growth of leasing since 1979

The official statistics on leasing, hiring and renting out, which are now compiled by the Bank, are described in a supplementary note to this article. They show an increase, at constant prices, of 20% in 1980 and 12% in 1981, compared with rises of around 40% in the three previous years. This picture, of a slowdown after 1979, is confirmed by figures compiled by the Equipment Leasing Association (ELA); the ELA accounts for roughly 90% of all domestic finance leasing in the United Kingdom, and for some 70% of total domestic leasing, hiring and renting out. The ELA figures, which, from 1980, separately identify international leasing—this is partly included in the official figures—indicate that the growth of leasing by UK industry slowed even more sharply than is implied by the aggregate official

(1) See the September 1980 *Bulletin*, pages 304-9.

(2) During the preparation of this article, officials of the Bank visited a number of lessors and brokers to discuss developments. The Bank would like to thank all those who helped.

(3) The Accounting Standards Committee has published an Exposure Draft recommending that lessees record the capitalised value of leased assets and the corresponding liabilities directly in their balance sheets.

Table A
Assets acquired for leasing

| | Domestic leasing by Equipment Leasing Association members(a) | Department of Industry/Bank of England estimates of leasing(b) | | | |
|---------|--|--|---------------------------|---|---|
| | | Leased assets as a proportion of investment in plant, machinery and vehicles | | Manufacturing, distributive and service companies | |
| | Current prices | Current prices | Constant (1975) prices(c) | Manufacturing industry | Manufacturing, distributive and service companies |
| | £ millions | £ millions | £ millions | Per cent | Per cent |
| 1977 | 675 | 930 | 710 | 8½ | 11½ |
| 1978 | 1,215 | 1,520 | 1,020 | 10½ | 14½ |
| 1979 | 1,800 | 2,270 | 1,470 | 12½ | 19 |
| 1980 | 2,175 | 2,795 | 1,770 | 16 | 22½ |
| 1981 | 2,100 | 3,300 | 1,980 | 20¾ | 26¾ |
| 1981 Q1 | | | 460 | 19½ | 25¾ |
| Q2 | | | 480 | 19¾ | 26½ |
| Q3 | | | 485 | 21½ | 26½ |
| Q4 | | | 495 | 22½ | 26½ |
| 1982 Q1 | | | 500 | 21½ | 26¾ |
| Q2(d) | | | 450 | 22½ | 26 |

(a) Gross assets acquired, including ships leased domestically and, from 1977 to 1979, some assets leased overseas. Identified assets leased overseas are shown in Table C.

(b) Figures are of assets acquired, net of disposals, and include operating leases and other short-term hirings. They cover not only all domestic lease business of ELA members but also (i) ships and aircraft leased by ELA members to overseas residents; (ii) leasing by non-ELA lessors which are registered for VAT purposes as specialist lessors; and (iii) an estimate for leasing by miscellaneous companies not included above. As explained in the supplementary note, the official figures exclude some leasing which is deemed an integral part of other business under the Standard Industrial Classification.

(c) Quarterly estimates at 1975 prices exclude ships, and are seasonally adjusted.

(d) Provisional.

figures. In current prices, the amount of new leasing fell in 1981. The figures shown in Table A (which exclude ships) point to a further fall in real terms between the second half of 1981 and the first half of 1982. However, some lessors have suggested that domestic leasing picked up again in the first half of 1982.

Nevertheless, the importance of leasing in the financing of fixed investment has continued to increase. In 1979, about 12½% of manufacturing industry's fixed investment in plant, machinery and vehicles was financed through leasing, and some 19% of such investment by manufacturing, distribution and service companies. But by 1981, these proportions had increased to about 20¾% and 26¾% respectively.

The supply of funds for leasing

Because of the overriding importance of capital allowances to leasing arrangements, the amount of leasing finance available continues to be determined primarily by the amount of lessors' tax liabilities that can be deferred through leasing. The clearing bank groups, with their extensive taxable capacity, still dominate the supply of leasing. They accounted for about 75% of assets acquired by ELA members in 1981. But the clearing banks' profits have grown more slowly over the last two years, and this year have been reduced by bad debt provisions. This, and the fact that many lessors were probably utilising most of their tax capacity two years ago, will have tended to depress the *rate of growth* of leasing (though not, of course, the *amount* of new leasing).

The banking groups have made more efficient use of capital allowances through subsidiaries with different financial year-ends, which often have been set up specifically to help groups spread their leasing over the year:⁽¹⁾ one lessor is reported to have subsidiaries with year-ends for every month of the year. Nonetheless, because many lessors have not been able to assess accurately their liability to tax until near to the end of their financial years, and because these year-ends have tended to coincide, particularly at end-December, there has been a concentration of leasing business transacted at such times.

The merchant and foreign banks appear to have increased the scale of their leasing activities over the past two years, but the volume of business, particularly of foreign banks, remained low because of their limited UK tax liabilities. Some smaller bank lessors have committed their available leasing capacity early in their financial years, and then subsequently passed on business to other lessors. The activities of non-specialist lessors, discussed below, seem to have become more important.

Taxation

The broad structure of capital allowances has remained the same over the last two years, but there have been important adaptations in fiscal arrangements:

- The *Finance Act* 1980 restricted lessors' entitlement to 100% first-year allowances to assets leased to companies which would themselves be eligible for allowances if they purchased the assets. Equipment leased to other bodies—such as local authorities and overseas residents—thereafter qualified only for a 25% writing-down allowance. The *Finance Act* also included measures to discourage leasing by individuals for tax avoidance. Provisions restricting car leasing to 25% writing-down allowances were tightened.
- The *Finance Act* 1981 increased first-year allowances on investment in larger industrial buildings (from 50% to 75%).
- The *Finance Act* 1982 limited the writing-down allowance available on equipment purchased for leasing to overseas residents to 10% per annum instead of 25%. Restrictions were imposed on the rental structure of such leases. Capital allowances on ships and aircraft chartered abroad under contrived arrangements using UK companies were restricted—to at most 10%, though sometimes no allowance is given. The Act withdrew all capital allowances on films, but allowed temporary relief for British-made films. Finally, the Act extended the 100% allowances on small industrial buildings for a further two years, and widened the uses to which such buildings might be put.

Of these changes, perhaps the most notable have been those relating to international leasing. ELA figures suggest that their members' international leasing increased from less than £100 million in 1979 to over £570 million in 1981.

(1) Capital allowances are effectively utilised at a date set in relation to a company's year-end (normally nine to twelve months later) when tax would become payable, so it is most advantageous—other things equal—to transact leasing business as close as possible to the end of the lessor's financial year.

This activity largely comprised leasing of assets acquired abroad to foreign lessees, rather than export leasing. The government reduced the rate of allowance on leasing to overseas residents to 25% in 1980, but profitable business was still possible by writing suitably long leases (the equipment being financed was typically aircraft or ships, but an increasing amount of film leasing occurred from mid-1981). There was also an element of 'double dipping', that is arrangements where lessors claim UK capital allowances and the lessees claim foreign allowances. The volume of leasing to foreign residents fell back towards the end of 1981; but some international business was still being transacted in early 1982. The 1982 *Finance Act* should finally have dampened such activity.

Lessors report that leasing of industrial buildings has increased following favourable changes in the last two Finance Acts. But the amount is probably still quite small. Leasing to local authorities faltered for a period after the reduction to 25% allowances, but picked up again as lessors realised that they could still earn profits, on a good credit risk, by writing longer leases. Local authorities have been attracted to leasing because leased assets have fallen outside capital expenditure limits. Leasing has continued to other public sector bodies, such as nationalised industries and passenger transport executives, where 100% first-year allowances are still available to the lessor.

Rental income

A substantial increase in rental incomes from previous leases has provided lessors both with additional funds and taxable capacity. ELA figures show that rental incomes of ELA members increased from £590 million in 1978 to £1,550 million in 1981, and that the proportion of total assets newly leased which was covered by rental income rose from 48% to 58%. This increase in the proportion of new business being financed from rents may point to a maturing of the leasing industry: it will also reflect the slower growth of new business in 1980 and 1981. In the mid-1970s, when leasing also grew slowly, rentals accounted for a still higher proportion. Nonetheless, the continued growth of rental incomes, and thus of taxable incomes, could put pressure on lessors to defer further their tax liabilities by seeking to increase the amount of leasing done.

Role of non-specialist lessors

Several lessors have suggested that the activities of non-specialist lessors have become much more significant over the last two years. These include industrial and commercial companies unconnected with financial institutions, as well as specialised finance arms of trading companies and subsidiaries of insurance companies.

Official estimates suggest non-specialist business may be around 10% of total leasing. This seems to be consistent with the published annual accounts of the largest industrial and commercial groups of companies, some fifteen of which have disclosed that they acted as lessors mostly in small amounts but one or two for more than £50 million.⁽¹⁾

A growing number of industrial and commercial companies have seen benefits in leasing to others as an investment. Their activities were particularly noticeable towards the end of 1981. Merchant banks often manage the leasing activities of non-specialist companies, and may pass business to them when their own tax capacity has been utilised. These banks sometimes bear the credit risk, either by guarantee or by a 'back-to-back' lease in which the non-specialist lessor leases to the bank which then on-leases to the user. The expertise of intermediaries and lease brokers has enabled non-specialist lessors to expand their activities beyond the local authority market, on which they concentrated two years ago, though this expansion has also been encouraged by the reduction to 25% in tax allowances on local authority business.

The range of leasing facilities

There has also been an extension in the range of facilities offered by lessors. For example, assets leased now extend from office copiers and dental equipment to oil rigs, chemical plant and industrial buildings.

There has been an increase in the size and number of large transactions—'big tickets'. The number of lessors prepared to negotiate deals of £3 million or more appears to have grown to about fifty, partly because of inflation, partly because rental income has added to their capacity, and partly because they are now more experienced in risk assessment. About three or four years ago, a large 'big ticket' by a single lessor might have been about £20 million. But some subsidiaries of the clearers have now leased assets of up to £50 million at a time, while a few have done business up to £90 million on oil or chemical plant. This increase in the size of 'big tickets' has been accompanied by a decline in the number of consortium deals: here, difficulties have arisen from different approaches to documentation and credit assessment, while consultation with all parties has proved cumbersome and time-consuming. Nevertheless, consortia could still be necessary for the largest leases, and they can enable some smaller lessors to compete with larger ones.

The average term of leases has lengthened in the last two years. ELA figures show that 56% of assets acquired by ELA members in 1981 had a primary period of over five years, compared with 37% in 1979 (Table B). The growth in leases with a primary period of over ten years was

Table B
Assets acquired by ELA members^(a)—analysis by primary period of lease

| | Percentages | | | |
|-----------------------------|-------------|-------|-------|-------|
| | 1978 | 1979 | 1980 | 1981 |
| Up to 2 years | 11.4 | 9.9 | 5.5 | 4.1 |
| Over 2 years up to 3 years | 17.3 | 19.5 | 11.2 | 9.9 |
| Over 3 years up to 4 years | 11.3 | 10.3 | 7.2 | 6.8 |
| Over 4 years up to 5 years | 29.7 | 23.5 | 27.8 | 23.4 |
| Over 5 years up to 7 years | 10.1 | 12.0 | 15.6 | 14.5 |
| Over 7 years up to 10 years | 14.7 | 11.7 | 11.8 | 9.5 |
| Over 10 years | 5.4 | 13.0 | 20.9 | 31.8 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

(a) Including assets leased to overseas residents.

(1) Including one company which provides a substantial amount of leasing finance for sales of its own product.

An illustrative example

An example may help to clarify some of the features of leasing described in the article.

Suppose that a five year lease for a capital sum of £1,000 is arranged and that the funds to finance this have to be borrowed by the lessor at a market rate of 15½ per cent. To keep the example simple, it is assumed that the lessor incurs no administrative or other costs, passes on his borrowing costs and all the benefit of deferring tax to the lessee, and makes no profit on the transaction. This example therefore, is unrealistic, but illustrates the pattern of cash flows involved.

The lessor will work out the amount of rental payments required to meet the cost of funds he needs to borrow (the amount of borrowing will of course depend on the rental income received and the interest and tax payments that will result from the lease). These rental payments work out at £231.90 per year and are shown in column 2 of the table. (Rental payments total £1,159.50 and thus contain an interest element of £159.50 over the five years.) The tax position of the lessor is seen in column 3. On the first anniversary of the lease he will not pay £399.41 (ie 52% of £1,000 – £231.90 rental income) of corporation tax that would otherwise have been due. Thereafter he will pay tax on rental (and interest) received less the cost of financing outstanding borrowing. Thus, in year 2 he will pay

52% of £231.90 – £119.06. The interest cost in column 4 is determined by the amount of borrowing outstanding during the previous year (column 5).

It can be seen that borrowing by the lessor has been virtually eliminated by the end of the third year, so that the payback period is considerably shorter than the 5 year primary period of the lease. In the two subsequent years he has a temporary surplus of funds on which interest is earned.

For comparison, the last two columns show how the lessee might perceive his position if he regarded his rental payments as though they were on a standard bank loan with equal repayments of capital plus interest. The implied interest rate would be 8%, only just over half the lessor's borrowing rate, because he has transferred the right to capital allowances to the lessor. His outstanding debt to the lessor is higher than the lessor's borrowing throughout the loan.

Of course, in practice the rental payments would be somewhat higher (and thus the lessor's tax payments) because the lessor will charge a margin. The chart on page 387 suggests that, although average lease rental rates have been considerably lower than interest rates, they have been high enough to produce a positive margin for the lessor.

| Date | Lessor's position | | | | Lessee's position | | |
|------------|--------------------------|--------------------------|--------------------|--------------------------------|-------------------------------|-----------------------------------|----------------------------|
| | Capital outlay by lessor | Lessee's rental payments | Tax paid by lessor | Cost of funds to lessor (15½%) | Lessors's balance outstanding | Balance of capital owed to lessor | Cost of funds (which = 8%) |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
| 31 Dec. 81 | 1,000 | 231.90 | — | — | 768.10 | 768.10 | — |
| 1 Jan. 83 | | 231.90 | (399.41)(a) | 119.06 | 255.85 | 597.65 | 61.45 |
| " " 84 | | 231.90 | 58.68 | 39.66 | 122.28 | 413.56 | 47.81 |
| " " 85 | | 231.90 | 99.96 | 18.95 | 9.30 | 214.74 | 33.08 |
| " " 86 | | 231.90 | 110.73 | 1.44 | -110.43 | Nil | 17.17 |
| " " 87 | | | 119.84 | -17.12 | -7.71 | | |
| " " 88 | | | 8.90 | -1.19 | Nil | | |

(a) This is the amount of tax which would have been due but for the leasing transaction. Leasing defers it to subsequent periods.

particularly marked—from 13% in 1979 to 32% in 1981, reflecting, in part, the growth of international leasing, and the type of assets involved in this (commonly, ships and aircraft). One reason for the overall shift towards longer leases was the reduction in car leasing, for which the primary period is normally three years, following the restriction on capital allowances on car leases in 1980 and low demand for cars.

Some lessors, with growing experience, have negotiated leases of up to fifteen years and, although that is still often regarded as an upper limit, a few have been willing to go even further. Lessors have been able to finance long term because they receive capital allowances and other subsidies which sharply reduce the funding period. The example in the box illustrates this. The investment pay-back period is therefore much shorter than the primary period of the lease.

Nevertheless, as the length of leases has grown, so lessors have had to assess credit risks more thoroughly, normally concentrating on the credit risk of the lessee rather than the asset value. Lessors generally aim to relate the primary period of a lease to the 'useful' life of the asset being leased (a primary period of about 75 per cent of the useful life of the equipment being leased may have been typical); and only certain types of asset, such as some ships, would generally be suitable for very long leases.

The lengthening in the primary leasing period has been one of the more significant developments in leasing over the past two years, and may be viewed as a parallel development to the lengthening in terms of bank loans. Indeed, leases of ten years or more now account for one-third of new leases. Moreover, it is quite common for leases of up to ten years to be at fixed rates—which is not the case with clearing bank term-lending.

Lessors have developed their facilities in a number of other ways. Repayment terms can now be structured very flexibly, allowing 'balloon' or 'guaranteed residual value' leases that delay rental payments (the example of US bank lessors may have helped to stimulate innovation in lease structuring). Larger prospective lessees can generally negotiate rentals to match the income flow from the equipment being leased, and can secure variable rates of interest.

The largest deals normally carry variable rates which adjust very rapidly to interest rate changes; smaller leases on the other hand are usually at a fixed rate, but these too can be adjustable, though normally only annually. At the same time, lessors have imposed more conditions on leases in an effort to limit their exposure to various risks. A notable example of this is the inclusion of tax variation clauses.⁽¹⁾

(1) There are two main kinds of tax variation clause: one allows for changes in the corporation tax rate, the other for changes in taxation allowances and in the taxation system (eg in the structure of corporation tax, or in the due dates for payment of taxes).

Another facility offered by specialist lessors is sales aid leasing, under which a supplier sells equipment with a ready-made leasing contract: it is particularly suitable for leasing smaller-value, standardised goods such as office equipment, where uniform contracts can be used. Such leasing, which is transacted directly by manufacturers or through subsidiaries of manufacturers, is still small in relation to the overall volume of leasing; but it is reported to have grown over the last two years. Primary periods are normally of three to five years. The manufacturer controls financing terms, and obtains more control over the supply of second-hand equipment. The lessor benefits from a more continuous and larger flow of business.

Demand for leasing

The main influence on demand for leasing is the underlying demand for fixed assets by industrial and commercial companies. Depressed economic activity and low profitability in 1980 and 1981 have produced discouraging conditions for investment for many industrial and commercial companies. But a surprisingly high rate of investment has nevertheless taken place (mainly to improve efficiency rather than expand capacity). Tax exhaustion will often have meant that companies could not obtain any early direct benefits from capital allowances. But such companies will have been able to obtain much of the benefit indirectly, through leasing. Leasing may have had a counter-cyclical effect because, during a period of high inflation and low taxable profits, the larger difference between interest rates and leasing rates (see chart) may have encouraged some fixed investment that would not otherwise have taken place.

The attraction of leasing in periods of low profitability (and high interest rates) may, in part, explain the reports by lessors that, while many companies of all sizes have turned to leasing for the first time over the last two years, a number which had already used leasing facilities have done more of it. It may also help to explain the switch away from other forms of financing fixed investment noted earlier in this

article. In this connection, it is interesting that figures published by the Finance Houses Association (whose members include both lessors and providers of hire purchase finance) show that the written-down value of leased assets rose from 42% of their outstanding corporate business in March 1980 to 59% in March 1982.

The overall demand by industry for fixed investment has been surprisingly well maintained over the past couple of years, despite the depth of the recession (see page 338), and leasing has become a more important source of financing it. But demand has varied considerably between industrial sectors, and probably between individual companies within sectors (Table C). Assets leased to the transport industry fell sharply in 1981, and demand from 'other distributive and service' industries, which had grown strongly in 1980, was also cut back. But manufacturers, agriculture, and central and local government increased their leasing, as did the 'other industrial' sector (whose leasing had fallen in 1980). The analysis by type of asset shows that leasing of commercial vehicles and computers and office equipment declined, as did car leasing, while leasing of plant and machinery, and of ships, aircraft, and oil equipment increased.

Knowledge of leasing has spread because of the wide dissemination of information on leasing through conferences, books and other publications; and, to some extent, because of the growing advisory activities of brokers and merchant banks. The number of lease brokers has multiplied (a Lease Brokers Association has been formed), and some merchant banks undertake lease advisory work as part of their corporate advisory service. These developments have contributed to better market intelligence which has enabled lessees to negotiate terms more suitable to their needs.

There is a wide range in the size and activities of lease brokers. Some brokers arrange leasing transactions for local authorities (which use them primarily to obtain the most competitive rates), some package small leasing transactions into sizes that larger lessors are willing to take on, and some simply provide introductions.

Table C
Analysis of assets acquired for leasing by ELA members

£ millions

| | 1978 | 1979 | 1980 | 1981 |
|--|-------|-------|-------|-------|
| Type of asset | | | | |
| Plant and machinery | 250 | 415 | 712 | 801 |
| Computer and office equipment | 240 | 315 | 445 | 380 |
| Ships, aircraft and oil production equipment | 158 | 298 | 291 | 355 |
| Commercial vehicles | 154 | 225 | 291 | 225 |
| Cars | 343 | 468 | 267 | 222 |
| Other (including railway rolling stock, shop fittings, and agricultural equipment) | 69 | 81 | 169 | 119 |
| Total for use in the UK | 1,214 | 1,802 | 2,175 | 2,102 |
| Classification of lessee | | | | |
| Manufacturers | 363 | 571 | 642 | 711 |
| Other industrial | 166 | 256 | 208 | 273 |
| Transport | 285 | 377 | 384 | 176 |
| Agriculture | 33 | 68 | 70 | 99 |
| Other distributive and service industries | 267 | 434 | 670 | 589 |
| Central and local government | 100 | 96 | 201 | 254 |
| Total for use in the UK | 1,214 | 1,802 | 2,175 | 2,102 |
| International leasing | (a) | (a) | 184 | 572 |
| Total leasing | 1,214 | 1,802 | 2,359 | 2,674 |

(a) Included within total for use in the UK.

Leasing rental rates and margins

The leasing rental rates in the chart give the effective cost of funds to lessees. They suggest that leasing rental rates have fluctuated much less widely than short-term interest rates, or even the one year LIBOR rate, from about the end of 1978, and that over the last two years they have changed little. Individual leasing rental rates may have been widely dispersed around the average rate shown in the chart. But the effect on leasing rates of variations in interest rates has been dampened by the benefit to lessors of deferring tax (the level of leasing rates has recently been substantially below market interest rates). Also, because bank profits tend to increase or contract when interest rates rise or fall, the supply of leasing tends to move similarly: but unless demand from lessees changes, pressure on leasing margins tends to offset the effect of interest rates on rental rates.

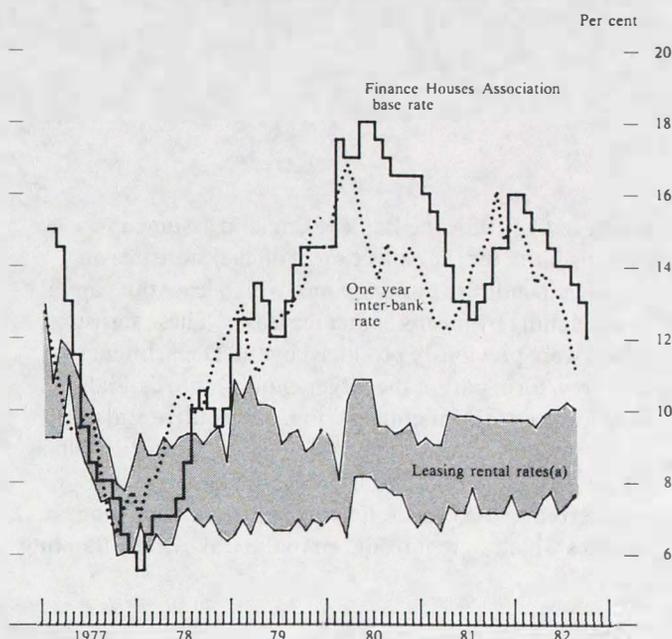
Another factor in the dynamics of the leasing market may be that, as the average maturity of leases has increased, rental rates have tended to follow longer-term expectations rather than movements in short-term interest rates. Some lessors appear to have lengthened the term of their borrowing over the past two years as the cash investment period of leases has generally lengthened, but few lessors have borrowed for periods of two years and more.

The stability of lease rates in recent years indicates the growing strength of competition among lessors. While average margins might have been quite high up to, say, late 1978, they then fell. They may have declined somewhat further over the last two years, remaining at about 2½%–3% on the better credit risks, but with a wider range of transactions now carrying such margins. Margins are reported to have continued tight in 1982, particularly on transactions of up to about £1 million.

Lessors have argued that the 2½%–3% margin mentioned above is not strictly comparable to a loan finance margin (which, for a good credit risk, would be around 1%), and that lease margins have not really been significantly thicker than banking margins, with lessors earning only a normal competitive margin, passing on to lessees the majority of the benefit obtained from deferring tax. It is impossible to calculate margins without knowing the cash profiles involved. Moreover, even where these are known, analysis is difficult.

The funding required by a lessor falls sharply on receipt of capital allowances (usually some 12–24 months after a lease has been granted) as shown in the box on page 385. On average the funds invested by a bank in a loan are roughly double those that a lessor would need to invest in a lease of the same amount and repayment structure. But, after tax, the credit exposures are essentially the same.⁽¹⁾ Therefore, the margin on funds invested that a lessor needs to charge to provide compensation for this equivalent credit exposure is about double that which a bank needs to charge on a loan (in fact, various timing differences associated with tax receipts and payments mean that the lessor's margin has to be slightly more than double).

Interest rates and leasing rental rates



Source for leasing rental rates: Saturn Lease Underwriting Limited.

(a) The upper limit of the range of leasing rates is the monthly average, and the lower limit the minimum, on five-year leases with quarterly rental payments.

This higher risk margin on a lease, with various other factors such as higher administrative costs than on an equivalent loan, probably explain most of the difference between pre-tax margins of 2½%–3% on a typical lease and 1% on a normal bank loan. It seems likely, therefore, that most of the benefit to lessors arising from tax allowances is being passed back to lessees.

Outlook

Lessors report satisfactory advance order books, and fixed investment has remained surprisingly strong in recent years. But the supply of leasing may tend to weaken to the extent that lower interest rates reduce the profits of major lessors (although growth of rental incomes may partly offset this). In parallel, the fall in interest rates and improved profitability of industrial and commercial companies will tend to reduce the attractions of leasing compared with loan finance, and thus reduce the demand for leasing.

(1) Losses on bad debts are fully offsettable against tax in the case of a loan, but only bad debts in excess of outstanding capital allowances in the case of leasing.

Supplementary note on estimates of investment in assets for leasing, hiring and renting out: 1975-1981

At the end of 1981, the Bank of England assumed responsibility for the collection of official statistics on capital expenditure by companies which lease out capital goods mainly by means of finance leases. These statistics, which were previously produced by the Department of Industry, form part of the larger enquiry into capital expenditure of the manufacturing, distributive and service industries now conducted by the Business Statistics Office for the Department of Industry. Responsibility was transferred to the Bank following statistical reporting changes which were introduced in the wake of the Banking Act 1979.

Under the previous arrangements for collecting statistics of leasing activity, banks which observed the credit control requirements reported to the Bank of England, while all other contributing companies sent returns to the Department of Industry. A significant number of the latter group were, however, accorded licensed status under the Banking Act and, with their inclusion in the new 'monetary sector', began to provide regular statistical returns to the Bank. The Department of Industry and the Bank considered that it would be more sensible and efficient for all the returns covering the leasing industry to be made to one collecting body, and they agreed that the Bank was the appropriate body to collect such returns and to compile future estimates based upon them.

The present note, which is expected to be the first of a series, is a successor to an annual article published by the Department of Industry in *British Business*, and like its predecessors it presents the results of the surveys of the previous calendar year's leasing activity. Some of the figures have also been included in *National Income and Expenditure*, 1982 edition (the 'Blue book'). Apart from some revisions for 1980, figures for earlier years have been adopted without amendment from the Department's series.

The statistics come from three sources. The main one is the quarterly enquiry into capital expenditure on assets for leasing, hiring or renting out: this enquiry, introduced by the Department of Industry in 1975 and now taken over by the Bank, is particularly directed to the larger leasing subsidiaries of banks, to finance house groups, and to specialist leasing companies. The second source is the quarterly banking returns made by the members of the monetary sector, which include figures for the amount of leasing business they undertake direct rather than through subsidiaries outside the sector. Thirdly, the Business Statistics Office provides aggregates from enquiries conducted annually under the Statistics of Trade Act 1947 covering, in the main, smaller businesses engaged in the leasing of such things as office equipment.

Table 1
Capital expenditure at current prices on assets for leasing, hiring and renting out^(a)

£ millions

| | Finance Leasing to | | | All other leasing, hiring or renting out ^(b) | Total |
|------------------------------------|--|------------------------|------------------|---|-------|
| | Central government and local authorities | Manufacturing industry | Other industries | | |
| New building work: | | | | | |
| 1975 | — | — | — | 5 | 5 |
| 1976 | — | — | — | 5 | 5 |
| 1977 | — | — | — | 4 | 4 |
| 1978 | — | — | — | 8 | 8 |
| 1979 | — | 1 | — | 6 | 7 |
| 1980 | — | 2 | 3 | 3 | 8 |
| 1981(c) | — | — | 8 | 7 | 15 |
| Vehicles: (d) | | | | | |
| Acquisitions | | | | | |
| 1975 | 7 | 20 | 58 | 36 | 121 |
| 1976 | 9 | 22 | 124 | 41 | 196 |
| 1977 | 10 | 55 | 132 | 70 | 267 |
| 1978 | 23 | 209 | 261 | 263 | 756 |
| 1979 | 27 | 230 | 626 | 293 | 1,176 |
| 1980 | 55 | 210 | 633 | 244 | 1,142 |
| 1981(c) | 20 | 144 | 635 | 391 | 1,190 |
| Disposals | | | | | |
| 1975 | — | 4 | 3 | 7 | 14 |
| 1976 | — | 5 | 7 | 9 | 21 |
| 1977 | — | 4 | 5 | 12 | 21 |
| 1978 | 2 | 9 | 14 | 18 | 43 |
| 1979 | 3 | 30 | 52 | 50 | 135 |
| 1980 | 4 | 40 | 120 | 70 | 234 |
| 1981(c) | 1 | 34 | 139 | 101 | 275 |
| Plant and machinery: | | | | | |
| Acquisitions | | | | | |
| 1975 | 39 | 102 | 67 | 203 | 411 |
| 1976 | 40 | 143 | 78 | 208 | 469 |
| 1977 | 35 | 184 | 146 | 368 | 733 |
| 1978 | 37 | 273 | 210 | 350 | 870 |
| 1979 | 72 | 415 | 345 | 490 | 1,322 |
| 1980 | 135 | 610 | 583 | 670 | 1,998 |
| 1981(c) | 89 | 651 | 612 | 1,183 | 2,535 |
| Disposals | | | | | |
| 1975 | — | 4 | 2 | 10 | 16 |
| 1976 | 1 | 6 | 8 | 15 | 30 |
| 1977 | 2 | 14 | 11 | 24 | 51 |
| 1978 | 9 | 16 | 22 | 26 | 73 |
| 1979 | 8 | 25 | 26 | 42 | 101 |
| 1980 | 9 | 30 | 30 | 50 | 119 |
| 1981(c) | 1 | 19 | 28 | 118 | 166 |
| Total expenditure: | | | | | |
| Acquisitions | | | | | |
| 1975 | 46 | 122 | 125 | 244 | 537 |
| 1976 | 49 | 165 | 202 | 254 | 670 |
| 1977 | 45 | 239 | 278 | 442 | 1,004 |
| 1978 | 60 | 482 | 471 | 621 | 1,634 |
| 1979 | 99 | 646 | 971 | 789 | 2,505 |
| 1980 | 190 | 822 | 1,219 | 917 | 3,148 |
| 1981(c) | 109 | 795 | 1,255 | 1,581 | 3,740 |
| Acquisitions less disposals | | | | | |
| 1975 | 46 | 114 | 120 | 227 | 507 |
| 1976 | 48 | 154 | 187 | 230 | 619 |
| 1977 | 43 | 221 | 262 | 406 | 932 |
| 1978 | 49 | 457 | 435 | 577 | 1,518 |
| 1979 | 88 | 591 | 893 | 697 | 2,269 |
| 1980 | 177 | 752 | 1,069 | 797 | 2,795 |
| 1981(c) | 107 | 742 | 1,088 | 1,362 | 3,299 |

(a) Capital expenditure by banks, leasing subsidiaries of banks, finance houses and specialist leasing companies.

(b) Includes some finance leasing for which information about lessees is not available. The proportion of such leasing varies between years so that simple comparisons are not strictly valid.

(c) Provisional.

(d) Includes some ships owned by the lessors specified in (a) above.

Table 1 closely follows the layout of the form used for the quarterly enquiry. The analysis of finance leasing by lessee sectors covers only business reported by companies participating in that enquiry, and a more detailed breakdown of the figures is not available.

The range of activity covered by the enquiry includes leasing of industrial and office machinery, but leasing of buildings by property companies is excluded, as is the leasing and hiring of road passenger transport, including self-drive hire, hiring of contractors' plant and scaffolding, and television rentals. The figures are mainly intended to measure the contribution to domestic capital formation of investment in assets for leasing out. They therefore chiefly comprise assets acquired for installation and use within the United Kingdom. Ships and aircraft owned by UK lessors are, however, considered part of domestic capital formation irrespective of their location, and expenditure on them is included in Table 1 within the 'vehicles: other industries' category. In 1981, aircraft particularly were acquired on a significant scale for leasing abroad, so swelling the figure.

In the national income 'Blue book', capital expenditure is classified according to industry of ownership, and expenditure by lessors is generally allocated to the insurance, banking, finance, and business service groups of industries.⁽¹⁾ The exclusions mentioned above are, however, entered under other headings such as road passenger transport. The figure for 'other leasing, hiring and renting out' is known to include some finance leasing not separately identified, and some 20% of this figure in 1981

Table 2
Net capital expenditure^(a) on assets for leasing, hiring and renting out:
current prices and constant (1975) prices compared

£ millions

| | New building work | Vehicles(b) | Plant and machinery(c) | Total |
|----------------|-------------------|-------------|------------------------|-------|
| 1975 | | | | |
| Current prices | 5 | 107 | 395 | 507 |
| 1975 prices | 5 | 107 | 395 | 507 |
| 1976 | | | | |
| Current prices | 5 | 175 | 439 | 619 |
| 1975 prices | 4 | 146 | 380 | 530 |
| 1977 | | | | |
| Current prices | 4 | 246 | 682 | 932 |
| 1975 prices | 3 | 168 | 540 | 711 |
| 1978 | | | | |
| Current prices | 8 | 713 | 797 | 1,518 |
| 1975 prices | 6 | 411 | 603 | 1,020 |
| 1979 | | | | |
| Current prices | 7 | 1,041 | 1,221 | 2,269 |
| 1975 prices | 5 | 533 | 931 | 1,469 |
| 1980 | | | | |
| Current prices | 8 | 908 | 1,879 | 2,795 |
| 1975 prices | 4 | 412 | 1,354 | 1,770 |
| 1981(d) | | | | |
| Current prices | 15 | 915 | 2,369 | 3,299 |
| 1975 prices | 7 | 378 | 1,597 | 1,982 |

(a) Acquisitions less disposals.

(b) Includes ships.

(c) The estimates at 1975 prices are subject to a considerable range of error.

(d) Provisional.

is thought to relate to finance leasing to manufacturing industry.

Figures at constant prices shown in Table 2 use price indices based on a 'basket' of capital goods reflecting the importance of the various types in 1975. This basket is being re-examined and new price indices, with 1980 as the base year, will be produced in due course.

(1) See Table 10.8 of the 'Blue book' under the heading 'insurance, banking, finance and business services—leased assets'. The value of new buildings acquired by property companies for leasing out is included, however, under the heading 'insurance, banking, finance and business services—other assets'. Figures for the net acquisition of land and existing buildings by property companies are shown in Table 10.3.