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Lease Financing in the Indian Context

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Foreword

The two important considerations in capital budgeting are the cost or economic value aspect and the liquidity aspect. The periods associated with "tight money" tend to increase the relative importance of liquidity aspect. On the other hand, the tight monetary policy and raising interest rates aimed at curbing inflation may result in higher cost of external debt financing and also in constraints on the availability of funds from the external sources. Thus, in such periods, an industry may be faced with the problem of liquidity, which will gain importance to other aspects of investment decisions. One possible solution to liquidity problem seems to be a financial lease of required asset. This strategy had been adopted by firms in USA to source the necessary funds at times of tight money periods. Any change in the Indian context in granting depreciation benefits to the lessor can disrupt industrial growth significantly especially at times of liquidity crunch and higher cost of external debt financing.

The role of leasing industry in creation of productive assets, obtaining assets on cross border operating lease without affecting "debt table computations", obtaining imported equipments at a lower cost of capital than that is feasible through supplier credit, obtaining major assets at a significantly lower cost through double dip benefits, etc., are significant benefits that would be foregone. NCAER study on lease financing lists in detail, benefits from the lease financing to the economy, lessee, lessor and supplier. The report based on discussions with stakeholders in the industry identifies the appropriate segmentation of lease financing in the Indian context and the likely growth areas of indentified segments. We hope this would be of interest to policy planners, academics as well as professionals involved in Lease Financing.

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Lease Financing in the Indian Context

1.0 Introduction

In today's context marked by the liquidity crisis and the high cost of debt-capital, an analysis of lease financing as an alternative source of financing of assets assumes great importance. Besides, lease financing has served filling up "budget gaps" of mega-projects. This paper analyses the lease financing system in the Indian context; this could help the corporate decision-makers in India. The present size of the Global Leasing Industry is estimated at US$ 350 billion and leasing has played a leading role in capital formation in developed economies. The annual volume of leasing exceeds US$ 100 billion in the United States with a market penetration of 32% as a means of financing. In the Asian economies, leasing is gaining importance and a country like South Korea has a volume exceeding US$ 10 billion and a market penetration of 20% compared to India, whose volume currently is hovering in the range of around US$ 0.7 billion with a penetration of hardly 5%. The market penetration of leasing as a source of financing is projected to grow substantially with the impending growth in the industry due to marked changes in strategies of lead players such as IDBI (current year leasing business volume estimated at $ 0.30 billion from last year's volume of $ 0.06 billion), ICICI ($ 0.20 billion in the current year), etc.

share of leasing business in India. In the Indian context, deferred payment of instalments of "capital cost"/"purchase price" of equipments/consumer durables popularly known as "Hire-Purchase Scheme" has a checkered history. The current volume of business under the "Hire-Purchase" scheme is estimated at around Rs. 60 billion. The hire purchase scheme is specifically suited for Corporates who wish to retain benefits associated with depreciation or for certain category of assets such as consumer durables. Per experts, this segment of the instalment sale has attained a "maturity" stage and is perhaps witnessing a "declining stage". Although the scope of this paper does not cover the hire-purchase segment of source of financing, yet broad parameters governing this sector have been briefly traced elsewhere as most of the non-financial institutions operate a mix of both hire-purchase and leasing type of operations. The leasing sector of the business which is the focus of this study is estimated between Rs. 20 to 30 billion.

2.0 Categories of Leasing

Virtually all lease-financing arrangements fall into one of the three main types of lease financing: a Sale and Leaseback arrangement, Direct Leasing and Leveraged Leasing. In today's context, all the three variants can provide innovative approaches to overcome the liquidity crisis. The three categories are briefly examined below:

2.1 Sale and Leaseback

Under the Sale and Leaseback arrangement, a firm sells an asset to another party, and the party leases it back to the firm. The firm receives the sales price in cash and the economic use of the asset during the basic lease period. In turn, it contracts to make periodic payment of lease rentals and gives up the title of the asset.

Example : Power Sector Leasing in the Indian context:

Electricity Boards which do not make enough profits to avail tax benefits associated with the depreciation can sell to profit making financing companies who avail the depreciation associated tax benefits; the electricity boards are able to charge lease rentals to the revenue account.

Private sector companies can take recourse to this route, if they have units with a significant gross block and are not earning profits as these units can obtain fresh funds for modernisation/technology imports.

2.2 Direct Leasing

Under direct leasing, a company acquires the use of an asset which it did not own previously. A firm may lease an asset from the manufacturer. For instance, BHEL, the manufacturer of boilers is able to lease its boiler to the Electricity Board through an intermediary Infrastructure Leasing and Financial Services Limited. Financing major equipments through this route can be the strategic question that every project manager should ask himself to overcome the liquidity crisis.

2.3 Leveraged Leasing/Syndicated Leasing

In recent years, a special form of leasing has developed in conjunction with the financing of assets requiring large capital outlays. In the Syndicated Leasing variant, a number of leasing companies join together to finance a major equipment and thereby reduce the "exposure" (risk). Since the Indian Government does not allow sharing of depreciation, the involved parties form an "Association of Parties".

On the other hand leveraged leasing concept involves three parties, namely, the lessee, the lessor and the lender. The lessee contracts to make periodic payments over the basic lease period and in return is entitled to use of the asset; the lessor acquires the asset part with his funds (equity) and the balance from a lender who provides the loan (based on either mortgaging the asset or through an assignment of lease payments).

In the Indian context, the latter variant is yet to take-off (except IDBI which has used an innovative alternative to increase its leasing volume) as all financing companies are aiming at reduction of the exposure (risk).

.The corporate sector may also examine the desirability of adopting the following special purpose leasing options to meet the funding gaps.

3.0 Special Purpose Leasing Operations

Special Purpose Leasing Operations are leasing operations tailormade to match sectoral requirements.

These are briefly described below:

3.1 Cross Border Operating Lease

Under this variant, assets are transferred to India for a minimum period (say X), with the Indian lessee paying a series of "insurance payments" to cover risks associated with the realization of the residual value. Since the Asset Lease transfer is cancelable, these are not treated as capital leases and hence are out of "Debt Table" computations. Since "Debt Tables" form the basis for commercial rating, this "Direct Operating Lease" is of considerable interest to India which does not want its external debts to increase at this juncture.

3.2 Venture Leasing

Vendors supplying spare parts/components to Maruti Udyog Limited would prefer lease financing as the tax outgo would be minimal with lease payments treated as revenue expenditure and thus seek lease financing from IDBI. Under this variant, Maruti is the lessee while its vendors are sub-lessees.

3.3 Wet Leasing/Dry Leasing

Acquiring an equipment/asset with/without crew are referred to as Wet and Dry leases. Examples of such leases can be the engagement of deep-sea trawlers with crew or acquiring an oil rig with or without the crew.

3.4 Cross Border Leasing/ Off shore Leasing-Onshore Leasing

The tripartite financial lease involving the Indian lessee, the supplier of equipments and the lessor abroad can be termed as a Cross Border Leasing. Under this variant the lessor supplies funds to the supplier of equipment and plays purely a financial role. The lessee is responsible for selection of equipment and does not depend on lessor's skill and judgement. The reverse transaction involving an Indian supplier and a foreign lessor and lessee is also a possible cross-border lease that could help exports of equipments.

3.5 Big Ticket/Small Ticket Leasing—Retail and Capital Leasing

Leasing of consumer and capital goods of value less than Rs. 50 lakhs is often referred to as Retail Leasing by Indian non-banking financial institutions. Lease financing of assets over Rs. 5 crores is normally referred to as Capital Goods Leasing. In the parlance of lead players, lease financing of around Rs. 50 crores is referred to as typical Big Ticket leasing.

Leasing of automobiles to corporates and individual consumers and white goods to individuals falls under the latter category. Of late, leasing of two-wheelers to employees through corporates is gaining popularity (recently, a small leasing company based in Dhanbad did a leasing business of the volume of Rs. 100 million in two wheelers to employees of Bharat Coking Coal at Dhanbad).

3.6 *Infrastructure Leasing*

Implementation of infrastructure projects on a commercial format without recourse to budgetary allocations towards integrated area development, power, transportation systems, etc.

Example : ILFS and Worli-Bandra Link Bridge.

3.7 *Auto Financing*

Leasing of cars to individuals/corporates by Kotak Mahindra, Escorts Finance fall under this catagory; provision of value added financing products (proposed by ORIX with IL & FS) are yet to be evolved.

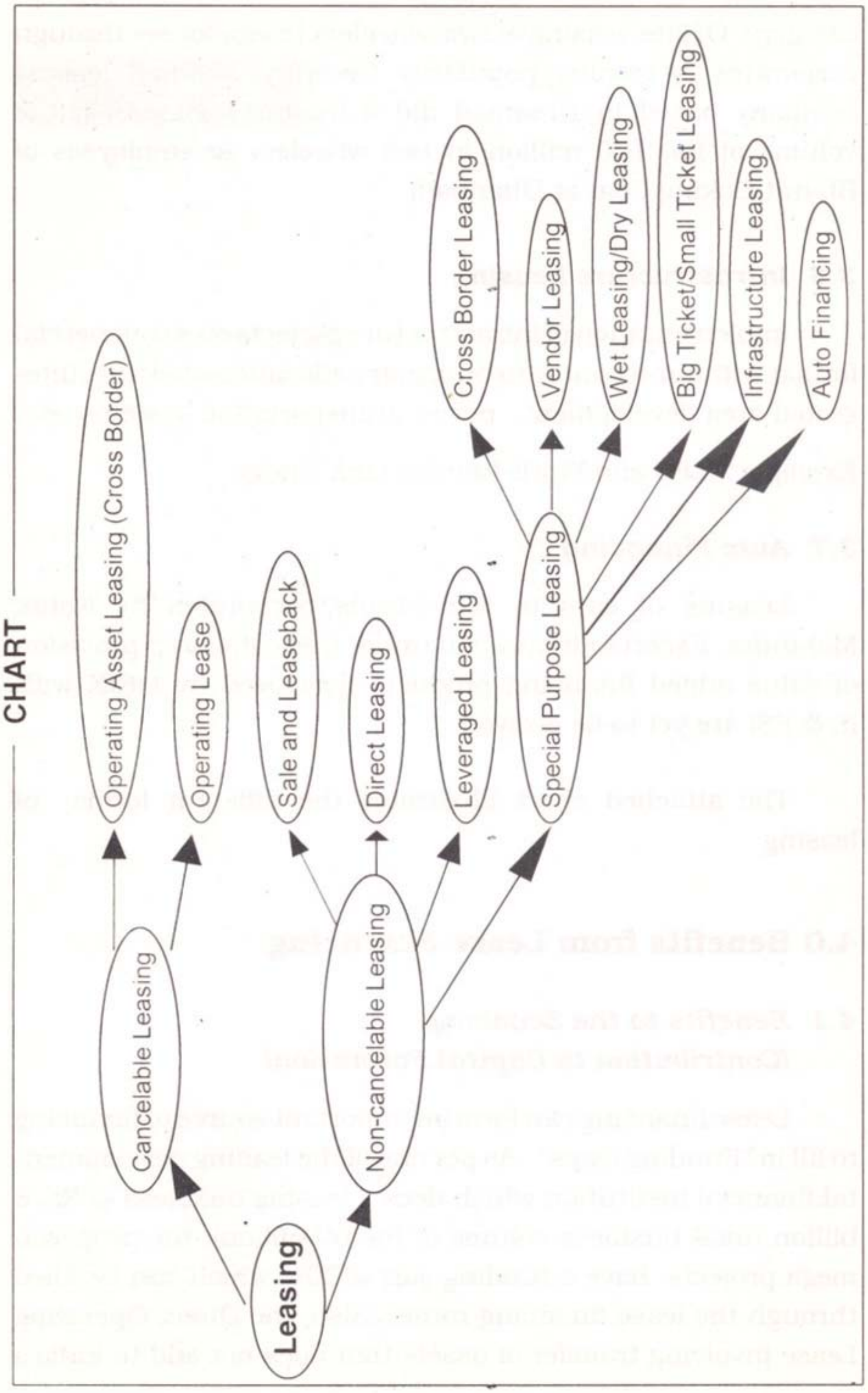
The attached chart illustrates the different forms of leasing.

4.0 Benefits from Lease Financing

4.1 *Benefits to the Economy (Contribution to Capital Formation)*

Lease financing can form an important source of financing to fill in "Funding Gaps". As per one of the leading developmental financial institution which does a leasing business of Rs. 6 billion (total business volume of Rs. 60 billion), the proposed mega projects have a funding gap of 30% which can be filled through the lease financing route. Also, the Direct Operating Lease involving transfer of assets that does not add to India's

CHART



Leasing
Cancelable Leasing
Non-cancelable Leasing
Operating Asset Leasing (Cross Border)
Operating Lease
Sale and Leaseback
Direct Leasing
Leveraged Leasing
Special Purpose Leasing
Cross Border Leasing
Vendor Leasing
Wet Leasing/Dry Leasing
Big Ticket/Small Ticket Leasing
Infrastructure Leasing
Auto Financing

external debt (thus avoiding possible poor credit ratings) can result in fresh flows adding to capital formation.

4.2 Benefits to the Lessee

Less costly than other forms of finance such as hire/ purchase scheme; in today's context of high cost of debt-finance, leasing as an alternative source of funding to fill up funding gaps is of paramount importance.

Table 1

	Cost of Capital to Leasing Companies		*IRR of Leasing Operations (Cost of capital user)*		*Spread to (margin) Lessor*	
	Hire-purchase	Leasing	Hire-purchase	Leasing	Hire-purchase	Leasing
1. Non-banking financial institutions (weighted average of equity & debt)	16.5% to 18.5%	16.5% to 18.5%	23% to 24%	21% to 22%	4.5% to 5.5%	3.5% to 4.5%
2. Term lending institutions	11% to 12%	11% to 12%	18% (to NBFI)	17% (to NBFI)	6%	5%

The lower cost of financing associated with the lease financing option has aroused considerable interest. For instance, financing of two-wheelers which was exclusively through the hire purchase scheme is giving way to lease financing — especially in the corporates for their employees, for an individual hardly makes use of depreciation benefits which, inci-dentally, forms an important tax shield for the lessor. However in the L.C.V and H.C.V. segments, people still prefer the hire-purchase route as lessees are interested in availing deprecia-tion associated benefits; for non-banking financial institu-tions higher spread in hire purchase scheme is an added attraction.

The cost of capital to the lessee can be as low as 11 to 12% (*e.g.* to Electricity Board) in the leasing route especially when it involves financing of 100% depreciable assets (such as pollution control and energy conservation equipments) and when the financing agency is a non-banking financial institution whose marginal tax rate is around 46%.

4.2.1 More Flexible than Other Sources of Financing

Lease financing can be either a "front-ended" or a "back-ended" deal. For instance, if the corporate availing the lease financing opts for more lease rental payments in the first three years then it has entered into a front-ended deal. Similarly, a back-ended deal has a ballooning interest rate in the last seven years to minimize tax outflow. Unlike the "debt" instruments with a "fixed interest rate", back-ended and front-ended deals lower the effective cost of capital.

4.2.2 Frees Working Capital for More Productive Use

The private corporate sector posted impressive results in 1993-94 and 1994-95 on account of abolition of the Controller of Capital Issues and lower interest outgo on account of low cost of funds obtained through the Euro issues. However, the present debt exposure has resulted in the government's clamping restrictions on corporates seeking external finance. The commercial banks which are now permitted to enter leasing upto 10% of their advances are also using the device to restrict the client's overall cash credit. Thus, this source of financing is likely to free the working capital funds which can be put into more productive use.

4.2.3 Means of "Off-Balance-Sheet Finance"

Lease details need not be disclosed in the balance sheet and the "off-balance-sheet" financing becomes an interesting proposition. Therefore, the lease transaction has no effect on the borrowing capacity of the lessee. For instance, in USA the Financial Accounting Standards Board Statement No. 13 requires capitalization on the balance sheet of certain types of leases. In essence, this statement states that if the lease acquires essentially all of the economic benefits and risks of the leased property, then the value of the asset along with the corresponding lease liability must be shown on the Balance Sheet. Apart from USA, England, Australia, Singapore most European nations such as Switzerland, Italy and Germany, and Latin American countries such as Brazil and Argentina refuse to accept FASB norms.

4.2.4 Direct Operating Lease Involving Asset Transfer

As already pointed out, this form of cancelable lease can be of interest to a lessee in India. Under this variant, the risk associated with the residual value is recovered through a premium on the insurance payment by the lessee. The period of lease is fixed as a minimum of period X and the lease is cancelable. Such a lease should not be construed as a capital lease for the World Bank to account for it in Debt Tables.

4.2.5 Double Dip Benefits to the Lessee

India is yet to ratify the UNIDROIT convention. Although this can act as a dampener to foreign investors, yet this can be used to obtain double dip benefit by the Indian lessee.

For instance, Indian lessee can use this double dip benefit to obtain an attractive cost of capital for aircraft acquisition. Under the programme, the aircraft supplier supplies the aircraft to a foreign lessor who obtains the associated depreciation benefits. He in turn forms a company in association with individuals who pay considerable tax in place where tax liability is near zero and this company in turn releases the aircraft to the Indian user on a hire-purchase scheme. The programme is executed by the Indian lessor who again obtains the depreciation benefit. Since the depreciation benefits are obtained twice, this form of lease-hire-purchase combination is known as the double-dip method and the resultant cost to the Indian party is negligible.

4.2.6 Higher ROI

Possibility to report a higher rate of interest (as the ratio increases due to lower total assets in the denominator) is also a possible apparent benefit.

4.2.7 Mode of Technology Transfer

An operating lease can emerge as a mode of technology transfer when the collaborator transfers his technology and the machines in a technical collaboration contract by way of a cancelable lease rather than an outright sale.

Operating Lease also allows the lessee to remain technologically state of art which is an important attribute in the present day competitive environment.

4.3 Benefits to the Lessor

4.3.1 Powerful Collateral for Moneys Lent

The leasing route proves a powerful collateral for moneys lent as the automobile leasing company (Dhanbad based) reported, the leasing route has inherent advantages in tackling defaulters.

4.3.2 Tax Benefits to the Lessor

The lessor is able to set off his tax liability by availing depreciation benefits; however, the leasing business has to progress in a geometric progression.

4.4 Benefits to the Supplier

Possible benefits to the supplier are as follows :

— Possibility of an increase in sales when lease financing induces potential customers who are unable to match one-time cash outflow.

— Possibility of an increase in exports of equipments through the cross-border leasing mechanism.

5.0 Participants in Indian Leasing Industry and Their Corporate Strategies

In terms of numbers, the leasing industry is mainly composed of the non-banking financial companies. However, in terms of value, very significant participation comes from banks and financial corporations, the lead players being ICICI IDBI, IFCI, HDFC and SCICI.

Banks were permitted in February, 1994 to get into leasing directly, which they were earlier carrying on through their subsidiaries. It is estimated that by the next financial year, most profitable banks would have established their leasing divisions, the lead players being Vysya Bank, Federal Bank and Canara Bank.

The three all-India financial corporations, IDBI, ICICI and IFCI are directly engaged in leasing. Even special purpose corporations including the HDFC, IRFC, IFLS etc., are direct players in the leasing market. Almost every state-level financing corporation has either entered leasing already, or is preparing to do so.

6.0 Leasing — A Fairly Regulated Industry

Leasing companies are treated as NBFCs, and are subjected to the overall discipline of the Reserve Bank of India. Per the recommendations of Dr. A.C. Shah study group, leasing companies have become fairly regulated. The major features of the regulation are as follows (most norms are similar to those applicable to banks):

— *Income recognition and provisioning:* Prudential norms similar to those applicable to banks issued by RBI

— *Accounting:* Guidelines to be framed by the Institute of Chartered Accountants of India.

— *Raising of deposits:* Strict control on rates of interest, amount of deposit, manner of solicitation, etc.

— *Maintenance of liquidity ratios:* Similar to that in case of banks, at the rate of 15% of outstanding deposits.

— *Credit rating:* Obligatory for sourcing deposits.

— *Directions* for Non-Banking Financial Companies (RBI).

RBI allows a gearing ratio of 10 : 1 (International norm is 12.5 : 1). This implies that a leasing company cannot raise more than three times its net worth from banking institutions, not more than two times from corporate deposits — the rest could be obtained from public fixed deposits. However, the combined raising of funds cannot exceed ten times the net worth.

7.0 Perceived Inefficiency of the Banking System as per Indian Experts which provided fillip to the Indian Leasing Sector

Inadequacies of the banking system that led to emergence of Indian leasing sector are as under :

(1) The banks cannot carry out 100% financing.

(2) Response time in processing applications is higher in the banks, a minimum of three months vis-a-vis three to four days are required by a leasing company resulting in either a loss of opportunity or an escalation in costs.

(3) Priority sector lending not a necessity in the leasing option.

(4) Leasing is an asset based lending and is more scientific than obtaining through banks; also loss making banks cannot enter this segment effectively.

(5) Banks are not niche financiers; often they lack the insight of leasing companies.

The main characteristics/strengths of all these lead players are:

— High net worth

— Strong credit appraisal credibility

— Fast movers

— Good quality assets
— Strong relationships with corporate houses
— Expertise in financial structuring
— Near zero bad debts
— Capital goods segment leasing as opposed to consumer goods segments

8.0 Corporate Strategy and Future Outlook of Indian Lead Financial Development Institutions in the Leasing Sector

Main strategy elements are summarised below:

— To be associated with all mega projects, with international funding and developmental agencies. It plans to leverage this exposure into creating a potential business environment in the leasing sector.

— To fill up funding gaps in mega-projects.

— If one were to segment the leasing business into three major segments such as consumer goods leasing, capital goods leasing and services group leasing, then the capital goods segment would be the fastest growing (in value terms) and the financial development institutions would concentrate on this segment.

— To utilise the existing in-house credit rating agency, near zero bad debts, expertise in financial engineering and the proposed "paperless office" through incorporation of E-Mail systems that would see them through as lead players for time to come.

— To enter into leasing business with the Electricity Boards through operation of Escrew Account to obviate defaults.

— To get into vendor leasing — Indian component manufacturers/ ancillaries have a great potential to absorb lease financing as they are not particularly concerned about depreciation associated benefits and the parent organisation can stand as lessee while the ancillary would be a sub-lessee.

— To recognize the fact that the NBFCs have a higher rate of marginal tax vis-a-vis the Financial Institutions and thus would be able to offer better rates to users.

9.0 Constraints of the Leasing Sector

The last decade has seen a phenomenal growth in the leasing industry with the growth rate hovering around 15%, largely due to the liberalization measures being followed by the Government. Increased industrial activity has necessitated the need of increased finance requirements. Per industry experts, the constraints facing the industry are as follows:

— Issue of lease tax, (lease financing being an alternative source of financing, like any other loan should not be brought under the ambit of sales tax) affects the pricing and compares unfavorably with other sources of financing.

— Increase in SLR requirements affects the cash flow and results in increased cost of borrowing thereby reducing return on capital employed.

— Restricting banks from advancing short term loans as bridges against issues of capital or debt.

— Denying NBFCs from sourcing overseas funds.

These NBFCs expect the Indian Government to provide a leading role with respect to raising external sources of financing, to consider "lease financing" at par with other debt and exclude from the provisions of the Sale of Goods Act and to rationalise the stamp duties on all financial instruments.

10.0 Outlook for the Future

Based on the discussions with Industry majors, the following areas are reckoned as areas of growth:

- Infrastructure Leasing
- Automobile Leasing
- Venture Leasing
- Big-Ticket Leasing
- Cross-Border Leasing
- Operating Lease cross-border asset transfer
- Mega-projects "funding gap" filling up

10.1 Infrastructure Leasing

The ILFS (Infrastructure Leasing and Financial Services Limited) has the mission to implement infrastructure projects on a commercial format, and the provision of financial services to the Government and corporate sector.

10.1.1 Thermal Power Projects

Boilers account for roughly 40% of equipment cost and are ideal big-ticket lease candidates; the electricity boards need a lower cost of capital rather than depreciation benefits.

10.1.2 Imported Equipments in Thermal Projects

Suppliers credit which ties down the assets becomes a costly source of funds and the cross-border lease involving the

Indian lessee and a sub-lessee works out advantageous to the Electricity Board (especially the double-dip formula).

The scope of foreign players in thermal power projects is rather limited as the cost of capital sought by the Electricity Boards is around 11 to 12% which only a higher marginal tax-paying NBFC can afford.

The power sector equipment leasing as well as the sale and lease-back transactions in the Electricity Board can easily result in an annual business volume exceeding Rs. 20 billion as indicated by Developmental Financial Institutions.

10.1.3 Road Infrastructure

IL&FS developed the Rau-Pitampur link road as their first major privatisation effort. Located at a distance of 31 kilometres from Indore city, Pitampur is being developed as a light engineering manufacturing base. Similarly IL&FS completed the Worli-Bandra link bridge as a part of the Western Express free way at a cost of Rs. 3 billion. In the same way, Delhi-Noida link bridge was constructed to link South Delhi to Noida. The other major projects under consideration are Tiruppur Area Development in Tamilnadu, Panvel bye pass linking Bombay and Pune, Bhubaneswar-Cuttack bye pass and light rail transit system at Hyderabad.

10.2 Automobile Leasing

Automobile Leasing is popular in India but is generally restricted to affluent clients. However, personal credit rating and credit monitoring systems need to be set up.

The current demand for passenger cars exceeds 320,000 units and in future, supply is expected to fulfill the demand. Per industry circles one out of every twelve cars sold in India is financed by the CITI Bank. There are other major players such as Kotak Mahindra, Escorts Finance, etc., who also finance personal automobiles in a big way. While no precise estimates are available, rough estimates indicate that around 50 to 60% of cars sold avail loan either from the CITI Bank, Kotak Mahindra or from Escorts Finance. Thus the leasing volume potential in the automobile sector can reach around Rs. 20 billion when Maruti expands its capacity and/or other players set up manufacturing facilities for production of standard cars.

In Europe and elsewhere, the role of auto financing agencies is to expand the market for car ownership by facilitating ownership of cars by the middle class. In India auto financing is used by people who have ready income and therefore do not need financing, but avail of it nevertheless benefit because of its tax features. Auto financing is an attractive investment and manufacturers themselves set up their own financing companies.

In India, one can afford to take loan upto 75% of an individual's annual salary. Indian executives earn substantial perquisites which are not reflected in their salary slips. Abroad, the amount lent for auto financing is less than three to four months salary and in view of the practice of purchase of consumer durables through cost effective loans, automobiles too are treated as just another consumer durable. The proportion of the cost of car to the personal disposable income is much higher in India as a result of which specialised agencies have been developed to cater to auto financing. The cost of financing too is higher in India than in other countries.

The IRR of money lent for auto financing lies in the range of 22% to 27%. The yield is lower if the period of payment is around 12 months (19.5 to 22.5%) while the rates are high around 25 to 28% when the payment period exceeds 60 months. The cost of capital is set lower for an income tax payer with a permanent account. The typical NBFCs charge a premium on interest rates around 1.5 to 2% which is clearly built into the expected cash flow stream (the consumer is only told of a flat rate of interest, a highly misleading figure). CITI bank mentions the actual IRR as the cost to the client. The CITI Bank restricted the car financing scheme from one out of eight cars to one out of twelve cars deliberately to reduce the exposure. The risks are assessed by noting whether the applicant is actually traceable, his intention of use of car, and repayment facility (Equated Monthly Instalment should be roughly 33% of disposable income).

Leasing in two-wheelers is slowly catching up as more and more NBFCs are offering lower rates of interest than the conventional hire-purchase schemes which the Indian customers are accustomed to. Earlier, there was an obsession with ownership (for the Indian middle class) but recently there has been a change in perception. Unlike other forms of business, automobile leasing is quite popular in the Indian context because the vehicle owner needs the registration book to transfer the vehicle to others which preclude sale to other parties during the lease period. In case of other assets there is no mechanism of registering the transfer of assets to avoid such sale of assets. The Light and Heavy Commercial Vehicles markets are predominantly hire-purchase markets as these are dominated by operators who wish to avail the depreciation benefits.

10.3 Vendor Leasing and Leasing Opportunities in Small Scale Industries

Ancillary units are becoming crucial vehicles of industrial development in the country. The advent of Maruti Udyog Limited in 1980s gave a fillip to the ancillary industries. At present there are more than 6 joint ventures of Maruti with various component manufacturers. The Indian automobile industry is a true success story of ancillarisation. Perhaps there are not many parallels, anywhere else in the world, of the extremely high levels of indigenisation that we have in the various vehicle segments in India.

In the last 40 years, companies in the auto component industry have developed strong product and process capabilities to cater to the demands of a wide range of vehicle models from light mopeds to heavy commercial vehicles and off-highway vehicles.

The Indian auto component industry has the capability to produce the complete range of components required and these include:

(i) Engine parts
(ii) Electrical parts
(iii) Drive transmission and steering parts
(iv) Suspension and breaking parts
(v) Equipments

Vehicle manufacturers have a strong working relationship with auto component manufacturing units and have used this partnership approach to effectively indigenise and rationalise the cost of production. The current levels of indigenisation for passenger cars, two wheelers, new LCVs and HCVs are 95%, 90%, 85% and 95% respectively.

10.4 Leasing with reference to SSI Sector

The small scale sector (SSS) contributes to more than one-third of total manufacturing output and over 30% of direct exports indicating its crucial role in the industrial sector. At present, the SSIs are numbering at about 16 lakh units and they provide employment to 95 lakh persons. Considering that the industrial sector as a whole accounted for a mere 13% of the total labour force in 1991, the role of SSIs in providing employment needs no emphasis. One of the major successes of the SSIs has been its contribution to exports. Its percentage share in direct exports has gone up from 13.2% in 1975-76 to around 30% in 1990-91. The SSIs exports in 1990-91 were more than that of large scale industries. The SSS is a highly non-homogenous sector in terms of the product range, size, value addition, capacity utilisation, employment, etc. The tiny enterprises (with investment in plant and machinery up to Rs. 5 lakhs) account for 87% of the total number of SSIs, but their share is 45% in production and 59% in employment. The non-tiny SSIs accounting for 13% of total SSIs contribute 55% to production and 41% to employment.

In the atmosphere of an ongoing liberalisation process where not only macro-economic reforms but also substantial micro-economic reforms (*viz.*, reforms that relate to industry and trade, licensing and direct foreign investment, public sector enterprises and financial sector) are being effected, the SSIs are trying to adopt appropriate strategies. They are seriously considering ancillarisation with quality upgradation, sub-contracting, etc., in order to maintain their significant position in the industrial sector.

10.5 Ancillary Unit

SSIs are thinking of ancillarisation as an optimal strategy for maintaining the position. Here, it is necessary to understand what we mean by an ancillary unit. A unit which produces parts, components, sub-assemblies and tooling in order to supply against known or anticipated demands, or is assembling complete products, and which is not a subsidiary and is not controlled by a large unit in regard to the negotiations of contracts for supply of its goods to any large unit, is considered an ancillary unit.

The Government of India defines an ancillary unit as follows:

(a) The Investment in fixed assets in plant and machinery whether held on ownership terms or by lease or by hire-purchase, does not exceed Rs. 45 lakhs (present ceiling is Rs. 75 lakhs) and

(b) The undertaking is engaged or proposes to be engaged in the manufacture or production of parts, components, sub-assemblies, tooling or intermediates; or it renders services and undertakes supplies or it renders or proposes to supply at least 30% of its production or services, as the case may be, to one or more other industrial undertakings.

It is important that no small scale or ancillary undertaking referred to above shall be a subsidiary of, or is owned or controlled by any other industrial undertaking.

10.5.1 Ancillarisation as a Strategy : International Experience

The ancillarisation system in Japan is referred to as the *Keiretsu* system which refers to the relationship between the assemblers and suppliers of inputs such as automobile assemblers and part suppliers. In May 1989, Japan was listed by USA along with India and Brazil, as priority countries under a law known as Super 301 where the USA argued that the *Keiretsu* system governing the relationship between big and small businesses wards off competition from outsiders. The *Keiretsu* system does aim at establishing a long term relationship to ensure stable long-term supplies, guaranteed quality and timely delivery on the basis of mutual trust.

During the post Second World War period the distribution system in Japan developed as an appendage of production