Chapter 13 – Hire-Purchase and Leasing

Content Outline

1. **Hire-Purchase** 13-2

2. **Leasing** 13-19

3. **What is the Difference Between Leasing and Hire-Purchase?** 13-29

Practice Questions 13-34

Learning Objectives

What you should achieve after completing this chapter:

- Understand hire-purchase and lease financing;
- Know how hire-purchase works and how calculations are done;
- Understand the procedure of the Hire-Purchase Act 1967;
- Know the problems and risks of hire-purchase;
- Know the difference between hire-purchase and leasing;
- Know how leasing works and how calculations are done;
- Know the different types of leasing; and
- Know the difference between operational lease and financial leases.

1. Hire-Purchase

Hire-purchase is a system of acquiring goods on credit whereby the seller of the goods is regarded as the dealer; the purchaser is regarded as the hirer and the financier as the owner.

The ownership of the goods bought on hire-purchase does not pass to the hirer at the time of the hire-purchase agreement or upon delivery of the goods. The ownership of the goods remains in the financier until the hirer has fully settled the price agreed upon in the hire-purchase agreement.

Hire-purchase is commonly carried out in the form of a triangular transaction. The **dealer**/seller/vendor sells the goods to the financier (usually finance or credit company), which becomes the **owner**, in return for an immediate payment, which is the cash price less deposit paid by the buyer/consumer, known as the **hirer**. The owner then hires the goods to the hirer under a hire-purchase agreement.

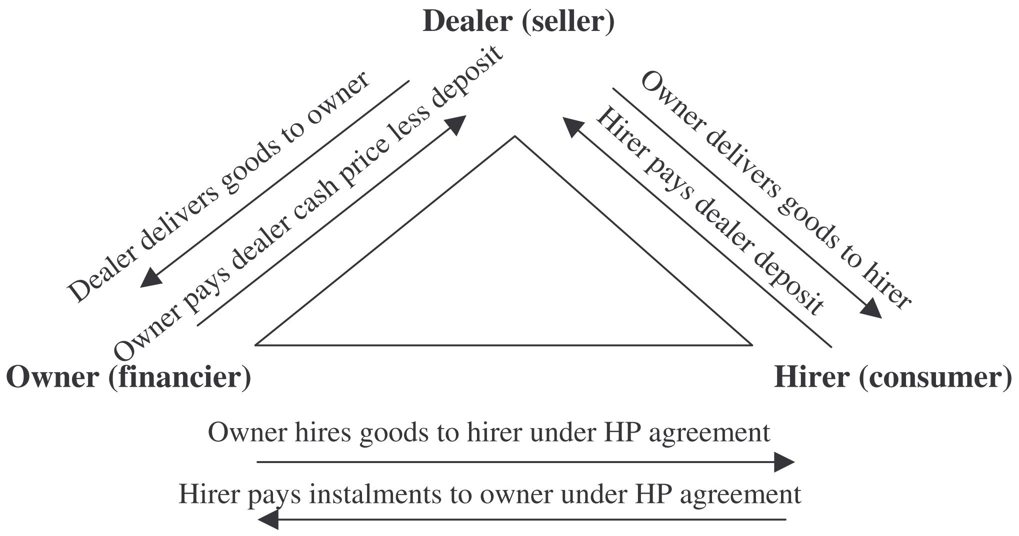

Figure 13.1: Hire-Purchase Transaction

The main legislation governing hire-purchase transactions in Malaysia is the Hire-Purchase Act 1967, which came into force on 11 April 1968 after hire-purchase became an increasingly popular method of acquisition.

The most common type of hire-purchase agreement in Malaysia is for the purchase of motor vehicles.

1.1 Types of hire-purchase

There are two types of hire-purchase financing.

(a) Consumer hire-purchase

This covers the financing of consumer goods purchased for personal, family and household purposes. Therefore, the hirer is a natural person (not business) and the goods are obtained for non-business purposes.

(b) Industrial hire-purchase

Industrial hire-purchase refers to goods purchased by companies for use in business or industry. Example, the purchase of a machine by a company to be used in business.

1.2 Features and benefits

(i) The consumer can obtain a maximum of 90% financing.

(ii) The hirer becomes the owner of the goods on settlement of the hire-purchase facility.

(iii) The hirer can opt for early full settlement (completion).

(iv) The hirer can terminate the agreement by returning the goods but has to indemnify the owner of any damages or losses incurred in disposing of the asset.

Arrangements that different finance companies have with dealers:

(a) Hire-purchase direct collection without recourse (to the dealer)
This is a facility where the dealer introduces the buyer of the vehicle to the financier. When the facility is approved, the hirer pays the monthly instalments to the financier. If the hirer defaults, the financier will have to repossess the vehicle.

(b) Hire-purchase direct collection with recourse (to the dealer)
This is a facility where the dealer introduces the buyer of the vehicle to the financier and guarantees repayment of the facility. When the facility is approved, the hirer pays the monthly instalments to the financier. If the hirer defaults, the financier will take action against the hirer and the dealer.

(c) **Hire-purchase scheduled collection (by the dealer)**
This is a facility where the dealer introduces the buyer of the vehicle to the financier. When the facility is approved, the dealer collects the monthly instalments on behalf of the financier. If the hirer defaults, the dealer has to make good the payment for the vehicle.

1.3 Risks of hire-purchase

1.3.1 Fraud

The dealers may, in collusion with the supplier, present used or reconditioned equipment for financing instead of new equipment. The owner may only come to know about it after repossession and will have difficulty in disposing of it.

The dealers might introduce fictitious hirers. This can happen in scheduled collection arrangements. The dealer can create a fictitious hirer's name and submit forged documents to financier The financier will pay the dealer for non-existent goods. The dealer will use the funds for his own purposes and dutifully pay the monthly instalments. The problem will surface when the dealer defaults on payment.

1.3.2 Other problems

Hire-purchase facilities are meant primarily for movable goods. Goods affixed to the ground (Land) would pose a problem. The National Land Code defines land to include all things attached to the earth or permanently fastened to anything attached to the earth whether on or below the surface. Therefore, a claim by any party on the land will include the fixture though financed by another party. Therefore, a disclaimer from the landlord over the fixture needs to be taken.

Stolen goods like machinery are difficult for the financier to ascertain. The financier will also lose its right over the machinery. This may not happen in cases where there is a registration body, for example, the Jabatan Pengangkutan Jalan for motor vehicles. The FIS is a system which tracks stolen goods or goods seized by customs. The hirer may not have insured the goods.

1.4 Specific terms and conditions

1.4.1 Term charges

Term charges are not to exceed the rate prescribed by the Act for Scheduled goods (refer to Item 1.5.1). Currently, the rate for term charges in a hire-purchase shall not exceed 10% per annum flat rate.

1.4.2 Margin of finance

The maximum financing under hire-purchase is 90% of the cash price of the goods.

1.4.3 Interest on overdue loans

Interest on any overdue loan instalments is currently charged at a rate not exceeding 8% per annum simple interest calculated on a daily basis or any such other rate as may be prescribed.

1.5 Hire-Purchase Act 1967

The Act is under the jurisdiction of the Ministry of Domestic Trade and Consumer Affairs. It does not set down any licensing requirements but provides for the regulation of hire-purchase activities relating to scheduled goods.

According to Section 2 of the Hire-Purchase Act, hire-purchase includes a letting of goods with an option to purchase and an agreement for the purchase of goods by instalments (whether the agreement describes the instalments as rent or as hire or as otherwise), but does not include any agreement:

(a) Whereby the property in the goods passes at the time of the agreement or upon or at anytime before delivery of the goods; or

(b) Under which the person by whom the goods are being hired or purchased is a person who is engaged in the trade or business of selling goods of the same nature or description as the goods comprised in the agreement.

Based on the above, subsection (a) seeks to exclude outright sale (ownership transfers to buyer upon sale). Likewise, a dealer cannot finance his stock under hire-purchase as the owner and hirer cannot be the same person.

Only the following goods can be bought on hire-purchase.

1.5.1 Definition of scheduled and non-scheduled goods

Hire-Purchase Act 1967 (Act Goods as per First Schedule of the Act)

- All consumer goods (goods purchased for personal, family and household purposes); and
- Motor vehicles namely:
  - Invalid carriages;
  - Motor cycles;
  - Motor cars including taxi cabs and hire cars;
  - Goods vehicles where the maximum permissible laden weight does not exceed 2,540 kilograms; and
  - Buses, including stage buses.

1.5.2 Non Hire-Purchase Act goods (Non-Act)

In respect of goods not specified in the First Schedule of the Hire-Purchase Act 1967, the parties are free to contract outside the provisions of the Act or agree to be bound by those provisions. For example, the hirer wants a 3-ton lorry to be financed under hire-purchase. As the item does not come under the Hire-Purchase Act 1967, the financier can quote an interest rate of more than 10% per annum, a margin of finance of more than 90% and the interest rate for overdue instalments of more than 8% per annum. However, all other provisions of the Hire-Purchase Act 1967 can be included in the agreement.

(Students are to note that this manual refers mainly to goods under the Hire-Purchase Act 1967)

1.5.3 Insurance for goods under hire-purchase

<u>The financier</u> at the expense of the hirer is to insure the goods in the name of the hirer:

- for motor vehicles, for the first year only.
- for all other goods, for the duration of time that the goods remain under hire-purchase against any risk that the financier thinks fit. The cost of the insurance is to be borne by the hirer.

For hiring periods in respect of motor vehicles, <u>the hirer</u> shall at his or her expense, insure the vehicle immediately following the first year in the name of the hirer.

The hirer shall, not less than 14 days before the date of expiry of a policy of insurance in respect of motor vehicle, inform the financier that he or she has renewed the said policy.

Where the hirer has failed to renew the policy of insurance, the financier shall be at liberty to insure the motor vehicle and any costs thereby incurred shall be borne by the hirer.

A financier cannot request or compel the hirer to insure any risks with any particular registered insurer.

1.5.4 Perfection of documentation

The Hire-Purchase Act 1967 requires the hire-purchase agreement to be in **writing**. Where the print size of the font is less than 10 points times (72 points being one inch large), it is **not** considered as to be in writing.

A hire-purchase agreement must be signed by or on behalf of all parties to the agreement. However, the financier, dealer, agent or person acting on behalf of the financier must not request an intending hirer or agent to sign a hire-purchase agreement or other form or document relating to the hire-purchase agreement **unless such document is duly completed or filled in.**

A hire-purchase agreement that does not comply with the above shall be void.

What are the details that must be stated in a hire-purchase agreement? Please see reference to a sample hire-purchase agreement below.

Particulars of Hire-Purchase agreement

Part I Particulars of Hirer

Full Name **Amar Anthony Abdullah** NRIC **500214-10-1011**

Address **No 66, Jalan Besar, Batang Berjuntai, Selangor 54210**

Part II Description of goods

i)	Description of goods	**New Lotus saloon GTX**
ii)	New or secondhand	**New**
iii)	Registration No	**WHX 8009**
iv)	Model	**1.8 Automatic**
v)	Engine No	**4G15P-LB3821**
vi)	Chasis or serial No	**PL1C97DFJ48916216**
vii)	Accessories	**Cobra alarm system**
viii)	Goods to be kept at:	**66 Jalan Besar, Batang Berjuntai, Selangor**

Part III Table of payments

i)	Cash price of goods	**RM81,500**	
ii)	Deposit Cash (RM10,500) Other than Cash (RM 21,000 – Trade in)	**RM31,500**	
	Cash price less deposit	**RM50,000**	**RM50,000**
iii)	Freight charges, if any		**RM -**
iv)	Vehicle registration fees, if any		**RM -**
v)	Insurance for motor vehicle for the first 12 months OR		**RM -**
	Insurance for goods other than motor vehicles, for duration of agreement		**RM**
vi)	Total of item i) iii) iv) and v less ii)		**RM50,000**
vii)	Term Charges a) rate per annum ………7………..% flat		
	b) total amount of term charges		**RM14,000**
viii)	Balance originally payable under this agreement Total items vi and vii		**RM64,000**
ix)	Annual percentage rate of term charges **12.68%**		
x)	Hire-Purchase price (Total of items viii and ii)		**RM95,500**
xi)	Difference between cash price of goods and the total amount you will have to pay		**RM14,000**

Part IV Particulars relating to payments

i) Date on which the hiring shall be deemed to have been commenced	**1 December 2003**
ii) Duration of payment of instalments in number of months or years	**48 months**
iii) Number of Instalments	**48**
iv) Amount of each instalment **RM1,333.33** and one final instalment of	**RM 1,333.49**
v) Instalments commencing **1st January, 2004** and thereafter on or before the 1st day of each succeeding month	

Under the Hire-Purchase Act 1967, a hire-purchase agreement must:

- Specify a date on which the hiring shall be deemed to have commenced
  [Please see IV (i)]

- Specify the number of instalments to be paid under the agreement by the hirer
  [Please see IV (iii)]

- Specify the amount of each of these instalments, and the person to whom and the place at which the payments of these instalments are to be made
  [Please see IV (iv)]

- Specify the time for the payment of each of those instalments
  [Please see IV (v)]

- Contain a description of the goods sufficient to identity them
  [Please see II (i)]

- Specify the address where the goods under the hire-purchase agreement are.
  [Please see II (V (iii)]

Among others, the hire-purchase agreement must also be set out in a tabular form.

Cash price – the price at which at the time of signing the agreement the hirer might have purchased the goods for cash **[Please see III(i)]**

Deposit – the amount paid by deposit **[Please see III(ii)]**

Freight or delivery charges if any – the amount included in the total amount payable to cover the expense of delivering the goods to the hirer **[Please see III(iii)]**

Vehicle registration fees – any amount included in the total amount payable to cover vehicle registration fees in respect of the goods **[Please see III(iv)]**

Insurance – any amount included in the total amount, payable for insurance in respect of the goods. The total amounts referred to in the (i), (iii), (iv) and (v), less (ii) **[Please see III(vi)]**

Terms charges or interests – the amount of any other charges included in the total amount payable.

1.5.5 Computation aspects of hire-purchase

Example:
STAR Finance Sdn Bhd has agreed to provide Zazen Zaibullah with a hire purchase facility of RM 75,000. The details are as follows:

Cost of goods	=	RM100,000
Deposit paid	=	RM25,000
Amount of loan	=	RM75,000
Hiring period	=	4 years
Rate of interest	=	6.5% flat p.a.

The term charges need firstly be computed. The term charges shall be calculated in accordance with the formula set out in the Sixth Schedule of the Act.

$$R = \frac{100 \text{ X } C}{T \text{ x } P}$$

R = represents the term charges calculated as a rate per centum per annum

C = represents the amount of term charges expressed in ringgit and fraction of ringgit

T = represents the time that elapsed between the time fixed by or under the agreement for the making of the 1st instalment and the time fixed for the last instalment, together with:

(i) 1 week where the instalment are payable under the agreement at regular weekly intervals;

(ii) 2 weeks where the instalments are payable under the agreement at regular fortnightly intervals;

(iii) 1 month where the instalments are payable under the agreement at regular monthly intervals; and

(iv) expressed in years or fraction of years.

P = represents the difference between the cash price and the deposit together with other charges if the goods is a motor vehicle.

$$6.5 = \frac{100 \times C}{4 \times RM75{,}000}$$

$$C = \frac{6.5 \times 4 \times RM75{,}000}{100}$$

Term charges = **RM19,500**

Add-on rate of interest

In an overdraft or many other types of loan, the interest charge is expressed as a percentage based on the outstanding balance of the debt at any particular point of time or during a particular period. Thus when we say that the rate of 10%, we mean that the interest will be calculated at the rate of 10% on the outstanding balance. However in hire-purchase, it is customary to state the financing charges, not as a fraction of the outstanding balances, but as a percent of the original cash price of the asset. That percent is called **add-on** rate of interest.

The formula used in computing the monthly hire-purchase instalments is as follows:

$$R = P + \frac{(P \times I \times N)}{N \times 12}$$

where, R = the monthly payment
P = loan amount
I = the rate of interest charged
N = Hiring period (in years)

By applying the above formula, the monthly hire payment is arrived at as follows:

$$\frac{75{,}000 + (RM75{,}000 \times 6.5\% \times 4)}{4 \times 12}$$

$$= \frac{RM75{,}000 + RM19{,}500}{48}$$

= **RM 1,968.75 per month**

The annual percentage rate (APR) for terms charges, which shall be calculated in accordance with the formula, set out in the Seventh Schedule of the Hire-Purchase Agreement:

$$\text{APR} = \frac{2NF(300C + NF)}{2N^2F + 300C(N + 1)}$$

where **N** is the total number of instalments
C is the number of instalments that would be paid in 1 year if instalments continued to be paid at the same intervals
F is the amount determined in accordance with the formula

$$\mathbf{F} = \frac{\mathbf{100C \times T}}{\mathbf{N \times A}}$$

C is the same number as the first mentioned formula
T is the total amount of predetermined term charges
N is the total number of instalments and
A is the amount financed

For example, in a hire-purchase loan of RM50,000, interest rate charged is 7% flat, the term charges is RM14,000 and the number of instalments is 48 then the APR is calculated as follows:

$$\mathbf{F} = \frac{100 \times 12 \times 14{,}000}{48 \times 50{,}000}$$

$$\mathbf{F} = 7$$

$$\mathbf{APR} = \frac{2 \times 48 \times 7(300 \times 12 + 48 \times 7)}{2 \times 48 \times 48 \times 7 + 300 \times 12(48 + 1)}$$

$$\mathbf{APR} = \frac{672(3{,}600 + 336)}{32{,}256 + 176{,}400}$$

$$\mathbf{APR} = \mathbf{12.68\ \%}$$

Computation of overdue interest

The formula for calculating the overdue interest is:

$$OI = \frac{I \times R \times D}{365}$$

OI represents the amount of overdue interest;
I represents the monthly instalment
R represents the overdue interest rate calculated as a rate per centum per annum; and
D represents the total number of days in arrears

In the following example, the overdue interest is computed as follows:

Example:

Instalment payment **RM1,968.75**
Due date for payment 15 January, 2004
Number of Overdue instalment = Three
Overdue Interest = 8%
Assume today as 27 March, 2004

Instalment	No of days in arrears
15 January, 2004	72 [17 days (Jan) + 29 days (Feb) + 26 days (Mar)]
15 February, 2004	41
15 March, 2004	12
Total	**125 days**

$$\mathbf{OI = \frac{RM1,968.75 \times 8 \times 125}{100 \times 365}}$$

Overdue Interest is RM53.93

Statutory rebate

The rebate system is based on the Sum of Digits (SOD) concept which relates to the amount term charges are recognised as earned up to the point of redemption. The remaining term charges that are not recognised as earned will be the amount to be rebated.

The formula for calculating the statutory rebate is:

$$\frac{RP\ (rp+1)}{OP\ (op+1)} \times \text{term charges}$$

RP = remaining period;
OP= original period and
Term charges is the total interest for the full duration of the hire-purchase agreement
Hire-purchase price = RM95,500 (RM75,000 + RM19,500)

Example:
The hirer has paid 36 monthly instalments promptly, i.e. RM1,968.75 x 36 = RM70,875.00. He wants to settle the entire loan (early settlement).

Outstanding balance = RM95,500 – RM70,875
= **RM23,625**

Rebate computation:

$$\frac{12\ (12+1)}{48\ (48+1)} = \frac{156}{2352} \qquad 0.66326 \times \text{RM19,500 (term charges)}$$

= RM 1,293.36

Early settlement amount = RM23,625 – RM1,293.36

= RM 22,331.64

1.5.6 Hire-purchase financing – the process

In any hire-purchase agreement, there is always the dealer, generally the seller, by whom or on whose behalf negotiations leading to the making of a hire-purchase agreement with the financier were carried out.

Where the negotiation is successful, the prospective hirer will submit his or her supporting documents to the financier for the approval of a hire-purchase facility or loan. The financier may require the prospective hirer to furnish a guarantor to guarantee the performance of the prospective hirer under the hire-purchase agreement.

A financier will not finance a loan for more than 90% of the “cash price” of the goods. Thus, a hirer must pay a deposit of at least

10% of the “cash price” of the goods. Nevertheless, the hirer can agree to pay more than 10% and the balance to be paid in instalments under a hire-purchase facility.

Once the hire-purchase facility is approved, the financier will send a letter of undertaking to the dealer to inform him of the approved hire-purchase facility. The parties related to the hire-purchase agreement will then be required to sign and enter into the agreement. Within 14 days after the making of the hire-purchase agreement, the financier must serve on the hirer and the guarantors a copy of the agreement each, failing which would render the hire-purchase agreement unenforceable by the financier. The document required to be served on the hirer and guarantors may be served by delivering it to them personally or by posting it by registered post addressed to the last known place of abode or business.

1.5.7 Repossession

The financier may only repossess the goods that is, take possession of goods mentioned in a hire-purchase agreement arising out of any <u>breach of the agreement</u> relating to the payment of instalments, where,

(i) There had been two successive defaults of payments (in the case of death of heir, 4 successive defaults) or a default of the last payment and the financier has served on hirer a Notice of Intention to Repossess; and

(ii) The period fixed by the Notice of Intention to Repossess has expired, which shall not be less than 21 days after the service of the notice.

1.5.8 Procedures involved during the repossession

The Hire-Purchase Regulations 1967 provides the procedure for actual repossession as follows:

(i) When taking the possession of goods to be repossessed, the financier’s officer, before taking possession has to inform the hirer the name and address of the financier to which he or she belongs.

(ii) If the financier sends his agent to repossess the goods, then the agent has to show the hirer an authority card issued by the financier and his identity card.

(iii) An authority card must bear the photograph, name and address of the agent, the name and address of the financier, the nature of appointment of agent and the signature of the authorised person of the financier.

(iv) The financier's officer or agent also has to show the hirer or the occupant of the hirer's premises, his identity card before repossessing the goods.

1.5.9 Procedures after the goods has been repossessed

Where the financier takes possession of the goods that were comprised in a hire-purchase agreement, the financier must deliver to the hirer personally a document, which shall set out

(i) A short description of the goods and

(ii) The date on which the financier took possession of the goods

(iii) The time at which the financier took possession of the goods

(iv) The place where the financier took possession of the goods

(v) The acknowledgment of receipt of the goods.

(vi) Where the hirer is not present at the time of repossession, the financier must send such document to the hirer immediately after taking possession of the goods.

(vii) Within 21 days after the financier has taken possession of goods, the financier must serve on the hirer and every guarantor of the hirer a Notice to Hirer under Section 16.

(viii) If the notice is not served, the rights of the financier under the hire-purchase agreement will thereupon cease.

(ix) However, if the hirer exercises his or her rights under the hire-purchase agreement to recover the goods taken possession by the financier, the notice is deemed to have been duly served on the hirer.

(x) Costs involved in the repossession will be borne by the hirer:

(1) The cost of repossession; and

(2) The cost incidental of taking possession and the cost of storage.

1.5.10 Problems of repossession

An area where complaints are common regarding hire-purchase is that of repossession fees and storage fees. When the borrower defaults on repayment, the hirer will use agents to repossess the hired goods (in most instances; motor vehicles) and then charges repossession fees and storage fees (if the borrower takes time to settle the repayment due and collects his goods late). The fee varies from hirer to hirer and from circumstance to circumstance, and is totally beyond control of the hirer.

Under the Act and regulations, there is no schedule of fees, which the borrower may refer to, so as to ensure the fees charged are reasonable and allowable under the law.

The vehicle may be used in a security area/border. Vehicles plying between border areas and security areas are prime suspects for smuggling and other unlawful activities. These vehicles may be detained for long periods of time pending investigations. Such detention makes it difficult for the owner to repossess the vehicle.

The premises are locked thereby preventing access. Even if access were possible, entry into the premises would result in trespassing.

The hirer could be a notorious/influential person. Repossessors may avoid repossessing a vehicle for fear of encountering an attack.

The vehicle could be used in a remote place like a land development scheme, e.g. FELDA scheme where the number plate is removed. Repossessors may have difficulty locating the vehicle.

The hirer absconds. The financier will have no other recourse than to institute legal action for recovery.

The repossessors appointed by the financier can sometimes be high-handed in their approach. This can cause a bad image to the financier. A Code of Ethics has been drawn up for repossessors to abide by. For example, the repossessor should be properly attired and approach the hirer in a professional manner. He must be cognizant of the laws like trespassing and breaking in.

1.6 Application of credit considerations

The financier is dependent on the dealers to introduce business. At the same time, the financier would need to check the credibility of the dealer.

- The dealer is expected to have a proper showroom and signboard prominently displayed unlike operating under a large shady tree.
- Dealers who are proprietors or directors, should not be blacklisted by any financial institution.
- The dealer's current account statement should show healthy operations and no cheque returns.

- Past experience of the financier with the dealer where fictitious accounts and non-existent hirers introduced by dealers as mentioned earlier.
- Vehicles of unpopular makes and sports models are normally avoided as their resale value is low. Exceptions are given for creditworthy borrowers.
- Equipment like machinery does not need to be registered. Therefore, a financier cannot know if a particular machine had been financed by another financier. This can lead to double financing. In the event of legal action, the first financier has legal right over the equipment.
- In the case of scheduled collections by the dealer, payments collected by the dealer and not paid to the financier will cause complications when the financier repossesses.
- Poor insurance control by the financier on the hirer will place the owner (Financier) in a vulnerable position. Though it is the duty of the hirer to cover insurance, the financier should follow up to ensure the vehicle is insured.

1.7 Supervision and control – periodic review

An inspection of the goods, like a vehicle, to ascertain that it is in good condition is to be carried out.

- A confirmation of the hirer hiring the goods. This is to prevent cases of fictitious hirers being created by the dealers.
- A periodic audit of the dealers is to be conducted. This is applicable for scheduled collections.
- A credit review of the dealer is required to determine whether the dealer introduces quality credits. Caution should be exercised with dealers who submit a high number of defaulting borrowers.

2. Leasing

The transaction of lease is generically an asset-renting transaction. In other words, the financier buys the assets and rents it out for a fee paid in instalments.

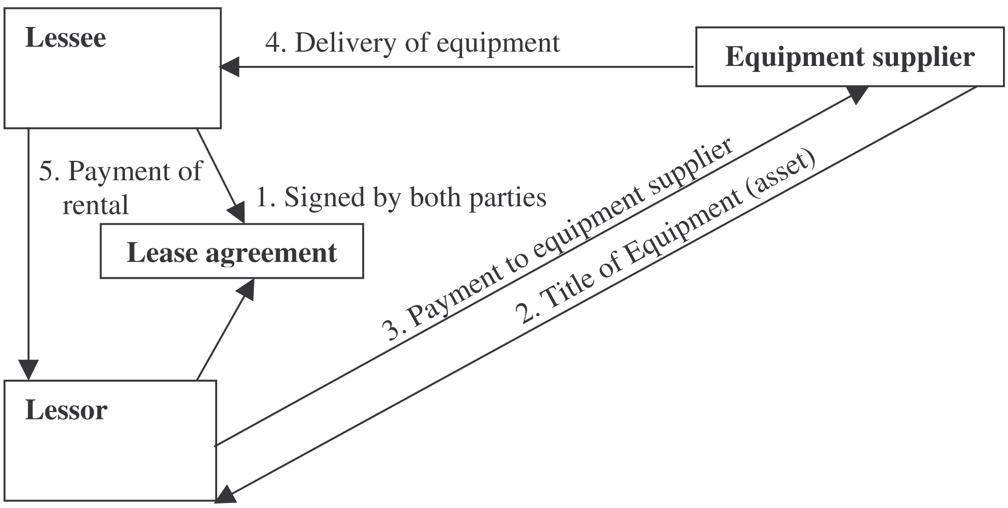

Figure 13.2: Lease Transaction

What distinguishes a lease from a loan is that in the latter, what is lent out is money; in a lease, what is lent out is the asset.

2.1 Definition of a lease

Therefore, a lease could be generally defined as a contract where a party being the owner (lessor) of an asset (leased asset) provides the asset for use by the lessee at a consideration (rentals), either fixed or dependent on any variables, for a certain period (lease period), either fixed or flexible, with an understanding that at the end of such period, the asset, subject to the embedded options of the lease, will either be returned to the lessor or disposed off as per the lessor's instructions.

2.2 Parties to a lease

There are two parties to a lease: the owner called the lessor and the user, called the lessee. Anyone can be a lessor, and anyone can be a lessee, subject to the usual conditions as to competence to contract, or holding of properties.

2.3 What equipment can be leased?

Virtually any movable asset can be leased. However, for easy reference the main items of equipment for leasing are categorised by some leasing companies as follows:

(1) Computers and IT-related;

(2) Office equipment;

(3) Industrial and manufacturing equipment;

(4) Commercial and private vehicles;

(5) Construction and heavy equipment;

(6) Medical equipment;

(7) Material handling equipment; and

(8) Others – garage equipment, photography equipment, etc.

2.4 Types of leasing

2.4.1 Financial lease

Financial leases allow the asset to be virtually exhausted by the same lessee. This means that the lessee fully utilises the asset till the end of the asset's life span. In short, the financial lease puts the lessee in the position of a virtual owner.

The lessor takes no **asset-based risks** or **asset-based rewards**. He only takes **financial risks** and **financial rewards**, and that is why the name financial leases. The lessor need not be liable when the equipment breaks down unless the equipment supplied was defective.

The lease is **non-cancellable**, meaning the lessee cannot return the asset and not pay the whole of the lessor's investment. If the lessee insists on returning the goods before the agreed period of lease, the lessee is still liable to pay the outstanding lease amount.

Provisions for early termination and the consequences are clearly laid out in the lease agreement.

A financial lease can be structured in either as a **full pay out lease or non-full pay out lease.**

(a) Full pay out lease

A full **pay out**, means the full repayment of the lessor's investment is assured.

As the lessor generally would not take any position other than that of a financier, he would not provide any services relating to the asset. As such, the lease is **net lease**. The risk the lessor takes is not an **asset-based risk** but a **lessee-based risk**.

As an example, the lessor finances an equipment for RM100,000. The lessor is only concerned with the risk involved in repayment of the RM100,000 plus the interest costs. The lessor is not concerned with the maintenance of the machinery nor breakdown. The value of the asset is important only from the viewpoint of security of the lessor's investment.

The lessor's payback period, viz., **primary lease period** is followed by an extended period to allow exhaustion of asset value by the lessee, called **secondary lease period**. As the renewal is at a token rental, this option is called **bargain renewal option**.

The lessor's rate of return is fixed: it is not dependent upon the **asset-value,** performance, or any other extraneous costs. The fixed lease rentals give rise to an ascertainable rate of return on investment, called **implicit rate of return**. In other words, the rate of return is calculated based on the lease rentals to be collected for the lease period irrespective of whether the machine is used or not.

(b) Non-full pay out lease

In a non-full pay out lease, the lessor does not recoup the initial capital investment of the equipment during the primary period. The period of lease is always less than the useful working life of the equipment and a part of the lessor's investment and income is derived from the <u>residual value</u> of the equipment leased.

For example, if the equipment is worth RM100,000 and its life span is 5 years. The value after 5 years may be

RM20,000 (residual value). In a non-full pay out lease, the lessor will collect, RM80,000 plus interest at 11% for 5 years plus RM20,000 at say 13% for 5 years. If there is a buy option, the lessor will recover this amount by selling it to the lessee.

Put simply, “residual value” means the estimated value of the leased equipment at the end of the lease term mutually agreed between the lessor and lessee. The estimated residual value has a direct effect on the calculation of the lease rentals. The higher the residual value, the lower will be the lease rentals but the higher the risk for the lessor. Effectively, the residual value represents a deferred repayment of the lessor’s investment in the equipment purchased. Hence, the lease rentals during the lease will be lower, but the risk of the lessor as the repayment of the investment will be deferred.

The residual value might also be the value that the lessor assures to pay-back to the lessee in case the lessee returns the asset to the lessor: that is, it might be the value the lessor assures as the minimum value of the equipment. Such a lease, obviously an operating lease because the lessor is taking a risk on asset values, is a full payout lease, but the lessor agrees to refund the guaranteed value on the lessee returning the equipment at the end of the lease term.

A non-full payout lease can be further sub-divided into two main categories:

(i) A residual value lease with 100% financing, i.e. the lessee does not have to pay anything at the outset.

(ii) A residual value lease with less than 100% financing, sometimes known as a deposit lease. A deposit lease require the lessee to pay a deposit to the lessor. On termination of the lease, the deposit is refunded provided the sale proceeds of the equipment leased is able to meet its residual value.

(c) Formula for Financial Lease (whether for Full Payout or Non-Full Payout)

The generic formula for lease rentals calculations for all financial lease is thus as follows:

$$CP - SD = (PMT \times PVA_{i\%pm,n}) + [(RV - RSD) \times PV_{i\%pm,n}]$$

where CP = Cash Price
SD = Security Deposit
$PVA_{i\%pm,n}$ = Present Value Annuity Factor at i% per month for n months
$PV_{i\%pm,n}$ = Present Value Factor at i% per month for n months
RV = Residual Value
RSD = Refunded Security Deposit
PMT = Monthly Lease Period

If a financial calculator is used then the inputs are:

PV = - (CP – SD)
i = i% pm
n = Number of Monthly Lease Rental
FV = RV - RSD
Then solve for PMT = Monthly Lease Rental

Therefore for Full Payout Lease, SD = 0, RSD = 0 and RV = 0 while Non-Full Payout Lease is where either SD and/or RV are not equal to 0.

2.4.2 Operating Lease

It should be noted that financial institutions do not deal in operating leases which are the domain of specialist lessors, e.g. car rental company. The following notes are merely designed to make a basic comparison between a financial and operating lease.

Under an operating lease, the lessor does not wholly recover the cost of the equipment out of the rentals receivable under lease during the non-cancelable period, which is normally significantly shorter than the estimated useful life of the equipment.

To recover the investment cost and make a profit, the lessor depends on continuing demand for the rental of the assets. The lessee normally pays all lease rentals upfront and in advance for very short lease period such as renting a car for 7 days. For longer lease periods, such as for 6-month lease period for a tower crane, the lease rentals may be payable on a monthly basis.

The lessee assures the lessor that the asset will be returned in a lease-able condition. If the asset is damaged, then the lessee is responsible for bearing the cost of repairs.

2.4.3 Difference between financial lease and operating lease

Financial Lease	**Operating Lease**
Example: Leasing a machine	**Example: Renting a car**
The asset is use specific and is selected for the lessee specifically. Usually, the lessee is allowed to select it himself.	The asset is of common-use utility, and may be used by a number in sequence.
The risks and rewards incident to ownership are passed on to the lessee. The lessor only remains the legal owner of the asset.	The lessee is only provided the use of the asset for a certain time. Risks incident to ownership belong wholly to the lessor.
The lessee bears the risk of obsolescence.	The lessor bears the risks of obsolescence.
The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is non-cancellable by either party.	As the lessor does not have difficulty in leasing the same asset to other willing lessee, the lease is kept cancellable by the lessee.
The lease period usually coincides with the economic life of the asset and may be broken into primary and secondary period.	The lease period is usually small and the lessor intends to lease the same asset over again to several users.
The lessor enters into the transaction only as a financier. He does not bear the costs of repairs, maintenance or operation.	Usually, the lessor bears costs of repairs maintenance or operations.

Financial Lease	Operating Lease
The lessor is typically a financial institution and cannot render specialised service in connection with the asset.	The lessor is specialised in handling and operating the particular asset and usually provides specialised services.
The lease is usually full pay out; that is the single lease repays the cost of the asset together with the interest.	The lease is usually non-pay out, since the lessor expects to lease the same asset over and over again to several users.

2.5 Features and benefits

(i) The lease period can be tailored to match the practical useful life of the equipment. Up to 100% financing can be arranged.

(ii) The rentals are payable unconditionally – meaning without reference to the state or value of the asset.

(iii) The lessee has a right of renewal. He could continue using the asset till it becomes an economic junk.

(iv) Provides certainty – non-cancelable unlike an overdraft which is repayable on demand and subject to reduction during a credit squeeze.

(v) The advantages of leasing to a lessee are:

1. It provides 100% financing – There is no down-payment
2. It improves cash forecasting – amount and number of lease payments over leasing period made are known
3. The lessee retains full use of the assets for an agreed period of time.
4. It is a sound hedge against inflation – can be acquired at current prices and rentals met out of future earnings
5. It is straightforward – minimises administrative costs and simplifies documentation, tax and accounting procedures
6. It is tax efficient – generally fully tax-deductible as operating expenses is used for production of assessable income
7. Flexible end of term options – several options for disposal of equipment after lease term ends

8. Most importantly the lessee has the freedom to negotiate with the supplier as if he had made the purchase with cash

(vi) The disadvantages of leasing to a lessee are:

1. The lease is non-cancellable. The lessee is irrevocably committed till all the investment is recovered.
2. The lessee absorbs the risk of obsolescence and all risks on the asset.
3. Which means he has to bear all maintenance costs.
4. It requires immediate repayment – no grace period on principal repayment pending commissioning of equipment which may take some time unlike term loan
5. There is a high stamp duty on the lease agreement – stamp duty is on an *ad valorem* basis unlike hire-purchase which is nominal.

(vii) The advantages of leasing to a lessor are:

1. It is simple to document. There is no Act for leasing. Leasing follows the Contract Act.
2. As an additional source of equipment financing, leasing allows conservation of working capital that can then be channelled to other productive business uses
3. The facility provides introductions to equipment suppliers
4. The contract can be closed quickly.

2.6 Risks of leasing

The risk of default over the long term is the major risk in lease financing. The lessor is responsible for defects in the goods even though the goods were bought at the insistence of the lessee (Please see decided **Case A** below).

<u>Other Risks:</u>

- For leases structured with high residual value such that at the end of the lease period, the asset may not be able to realise the full residual value and the lessee may not have the financial means to honour the residual value to the lessor.
- Quality of the asset (including the risk of obsolescence) which can affect its cash-flow generating ability and realisation of the residual value at the end of the lease period

- Failure of the asset to generate the cash-flow originally expected due to lack of demand for output produced by the asset.

2.7 Lease Structures

There are three flexible and comfortable ways to pay the lease:

1. The lease period is broken up into primary and secondary periods. For the primary period, monthly payments that include the cost of the assets and interest are paid. One may use the assets for a predetermined period. At the end of the lease period, the lessee may terminate the contract by returning the assets.

2. **Fixed rate lease**: Under this concept, fixed amounts are paid throughout the lease period. It is the preferred structure if the lessee feels that interest rates are on the rising trend. The same implicit Rate of Return applies throughout the lease period.

3. **Floating rate lease**: This payment mode allows the lease rental payments to vary according to the FI's lending rate. The common reference rate used by Financial Institutions is the Base Lending Rate. Hence, the lease rental will vary as the reference rate changes. This method is ideal for the lessee in an economic scenario of declining interest rates.

Lessors may require one or more of the following upfront, that is, instant payments from a lessee:

- Initial lease rental or downpayment
- Advance lease rental
- Security deposit
- Initial fees

Margins in leases are taken as initial rental
The initial lease rent is a substitute for a margin or borrower contribution in case of loan transactions. Note that given the nature of a lease as asset-renting transaction, it is not possible to expect a lessee's contribution to asset cost as such. Hence, the down-payment or first lease rent serves the purpose of a margin.

Between advance lease rent and initial lease rent – the difference is only technical. The whole of the initial lease rental is supposed to be appropriated to income on the date of its receipt, whereas advance rental is still an advance – normally an advance against the last few rentals.

Therefore, the advance rental will remain as a deposit with the lessor to be adjusted against the last few rentals.

It should be noted that the various ways of taking the margins will invariably have a direct effect on the lease rentals.

Examples of how the advanced rentals will be applied is as follows:

Lease period	No of prepaid rents required	Application
2 years	One	Applied towards 24th rental when it falls due
3 years	One	Applied towards 36th rental when it falls due
4 years	Two	Applied towards 47th and 48th rental when they fall due
5 years	Three	Applied towards 58th, 59th and 60th rental when they fall due

The security deposit is a proper deposit to secure against the lessee's commitments under the contract – it is generally employed in a lease structure to determine the lease rental and may be refunded to the lessee at the lease contract, in the event there is a surplus to rental requirement.

2.8 Application of credit considerations

The rate of return of the business as a whole depends on timely realisation of debts. The lease rentals represent the consideration for the lease transaction. This is what the lessee pays to the lessor. If it is a financial lease transaction, the rentals will simply be the recovery of the lessor's principal, and a certain rate of return on outstanding principal. In other words, the rentals can be seen as bundled principal repayment and interest.

If it is an operating lease transaction, the rentals might include several elements depending upon the costs and risks borne by the lessor, such as interest on the lessor's investment. If the lessor bears any repairs, insurance, maintenance or operation costs, then he charges for such costs.

The leasing company (a specialist company, not a financial institution) cannot call back the asset unless the lessee fails to pay.

Upon default of payment of lease rentals, lessor has the right to repossess the asset or call back the asset. commitments under the contract – it is generally employed in a lease structure to determine the lease rental and may be refunded to the lessee at the lease contract, in the event there is a surplus to rental requirement.

To obtain credit information, the lessor has the right to request for information from the lessee, who is effectively the borrower.

2.9 Supervision and Control – Pre-disbursement Precautions and Periodic Review

- An inspection of the goods like the machines before financing, to ascertain that they are in good condition is to be carried out. This is to prevent used and reconditioned machines from being financed.
- Checks have to be made on whether double financing has been done on the same machine.
- Stolen equipment. This may be possible with checks with the FI's Vehicle and Equipment Registry, which is constantly updated with records on stolen vehicles obtained from the Police and vehicles and equipment detained by the Customs.
- Periodic site visits especially to businesses to inspect the equipment.

3. What is the Difference between Leasing and Hire-Purchase?

The lessor is the owner of leased equipment and the lessee rents the equipment to use by paying to the lessor a fixed monthly rental. Ownership stays with the lessor. In hire-purchase, the hirer services the instalment payments for and is the beneficial owner of the equipment financed. Title to the equipment will pass to hirer once instalment payments are concluded.

Case A

LIABILITY OF THE LESSOR ON A DEFECTIVE PHOTOCOPYING MACHINE HAVING BEEN LEASED OUT:

This case is significant as it holds the lessor responsible for defects in goods, even where it is apparent that the goods were bought at the instance of the lessee.

In this case, at the request of the respondents (LESSEE), the appellant (LESSOR) purchased a photostat copier machine and leased it to them for a term of 36 months for the total rental of $13,623.84 payable in the sum of $378.44 per month. At the expiration or sooner determination of the lease the appellant as the owner was entitled to take back the machine and dispose of it. Two days after installation in the respondents' premises the machine broke down. It became defective thereafter in spite of constant servicing, repairs and replacement of parts by the supplier at the request of the respondents and with the knowledge of the appellant. As a result, the respondents' business was adversely affected, resulting in losses. The respondents stopped paying the monthly instalments. The appellant exercised its right under the agreement and took custody of the machine. The appellant brought an action and claimed the total rental as specified in the agreement less that already paid. The President of the Sessions Court gave judgment for two months' arrears of rental and the appeal of the appellant was dismissed in the High Court. The appellant appealed to the Federal Court.

Held, dismissing the appeal: (1) in the circumstances, there was more than sufficient ground for the appellant to have taken action against the suppliers for damages and the respondents were not obliged to continue paying the total specified rental; (2) the appellant had also committed a breach of the agreement in failing to dispose of the machine by means of a bona fide sale according to the stipulation therein.

Credit Corp (Malaysia) Bhd v KM Basheer Ahamed & Anor [1985] 1 MLJ 208 Federal Court, Kuala Lumpur [Abdul Hamid CJ (Malaya)].

Sample

Lease agreement

Parties
This lease made the ________of _______ between (Lessor) having the registered office at (address) called the lessor on one part and the (Lessee) having the registered office at (address) called the lessee on other part.

Witnessed as follows:

Terms of lease
The lessor hereby lets and the lessee takes on the lease from the lessor upon the terms and conditions hereinafter mentioned the equipment more particularly described in the schedule hereto (hereinafter called the equipment) for the term of year commencing on the _______of (month and year).

Rentals
The lessee shall pay to the lessor during the said term a rental of RM ___________ per month payable in advance on the first day of each month, the first rental payment to be made on the _________of the_______________. Punctual payment shall be essence of this lease and the lessee shall be deemed to have repudiated this lease if any rental or part thereof shall remain unpaid for more than fourteen days after becoming due. All payments of rental hereunder shall be paid to the lessor at (address) or as the lessor may from time to time specify and payments made by post shall be at the risk of the lessee.

Summary of covenants by the lessee
The lessee shall throughout the said term:

- Punctually make payment
- Pay interest on overdue instalments
- Repair and maintain the equipment
- Operate the equipment by competent operators
- Pay all charges incidental to the leasing to the lessor
- Permit the lessor to enter the premises and inspect the equipment
- Keep the goods in the lessee's possession
- Notify the lessor to any change of address and whereabouts of the equipment
- Indemnify the lessor against loss of or damage to equipment
- Keep the equipment free from distress

- Insure the goods throughout the tenure of the agreement
- Pay the insurance premiums punctually
- Obtain all necessary permits (if applicable) from any authority for use of the equipment
- Indemnify the lessor from third part claims
- Pay all legal and other expenses
- Ensure that equipment affixed to realty(land) can be removed without material damage

The lessee shall not sell or otherwise dispose the equipment.

The lessee shall not sell, charge the land on which the equipment is kept without prior notice of the lessor.

The lessee shall not compromise any claim for equipment destroyed, lost or damaged without the consent of the lessor.

Application of Insurance Claims:

(i) Insurance payments for repair to damaged equipment is to be applied towards the repair costs.

(ii) Insurance payments for loss and total loss of the equipment is to be applied at the option of the lessor for which the lessor shall as far as possible replace the equipment.

The lessee shall not be liable for normal wear and tear of the equipment.

The lessor may terminate the agreement due to default in payment with notice.

The agreement is automatically terminated under stated terms in the agreement.

The lessor may recover from the lessee any loss suffered by termination.

On termination, the lessee is to deliver the equipment and **the lessor** may repossess the equipment and may sever equipment affixed to the land.

This right of **the lessor** is assignable.

It is **the lessee's right** to renew the lease for a further term.

This agreement is to include all renewals made before and after the agreement.

The dealer or supplier shall not be the agent of **the lessor**.

The equipment is to remain the property of **the lessor**.

(Schedule – Here set out the particulars of the equipment)

Practice Questions

1. What are the 2 different types of hire-purchase financing?
2. Explain the 4 types of HP arrangement that an FI can have with dealers.
3. What are Act and non-Act goods?
4. What events of default can cause goods under hire-purchase to be repossessed?
5. What are the problems of repossession?
6. What is the definition of a lease?
7. What are the types of leases?
8. What is a full pay out lease?
9. What are the credit considerations in a lease?
10. What is the difference between hire-purchase and leasing?