

ADDIS ABABA UNIVERSITY
COLLEGE OF LAW AND GOVERNANCE
STUDIES
SCHOOL OF LAW

**REGULATION OF CAPITAL GOODS LEASE
FINANCING BUSINESS IN ETHIOPIA: CHALLENGES
AND PROSPECTS**

BY
ALEMNEW ALAMIREW

ADVISOR
SOLOMON ABAY (Dr.)

March, 2025

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ALEMNEW ALAMIEW

**A THESIS SUBMITTED TO THE COLLEGE OF LAW AND
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**Regulation of Capital Goods Lease Financing Business in Ethiopia:
Challenges and Prospects**

Approved by:

Solomon Abay (Dr.)

Advisor's Signature

Date

Examiner's Signature

Date

Examiner's Signature

Date

Declaration

I, the undersigned, declare that this LLM Thesis is my original work, and this thesis has not been presented for a degree in any other University, and that all sources of materials used for the thesis have been acknowledged.

Alemnew Alamiew Fentie

Signature_____

Date _____

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Acronyms

AML/CFT: Anti-Money Laundering and Countering the Financing of Terrorism

CGLFC: Capital Goods Lease Financing Company

DBE: Development Bank of Ethiopia

IAS: International Accounting Standards

IFC: International Financial Cooperation

IMF: International Monetary Fund

MFI: Micro Finance Institution

MOT: Ministry of Trade

NBE: National Bank of Ethiopia

SME: Small and Medium Enterprises

UNIDROIT: International Institute for the Unification of Private Law

VAT: Value Added Tax

WB: World Bank

Abstract

Lack of access to finance is a significant challenge for SMEs, micro-enterprises, and new firms in Ethiopia. In today's Ethiopia, banks often prefer to lend to larger, well-established businesses that have a profitable track record and can offer stronger security. Lease financing has strong development impact and crucial role in bridging this gap and expanding financial accessibility. Leasing provides an alternative financing mechanism that enables business to use assets without outright ownership, thereby overcoming the limitations of conventional bank loans, which often prioritize larger, well-established business with strong credit histories. In countries like Ethiopia, where lease financing is still an emerging concept, establishing a well-defined legal, regulatory, institutional, and tax framework is essential to maximize its benefits and ensure its effective implementation. This research aims to analyze the regulatory framework governing capital goods lease financing business in Ethiopia, identify the key regulatory challenges, and explore the potential reforms to enhance the sector's effectiveness and growth. To properly address the questions, both doctrinal and non-doctrinal research methods have been employed. The findings reveal that there are significant regulatory challenges that hinder the sector's growth. These include unclear legal position regarding the conduct of capital goods lease financing business through interest free leasing modality, prohibition of local commercial banks in the leasing sector, excessive regulation, lack of clear institutional enforcement of registering capital goods and capital goods lease agreement, lack of clarity on interpretation of duty free tax incentives provided by law, uncertainty and unpredictability of the regulatory environment regarding lease financing, and lack of organized and centralized training program to stakeholders and employees of capital good lease financing companies. The finding also reveal that while regulatory and legal barriers hinder the growth of lease financing, recent government initiatives, such as the move to enact a comprehensive Capital Goods Financing Business Proclamation and the formation of a National Leasing Association, represent significant progress. These measures indicate a strong commitment to addressing existing challenges, fostering a more structured leasing market, and promoting financial accessibility. The study underscores the importance of these developments and recommends further regulatory enhancements to ensure the sector's sustainable growth.

Keywords: *Leasing, Capital Goods Finance, Regulation, Proclamation, Directive, NBE*

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Chapter One

1.1. Background of the Study

Economic activities are dependent on available and accessible resources, both financial and physical. Businesses can acquire financial resources through equity, debt capital, government subsidy, or both.¹ However, government subsidy and equity financing cannot adequately satisfy the finance needs of businesses; hence debt capital (credit) is recently the most important source of financing in the world.² Credit financing, however, is not accessible to all persons. Lack of access to finance is a significant challenge for SMEs, micro-enterprises, and new firms in developing countries.³ Similarly, in Ethiopia, SMEs have very limited access to bank credit or other financial services.⁴ This is because financial institutions prefer to provide credit to large and well-established enterprises that have sufficient collateral.⁵ Traditional bank finance accepts limited types of assets as collateral, and the value of the collateral is usually higher than the amount of the loan requested.⁶

Lease financing has a strong development impact and a crucial role to play in bridging the SMEs' finance gap and promoting financial sector development. Leasing is an efficient and effective source of finance for capital formation and financing business assets.⁷ It is a highly flexible form of financing and helps SMEs acquire funds easily since, in a lease financing arrangement, the leased asset itself is a principal security. Leasing is a contract between two parties where one party (the lessor) provides an asset for usage to another party (the lessee) for a specific period, in return for specified payments.⁸ The lessor is the owner of the asset that is

¹ Asress Adimi Gikay, 'Ethiopian Law of Security Rights in Movable Property' (2021) 1, RsearchGate 18.

² Ibid.

³ Asress Adimi Gikay, 'Rethinking Ethiopian Secured Transactions Law through Comparative Perspective: Lessons From the Uniform Commercial Code of the US' (2017) 11 Mizan Law Review 169.

⁴ International Monetary fund, Global Financial Stability Report: Old Risks, New Challenges (IMF 2013) <https://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Old-Risks-New-Challenges> Accessed on 15 February 2025.

⁵ Ibid.

⁶ Fekadu Petros, 'Sense and Nonsense in the Regulation of Equipment Financing Business in Ethiopia' (2019) 13 Mizan Law Review 33.

⁷ U.F. Abdulkarim, et al 'Lease Finance in Nigeria: Current Status, Challenges and Future Prospects' (2020) 3 Journals of Accounting Research, Organization and Economics 172.

⁸ Mathew Fletcher, et al 'Leasing in Development: Guideline for Emerging Economies, (2005) Washington D.C IFC 1.

being leased to the lessee, and the lessee is the user of the leased equipment. The separation of property from ownership is the very essence of leasing.⁹

While leasing can be traced back thousands of years, the leasing industry has evolved significantly over the past 50 years.¹⁰ Modern leasing emerged in the 1950s as a specialized financial service industry and expanded to Europe and Japan in the 1960s and has been spreading through developing countries since the mid-1970s.¹¹ The development and evolution of leasing necessitate a robust legal and regulatory framework to ensure transparency, protect stakeholders, and promote sustainable growth in the industry.¹²

In Ethiopia, to create an enabling environment for the establishment of alternative sources of financing for those investors who could not participate in various investment activities due to lack of capital, the government enacted the first leasing law in 1998, known as Capital Goods Leasing Business Proclamation No. 103/98. This proclamation was issued to address the existing gap not covered by financial institutions. MOT was empowered to license and supervise leasing companies. Despite significant interest from local and international investors following separate legislation, no single leasing company was licensed or engaged in the lease financing business until 2014.¹³ This situation necessitates amending the existing Capital Goods Leasing Business Proclamation No. 103/98 to authorize the appropriate government body to facilitate the licensing and supervision of leasing companies. The Amendment Proclamation has shown a clear demarcation of authority between MOT and the NBE.¹⁴ As a consequence, the NBE is entrusted with the authority to license, regulate, and oversee capital goods financing, encompassing financial leases and hire-purchases. Meanwhile, the MOT is authorized to license and supervise operating leasing business. As a result, the NBE licensed five capital goods finance companies (Waliya, Oromia, Addis, Dehub, and Kaza) which are established with majority ownership of

⁹ Umar Bello, et al 'The Impact of Lease Financing on Financial Performance of Nigeria Oil and Gas Industry' (2016) 7 Research Journal of Finance and Accounting 28.

¹⁰ Alexandra Bolea & Roxana Cosma, 'Leasing as a Modern Form of Business Financing' in Progress in Economic Sciences' (2015) Jan Polcyn PWSZ Poland 295.

¹¹ Ibid.

¹² Ibid.

¹³ National Bank of Ethiopia, 'Capital Goods Finance Companies in Ethiopia: An Overview' (2014) Birritu Magazine 118 31

¹⁴ Capital Goods Leasing Business (Amendment) Proclamation No. 807/2013, Neg. Gaz. 19th year No.60, 2013, Articles, 3(1) & 4(1).

regional governments and MFIs.¹⁵ Foreigners are also allowed to invest in the business.¹⁶ In this regard, the first foreign-owned leasing company (Ethio Lease) was licensed to engage in the leasing business in 2019.

However, the government's effort to establish developed capital goods financing businesses has faced challenges with only a few government-owned entities and one foreign-owned company operating. Regulatory challenges led to the closure of Ethio Lease Capital Goods Financing Company, impacting the industry's prospects in Ethiopia. Currently, the government is implementing new initiatives to reform leasing laws.¹⁷ This paper will look into the regulatory frameworks, regulatory challenges facing the capital goods lease financing business in Ethiopia, and potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia.

1.2. Statement of the Problem

Lack of access to finance is one of the main obstacles affecting SMEs in Ethiopia. Various studies have pointed out that SMEs in Ethiopia have very limited access to bank credit or other financial services.¹⁸ This is because financial institutions prefer to provide credit to large and well-established enterprises; and start-ups, micro, and SMEs have insufficient collateral.¹⁹ Financial institutions prefer large borrowers with large volumes of transactions because small and large loans need somehow the same procedures and a large loan is easy to administer and lower transaction costs.²⁰ Collateral requirements are also one of the major constraints for access to finance since nearly all loans in Ethiopia require collateral and the value of collateral is higher relative to the amount of loan requested and granted.²¹ Consequently, SMEs often depend on

¹⁵Asfaw Abera, 'Lease Financing in Ethiopia: An Assessment of the Five Regulated Lease Financing Companies'(2016) MSC Thesis, Department of Accounting and Finance, AAU, unpublished 4

¹⁶ Investment Regulation, (2020) Neg. Gaz. No. 474, 26th Year, No.78 Art.4(1)

¹⁷ In 2023, the government introduced a Draft Proclamation to reform capital goods financing laws, aiming to regulate, boost growth, and improve leasing access.

¹⁸ International Monetary Fund (n 4).

¹⁹ Ibid.

²⁰ Getnet Alemu zvedu, 'Financial Inclusion, Regulation and Inclusive Growth in Ethiopia' (2014) Working Paper 408, 22

²¹ Ibid.

informal sources of funding at the early stages of development and external sources when they start expanding.²²

Lease financing has a strong development impact and a crucial role to play in bridging the SMEs' finance gap and promoting financial sector development. Leasing as an alternative source of financing should be embraced by business operators to enable them to make use of productive assets without necessarily acquiring them. However, many countries face various legal and regulatory challenges in developing the leasing industry. Because of a lack of prior experience, regulations either do not exist or do not take into account the specific characteristics of leasing, or their application and interpretation are uncertain.²³ The lack of clear and favorable legal and regulatory frameworks for leasing can discourage investment and limit the availability of leasing services. Conducive regulatory and legal frameworks are the most important enabling environment for the development of the leasing industry. In some circumstances, a separate legal and regulatory framework for leasing companies could also help promote confidence in the efficiency and fairness of the market.

Although the capital goods lease financing business existed in Ethiopia for a long period, it is only recently that detailed law on the subject has been introduced. Modern leasing in Ethiopia was introduced in the 1960 Civil Code. The Civil Code provides various types of contracts for the transaction of lease financing business which include: sale with ownership reserved, sale with right of redemption, hiring sale, and letting and hiring.²⁴ Separate legislation was first introduced in Ethiopia in 1998, Capital Goods Leasing Business Proclamation No. 103/1998. The proclamation provides three types of lease contract models which include: finance lease, hire-purchase, and operational lease. MOT was the only regulatory body of the leasing business.²⁵

Despite significant interest from local and international investors following separate legislation, no single leasing company was licensed or engaged in the lease financing business until 2014. This situation necessitates amending the existing Capital Goods Leasing Business Proclamation No. 103/98 to authorize the appropriate government body to facilitate the licensing and supervision of leasing companies. The Amendment Proclamation has shown a clear demarcation

²² Haylekiros S. et al, 'Lease Financing for Competitiveness and Expansion of SMEs in Tigray: Challenges and Strategic Solutions' (2020) 2 Branna Journal of Engineering and Technology 4

²³ Asfaw Abera, (n 15) 6.

²⁴ Civil Code of the Empire of Ethiopia Proclamation, 1960, Proc. No 165, Neg. Gaz. Year 19, no 2.

²⁵ Capital Goods Leasing Business Proclamation No. 103/1998, Neg. Gaz. 4th year No.27, 1998, Art. 3.

of authority between MOT and the NBE by which the operational lease is retained under the supervision of the MOT and the NBE is authorized to regulate financial leases. Consequently, the NBE issued several directives that imposed excessive regulatory requirements on capital goods lease financing companies. This resulted in a lack of interest from the private sector to invest in the leasing industry. Currently, there are only five government-owned leasing companies, and one foreign-owned company (Ethio Lease) operating in the industry.²⁶ Even worse, excessive regulatory requirements forced Ethio Lease to officially enter into voluntary liquidation. Therefore, this paper will attempt to assess the regulatory frameworks of capital goods lease financing companies and examine the regulatory challenges, and potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia. The study will focus only on financial leases (hire-purchase and finance leases) which are under the supervision of the NBE.

1.3. Objectives of the study

1.3.1. General Objective

The general objective of the study is to examine the regulatory approach to capital goods lease financing business in Ethiopia with particular emphasis on the regulatory challenges facing the capital goods lease financing business in Ethiopia as well as the potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia.

1.3.2. Specific Objectives

Specific objectives of the study are:

- Examining the regulatory approach to capital goods lease financing business in Ethiopia.
- Assessing the key regulatory challenges facing the capital goods lease financing business in Ethiopia.
- Assessing the potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia.

²⁶ Ethio Lease CGFC officially launched on August 8th, 2019, with the aim of addressing equipment and forex shortages and provides easy access to needed equipment, thereby creating local jobs and increasing productivity.

1.4. Research Questions

The study mainly focuses on answering the following research questions:

- What are the key regulatory challenges affecting the capital goods lease financing business in Ethiopia?
- What are the potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia?

1.5. Scope of the Study

The study focuses on the regulation of capital goods lease financing in Ethiopia, specifically financial leasing and hire-purchase agreements. It does not address the regulation of operating leases, as these are governed by the MOT, whereas financial leasing and hire-purchase are regulated by the NBE. The study aims to examine and identify relevant laws governing financial leasing and hire-purchase agreements. Furthermore, the research incorporates an analysis of international best practices and experiences related to capital goods lease financing. Key participants in the study included officials from the Microfinance Institutions Directorate at the NBE, as well as management staff from Oromia Capital Goods Finance Company, Addis Capital Goods Finance Company, Development Bank of Ethiopia, Liyu MFIs and Vison Fund MFIs.

1.6. The Research Method

The research employed both doctrinal and non-doctrinal research methodologies, utilizing primary and secondary data sources. Primary sources include the Capital Goods Leasing Business Proclamation No. 103/1998 (with amendments), other relevant proclamations, regulations, and the relevant NBE directives. Secondary sources comprise published and unpublished materials on the subject. Additionally, qualitative data is gathered through interviews with key stakeholders, including the senior lease financing examiner/representative director of the Micro Finance Institution Directorate at the NBE, a branch manager from Oromia, and Addis Capital Goods Lease Financing Companies, a legal director from Liyu, and Vision Fund MFI, and a corporate legal affairs director from the Development Bank of Ethiopia. The study adopted a combination of purposive and random sampling techniques to select respondents, ensuring a comprehensive approach to data collection. Relevant books, articles, and

other relevant materials supplement the research as secondary sources. The data collected from primary and secondary sources is presented and interpreted using a qualitative analysis method.

1.7. Significance of the Study

The study holds significance for three primary reasons. Firstly, it contributes to the existing body of knowledge on the subject. Secondly, it examines the legal framework governing the capital goods leasing business and offers insights for policymakers on potential improvements. Lastly, it serves as a foundational resource for students and researchers interested in conducting further studies on the topic.

This study holds particular significance as it builds upon and extends the structural approach employed in Getu Shiferaw's earlier work (2016), which organized the analysis of leasing legislations into thematic sections for clarity and precision. While adopting a similar format, this research goes further by examining both the legal framework that existed prior to his study and the various legislative enactments introduced afterward. Moreover, it explores significant developments in to the industry, including legal reforms and establishment of institutional mechanisms for enforcement. By addressing two distinct research questions not covered in the earlier work, this study fills notable gaps and offers a more current and comprehensive perspective on leasing legislation and practice in Ethiopia.

1.8. Limitations of the Study

The researcher encountered limited local publications on the topic. In addition, the researcher faces time and resource constraints. Due to this, the research may not be feasible to cover every aspect and area of the leasing industry. Furthermore, the regulatory landscape of the leasing industry in Ethiopia undergoes continuous changes; hence the dynamic nature of the regulatory landscape may influence the clarity of research findings. Lastly, it was too tough to interview the participants and accomplish the tasks on time thereby limiting the researcher from obtaining diversified information. These above-mentioned limitations may have compromised the quality of the research findings.

1.9. Organization of the paper

This research paper is organized into four chapters. The first chapter provides an introduction, statement of the problem, objective of the study, research questions, scope of the study, significance of the study, limitations of the study, and research methodology. Chapters two describe and analyses relevant literature. Chapter three deals with the legal and regulatory frameworks of capital goods lease financing business in Ethiopia. Accordingly, chapter three gave a particular emphasis on the regulatory challenges facing the capital goods lease financing business in Ethiopia as well as the potential regulatory reforms and prospects for improving the capital goods lease financing sector in Ethiopia. The last chapter, which is chapter four, will draw conclusions and recommendations.

Chapter Two

Conceptual and Theoretical Background of Lease Financing

2.1. Introduction

This chapter deals with concepts related to lease financing, its evolution, advantages, types of lease, types of lessor, and enabling environment of lease financing business. In the following discussions, more emphasis is given to the legal and regulatory frameworks of lease financing business. This chapter also deals with other countries' experience towards the regulation of lease financing business.

2.2. The Concept of Leasing

Leasing is a contract between two parties where one party (the lessor) provides an asset for usage to another party (the lessee) for a specific period, in return for specified payments.²⁷ The lessor is the owner of the asset that is being leased to the lessee, and the lessee is the user of the leased equipment. Lease financing is carried out based on a short, medium, or long-term contract. Lease financing is offered by a leasing entity that acquires equipment at its own expense to lease it for many years to a lessee which periodically makes rent payments for the use of such leased property.²⁸ At the end of the period of the contract, an asset returns to a lessor unless there is a provision for the renewal of the contract. Based on the agreement between the parties, upon the expiry of the contract period, a lessee either buys the asset for the residual value or returns the asset to a lessor. The lessee at the end of the leasing contract shall have one of three options usually stated in the contract. First, to renew the lease contract under the same condition as the original contract or with a depreciation percentage of the said asset. Second, the lessee may desire to terminate the contract and return the asset to the lessor. Finally, the lessee may request the lessor to purchase these assets.²⁹ Leasing provides financing of assets rather than direct capital. The lessor is required to provide the asset to the lessee for possession and use.³⁰ A lessee

²⁷ Mathew Fletcher, (n 8).

²⁸ Getu Shiferaw, 'Law, Policy and Practice of Capital Goods Lease in Ethiopia' (2016) LL.M Thesis, School of Law, AAU, Unpublished 10.

²⁹ Monuir Salem & Abdullah Salem, 'Finance Lease-Legal Accounting and Organizational Aspects' (1997), Cairo 9-10.

³⁰ Abdel Rahma Koman, 'The Contract of Finance Lease- Comparative study' (1996) Dar El Nahda AlArabia, Cairo 6.

in return is required to pay specified rentals over a predetermined period for possession and use of the equipment. Accordingly, lease financing is a financing mechanism to acquire a property and transfer it for temporary possession and use. Therefore, leasing separates the legal ownership of an asset from the economic use of that asset.³¹

The equipment under lease financing is capital goods. Capital goods are durable and non-consumable assets.³² Usually, capital goods are durable goods that are used for the production of more capital goods as well as consumer goods.³³ Usually, capital goods leasing involves three parties; lessee, lessor, and supplier. A lessee has the right to choose a capital good and a supplier.³⁴ At the lessee's request with a specification of a given capital good and selection of a supplier, a lessor enters into a supply agreement with a supplier and acquires a capital good from a supplier, who receives outright payment from a lessor. Then, a lessor leases a good to a lessee for a term which is usually most of the useful life of a good, in return for a lessee's payment of rental.³⁵

2.3. Evolution of Leasing

Lease financing has a rich history dating back centuries, evolving alongside changes in economic practices and legal frameworks. The concept of leasing finds its roots in the ancient practices of land tenure, where landowners leased their land in exchange for agricultural produce.³⁶ As economies progressed, particularly during the Industrial Revolution, leasing expanded beyond land to encompass machinery and equipment.³⁷ The history of leasing dates back to 2000 B.C. when Sumerians leased goods which was then a major commercial center and it involved the rental of agricultural tools to farmers by the priests who were government authorities.³⁸ In 1750 B.C., a Babylonian king named Hammurabi acknowledged the existence of leases of movable

³¹ International Finance Corporation, 'Leasing in Development: Guidelines for Emerging Economies' (2009) Washington, DC, 2nd Ed. 9.

³² Ibid.

³³ Birritu Magazine (n 13) 31.

³⁴ Galal W. Mohamedin, 'Legal Aspects of Leasing: A Critical Review of Egyptian Law No. 95 on Finance Lease' (2002) Arab Law Quarterly, Vol. 17, No. 2, 10.

³⁵ Getu Shiferaw, (n 28) 1.

³⁶ Jeffrey Taylor, 'The History of Leasing' (2012) <https://www.slideshare.net/slideshow/the-history-of-leasing/12906842>, accessed 22 may 2024.

³⁷ Ibid.

³⁸ Iyare Otabor-Olubor, 'The Next Frontiers for Finance Leasing in Sub-Saharan Africa: Revisiting Secured Transaction Law in Nigeria' (2017) Vienna, UNICTAD 4.

property in his famous code of laws.³⁹ Other cultures of ancient times, such as the Egyptians, Greeks, and Romans, engaged in leases of both movable and immovable property⁴⁰. While leasing can be traced back thousands of years, the leasing industry has evolved significantly over the 50 years through which the modern leasing industry as a specialized financial service industry emerged in the United States of America in the 1950s and expanded to Europe and Japan in the 1960s and has been spreading through developing countries since the mid-1970s.⁴¹ The world's annual leasing volume in 2021 was 1.463 billion (USD).⁴²

2.4. Types of Lease

Leasing is a compound transaction related to more than one contract such as sale, rent, and agency. It may resemble certain other transactions, which require in their nature the implementation of certain sale or lease rules as the case may be.⁴³ Characterizing a particular transaction as a lease, sale, and rent, agency, or security interest matters helps to answer different legal issues. Among these are who should bear property tax, and income tax, who benefits from depreciation deduction, who bears extra-contractual liability, etc.⁴⁴ Lease financing can be provided in different arrangements. The following are the types of leases that are known in different jurisdictions.

2.4.1. Finance Lease

Financial leases are long-term non-cancellable lease contracts which are also known as capital or full pay-out leases.⁴⁵ Financial leasing is a contractual arrangement between two parties, which allows one party (the lessee) to use an asset owned by the other (the lessor) in exchange for specified periodic payments.⁴⁶ Finance lease allows the lessor, as owner, to retain legal ownership of an asset while transferring substantially all the risks and rewards of ownership to

³⁹ Iyare Otabor-Olubor(n 38).

⁴⁰ Alexandra Bolea & Roxana Cosma (n 10) 297.

⁴¹ Iyare Otabor-Olubor, (n 38) 5.

⁴² World Leasing Year Book 2023, 'The Essential Guide to Current Opportunities in International Leasing and Asset Finance', (2022) 44th ed, <https://www.codix.eu/img/company/stories/world-leasing-yearbook-2023.pdf> , Accessed 22 may 2024.

⁴³ Ibid, 31.

⁴⁴ Getu Shiferaw, (n 28) 26.

⁴⁵ Grip Invest, 'Different Types of Leases Explained: a Comprehensive Guide' (2024) <https://www.gripinvest.in/blog/types-of-lease> (accessed on 13 June 2024).

⁴⁶ Ibid.

the lessee.⁴⁷ There is a full transfer of all the risks and rewards related to the asset from the lesser to the lessee.⁴⁸

2.4.2. Hire-purchase

Hire-purchase is the installment sale contract that provides the lessee an alternative to bank financing for the purchase of equipment.⁴⁹ Leasing installment paid by the lessee during the contract period represents the payment to own the leased object at the end of the agreed-upon period, and the amount paid by the lessee as the price of purchase, may be considered the last installment of the sale price.⁵⁰ The lessee tenders a higher down payment and, with each lease payment an increasingly higher percentage of ownership is transferred to the lessee, thus building up equity. Ownership transfer is automatic once all required payments are made. Therefore, transfer of ownership marked the basic difference between a financial lease and a hire-purchase agreement. Under the financial lease, the ownership remains with the lessor, whereas in hire-purchase, ownership is progressively transferred to the lessee in proportion to the installments paid. Compared to a financial lease, this arrangement is judicially less secure for the lessor because the lessee is part owner of the asset.⁵¹

2.4.3. Operating Lease

An operating lease is a short-term arrangement that may run for three to five years and involves the lease only renting an asset over a while substantially less than the asset's useful life.⁵² An operating lease is a rental arrangement in which the lessee enters into a contract for short-term use of equipment the leasing company has on hand.⁵³ It is a contract that allows the lessor, as owner, to retain legal ownership of an asset but allows the lessee to enjoy the economic use of the asset for a predetermined period before returning the asset to the lessor. Simply, an operating lease is a short-term equipment rental.

⁴⁷ Aliyev Adalat Zeynal, 'The Practice of Reflecting Leasing Transactions in Financial Statements' (2023) 23 Global Journal of Management and Research, 31.

⁴⁸ Ibid.

⁴⁹ Galal W. Mohamedin (n 34) 36.

⁵⁰ Ibid, 36-37.

⁵¹ Getu Shiferaw, (n 28) 27.

⁵² Aliyev Adalat Zeynal, (n 47) 32.

⁵³ Getu Shiferaw, (n 28) 28.

2.4.4. Sale and Leaseback

A sale and leaseback transaction occurs when the owner of a previously purchased asset contracts to sell the asset and to lease it back from the buyer.⁵⁴ Sale and leaseback provide a means of raising money based on an asset while continuing to use the asset. The use of the property is generally continued without disruption.⁵⁵ Sale and leasebacks differ from direct leases in that they can provide additional cash whereas direct leases do not. When financing is scarce and/or the firm is credit impaired, external financing costs may be high. A sale and leaseback can provide needed liquidity and is a practical alternative to other forms of external financing.⁵⁶ Tax-related incentives, asymmetric information or financial contracting costs, financial distress, capital constraints, and liquidity needs are the motives that make sale and lease back favorable to the initial decision to purchase at the later stage.⁵⁷

2.4.5. Ijara (Islamic Lease Finance)

The term Ijara means leasing of property under a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.⁵⁸ Ijara is a Shari'ah-compliant mode of financing, as it avoids interest (riba), which is prohibited in Islam.⁵⁹ It is a type of leasing that is consistent with and applicable under Islamic financing.⁶⁰ One of the forms of Ijarah used by Islamic financial Institutions is Ijarah Muntahia Bittamleek. It is a form of leasing contract that includes a promise by the lessor to transfer the ownership of the leased property to the lessee, either at the end of the term of the Ijarah period or by stages during the term of the contract.⁶¹

In addition to the above lease classifications, there are other terminologies known in leasing literature which include among others; cross-border lease, wet and dry lease, master lease, single investor lease or leveraged lease, and closed and open-ended lease.⁶² The writer did not discuss

⁵⁴ Kyle Wells and Ryan Whitby, 'Evidence of Motives and Market Reactions to Sale and Leasebacks' (2011) *Journal of Applied Finance*, 1.

⁵⁵ Kyle Wells and Ryan Whitby (n 54).

⁵⁶ Ibid.

⁵⁷ Ibid,

⁵⁸ Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah Standards* (2015) AAOIFI, 266.

⁵⁹ Muhammad Taqi Usmani, 'An Introduction to Islamic Finance' (2010) *Maktaba Ma'ariful Quran*, 109.

⁶⁰ Ibid.

⁶¹ Ibid.

⁶² Getu Shiferaw, (n 28) 32.

in detail about these types of leasing as they are not as relevant as other types to the better understanding of the regulation of the leasing business in Ethiopia.

2.5. Leasing Entities

Lessors under lease financing are entities that provide leasing services.⁶³ Leasing entities are organizations or institutions involved in leasing transactions. Leasing entities can be broadly categorized into the following types.

2.5.1. Private Leasing Companies

Private Leasing Companies are specialized firms that provide leasing services. Leasing companies are usually treated as non-bank financial institutions, which are subject to less stringent regulations than banks.⁶⁴ This allows non-bank financial institutions to leverage more resources to be exempted from credit allocation requirements, and to use market rates of interest.⁶⁵ Leasing companies also have better technical and financial skills required for leasing as leasing officers are better informed than bank officers about new equipment on the market, and have better skills in assessing the value of used equipment and potential residual values.⁶⁶

2.5.2. Commercial Banks/Commercial Bank Subsidiaries

In emerging economies, banks offer leasing as a product alongside their traditional products such as loans and overdrafts.⁶⁷ Banks dominate the leasing markets as they have the advantage of accessing low-cost public deposits as sources of funds. The huge fund under their custody helps the banks acquire the equipment needed for leasing at a lesser cost.⁶⁸ Currently, bank-related leasing companies comprise the major share of leasing volume in the world.⁶⁹ Owing to major funding advantages for the banks, and existing customer relationships that can be developed

⁶³ International Finance Corporation, (n 31) 14.

⁶⁴ Renate Kloppinger-Todd et al, 'Leasing: An Under-Utilized Tool in Rural Finance' (2004) The International Bank for Reconstruction and Development/World Bank, 9.

⁶⁵ Ibid.

⁶⁶ Ibid.

⁶⁷ International Finance Corporation, (n 31) 18.

⁶⁸ Fekadu Petros (n 6) 41.

⁶⁹ International Finance Corporation (n 31) 18.

further, banks would continue to have dominated the leasing business in the future.⁷⁰ In many countries, however, banks provide leasing services only by forming subsidiaries.⁷¹

Bank subsidiaries are companies in which banks have a significant share. Leasing is a relatively simple product to sell and administer but it requires different selling skills, different information technology solutions, and different credit risk policies than administering a loan or overdraft portfolio.⁷² Taking into consideration the special nature of lease financing, most of the world's leading banks create their leasing subsidiaries.⁷³

2.5.3. Equipment Manufacturers

Equipment manufacturers usually provide leasing as a value-added service through captive leasing companies.⁷⁴ A captive leasing company is an entity whose primary mission is to provide the sale or lease services of products manufactured by the parent company. They are subsidiaries of the parent company and their primary objective is to generate profit for the parent company.

2.5.4. State-owned Leasing Companies

State-owned leasing companies are government-controlled enterprises that provide leasing services for the assets. They appear to have weaknesses similar to that of state-owned development banks.⁷⁵ While their outreach appears significant, a large proportion of the leases are provided at subsidized interest rates with detrimental effects on organizational sustainability.⁷⁶

2.5.5. Microfinance Organizations

Microfinance organizations reach a client not usually reached by commercial banks or independent leasing companies.⁷⁷ Better knowledge of micro-enterprise finances, relatively low staff costs, and synergy between micro-credit and micro-lease are the advantages of leasing

⁷⁰ Charles B. Wendel, 'The Leasing Role of Banks in Equipment Finance: Establishing a Sustainable Engine for Growth' (2014) *Journal of Equipment Lease Financing*, 1.

⁷¹ Renate Kloepfinger-Todd et al, (n 64) 10.

⁷² International Finance Corporation, (n 31) 15.

⁷³ Ibid.

⁷⁴ Renate Kloepfinger-Todd et al, (n 64) 10.

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ Ibid.

through MFIs.⁷⁸ The major constraint associated with MFIs providing leasing is the possibility that their limited resources and skills would be insufficient to handle the risks involved.⁷⁹

2.6. The Financial and Economic Importance of Lease Financing

Leasing has several advantages, some of which are mentioned below, for the lessee, the finance entity, the seller or supplier, and the national economy.

2.6.1. Advantages of Leasing for the Lessee

Lessees usually evaluate investments based on expected cash flow but not based on expected profits.⁸⁰ The following are among the advantages of leasing for the lessee.

Firstly, the tax savings achieved as a result of downloading all operating expense payments decade leading to the reduction of the value of taxable profit.⁸¹ Secondly, leasing helps to achieve the advantages of financing through savings in cash instead of using it to buy the leased asset and use this liquidity to finance the working capital needed for operations rather than directed to capital funding.⁸² Thirdly, it improves the financial position of the lessee, which saves him from borrowing to buy assets. At the same time, this will raise the rate of return on assets and lead to improving the image of the financial position.⁸³ Fourthly, leasing reduces the asset risk as a result of becoming obsolete and transfers this risk to the lessor at the end of the contract and gives him the right to change the original leased asset by another which will be more efficient.⁸⁴ In the fifth place, leasing provides access to finance to business entities with no or less collateral because, under the leasing contract arrangement, the leased equipment itself serves as security for the lessor since the ownership is retained under the lessor.⁸⁵

⁷⁸ Renate Kloppinger-Todd et al, (n 64) 11.

⁷⁹ Ibid.

⁸⁰ Marwan Mohammad Abu Orabi, 'The Impact of Leasing Decisions on the Financial Performance of Industrial Companies' (2014) 33 Global Journal of Management and Business Research, vol, 14, 33-34.

⁸¹ Ibid, Pros and Cons of Lease Financing, <https://www.iibs.edu.in/news/pros-and-cons-of-lease-financing-1004> (accessed on 17 may 2024).

⁸² Ibid.

⁸³ Ibid.

⁸⁴ Ibid.

⁸⁵ Galal W. Mohamedin (n 34) 12.

2.6.2. Advantages of Leasing for the Lessor

The lessor assesses the investment decision of the commodity based on the evaluation of the lease, where this decision is based on cash outflows and inflows together and the difference on a net basis between the two (the difference between cash inflows and outflows).⁸⁶ The following are among the advantages of leasing for the lessor.

Firstly, leasing contracts, as a finance tool, are consistent in general with the provisions of the Islamic Sharia's as the finance entities are not forced to add fixed interests on the accounts of their customers. This is because the proceeds obtained by the finance entities after deducting whatever they paid as a price for buying the assets they lease to the customer, are profits decided per the applicable rules.⁸⁷ Secondly, leasing has greater protection to the lessor during bankruptcy. In case of bankruptcy of the enterprise requesting the finance, the lender or the seller shall enter the bankruptcy as an ordinary creditor subject to pro rata distribution. As the leased fund shall not be removed from the proprietary rights of the finance entity, the lessor shall have the right to recover it without being exposed to the competition of the creditors of the bankrupt lessee.⁸⁸ Thirdly, under the leasing system, the finance entity shall not be liable for the latent defects of the leased assets. It is based on the ground that the lessee in the leasing contract is the party who specifies to the lessor the machinery and the equipment which the latter is required to purchase and he shall define their specifications as well as inspect, examine, and test them before the lessor enters into a contract for purchasing them.⁸⁹ Fourthly, the delivery of assets by the lessor to the lessee under the leasing contract shall not expose the lessor to a high risk in case of destruction or damage as the lessor usually obliges the lessee to obtain an insurance policy.⁹⁰ In the fifth place, the lessor usually enjoys - according to law - several benefits like taxes and customs exemptions for the capital assets which are the subject matter of the leasing contract.⁹¹

⁸⁶ Marwan Mohammad Abu Orabi, (n 80) 34.

⁸⁷ Galal W. Mohamedin (n 34) 15.

⁸⁸ Ibid.

⁸⁹ Ibid.

⁹⁰ Ibid, 17-18.

⁹¹ Ibid, 18-19.

2.6.3. Advantages of Leasing for the Supplier

Concerning the advantage of leasing to the supplier, the opportunity to take advantage of excess idle assets and get excess returns on these assets, the opportunity to market the commodity of goods produced by the lease and provide a refund for the leased asset with a payoff, and the opportunity to sell the asset at the expiry of the lease term can be mentioned.⁹²

2.6.4. Advantages of Leasing for a National Economy

Firstly, the productivity of capital assets adds great additions to the national GDP.⁹³ Secondly, leasing contracts are considered stability factors for the sustainability of investments during crises and economic changes.⁹⁴ Thirdly, the finance of capital assets through leasing requires potentially qualified working hands to provide speed in the implementation of the projects.⁹⁵ Finally, leasing contracts help keep pace with technological developments, raise production quality, reduce cost, and increase the level of investment opportunities by opening new markets at home and abroad.⁹⁶

2.7. Enabling Environment for Lease Financing

Leasing as a financial instrument needs a legal framework on which its overall operation is governed.⁹⁷ Hence, the success and development of lease financing primarily depend on how well the country designed and crafted the leasing legislation adequately and comprehensively.⁹⁸ There is no doubt about the importance of creating an enabling environment that includes clear legal bases and minimal regulation for the development of leasing like all other economic activities.⁹⁹ However, in many developing countries domestic legal frameworks are not conducive to the development of leasing, and even such frameworks do not exist in some of them.¹⁰⁰ Therefore, adopting a comprehensive and conducive legal and regulatory framework

⁹² Galal W. Mohamedin (n 34) 15.

⁹³ 'Leasing: Types, Features, Advantages & Disadvantages' <https://www.geeksforgeeks.org/leasing-types-features-advantages-disadvantages/> (accessed on 17 may 2024).

⁹⁴ Ibid.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Mathew Fletcher, (n 8) 14.

⁹⁸ Ibid.

⁹⁹ Renate Kloppinger-Todd, et al (n 74) 12.

¹⁰⁰ Mathew Fletcher, (n 8) 15.

that addresses the basic ingredients of lease transactions helps to develop a leasing sector.¹⁰¹ Accordingly, clear legal bases, minimal regulation, and the use of internationally accepted accounting standards, and tax codes are among the major contributing factors for the development of leasing.¹⁰²

2.7.1. Legal Frameworks

Lease financing can be regulated either by a homogeneous legal framework or a general code of laws depending on countries experience.¹⁰³ Some countries such as the United States, France, Argentina, Brazil, Russia, Korea, Indonesia, Morocco, and Ghana have specific leasing laws.¹⁰⁴ The development of a specific and separate leasing law may not be necessary, although this will ultimately depend on local circumstances and existing legislation. However, due to a lack of a well-developed legal system that provides a strong basis for the development of lease financing, weak property rights protection, and a weak culture of contract enforcement, it is very difficult for developing countries to build a leasing sector without adopting specific leasing legislation.¹⁰⁵ Hence, in emerging economies, a specific law on lease financing is imperative, both because it will help fill legislative gaps and will address the rather complex tripartite legal structure implicit in a leasing transaction which involves the third-party supplier from whom the lessor buys the leased asset.¹⁰⁶

One of the main issues in adopting leasing-specific legislation is how to craft the legal framework and what matters should be incorporated in this framework. In this regard, IFC and UNIDROIT advocate the incorporation of certain basic elements in leasing legislation to make the law comprehensive and in effect foster the development of the sector.¹⁰⁷ The coming section

¹⁰¹ Mathew Fletcher, (n 8) 15.

¹⁰² Renate Kloppinger-Todd, et al, (n 74) 13.

¹⁰³ Daferighe Emmanuel E. & Aje, Samuel O. 'Leasing in Emerging Economies: The Nigerian Perspective' (2008), Reaserch Gate 38.

¹⁰⁴ Renate Kloppinger-Todd, et al, (n 74) 13.

¹⁰⁵ International Finance Corporation, (n 31) 26.

¹⁰⁶ Ibid.

¹⁰⁷ The International Institute for the Unification of Private Law (UNIDROIT) was founded in 1926 with the purpose of studying ways of modernizing, harmonizing and coordinating private and in particular commercial law between States and groups of States. The IFC and UNIDROIT model law highly influence the existing lease financing legislation of many countries, since elements that are recommended by IFC and incorporated under the UNIDROIT model law, more or less recognized and incorporated, at least in substance, in the law of many countries, or influenced the law in many aspect.

will briefly address some of the elements regulated and specifically treated under the IFC guideline and UNIDROIT model law related to leasing legislation.

2.7.1.1. Clear Definition of Leasing

The legal framework should define leasing and what constitutes a lease transaction. IFC guidelines and UNIDROIT model law provide a clear definition of leasing. In this respect, UNIDROIT model law defines leasing as ‘A transaction in which one person provides another person with the right to possess and use an asset for a specific term in return for rentals. The term includes a sub-lease.’¹⁰⁸

The IFC also defines leasing as ‘a means of providing access to finance and may be defined as a contract between two parties wherein one party (the lessor) provides an asset for use to another party (the lessee) for a specified period in return for specified payments.’¹⁰⁹ According to these definitions, the separation of the legal ownership of an asset from the economic use of that asset is the central point of leasing.

2.7.1.2. Parties to Leasing Transaction

Lease financing law needs to determine the parties involved in the lease transaction and their legal status. Both the IFC and the UNIDROIT model law recognize leasing as a transaction between three parties with the possibility of two parties.¹¹⁰ Accordingly, the parties to the lease agreement are the lessor, lessee, and supplier. The parties to the lease agreement can be individuals or legal entities.¹¹¹ However, the experience of many countries demonstrates that only legal entities incorporated in that particular nation are allowed to engage in leasing business as a lessor whereas individuals can be a lessee or a supplier.¹¹²

2.7.1.3. Clear Definition of Leased Asset

Providing a clear definition of an asset is significant in determining which asset can be subjected to leasing and which asset should be subjected to different types of lease financing agreements.

¹⁰⁸ UNIDROIT Model Law on Leasing, UNIDROIT 2008, Study LIXA – Doc. 17, Art. 2.

¹⁰⁹ International Financial corporation, (n 31) 7.

¹¹⁰ Ibid, UNIDROIT Model Law on Leasing, (n 108).

¹¹¹ Ibid.

¹¹² International Finance Corporation, (n 31) 7.

According to the IFC, the leased asset must be identifiable and non-consumable and cannot be destroyed or transferred into another form or condition once used and retain its original form during its use while depreciating gradually.¹¹³ Generally, IFC believes that anything that cannot be owned or held title to cannot be leased, because to act as a lessor one needs to own the asset first.¹¹⁴ On the other hand, the UNIDROIT model law allows all property used in the craft, trade, or business of the lessee, including immovable, capital assets, equipment, future assets, specially manufactured assets, plants, and living and unborn animals except money, and investment securities, can be subject of a lease agreement.¹¹⁵

2.7.1.4. Lease Rental Payments

Lease rentals represent the consideration, usually monetary, for the lease transaction that the lessee pays to the lessor. According to IFC, lease rentals are most frequently calculated based on an amortization plan with fixed payments, and the determination of the interest rate is left to the agreement of the parties¹¹⁶. The interest rate implicit in the lease is defined in IFRS 16 as ‘the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.’¹¹⁷ Generally, lease interest rates tend to be higher than traditional financing rates because leasing companies take on more risk by providing financing for assets that they do not own and that may depreciate over time.¹¹⁸

2.7.1.5. Lease Term

The lease period is the term for which the agreement of the lease is in operation. Parties to the lease contract may stipulate the terms of the lease as short, medium, or long-term periods through which lease financing is carried out based on an agreed period. Based on the party's agreement on the contract, the lease period can be bifurcated into two seasons which are the primary and secondary periods of lease.¹¹⁹ In the primary period, the lessor will recover all of the

¹¹³ International Finance Corporation, (n 31) 28-29.

¹¹⁴ Ibid.

¹¹⁵ UNIDROIT Model Law on Leasing(n 108)

¹¹⁶ International Finance Corporation, (n 31) 30.

¹¹⁷ International Financial reporting standard 16, (2018) IFRS Foundation, paragraph 39 AB.

¹¹⁸ Tegegne Zergaw, ‘The Legal Framework of Finance Leasing in Ethiopia: The Need For Improvement’ (2015), LL.M Thesis, School of Law, Bahir Dar University, Unpublished.

¹¹⁹ International Finance Corporation, (n 31) 29.

cost of the equipment plus any fees and interest chargeable whereas in the secondary period, it is an option for the lessee to continue the economic usage of the asset without taking ownership.¹²⁰ During this secondary period, the rentals are much smaller than those paid during the primary period.¹²¹ UNIDROIT model law leaves such matters for the determination of the parties.

2.7.1.6. Rights and Duties of Parties in Lease Financing Transaction

Lease financing legislation needs to stipulate the respective rights and duties of the lessee, the lessor, and the supplier based on their respective role, with the view to ensure the effectiveness, sustainability, and integrity of lease financing as a viable source of finance.¹²² The following section briefly discusses the rights and duties of the parties to lease transactions.

a) Parties freedom of contract

Freedom of contract is a corner stone of leasing parties' rights and responsibilities. The parties should be given the maximum opportunity to provide in the contracts the full extent of their rights and responsibilities.¹²³ UNIDROIT model law also recognizes parties' freedom to determine the content of their contract.¹²⁴ However, in some situations, to protect the basic rights of parties and ensure the integrity of the transaction, parties' freedom of contract should be subjected to a mandatory provision of the law that the parties should not be allowed to derogate from. For example, the lessee's direct recourse against the equipment supplier clause, limitation of the lessor's equipment responsibilities and third-party liability, and lessee's absolute duty to pay leasing payments should be established in the law without subject to the freedom of the contract provision.¹²⁵

b) Limitation of lessor's equipment responsibilities and third-party liability

One of the most important protections that leasing legislation should accord for the lessor is relieving him from liability for injury, death, and damage of a third party due to the use for the leased asset and for defects, non-conformity, and unfitness of the asset. The IFC provides that the lessor shall not be accountable to the lessee for the nonfulfillment of the sale-purchase contract

¹²⁰ International Finance Corporation, (n 31) 29.

¹²¹ Ibid 29.

¹²² Ibid, 28-31.

¹²³ Ibid.

¹²⁴ UNIDROIT Model Law on Leasing, (n 108) Art. 5.

¹²⁵ Ibid, Articles 5, 7(4), 22(3), International Finance Corporation, (n 31) 31.

by the supplier, and the lessor, when acting in its capacity as owner shall not be liable to the lessee or third party for death, personal injury, or damage caused by the leased asset or its use.¹²⁶ In this regard, the UNIDROIT model law also follows a similar position with the IFC.¹²⁷

c) The irrevocable and independent nature of parties' responsibility

The lease financing law should have a provision that ensures the irrevocability of the lease agreement once it is entered into. Irrevocability of the lease agreement helps to ensure the integrity of the lease financing market. In this respect, the UNIDROIT model law makes the duties of the parties in lease financing transaction irrevocable once the leased asset has been delivered to and accepted by the lessee, and the performance of the duty of one party is not dependent on the performance of the duty of the other party.¹²⁸ Hence, the duty that is irrevocable and independent must be performed, whether the other party has performed its duty or not.

d) Warranty of quiet possession

The lessee's right to enjoy quiet possession over the leased asset is one of the fundamental rights that needs to be recognized by the law. In this respect, the law should require the lessor to transfer possession rights to the lessee that are free from any encumbrances and claims of third parties to enable the lessee to enjoy the quiet possession of the asset.¹²⁹ The lessor should warrant the lessee a quiet possession and use of the asset and be liable for any damage suffered by the lessee due to encumbrances created over the leased asset.¹³⁰

e) Repossession of the Leased Asset

Easy and fast repossession of leased assets is one of the main advantages the lessor has compared with the lender. The legal framework should permit non-court repossession so that lessors can repossess leased assets without going to court as long as the lessee does not contest the repossession.¹³¹ In the event of a default by the lessee, there should be scope within the legislation to allow it to voluntarily return the leased asset to the lessor without penalty.¹³² When

¹²⁶ International Finance Corporation, (n 31) 31.

¹²⁷ UNIDROIT Model Law on Leasing, (n 108) Art 9.

¹²⁸ UNIDROIT Model Law on Leasing, (n 108), Art. 10.

¹²⁹ Ibid, Art. 16.

¹³⁰ Ibid.

¹³¹ International Finance Corporation, (n 31) 35.

¹³² Ibid, 35.

the lessee disputes the grounds for repossession, the lessee should have access to the courts to challenge the repossession order, and such a lawsuit shall not prevent the repossession order from being executed and enforced and the lessor should be free to sell the leased asset regardless of the action of the lessee.¹³³ In those cases where the lessee does not voluntarily return the asset, a non-judicial process should be available and processed within a short period such as 10 days.¹³⁴ Similarly, the UNIDROIT model law entitles the lessor to repossess the asset when the lease agreement is terminated or at the end of the lease term and imposes a duty on the lessee to return the asset with the standard of due care required by the law.¹³⁵ However, unlike the IFC, the UNIDROIT model law is silent about the modality of repossession, the remedy of the lessor during the lessee's refusal to surrender, the possibility of self-help repossession, and the role of the court during repossession.

f) Transfer of rights and duties

Parties' right to transfer their right and duty is the other important issue that needs to be addressed in the lease financing legislation. The UNIDROIT model law allows the lessor to transfer his right to a third party without the consent of the lessee.¹³⁶ However, the lessor and lessee may agree that the lessee shall not raise against a transferee any of its defenses or rights of set-off against the lessor other than those arising from the incapacity of the lessee.¹³⁷ However, the model law requires the lessor to secure the consent of the lessee to transfer his duty to a third party.¹³⁸ On the other hand, the model law requires the lessee to transfer his right and duty to a third party only upon the prior consent of the lessor.¹³⁹

g) Priority of liens

This provides the basis for the advantage of leasing over lending under conditions of lessee bankruptcy. As the equipment owner, the lessor's claim to the asset should be superior to any claim creditors may have on the lessee. In this respect, the UNIDROIT model law recognizes the enforceability of rights and remedies of parties under the lease agreement against purchasers and

¹³³ International Finance Corporation, (n 31) 35.

¹³⁴ Ibid.

¹³⁵ UNIDROIT Model Law on Leasing, (n 108) Art. 24.

¹³⁶ Ibid, Art. 15(1) (a).

¹³⁷ Ibid.

¹³⁸ Ibid, Art. 15(1) (b).

¹³⁹ Ibid, Art. 15(2).

creditors, including an insolvency administrator.¹⁴⁰ The creditors of the lessee cannot impair the lessor's right in the asset and similarly, a creditor of the lessor takes subject to the right of use and possession of the asset by the lessee.¹⁴¹

h) Bankruptcy of the lessor and the lessee and its legal effect

According to the IFC, the law should in principle, entitle the lessor the right to re-possess the asset when the lessee becomes bankrupt and defaults on discharging its obligations.¹⁴² However, the successor may retain the lessee's rights under the lease agreement in case the bankrupt lessee's liabilities are assumed by another party and there is no default on the lease agreement.¹⁴³ This will require the acceptance of the lessor, which will assess the creditworthiness of the new party and request that a new lease contract be signed.¹⁴⁴ On the other hand, the bankruptcy of the lessor shouldn't affect the continuation of the lease agreement unless the lessee fails to discharge its obligation.¹⁴⁵ In this respect, the UNIDROIT model law doesn't provide a specific provision and leaves such matters to be regulated by the insolvency law of the nations.

i) Registration of lease agreement

Registration of a lease agreement is a method by which the lessor may publicize its interest in the leased asset. The rationale for registration is to give a potential buyer, or perhaps a potential secured creditor, a means by which to determine whether an asset it proposes to buy or to accept as collateral is free of prior interests, specifically the lessor's ownership interest.¹⁴⁶ IFC recommends a notice registration model in which the notice with certain particulars of the lease agreement is registered instead of the whole contract.¹⁴⁷ In this respect, the UNIDROIT model law doesn't incorporate any specific provision that governs the registration of the leased asset and its effect on the claim of the lessor against a secured creditor.

¹⁴⁰ UNIDROIT Model Law on Leasing, (n 108) Art. 8.

¹⁴¹ Ibid.

¹⁴² International Finance Corporation, (n 31) 36

¹⁴³ Ibid.

¹⁴⁴ Ibid.

¹⁴⁵ Ibid.

¹⁴⁶ Ibid, 32.

¹⁴⁷ Ibid.

j) Termination of a lease agreement and its legal effect

According to the UNIDROIT model law, a lease may be terminated by operation of law, by agreement of the parties, or by an aggrieved party upon fundamental default by the lessee or lessor.¹⁴⁸ However, after the asset subject to the lease has been delivered to and accepted by the lessee, the lessee in a financial lease may not terminate the lease upon fundamental default by the lessor or the supplier but is entitled to such other remedies as are provided by the agreement of the parties and by law unless a fundamental default by the lessor is in respect of the warranty of quiet possession.¹⁴⁹

2.7.2. Regulatory Frameworks

The cost of financial institutions' crises to society is invariably enormous and exceeds the private cost to individual financial institutions. Thus, ensuring the safety of individual financial institutions may help to achieve the safety of the whole financial system. The main tool to internalize these externalities is regulation. The current approach to financial institution regulation seems to assume that financial crashes occur randomly as a result of a bad institution failing and then the failure is becoming systemic.¹⁵⁰ Generally, financial sector institutions are subject to two broad categories of regulatory supervision; prudential and non-prudential.¹⁵¹

2.7.2.1. Prudential Regulation

Prudential regulation is the form of regulation involved in counteracting asymmetric information problems in the financial market.¹⁵² Information asymmetry arises when products and services are sufficiently complex that other forms of regulations are insufficient to administer.¹⁵³ Prudential regulation has as its objectives the safety of individual institutions and the stability of the financial system as a whole.¹⁵⁴ Traditionally, such regulation has been primarily directed at

¹⁴⁸ UNIDROIT Model Law on Leasing, (n 108), Art. 23(1).

¹⁴⁹ Ibid, Art 23(2&3).

¹⁵⁰ Markus Brunnermeier, et tal, 'The Fundamental Principles of Financial Regulation' (2009), International Center for Monetary and Banking Studies, Geneva Reports on the World Economy 11, 1.

¹⁵¹ Daferighe Emmanuel E. & Aje, Samuel O. (n 103).

¹⁵² Jeffery Carmichael and Michael Pomerleano, 'the Development and Regulation of Non-Bank Financial Institutions' (2002) World Bank, 9.

¹⁵³ Ibid.

¹⁵⁴ William R. White, 'The Prudential Regulation of Financial Institutions: why Regulatory Responses to the Crises Might not Prove Sufficient' (2013) the School of Public Policy Research Paper, Vol, 6, 8.

banks.¹⁵⁵ However, in recent years, a view has emerged that other institutions might also have the potential to generate financial instability which considers regulation on the many different types of financial institutions involved in non-banking financial institutions.¹⁵⁶ However, not all financial institutions pose similar systemic risks. Regulation should acknowledge that some are systemically important and others are less so.¹⁵⁷ Thus, the approach to regulating financial institutions should be determined based on the nature of the institutions and the risks they may pose to the financial system. There are two different approaches to prudential regulation; which are micro-prudential and macro-prudential.¹⁵⁸

The micro-prudential approach to prudential regulation is the more traditional of the two. It focuses on the health of individual institutions, essentially assuming that, if each institution is healthy, the system will be healthy.¹⁵⁹ Issues of interdependence are given little attention and risks are taken as exogenous. This approach is essentially static. It assumes that defaults could occur at any time and the regulatory response should be to reduce the probability of this happening.¹⁶⁰ Micro-prudential regulation concerns itself with the stability of each institution. It also ignores the systemic importance of individual institutions depending on such factors as size, degree of leverage, and interconnections with the rest of the system.¹⁶¹

The macro-prudential approach to prudential regulation rather focuses on the stability of the financial system as a whole and has both a static (cross-sectional) and a dynamic (time-varying) dimension.¹⁶² The static dimension recognizes the inter-dependencies in the financial system and the diverse ways in which the actions of individual institutions can feed back on the health of others. It recognizes the fact that “shared shocks” can be dangerous to the system, even if all its components initially seem healthy.¹⁶³ This approach does not just focus on reducing the probability of a crisis but also reducing the size of the economic costs that might be associated

¹⁵⁵ William R. White, (n 153) 9.

¹⁵⁶ Ibid.

¹⁵⁷ Markus Brunnermeier, et tal (n 150) 2.

¹⁵⁸ Ibid, 2

¹⁵⁹ Ibid.

¹⁶⁰ Ibid.

¹⁶¹ William R. White (n 153) 9.

¹⁶² Ibid, 10.

¹⁶³ Ibid.

with such a crisis. The macro-prudential approach also has a time dimension. This reflects the assumption that expected losses are not constant, but change over time.¹⁶⁴

The general practice is to subject institutions that obtain public deposits to prudential regulations because of the information asymmetry problems faced by a large number of depositors in monitoring the use of their deposits.¹⁶⁵ Systemically-important institutions would be subject both to micro-prudential regulation and to macro-prudential regulation, related to their contribution to systemic risk.

This can be done by adjusting the micro-prudential ratio by a coefficient corresponding to their macro-prudential risk.¹⁶⁶

The most common administrative requirements imposed on leasing companies include entry requirements, capital requirements, balance sheet restrictions, maximum debt-to-equity ratio, foreign exchange and customs, liquidity requirements, association among institutions, etc.¹⁶⁷ The minimum capital requirement refers to the minimum level of capital that active financial organizations are expected to retain to serve as a foundation for future growth and provide liquidity as a cushion against unexpected losses.¹⁶⁸ Banks and other financial institutions are required to have a minimum amount of capital. Capital requirements for leasing companies are normally lower than those for banks.¹⁶⁹ Whereas, the debt-equity ratio compares the amount of capital borrowed by the lessor with the amount of capital injected by shareholders. The 10:1 maximum ratio was recommended by the IFC.¹⁷⁰ Financial statements are a means by which external parties can evaluate the financial health of the lessor. Presentation of the lessor's financial statements is one of the areas prudential regulation requires from the leasing company. Regarding foreign exchange and customs, lessors need to be able to freely convert local currency into foreign exchange. This enables them to buy equipment with foreign currency while settling

¹⁶⁴ William R. White (n 153) 10.

¹⁶⁵ Daferighe Emmanuel E. & Aje, Samuel O. (n 103) 39.

¹⁶⁶ Markus Brunnermeier, et al (n 150) 18.

¹⁶⁷ Daferighe Emmanuel E. and Aje, Samuel O. (n 103) 38.

¹⁶⁸ Ibid.

¹⁶⁹ Ibid.

¹⁷⁰ International Finance Corporation, 'Leasing in Development: Guidelines for Emerging Economies' (1996), Washington, DC, 38.

lease payments in local currency.¹⁷¹ Many countries have adopted favorable regulations regarding customs duty in leasing.¹⁷²

2.7.2.2. Non-Prudential Regulation

In addition to prudential regulation, most countries have regulations directed to consumer protection which is non-prudential regulation.¹⁷³ It is a type of regulation which is less strict than prudential regulation. Competition regulation and consumer protection regulation are among the non-prudential types of regulation.¹⁷⁴ The objectives of these regulatory interventions are the protection of consumers, efficiency enhancement, and other broader social objectives such as supporting the growth of particular sectors such as SMEs, export sector, manufacturing sector, or housing.¹⁷⁵ IFC advises against prudential regulation for leasing companies that do not obtain public deposits.¹⁷⁶ It is based on the proposition that overly regulating may prevent innovation at early stages, and many success stories of leasing development have occurred in non-regulated leasing markets.¹⁷⁷ Over-regulating the leasing sector at the early stages of development may hamper its development.¹⁷⁸ Therefore, the overall recommendation is minimal regulation for leasing companies.¹⁷⁹ The IFC further found that poorly executed and designed regulations are often a major impediment to business. The type of lessor involved also plays a role in determining the need and kind of regulation to be applied. Non-bank and non-deposit-taking leasing institutions may not need the same level of stringent regulation as deposit-taking commercial banks; and, in some cases, no specific prudential regulation may be necessary.¹⁸⁰ There is also evidence from other countries, both developed and emerging economies like the US, UK, Germany, South Korea, Thailand, Ghana, and Nigeria, etc. that independent equipment financing companies are not subjected to prudential regulation.¹⁸¹

¹⁷¹ International Finance Corporation(n 170).

¹⁷² Ibid, 39.

¹⁷³ William R. White (n 153) 9.

¹⁷⁴ Fekadu Petros (n 6) 49.

¹⁷⁵ Ibid, 49.

¹⁷⁶ International Financial Corporation (n 31) 38.

¹⁷⁷ Ibid.

¹⁷⁸ Ibid.

¹⁷⁹ Ibid.

¹⁸⁰ Daferighe Emmanuel E. and Aje, Samuel O. (n 103) 39.

¹⁸¹ Fekadu Petros (n 6) 49.

2.7.3. Tax Treatment of Lease Financing

Tax treatment of lease for both the lessor and the lessee is a major determinant of whether a country develops leasing as a successful financial product.¹⁸² The best approach to tax treatment of lease starts with a clear definition of what constitutes a leasing transaction for tax purposes. According to the IFC, however, the development of the leasing sector has suffered not only from differences in interpretation but also from a lack of definition.¹⁸³ Thus, to develop the leasing sector through domestic investment, the government should introduce preferential tax treatment to leasing. Value-added tax (VAT) and income or profit tax are the two major tax bases that have significant implications for leasing.¹⁸⁴ VAT is a tax on consumer spending collected by VAT-registered traders on their supplies of goods and services to their customers. There are two distinct types of VAT which are output VAT and input VAT. Output VAT is the tax a business charges on the items or services that it sells, and input VAT is the tax a business charges on the items or services that it purchases.¹⁸⁵ Regarding the concern about who must pay the VAT, the most common arrangement is for the lessor to pay VAT during equipment purchase, and for the lessee to pay VAT on lease payments and on the value of the asset if ownership is transferred at the end of the lease period. Since most leases are simple finance leases that are close substitutes for term-loans; VAT is typically not charged on loan payments.¹⁸⁶ In income or profit tax, the two factors of particular relevance are whether lessors are allowed to deduct depreciation (and lessees deduct lease payments) from their taxable income and whether accelerated depreciation is permitted.¹⁸⁷ The IFC recommends that at a minimum, the lessees should be able to deduct the interest portion of their repayment from gross income. However, allowing leasing companies to pay no income tax as an incentive is not a sound approach since it may create market distortion in the long run.¹⁸⁸ Leased assets should also be exempted from customs duties.¹⁸⁹

¹⁸² International Financial Corporation (n 31) 41.

¹⁸³ Ibid, 41.

¹⁸⁴ Ibid, 46.

¹⁸⁵ Ibid, 41.

¹⁸⁶ Sudhir P. Amembal, 'International Leasing : the Complete Guide' (2000) Amembal and associates vol. 1, 45

¹⁸⁷ Ibid.

¹⁸⁸ International Financial Corporation (n 31) 52.

¹⁸⁹ Ibid.

2.7.4. Lease Accounting Standards

The accounting framework defines how leased assets should be reflected in the accounts of the lessor and the lessee.¹⁹⁰ The International Accounting Standards Schedule (IAS-17) provides guidelines for the categorization of leases into operating and finance leases. All European Union countries are required to use IAS-17 by 2005.¹⁹¹ IAS-17 has the advantage that lessees can no longer hide financial commitments arising out of non-cancelable lease agreements.¹⁹² Lease accounting standards establish rules for how leases should be recognized, measured, and disclosed in financial statements.

2.8. Lessons from other Countries Leasing Experience

This section deals with the leasing experience of Nigeria, Ukraine, and Sri Lanka. The Nigerian experience was discussed because the country follows non-prudential regulation, and the Sri-Lankan experience was addressed to get an insight into how lease financing companies can be regulated micro-prudentially. The recent visit of personnel from NBE to Ukraine to acquire experience for lease financing legislative reforms was the calling factor to discuss Ukraine's experience.

2.8.1. Nigerian Leasing Experience

The leasing industry was first introduced to Nigeria as a means of financing by British Lessor Companies in 1960.¹⁹³ The Leasing industry in Nigeria has recorded a notable growth of 13.5 percent in 2019, with outstanding lease volume at N1.91 trillion as against N1.68 trillion in 2018.¹⁹⁴ The key regulators and participants in the Nigerian lease industry are the Equipment Leasing Association of Nigeria (ELAN), and the Finance Houses Association of Nigeria (FHAN) along with bank and non-bank lease companies.¹⁹⁵ Finance leases and operating leases are the two types of leasing in Nigeria.¹⁹⁶ There are four broad categories of market participants

¹⁹⁰ Renate Kloepfinger-Todd et al, (n 64) 14.

¹⁹¹ Ibid.

¹⁹² Ibid.

¹⁹³ Daferighe Emmanuel E. & Aje, Samuel O. (n 103) 36.

¹⁹⁴ U.F. Abdulkarim et al (n 7) 173.

¹⁹⁵ Ibid.

¹⁹⁶ Ibid.

in the country's leasing industry which comprise regulators, associations, lessors, and lessees.¹⁹⁷ The regulators include the Central Bank of Nigeria which is the apex regulator of all banking and banking financial transactions. The associations include the Equipment Leasing Association of Nigeria (ELAN) and Finance Houses Association of Nigeria (FHAN) which provide the platform and oversight for consummation of lease transactions.¹⁹⁸ Lessors are mostly banks that correspondingly finance other lessors (non-bank) in the leasing business.¹⁹⁹ Nigeria has a specific legal framework for the conduct of leasing activities since 2015. Though bank and non-bank financial institutions are participants in the leasing industries, the leasing industry in Nigeria is not subject to prudential regulations.²⁰⁰

2.8.2. Ukraine Leasing Experience

In Ukraine, the provision of financial leasing services is regulated by the Economic, Civil, and Tax Codes of Ukraine, the laws of Ukraine "On Financial Leasing" (2021), "On Financial Services and Financial Companies" (2021), "On Banks and Banking Activities" (2000), and as well as the UNIDROIT Convention (1988) on international financial leasing, which generally corresponds to the peculiarities of regulation in European countries.²⁰¹ Ukraine's "On Financial Leasing" is built exclusively on a civil law basis; its subject is primarily the regulation of contractual relations.²⁰² Banks and non-bank financial institutions can provide leasing services in Ukraine.²⁰³ Although financial companies with the right to carry out leasing activities are more numerous, they are not the main players in the market. It is legal entities that form the main part (90%) of financial leasing contracts.²⁰⁴ In Ukraine, Bank-affiliated lessors are regulated by the National Bank of Ukraine.²⁰⁵ However, the only requirement placed on independent lessors is to file quarterly reports on leasing operations as opposed to bank-affiliated lessors.²⁰⁶ There is no requirement that an independent lessor obtain a leasing license, meet minimum capital

¹⁹⁷ U.F. Abdulkarim et al (n 7), 174 -175.

¹⁹⁸ Ibid.

¹⁹⁹ Ibid, 174-175.

²⁰⁰ Ibid.

²⁰¹ Belianko Lidiia, 'Potential for the Development of Financial Leasing in Ukraine' (2024) *Scientia Fructuosa*, 127.

²⁰² Ibid.

²⁰³ Ibid.

²⁰⁴ Ibid.

²⁰⁵ International Finance Corporation, 'Critical review and assessment of the existing legal framework for Capital Goods Finance Business in Ethiopia' (2019) Legal and regulatory diagnostic report Prepared by IFC for National Bank of Ethiopia, 32.

²⁰⁶ Ibid.

requirements, submit financial statements to a government agency, etc.²⁰⁷ Ukrainian Association of Lessors" (UAL), which began as the only leasing association in the country is a voluntary non-commercial association of professional leasing companies.²⁰⁸

2.8.3. Sri-Lankan Leasing Experience

The leasing industry in Sri Lanka has been in operation since 1980.²⁰⁹ The Central Bank of Sri Lanka is responsible to regulate and supervise the leasing industry in the country.²¹⁰ Finance companies and specialized lease companies provide leasing services.²¹¹ Leasing companies are generally governed by the Finance Business Act (2011) and the Finance Leasing Act (2000). The Department of Supervision of Non-Bank Financial Institutions of the Central Bank of Sri Lanka carries out the regulatory and supervisory functions to licensed finance companies and specialized leasing companies.²¹² Regulatory functions are carried out mainly through off-site surveillance and on-site examinations.²¹³ Both finance companies and specialized lease companies are subject to prudential regulation.²¹⁴ However, the degrees of accountability in both companies are quite different. The Monetary Board is empowered to oversee finance companies, and the director of the Department of Supervision of Non-Bank Financial Institutions is empowered to regulate finance leasing establishments.²¹⁵

²⁰⁷ International Finance Corporation (n 206).

²⁰⁸ Belianko Lidiia, (n 201) 132.

²⁰⁹ Weerasinghe K.w.A.M, 'Legal Protection Afforded to Leases: A Critical Analysis of vehicle Leasing Law in Sri Lanka' (2023) 2 International Journal of Contemporary Business Research 19.

²¹⁰ Saman Kelegma & Ganga Tilakaratna, 'Financial Inclusion, Regulation, and Education in Sri Lanka' (2014) Asian Development Bank Institute 15.

²¹¹ Ibid.

²¹² Ibid.

²¹³ Ibid.

²¹⁴ Ibid.

²¹⁵ Ibid.

Chapter Three

Regulatory Framework of Capital Goods Lease Financing Business in Ethiopia

3.1. Introduction

Although Ethiopia has a long history of lease financing practices, the modern business of capital goods finance is a new phenomenon in the country.²¹⁶ Modern leasing in Ethiopia was introduced in the 1960's Civil Code. The Civil Code provides various types of contracts for lease financing business which include sale with ownership reserved, sale with right of redemption, hiring sale, and letting and hiring. Separate legislation was first introduced in Ethiopia in 1998 when Capital Goods Leasing Business Proclamation No. 103/1998 was enacted. This proclamation was amended by Capital Goods Leasing Business (Amendment) Proclamation No. 807/2013 which restructured the capital goods lease financing business into operating lease and capital goods finance (financial lease and hire-purchase).²¹⁷ The regulatory power of the capital goods lease financing business was also taken from the MOT and transferred to the NBE by the same Proclamation.²¹⁸

The Amended Leasing Proclamation requires the issuance of implementation regulations and directives. Based on this, the Council of Ministers issued the Registration and Supervision of Capital Goods and Capital Goods Leasing Agreement Regulation No. 309/2014. Similarly, the NBE issued about fourteen directives to regulate the licensing and supervision of the business of capital goods lease finance companies. Currently, admitting the inadequacy of the existing capital goods financing business legal and regulatory frameworks and business environment, there is an ongoing reform to the existing capital goods financing business legal and regulatory frameworks.²¹⁹ The normative framework, the institutional frameworks, and a lease contract (agreement) together constitute the regulatory framework of capital goods leasing business in Ethiopia.

The purpose of this chapter is to describe, analyze, and comment on the regulatory framework of capital goods lease financing business in Ethiopia. In doing so, this chapter tries to identify the

²¹⁶ Fekadu Petros(n 6) 37.

²¹⁷ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art.2 (2).

²¹⁸ Ibid Art. 4(1).

²¹⁹ Draft Capital Goods Financing Business Proclamation No. ---/2023.

key regulatory challenges facing the capital goods lease financing business, and the potential regulatory reforms or prospects for improving the capital goods lease financing sector in Ethiopia.

3.2. Evolution of Capital Goods Lease Financing Business in Ethiopia

Equipment leasing in Ethiopia can be traced far back to the mid-15th century when the relationship between the lessor and lessee was regulated by the Fetha Nagast.²²⁰ However, there has been no comprehensive legal framework that governs and regulates the business of capital goods leasing business. Modern leasing in Ethiopia was introduced in the 1960s Civil Code by which various types of contracts for lease financing business were provided. However, the Civil Code does not have detailed rules about the nature of lease contracts and the rights and obligations of the parties. To address the gaps in the existing laws concerning the capital goods leasing business and to create an enabling environment for the establishment of alternative sources of financing to bank finance, the government of Ethiopia enacted the first separate Proclamation, Capital Goods Leasing Business Proclamation No. 103/1998 in 1998.

This Proclamation provides three types of leasing that include: finance lease, hire-purchase lease, and operating lease.²²¹ According to this Proclamation, the capital goods leasing business was operated only by the lessor licensed by the MOT.²²² However, there was no single finance leasing company for 16(sixteen) years from the coming into effect of the first separate legislation. This existing gap and the need to support the development of the manufacturing sector and industrialization of the country led to the enactment of Capital Goods Leasing Business (Amendment) Proclamation No. 807/2013. The Amendment Leasing Proclamation took the regulatory power of capital goods lease financing business (hire-purchase and finance lease) from the MOT and transferred it to the NBE. The proclamation also introduced portfolio separation in such a way that financial leasing companies cannot do operation leases and vice versa.²²³

Following the mandate given by the Amendment Leasing Proclamation, the NBE licensed five lease financing companies that operate in five different regions of the country. Accordingly, the

²²⁰ Fekadu Petros (n 6) 37.

²²¹ Capital Goods Leasing Business Proclamation (n 25) Art. 2(2).

²²² Ibid, Art. 3(1).

²²³ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Articles 3(2) & 4(3).

five government leasing companies, namely: Addis CGFC, Oromia CGFC, Waliya CGFC, Debub CGFC, and Kaza CGFC, obtained capital goods finance business licenses in 2014 and currently operating in Addis Ababa, Oromia, Amhara, SNNPR, and Tigray regions, respectively. The major shareholders of these leasing companies were regional governments and the five big MFIs in the country since MFIs are allowed to invest in the leasing financing sector by the Amendment Leasing Proclamation.²²⁴ However, the reform of leasing legislation did not stimulate investment from the private sector and no independent leasing company emerged until 2019 when the first foreign-owned private leasing company (Ethio Lease Capital Goods Financing Company) was introduced. Currently, Ethio Lease officially entered into voluntary liquidation.

3.3. The Civil Code of 1960

The Civil Code provides various types of contracts for lease financing business which include: sales with ownership reserved, sales with the right of redemption, hiring sales, and letting and hiring. Sale with ownership reserved is a contract that transfers the possession of the thing to the buyer and ownership reserved to the seller until the buyer pays the full price of the things and takes ownership thereof.²²⁵ Risk is transferred to the buyer upon delivery.²²⁶ Sale with the right of redemption gives the right to the seller to take back the things sold within a maximum of two years from the date of sale.²²⁷ Ownership is not transferred from the seller to the buyer since the contract is valid for two years and the seller can take back the property after the expiry of the contract period. Hiring sale which is equivalent to the hire-purchase contract is a contract by which the lessee becomes the owner of the things after payment of the full price.²²⁸ Except for a few special rules under the hiring sale,²²⁹ the Civil Code states that “the provisions applicable to contracts of sale shall apply where the parties have described their contract as one of hiring a thing if it has been provided that the tenant of the thing will become the owner thereof upon payment of a given number of installments.”²³⁰ In addition to its cross-reference to the applicability of rules and principles of the law of sales, this provision indirectly defines contract

²²⁴ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art. 4(2).

²²⁵ Civil Code of the Empire of Ethiopia (n 24) Art. 2387(1).

²²⁶ Ibid, Art. 2388.

²²⁷ Ibid Articles 2390-2393.

²²⁸ Ibid, Art. 2412

²²⁹ Ibid Articles, 2413-2415.

²³⁰ Ibid, Art. 2412.

of hiring sale. Contracts of hiring-sale are assimilated to contracts of sale. Like in a sale with ownership reserved, the risk under hiring sale is transferred to the lessee upon delivery.

A contract of letting and hiring is defined as a contract whereby one party, the lessor, undertakes to transfer to the other party, the lessee, the possession of an object for a fixed term in return for a consideration called the rent or hire.²³¹ Contract of letting and hiring recognized under the Civil Code conceptually resembles the operating lease recognized under the Capital Goods Leasing Business Proclamation.²³²

3.4. Capital Goods Leasing Business Proclamation

Capital Good Leasing Business Proclamation No. 103/98 as amended by Capital Goods Leasing Business (Amendment) Proclamation No. 813/2013 is the main law that regulates capital goods leasing business in Ethiopia. These proclamations define capital goods, leasing, and lease agreements, and classify leasing into different categories. Leasing entities, regulatory bodies, general and special terms of the lease agreement, rights and obligations of the parties, responsibilities of the parties, taxation of leased goods, and termination and repossession of the leased goods are also addressed under the proclamation.

3.4.1. Definition of Capital Goods under Leasing Proclamation

Capital goods are durable goods that are used for the production of more capital goods as well as consumer goods.²³³ According to the Capital Goods Leasing Business Amendment Proclamation, capital goods are any equipment or machine that may be used to produce products or to provide services and include accessories.²³⁴ The Amendment Proclamation purposely provides a general definition in scope and wide enough to encompass different machinery and equipment that can be used either to produce any man-made products or to render services.²³⁵ The definition of capital goods under the Ethiopian leasing law is closer to what is designated as an asset under the UNIDROIT model law on leasing.²³⁶ According to this model law, the term asset does not include

²³¹ Civil Code of the Empire of Ethiopia (n 24), Art. 2727.

²³² Ibid, Art. 2728(1).

²³³ Birritu Magazine (n 13) 31.

²³⁴ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art.2 (8).

²³⁵ Getu Shiferaw(n 28) 39.

²³⁶ UNIDROIT Model Law on Leasing (n 108) Art 2.

money or investment securities, and no movable shall cease to be an asset for the sole reason that it has become a fixture to or incorporated in an immovable.

3.4.2. Concept of Leasing under Leasing Proclamation

Lasing is defined as ‘financing in kind for production and service purposes by which a lessor provides the lessee with the use of specified capital goods on financial or operating lease or hire-purchase agreement basis, without the requirement of collateral, for a specified period and collects, in turn, a certain amount of installment in periodical payments over the specified period.’²³⁷ Lending the equipment instead of lending the funds needed to purchase the asset is the main feature of leasing. Under the leasing agreement, there is no collateral requirement because the equipment in leasing serves an equivalent purpose to the collateral.

3.4.3. Types of Leasing under the Leasing Proclamation

The Capital Goods Leasing Business Proclamation No. 103/1998 clearly outlined three types of lease contract models; namely financial lease, hire-purchase agreement, and operating lease. Financial lease and hire-purchase are together known as capital good finance.²³⁸ Financial lease is ‘type of leasing by which a lessor provides a lessee against payment of mutually agreed installments over a specified period with the use of specified capital goods which is (a) either already acquired by the lessor; or (b) purchased by the lessor from a third party, known as the supplier, chosen and specified by the lessee; and under which the lessor shall retain full ownership right on the capital goods during the period of the lease agreement, and, subject to agreement between the two parties, the lessee may have the option to purchase the capital goods outright after the termination of the lease period at an agreed price.’²³⁹ The parties to the financial lease are a lessor, a lessee, and a supplier that would be possibly chosen and specified by a lessee. However, a financial lease does not have to be a tripartite arrangement always and the transaction can be performed only by two parties (lessor and lessee).

The second type of capital goods finance is hire-purchase. According to the Leasing Proclamation, hire-purchase is a ‘type of leasing by which a lessor provides a lessee with the use of specified capital goods, against payment of mutually agreed installments over a specified

²³⁷Capital Goods Leasing Business Proclamation (n 25) Art. 2(1).

²³⁸ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art 2(2).

²³⁹ Capital Goods Leasing Business Proclamation (n 25) Art. 2(3).

period under which, with each lease payment, an equal percentage of the ownership is transferred to the lessee and, upon effecting of the last payment, the ownership of the capital goods shall automatically be transferred to the lessee.²⁴⁰ Transfer of ownership marked the basic difference between a financial lease and a hire-purchase agreement. Under the financial lease, the ownership of the leased asset remains with the lessor, whereas in hire-purchase, ownership is progressively transferred to the lessee from the lessor in proportion to the installments paid. Under hire-purchase, payment of the last installment signals a transfer of ownership. But there is no transfer of ownership under a financial lease unless specifically agreed between the lessor and lessee.²⁴¹

An operating lease is a ‘type of leasing for a period not exceeding two years, by which a lessor provides a lessee against payment of mutual: agreed rent with the use of specified capital goods that the lessor has at hand.’²⁴² It is less of a financing instrument than the two because it does not in any way lead to the eventual transfer of ownership of the leased asset to the lessee.

However, the Leasing Proclamation is silent on Islamic lease finance (Ijarah). Ijarah is one of the essential financing contracts offered by Islamic financial institutions to meet the demand of the clients.²⁴³ Ijarah financing saw a significant increase in the global market and had a huge impact on the growth of the world economy.²⁴⁴ In Ethiopia, only the Development Bank of Ethiopia (DBE) provides Ijarah financing to SMEs.²⁴⁵ The interest free leasing service is provided in the DBE with interest free lease financing special department.²⁴⁶ The DBE also issued the Ijarah Financing Policy to regulate sharia-acceptable features that help facilitate the uniform application of Ijarah financing.²⁴⁷ Accordingly, the absence of clearly stipulated authority allowing leasing companies to offer interest-free leasing has negatively impacted the leasing

²⁴⁰ Capital Goods Leasing Business Proclamation (n 25) Art 2(4).

²⁴¹ Ibid, Art. 5(3) (a).

²⁴² Ibid, Art. 2(5).

²⁴³ Mohamud Said Yusuf & Mohamad Yazid Isa, ‘The Impact of Ijarah/Lease Financing on Malaysian Islamic Bank Performance’ (2021) *International Journal of Islamic Business*, 49.

²⁴⁴ Global growth in Ijarah and lease financing, <https://www.theasianbanker.com/updates-and-articles/global-growth-in-ijarah-and-lease-financing> accessed on 10 Feb, 2025.

²⁴⁵ Interview with the Legal Director of Corporate Legal Affairs Directorate, Development Bank of Ethiopia (18 March 2025).

²⁴⁶ Ibid.

²⁴⁷ Interest Free Ijarah Financing Policy of Development Bank of Ethiopia No. IFIFP/001/2022.

industry.²⁴⁸ This regulatory gap has restricted leasing companies from innovating their product offerings, limiting their ability to cater to market segments seeking Sharia-compliant products.²⁴⁹ Consequently, it has stifled potential growth and diversification within the industry.

3.4.4. Lessor under the Leasing Proclamation

Under the Ethiopian leasing law, a lessor is a person who engages in the business of capital goods finance. According to the Amendment Capital Goods Leasing Business Proclamation, capital goods finance can be provided under a financial lease, hire-purchase, and operating lease modality. The Amendment Proclamation made a distinction between capital goods finance and operating lease, whereby operating lease is excluded from the ambit of capital goods finance.²⁵⁰ Except for micro-finance institutions that can engage in capital goods financing business without the requirement of a specific license, only capital goods finance companies licensed by the NBE can engage in the business of capital goods finance.²⁵¹ Operating lease services can be provided by any licensed person by the MOT or other regional trade bureaus. Under the Amendment Proclamation, a person providing operating lease service cannot engage in the provision of capital goods finance and vice versa.²⁵² In this regard, the IFC with its legal and regulatory diagnostic report to the NBE recommended the total exclusion of operating lease from the leasing proclamation.²⁵³

In Ethiopia, banks are not allowed to provide leasing as one of their products. The leasing Proclamation is silent on the authority of banks to engage in leasing, whereas MFIs licensed by NBE may engage in the product without the need to obtain any additional license. The capital goods finance company shall be established as a Share Company.²⁵⁴ Accordingly, the law prohibits banks from providing leasing by clearly authorizing MFIs to provide leasing services and remain silent about such authority to the bank. Furthermore, pursuant to Article 2(6) of the Banking Business Proclamation No. 1360/2025 of Ethiopia, the definition of “Banking

²⁴⁸ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director, Micro finance institution Directorate, National Bank of Ethiopia (27 August 2024).

²⁴⁹ Ibid (n 248); Interview with the Branch Manager, Bole Branch, Addis Capital Goods Finance Company (17 August 2024); Interview with the Manager, Oromia Capital Goods Finance Company (17 August 2024).

²⁵⁰ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art 2(14).

²⁵¹ Ibid, Art. 4(1&2).

²⁵² Ibid, Articles 3(2) & 4(3)

²⁵³ International Finance Corporation Legal and regulatory diagnostic report (n 205) 9.

²⁵⁴ Requirements for Licensing of Capital Goods Finance Business Directives No. CGFB /02/ 2013, Art. 5(1)

Business” expressly excludes the provision of lease financing services, thereby establishing a clear legal boundary that prohibits banks licensed under this proclamation from engaging in leasing activities, which are reserved for separate financial institutions authorized to conduct lease financing. Interviewee from the NBE also has a similar position that banks are not allowed to provide leasing services unless they establish independent leasing companies or subsidiary companies to venture into the leasing market. Hence, only independent leasing companies and MFIs can provide capital goods finance in Ethiopia. The existing capital goods financing companies were established with the joint ownership of regional governments and MFIs.²⁵⁵ However, only a limited number of MFIs (e.g. Dire MFI) offer leasing products because of capital capital-intensive nature of the sector compared to the capital requirement of MFIs.²⁵⁶ However, DBE was authorized to engage in leasing during the year 2015/2016.²⁵⁷ In this regard, the DBE’s authority to provide leasing service does not imply that other banks are permitted to do so. It is because DBE is a policy bank and treated differently from other banks. The IFC recommended that allowing commercial banks to engage in leasing, could mean a breakthrough for leasing in Ethiopia.²⁵⁸ According to the IFC study in 2009, banks dominate the leasing market. The Nigerian, Sri Lanka, and Ukrainian experiences also show that leasing services provided by the bank dominated the leasing sector.

3.4.5. Regulatory Bodies under the Leasing Proclamation

One of the objectives of the Amendment Proclamation was to demarcate between the roles of NBE and MOT in providing licenses. The NBE has the power to license companies that provide capital goods finance business (financial lease and hire purchase) whereas the MOT licenses operating lease service-providing companies.²⁵⁹ Both the MOT and the NBE were empowered to issue directives on how to conduct the respective businesses. Microfinance Institutions Supervision Directorate (MISD), at the NBE, carries the mandate and the duty to supervise the

²⁵⁵ Currently, except Dedebit MFI, the major shareholders of leasing companies in Ethiopia was transformed into banks that Sinqe Bank, Siket Bank, Tseday Bank, and Omo Bank were major shareholders of CGFCs in their respective regions.

²⁵⁶ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248); Interview with the Legal Director, Liyu Microfinance Institution (27 August 2024); Interview with the Legal Director, Vision Fund Microfinance Institution (28 August 2024).

²⁵⁷ International Finance Corporation Legal and regulatory diagnostic report (n 205) 12; Interview with the Legal Director of Corporate Legal Affairs Directorate at the DBE (n 245).

²⁵⁸ International Finance Corporation Legal and regulatory diagnostic report (n 205) 12.

²⁵⁹ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art 3(1) &4(1).

operations of CGFCs in Ethiopia.²⁶⁰ The Amendment Proclamation provides an exhaustive list of powers to the NBE to issue directives in respect of the following matters: (a) criteria to obtain capital goods finance business license; (b) fitness and qualification criteria for directors and chief executive officers of CGFCs; (c) capital and legal reserve requirements; and (d) provisioning for doubtful accounts and depreciation of fixed assets.²⁶¹ The Proclamation also provides supervisory power to the NBE to ensure the adequacy of risk management, safety, and soundness of capital goods finance companies.²⁶² The NBE enacted about 14 directives to regulate and supervise leasing companies. The directives enacted by the NBE impose excessive regulatory requirements on the leasing companies. According to interview results with respondents from MFIs and CGFCs, excessive regulation is the main regulatory challenge facing the leasing industry in Ethiopia. There are also some researchers conducted in the area of the leasing industry in Ethiopia with similar findings.²⁶³

3.4.6. Features of Lease Agreement

The Capital Goods Leasing Business Proclamation No. 103/1998 provides the general and specific features that should be fulfilled under a lease agreement. Accordingly, the leasing agreement should generally specify the type of lease, description of the capital goods, the full price and total lease rent payable under the lease agreement, the amount of each rent, the period within which the total rent is to be paid and the date on which each installment is due, the lessee's right to terminate the contract in case of defect in the goods, liability to third party, transfer of possession right from the lessor to the lessee, and a statement about quiet possession.²⁶⁴ The special terms for the three types of lease are also provided under the proclamation which is about transfer of ownership, payment modality, and cancellation of the agreement.²⁶⁵

²⁶⁰ Birritu Magazine (n 13) 31.

²⁶¹ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art. 4(4).

²⁶² Ibid, Art. 4(5).

²⁶³ Asfaw Abera, (n 15); Fekadu Petros(n 6); Simret Aweke, The Regulation of Capital Goods Leasing Business in Ethiopia: An Appraisal on the Legal and Institutional Challenges,(2023) LLM Thesis, Department of Commercial and Investment Law, Oromia State University, unpublished; Tegegne Zergaw (n 118).

²⁶⁴ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art. 4

²⁶⁵ Ibid, Art. 5.

3.4.7. Registration of Capital Goods and Lease Agreement

Capital goods lease agreements, amendments, modifications, and termination should be registered. The Leasing Proclamations introduced a new registration system for leases and leasing agreements. MOT was given the power to register lease agreements.²⁶⁶ The same power was extended under Article 6(2) of the Amendment Proclamation which, further gives the Council of Ministers a prerogative to issue regulation on registration and supervision of capital goods in Ethiopia. This prerogative was exercised per Article 18 of the Amendment Proclamation, and the Registration and Supervision of Capital Goods and Capital Goods Leasing Agreements Council of Ministers Regulation No. 309/2014 was issued. Article 3 of the Regulation gives a duty to any person who has engaged in the capital goods leasing business to register the capital goods he has supplied to the lessee. Not only capital goods but also capital goods leasing agreements or amendment, modification, and termination of the agreements must be registered.²⁶⁷ The registering organ can be either the MOT or competent regional organs. However, capital goods and capital goods lease agreements concerning capital goods to be used in more than one region should be registered by the MOT.²⁶⁸ The Lease Regulation provides a requirement that any lessor should register a given capital good and obtain a certificate of registration of capital good before leasing.²⁶⁹ Registration is a validity requirement for capital goods lease agreements, and the certificate of registration of capital goods has to be renewed annually. However, the effect of failure to renew the certificate of registration of capital goods is not properly addressed in the regulation.

After Movable Property Security Right Proclamation No. 1147/2019 was issued, a movable collateral Registry Office was established in the NBE.²⁷⁰ Currently, capital goods registration is conducted at the office of collateral registry at the NBE.²⁷¹ This office is also mandated to guide the repossession process of capital goods.²⁷² In this regard, leasing companies are required to register capital goods at the NBE and lease agreements at the MOT. This creates practical

²⁶⁶ Capital Goods Leasing Business (Amendment) Proclamation (n 14), Art. 17(1),

²⁶⁷ Registration and Supervision of Capital Goods and Capital Goods Leasing Agreements Council of Minister Regulation No. 309/2014, Federal Negarit Gazette, 20th Year, No. 40, Art. 6(1)

²⁶⁸ Ibid, Art. 2(4).

²⁶⁹ Ibid, Art. 6(2).

²⁷⁰ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248).

²⁷¹ Ibid; Interview with the Legal Director of Corporate Legal Affairs Directorate at the DBE (n 245).

²⁷² Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248).

difficulty, especially for companies providing leasing in different regions since they are required to appear at the NBE for registration purposes.²⁷³ Therefore, the lack of clear institutional separation between the NBE and MOT regarding the registration process is a challenge in the regulation.

3.4.8. Rights and Obligations of the Parties

The lessee has the right to enjoy quiet possession of the goods during the entire lease period, use capital goods, terminate the agreement, and return the leased capital goods to the lessor, where, at the time of its transfer to him, the capital goods is found to have a defect which diminishes its usefulness to the lessee and demand the reduction of the rent or the cancellation of the agreement, where the value of the capital goods has decreased as a result of legal proceedings instituted by a third party against the lessor.²⁷⁴ A lessor has a right to collect rent and cancel the lease agreement in case of default by the lessee or in case of improper use by the lessee per the lease agreement or accepted norm or usage, and such use entails a risk of irreparable damage to the capital goods leased, and claim interest and damages even where the default is remedied within the grace period, assign its rights under the lease agreement to third parties, etc.²⁷⁵

Regarding the obligation of the parties, the lessee has also obligations to pay rent on time, insure and maintain the capital goods, take care of and preserve the capital goods in his custody, return the goods if not using the option to buy at the end of the lease, do not create any charge or encumbrance on the capital goods and inform the lessor of any impediments or disturbances to his quiet possession by third parties.²⁷⁶ The lessor has obligations to provide the capital goods to the lessee with the rights and benefits deriving from the contract, give notice of non-performance and 30 day grace period before repossession, and inform the lessee of any defects in the capital goods that the lessor is or should be aware of at the time of delivery.²⁷⁷

²⁷³ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248).

²⁷⁴ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Articles 4-11.

²⁷⁵ Ibid.

²⁷⁶ Ibid, Articles 4-14.

²⁷⁷ Ibid.

3.4.9. Termination of Lease Agreement and Bankruptcy

The lease agreement normally terminates upon the expiry of the agreed period. Unless the parties agree otherwise, the lease agreement shall not be terminated by the death or incapacity of the lessee.²⁷⁸ The financial lease terminates through performance on the agreed date because it is non-cancellable.²⁷⁹ In this regard, the lease proclamation follows the approach adopted by the UNIDROIT model law that under the model law, after the asset is delivered to and accepted by the lessee, the lessee may not terminate the financial lease unless there is a fundamental default by the lessor in respect of the warranty of quiet possession. In an operating lease, unless the lessor claims the return of the asset upon expiry of the agreed period, the agreement shall be deemed to have been extended until one of the parties' demands termination.²⁸⁰

Under the Lease Proclamation, a lessor's right of ownership, right to claim payment, and other rights as provided under the law and lease agreement may not be affected because of the bankruptcy of a lessee. A declaration of bankruptcy of the lessee may not affect the ownership right of the lessor over the leased property.²⁸¹ Additionally, all the rights and duties of the lessee and lessor remain intact during the bankruptcy proceeding and it may even continue with an organ legally subrogated to the judicially bankrupt lessor as long as the lessee performs its obligations per the terms of the lease agreement.²⁸² Under the Ethiopian Commercial Code, until the expiry of the period of notice to be given by a trustee to a lessor, movable properties used for the business or industry shall not be detained upon nor shall leases be canceled, without prejudice to provisional measures and the right of the lessor to take possession of the premises.²⁸³ The Commercial Code empowers a bankruptcy trustee to decide whether to continue or cancel the debtor's leases.²⁸⁴ In this regard, the lease proclamation follows the approach adopted by the IFC that the lease agreement shouldn't be affected unless the lessee fails to discharge its obligation.

²⁷⁸ Capital Goods Leasing Business (Amendment) Proclamation (n 14), Art. 12(2).

²⁷⁹ Ibid, Art. 5(1) (a).

²⁸⁰ Ibid., Art 12(3).

²⁸¹ Ibid, Art. 8(2).

²⁸² Ibid, Art 8(1).

²⁸³ Commercial Code of the Empire of Ethiopia Proclamation No. 166/1960, Neg. Gaz. Extraordinary 5th Year No. 1960, Art. 1040(4).

²⁸⁴ Ibid.

3.4.10. Repossession of the Leased Asset

According to IFC and the UNIDROIT model law, the legal framework should allow easy and fast repossession of leased assets. According to the IFC, voluntary return of the leased asset to the lessor without penalty other than its obligations under the lease should be allowed to the lessee. However, in case of default, the legal framework should permit non-court repossession so that lessors can repossess leased assets without going to court as long as the lessee does not contest the repossession, and the non-judicial process should be available and processed within a short period. In this regard, the lease proclamation as amended introduced repossession. If the lessee defaults during the term of the agreement, the lessor has the right to repossess the asset after granting 30 days of notice.²⁸⁵ The lease Proclamation as amended gives the right to the MOT power to take appropriate measures to ensure repossession where the lessee fails to return the asset and may order the police to facilitate the execution.²⁸⁶

In this regard, Movable Property Security Right Proclamation No. 1147/2019, Article 2(17), defines a financial lease as a contractual arrangement in which the lessee obtains the right to use an asset for an agreed period in exchange for payment. Article 2(27) includes, under the definition of movable property, the security right under a hire-purchase agreement, sale with ownership reserved, and sale with the right of redemption. Additionally, Article 2(44) defines a security right as a property right in movable property created by agreement to secure payment or the performance of other obligation. With respect to repossession, Article 81(1) & (2) establish the secured creditor's right to repossess the leased asset without court intervention in the event of default, with the assistance of collateral registry office and police force. Article 82 of the Proclamation further provides that the secured creditor may dispose of the collateral after default either by selling, leasing or licensing it through a process that specifies the method, time, place, and manner of sale or disposition. If the secured creditor chooses to transfer ownership of the collateral to the buyer at a public auction or acquire the property due to the absence of a buyer at a second auction, a procedure must comply with articles 394-449 of the Civil Procedure Code which outline the detailed procedures to be followed during auction process.

²⁸⁵ Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art. 6(1).

²⁸⁶ Ibid, Art. 6(3)

In this regard, interview results reveal that, in practice, the absence of a clear repossession procedure under the Lease Proclamation has led to lengthy court proceeding to repossess the leased asset in case of default.²⁸⁷ The IFC has also reached similar conclusion.²⁸⁸ In contrast, the Movable Property Security Right Proclamation provides a detailed and structured repossession procedure.

3.4.11. Taxation and Accounting Treatment

In principle, tax and accounting treatments for leasing are governed by separate laws to prevent conflicts between leasing regulations and specialized legislation, such as the tax code.²⁸⁹ In this regard, the government has chosen to add tax and accounting incentives in the Leasing Proclamation. For accounting purposes, the leasing law provides that depreciation allowance is deductible from the rental income received by the lessor in the case of financial lease; and in the case of hire-purchase, depreciation allowance is deductible under lessee's accounts.²⁹⁰ Rent paid by a lessee is treated as income for a lessor and an operating expense for a lessee and deductible from its income for taxation purposes.²⁹¹

Concerning VAT, all payments made to a lessor under capital goods finance are exempted from VAT.²⁹² The main principle here is that there should be no discernible differences between the tax treatment of capital goods finance and bank loans because capital goods finance is merely an alternative financing mechanism. The leasing Proclamation also provides that both a lessor and a supplier are exempted from customs duties on capital goods they import per the relevant laws.²⁹³ According to the Proclamation, relevant laws are investment laws and related regulations or directives. The foundational legal frameworks governing these provisions include the Investment Proclamation No. 1180/2020 and the Investment Incentive Regulation No. 517/2022. Investors can import capital goods and construction materials duty-free for establishing new enterprises or

²⁸⁷ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE(n 248); Interview with the Legal Director of Corporate Legal Affairs Directorate at the DBE(n 245);

²⁸⁸ International Finance Corporation Legal and Regulatory Diagnostic Report (n 205) 18.

²⁸⁹ Ibid, 12

²⁹⁰ Capital Goods Leasing Business Proclamation (n 25) Art. 16/1.

²⁹¹ Ibid, Art 16 (2&3).

²⁹² Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art 5(3).

²⁹³ Capital Goods Leasing Business Proclamation (n 25) Art 15(1); Capital Goods Leasing Business (Amendment) Proclamation (n 14) Art 5(2).

expanding existing ones.²⁹⁴ However, these goods must not be transferred to individuals without similar privileges without prior custom duty payment except on conditions prescribed in a directive to be issued by the Tax Authority which forces the investor to transfer such property.²⁹⁵ However, there are no specific directives that regulate such transfer of ownership. In this regard, a financial lease based on the interest of the lessee, and hire-purchase by its varied nature requires a transfer of ownership to capital goods, and the lessee (mostly SMEs) does not obtain an investment permit from the Ethiopian Investment Commission. Hence, they cannot benefit from duty-free privilege because they don't have similar privileges as the lessor and are required to pay customs duty. Connected to this point is the fact that NBE has not allowed regional leasing companies to import capital goods on behalf of their customers. Instead, the lessees of regional leasing companies need to get the capital goods imported by the supplier/equipment dealer.²⁹⁶ Results from all the interviewee also reveal that duty free tax incentive is always the area of concern and in practice; capital goods are not free from custom duty. The lack of clarity on the interpretation of duty-free tax incentives provided by the law was also addressed as one of the regulatory challenges in various research conducted in the area of the study.²⁹⁷

3.5. Directives of the National Bank of Ethiopia

The National Bank of Ethiopia is empowered to issue Directives to regulate the licensing and supervision of the business of capital goods lease finance companies. As a government institution with the mandate and powers of regulating financial institutions in general and capital goods finance companies in particular, the NBE has issued fourteen Directives(including amendments) to regulate the licensing and supervision of the business of capital goods finance companies. This section deals about the Directives enacted by the NBE related to capital goods lease financing business.

²⁹⁴ Council of Ministers Investment Incentive Regulation No. 517/2022, Federal Negarit Gazette, 28th Year, No. 39, Art. 12(1).

²⁹⁵ Ibid, Art. 14.

²⁹⁶ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248); International Finance Corporation Legal and Regulatory Diagnostic Report (n 205).

²⁹⁷ Getu Shiferaw(n 28); Asfaw Abera(n 15); Simret Aweke(n 263); IFC Diagnostic Study(n 205); Mengistu Ararsa, 'Challenges and Prospects of Lease Financing Small and Medium Enterprises in Ethiopia: Evidence from Development Bank of Ethiopia' (2019) MSC Thesis, Department of Accounting and Finance, AAU, unpublished.

3.5.1. Minimum Paid-up Capital Requirement Directive

The criteria for licensing of capital goods finance companies are stipulated in the Directives issued by NBE. The first requirement is a minimum capital requirement. The Minimum Paid-up Capital Requirement Directives No. CGFB/07/2017 set bifurcated paid-up capital requirements (not subscribed) for companies based on their target to a single lessee. Accordingly, a company that targets a lessee having capital goods finance requirements up to 1,000,000 Birr per single lessee should have a minimum paid-up capital of Birr 200,000,000 Birr, whereas 400,000,000 Birr is required to establish a company that targets lessees having capital goods finance requirements not exceeding Birr 30,000,000 Birr per single lessee.²⁹⁸

All interviewees of this research believe that the minimum paid-up capital requirement is set to be high to the extent it affects private investor's interest in investing in the leasing industry. Some research conducted in the area of the study also found that the minimum paid-up capital requirement is a barrier for new entrants from the private sector.²⁹⁹ On the other hand, MFIs have been allowed to engage in leasing business without the need to obtain any additional license. However, the initial minimum paid-up capital requirement for MFIs is Birr 75,000,000 Birr.³⁰⁰ In this regard, individual companies and MFIs are treated differently. However, due to stringent regulations and the capital-intensive nature of the leasing business, MFIs are not engaging in the industry as intended.³⁰¹

3.5.2. Requirements for Licensing of Capital Goods Finance Business Directives

The Directive on the Requirements for Licensing of Capital Goods Finance Business Directives No. CGFB/02/2013 describes detailed requirements the capital goods finance company should comply with during pre-application, application, and commencement of operation. For instance, a capital goods finance company, which is under formation, should prepare and submit a comprehensive business plan, articles of association, and memorandum of association as per the standard format or outlines provided by the NBE. Additionally, policy and procedure manuals

²⁹⁸ Minimum Paid Up Capital Requirement Directives No. CGFB /07/2017 Art. 4

²⁹⁹ Asfaw Abera(n 15); Simret Aweke (n 263); Fekadu Petros (n 6).

³⁰⁰ Minimum Paid-up Capital and Capital Adequacy Requirements of Microfinance Institutions Directive No. MFI/36/2023 Art. 4.

³⁰¹ Interview with the Legal Director at the Liyu MFIs (n 256); Interview with the Legal Director at the Vision Fund MFIs (n 256).

including internal audit manual, risk management guidelines, operation manual, and finance manual should be prepared and submitted to the Bank.³⁰² Capital goods finance company shall be established in the form of a Share Company according to the Commercial Code of Ethiopia.³⁰³ The Directive also set “fit and proper criteria” to be fulfilled by organizers, project managers, board of directors, chief executives officers, and persons with significant influence on envisaged companies. Fit and proper criteria are defined as ‘criteria used to assess and determine whether project managers, organizers, and persons with significant influence possess the integrity, financial soundness, competence, and capacity to discharge the responsibilities in their positions.’³⁰⁴ For instance, a project manager shall have a first degree and business experience preferably in capital goods finance-related projects, and a person nominated to be a member of the board of directors of capital goods finance companies shall hold a minimum of diploma, three years of work experience, and shall be at least 25 years old.³⁰⁵ Hence, the requirements under the Directive are very similar to requirements under Requirement for Licensing and Renewal of Banking Business Directive No. SBB/56/2013 thereby imposed excessive licensing requirements on leasing companies.³⁰⁶

3.5.3. Manner of Financial and Operational Information Reporting Directives

Manner of Financial and Operational Information Reporting Directive emphasizes that obtaining complete and relevant data from companies that engaged in capital goods finance business enables the identification of inherent risks associated with each company and the sector at large; developing reporting formats in one set eases the reporting works of companies engaged in capital goods finance business, and availing necessary data is important for calculation of financial and operational performance indicators and ratios by the NBE.³⁰⁷ This Directive requires that capital goods leasing companies submit financial and operational information and

³⁰² The Directive No. CGFB/02/2013 (n 254) Art. 5.

³⁰³ Ibid, Art. 5(1).

³⁰⁴ Ibid, Art. 2(5).

³⁰⁵ Ibid, Art. 4.

³⁰⁶ Interview with the Manager at the Addis Capital Goods Finance Company (n 249); Interview with the Manager at Oromia Capital Goods Finance Company (n 249).

³⁰⁷ Manner of Financial and Operational Information Reporting Directives No. CGFB/03/2016 Preamble.

reports quarterly within thirty consecutive days from the end of the quarter to the NBE.³⁰⁸ To submit the required information and reports, formats and tables are attached to the Directive.

3.5.4. Capital Adequacy Ratio Requirement Directives

The purpose of this Directive is to strengthen the safety and soundness of capital goods finance companies by creating a consistent capital adequacy measurement and regulating a minimum level of capital adequacy of capital goods finance companies according to the perceived level of risks of on balance sheet items, to build the level of confidence in the industry.³⁰⁹ To meet this purpose, the Directive provides for a capital adequacy measurement formula that has to be consistently applied by all capital goods finance companies. Accordingly, it states that each capital goods finance company shall maintain at all times a minimum capital adequacy ratio of 10% (ten percent) computed as a ratio of total capital to total risk-weighted assets.³¹⁰ To monitor compliance with the requirements set out under the Directive, each capital goods leasing company shall submit to the NBE a quarterly capital position report using formats attached to the Directive.³¹¹ The requirement of a 10 % maximum ratio in the Directive allied with the IFC recommendation for the sound operation of a leasing company.³¹²

3.5.5. Limits on Capital Goods Finance Exposure to Single Lessee Directive

This Directive imposed a responsibility on the board of directors of the company to manage capital goods finance concentration risk. Accordingly, the board of directors of a company shall establish, assess, and approve the capital goods finance concentration risk policy, and review this policy at least once a year.³¹³ The board shall also ensure audit and inspection, adherence to the capital goods finance concentration risk policy, and review all significant exposure to capital goods finance concentration risk at least quarterly.³¹⁴ The Directive also introduced the maximum exposure limit of a company on different bases. In this regard, the aggregate sum of capital goods finance granted to and outstanding at any one time to any single lessee shall not

³⁰⁸ Directives No. CGFB/03/2016(n 307), Art. 3.

³⁰⁹ Capital Adequacy Ratio Requirement Capital Goods Finance Business Directives No. CGFB/04/2016 preamble.

³¹⁰ Ibid, Art 4.

³¹¹ Directives No. CGFB/04/2016(n 309), Art 5.

³¹² International Finance Corporation (n 170).

³¹³ Limits on Capital Goods Finance Exposure to a Single Lessee Directive No. CGFB/09/2019 Art. 4.

³¹⁴ Ibid.

exceed 2.5 % of the total capital of the company.³¹⁵ However, for a company intending to serve lessees having relatively higher capital goods finance requirements through meeting the Birr 400,000,000 minimum paid-up capital requirement, the aggregate sum of capital goods finance granted to and outstanding at any one time to any single lessee shall be 15% of total capital for single SMEs, and 25% of total capital for single large businesses other than SMEs.³¹⁶ This exposure limit to single lessee requirements does not apply to a company partly or wholly owned by regional governments and/or city administration of the federal government.³¹⁷

3.5.6. Penalty for Failure to Comply with Regulatory Requirements of Capital Goods Finance Business Directive

The purpose of this directive is to ensure capital goods finance companies' compliance with the relevant legal and regulatory requirements at all times to enhance the level of trust and confidence of customers and also promote the healthy development of the capital goods finance sector in general.³¹⁸ To achieve this objective, the Directive provides both financial and non-financial penalties depending on the nature of the violation to be imposed on a capital goods finance company that fail to comply with or violates the NBE requirements. The Directive set a financial penalty from 5,000- 50,000 based on the nature of legal and regulatory requirements the company failed to comply with.³¹⁹ The NBE may also impose other non-financial penalties if it considers necessary including but not limited to ceasing the company from opening new branches or providing new capital goods finance until the violation is corrected.³²⁰ However, the NBE may waive the imposition of penalties on the ground that the circumstances that led to non-compliance are found acceptable.³²¹

3.5.7. Capital Goods Finance Operational Modality Directive

This Directive aims to ensure that the operation of capital goods finance companies aligns with and supports the growth and development policy objectives of the government; to support the

³¹⁵ Directive No. CGFB/09/2019(n 313), Art. 5.

³¹⁶ Ibid.

³¹⁷ Ibid.

³¹⁸ Penalty for Failure to Comply with Regulatory Requirements of Capital Goods Finance Business Directive No. CGFB/06/2017 preamble.

³¹⁹ Ibid, Art. 3.

³²⁰ Ibid.

³²¹ Ibid, Art 4.

growth and development of SMEs, and improve the manufacturing sector; and to promote market discipline and encourage the participation of private investor by putting in place enabling legal environment.³²² To achieve these objectives, the Directive set various requirements a capital goods finance company needs to comply with.

The first requirement is a determination of the lease interest rate. According to this Directive, lease interest rate on capital goods finance provided to lessees shall be freely determined by each company.³²³ The Board of Directors of each company shall set in writing a lease interest rate based upon explicit and clear criteria to be set in writing.³²⁴ Lease interest rate determined by the Board of Directors of each company and the criteria upon which they are based should be submitted to the NBE within five working days.³²⁵ The Capital Goods Finance Operational Modality Directive No. CGFB/10/2019 was amended by Capital Goods Finance Operational Modality (Amendment) Directive No. CGFB/11/2021. According to article 3 of the Amendment Directive, the lease agreement between the lessee and the company should constitute the periodic lease installment payment to be set in writing with a details schedule of payments during the lease term in Ethiopian Birr. These aim to ensure that payments for capital goods leasing transactions are conducted exclusively in Birr, rather than foreign currency. As claimed by Ethio Lease Capital Goods Finance Company, this payment modality requirement is the imminent reason for its voluntary liquidation after four years of operation in the country.³²⁶ After four years of becoming the first foreign-owned financial service company licensed by the NBE as a subsidiary of African Asset Finance Company (AAFC), Ethio Lease was no longer able to write a new lease.³²⁷

The second requirement is a prohibition of foreign-owned leasing companies to borrow from domestic funds. According to this Directive, a foreign company shall not borrow funds from the domestic financial system in any manner.³²⁸ However, a foreign company can borrow from foreign sources per External Loan and Supplier's Credit Directive No. FXD/47/2017 (this

³²² Capital Goods Finance Operational Modality Directive No. CGFB/10/2019 Preamble.

³²³ Ibid, Art 3.

³²⁴ Ibid.

³²⁵ Ibid.

³²⁶ Ethio Lease to Cease Operations in Blow to Abiy's Financial Sector Plans <https://african.business/2023/11/finance-services/ethio-lease-to-cease-operations-in-blow-to-abiy's-financial-sector-plans> (Last Accessed, 20 July 2024).

³²⁷ About us, <https://www.ethiolease.com/about> (Last Accessed, 20 July 2024)

³²⁸ Directive No. CGFB/10/2019 (n 323) Art 6(1).

Directive is repealed by External Loan and Suppliers Credit (As Amended) Directive No. FXD/82/2022) and its subsequent amendments thereof.³²⁹ The External Loan and Supplier's Credit Directive No. FXD/82/2022 set a limit of debt to equity ratio for foreign investors to borrow from foreign sources that it should not exceed 60:40 of the foreign capital.³³⁰ The Amendment Capital Goods Finance Operational Modality Directive requiring all lease agreements to have fixed payments denominated in Ethiopian Birr, and prohibiting foreign-owned leasing companies from borrowing in Ethiopian Birr made it challenging for Ethio Lease to manage currency fluctuations and maintain financial viability.³³¹ However, the governor of the NBE denies the assertion by Ethio Lease Capital Goods Finance Company that they were fully aware of the law and borrowing policies during their license.³³²

In this regard, the NBE has amended and repealed various Capital Goods Finance Directives within Ten-year span of time.³³³ Those amendments and replacements come up with various impositions and new obligations to the capital goods finance company. According to the interview all respondents, there was no experience of consultation with stakeholders conducted by the NBE before the enactment of these directives. The interview with all respondents also reveals the NBE has chosen to subject only certain Directives, which is deemed non-sensitive, to stakeholder consultation. Therefore, the unpredictability of the legal and regulatory environment was among the contributing factors to the lack of interest from private investors (domestic and Foreign) in the leasing industry. Predictability is one of the most prominent principles of rule-of-law. The rule of law demands that law be made and applied predictably thereby enables people to plan their lives per it.³³⁴ Predictability improves the efficiency of a legal system by lowering the legal resources necessary to understand the implications of an action. This is because legal predictability denotes the capability to foresee the potential legal outcomes of an action, based on existing laws, regulations, and other statutes.

³²⁹ Capital Goods Finance Operational Modality (Amendment) Directive No. CGFB/11/2021, Art 2.

³³⁰ External Loan and suppliers Credit (As Amended) Directive No. FXD/82/2022 Art 4.2.2.

³³¹ Central Bank Governor Dismisses Ethio Lease Exit Rationales as "Unfounded" <https://birrmetrics.com/central-bank-governor-dismisses-ethio-lease-exit-rationales-as-unfounded/> Last Accessed 23 July 2024).

³³² Central Bank Governor Dismisses Ethio Lease Exit Rationales as "Unfounded" <https://birrmetrics.com/central-bank-governor-dismisses-ethio-lease-exit-rationales-as-unfounded/> Last Accessed 23 July 2024).

³³³ For instance, Directive No. CGFB/01/2013 was replaced by Directive No CGFB/07/2017; Directive No. CGFB/05/2013 was replaced by Directive No CGFB/08/2017, and this Directive was also replaced by Directive No CGFB/09/2019; and Directive No CGFB/10/2019 was amended by Directive No CGFB/11/2021.

³³⁴ George G. Bailey, 'Predictability of the Law; Its Relation to Respect for Law' (1963) 66 West Virginia Law review 1.

The third requirement is a compulsory target market that capital goods finance companies shall primarily focus on and provide their capital goods finance services. According to this Directive, a company shall put in place within its internal policy and procedure on how to address/serve the capital goods financing need of the manufacturing sector and SMEs including the allocation of a certain percentage of its portfolio.³³⁵

3.5.8. Requirement for Information Technology (IT) Management of Capital Goods Finance Company Directive

The NBE enacted this directive intending to improve the efficiency, effectiveness, and competitiveness of capital goods financing company through the support of information technology and ensuring the safety and soundness of the sector by identifying and managing risks associated with the usage of information technology.³³⁶ To achieve this regulatory objective, the Directive prescribes general and specific requirements to capital goods finance companies. In this regard, the general requirement includes the description and inclusion of the role of IT in the company's business strategy; development and implementation of IT strategy; ensuring the coherence of IT strategy with the company's business strategy; ensuring proper implementation of IT strategy; allocation of financial and human resources to effectively implement IT strategy; development and implementation of effective project and IT vendor management framework; review the progress and implementation of IT related plans on quarterly bases.³³⁷ Whereas, the specific requirement includes automation of the core business process of a company; management of IT risks with institutions' risk management program; development and implementation of IT risk management strategies, policies, plans, and standards; annual IT security awareness plan for employee and stakeholders; conducting IT audit; and reporting the IT incidents that could have a significant impact on the company's ability to provide service within 2(Two) working days after the incident.³³⁸ Regarding training and awareness, the Directive provides that a capital goods finance company shall prepare an annual IT security awareness plan and provide training to enhance the awareness of all concerned stakeholders and employees of the company. However, the absence of centralized IT-

³³⁵ Directive No. CGFB/11/2021(n 330), Art 2.

³³⁶ Requirements for Information Technology (IT) Management of Capital Goods Finance Company Directive No. CGFB/12/2022 preamble.

³³⁷ Ibid, Art 4.

³³⁸ Ibid, Articles 4-10.

related training by the NBE for capital goods finance company staff has led to inconsistent knowledge, and regulatory non-compliance contributing to a lack of awareness about It security, digital financial services, and operational efficiency.³³⁹ Establishing a standardized training program would enhance staff competency, improve compliance, and strengthen the overall financial ecosystem.

3.5.9. Licensing and Credit Information Fees of Capital Goods Finance Companies

Directive

The NBE enacted this Directive with the view of improving the service quality provided to customers.³⁴⁰ The Directive provides different amounts of fees depending on the type of service requested by a capital goods finance company.³⁴¹ Accordingly, a company applying to obtain a new license shall pay 150,000 Birr (investigation and licensing fee); whereas a company shall pay 10,000 Birr to renew a license.³⁴² A capital goods finance company shall also renew its business license every year. On the other hand, a capital goods finance company applying for a new branch or replacement is required to pay a licensing fee of 4,000 Birr per branch. Furthermore, the Directive provides different amounts of fees to obtain credit information based on the amount of aggregate loans requested.

3.5.10. Opening, Relocation, and Closure of Branch Offices of Capital Goods Finance

Companies Directive

This Directive aims to ensure the safety and soundness of capital goods finance companies through sound and prudent practices during branch office opening, relocation, and closure activities.³⁴³ The Directive set out a precondition to open new branch and commence operation such as a feasibility study; adequate training to assigned staff on policies and procedures of the company, relevant National Bank Directives, and AML/CFT requirements; ensuring all relevant

³³⁹ Interview with the Manager at the Addis Capital Goods Finance Company (n 249); Interview with the Manager at Oromia Capital Goods Finance Company(n 249).

³⁴⁰ Licensing and Credit Information fees of Capital Goods Finance Companies Directive No. CGFB/13/2022 preamble.

³⁴¹ Ibid, Art 4.

³⁴² Ibid.

³⁴³ Opening, Relocation and Closure of Branch Offices of Capital Goods Finance Companies Directive No. CGFB/14/2022 preamble.

policy and procedure manuals, directives of National Bank and laws related to AML/CFT are distributed to appropriate staff members of the branch; ensure the branch is guarded at all time, etc.³⁴⁴ A capital goods finance company that has opened a new branch office shall get a branch license from the NBE within 30 working days after the commencement of operation.³⁴⁵ Additionally, the Directive set clear requirements to close a branch of a capital goods finance company. In this regard, a capital goods finance company shall get written approval from the NBE to close its branch office. A capital goods finance company that intends to close its branch office shall ensure that the concerned customers of the office are notified before the closure of the office and that the interests of the customers are protected.³⁴⁶

3.6. Regulatory Reforms and Future Prospects to Capital Goods Lease Financing Sector in Ethiopia

The Capital Goods financing sector in Ethiopia is at a critical juncture, with ongoing regulatory reforms aimed at fostering a more structured and efficient leasing industry. Leasing plays a crucial role in facilitating access to capital goods, particularly for small and medium enterprises (SMEs) that may struggle with traditional financing options. However, the sector has faced challenges due to regulatory gaps and institutional inefficiencies. This section examines the major reforms and initiatives shaping the future of lease financing in Ethiopia which include the Draft Capital Goods Financing Business Proclamation, and establishment of the National Leasing Association and their impact.

3.6.1. The Draft Capital Goods Financing Business Proclamation

Despite certain reforms in the legislative framework of capital goods financing business in Ethiopia,³⁴⁷ many constraints and threats still hamper the full development of the capital goods finance market in the country. To address these market and government-regulatory failures, the NBE signed a cooperation agreement with IFC in 2018, with the objective that IFC would work closely with the NBE to support additional improvements to financial leasing operations and

³⁴⁴ Directive No. CGFB/14/2022(n 344) Art. 4.

³⁴⁵ Ibid.

³⁴⁶ Directive No. CGFB/14/2022(n 344), Art 5.

³⁴⁷ For instance, Capital Goods Finance Operational Modality Directives No. CGFB/10/2019 lifted several restrictive policies that include lifting of the interest-rate cap, access to foreign borrowings, allowance to include big-ticket leases within portfolios, and increase of the single borrowers' credit limit.

upgrade the legal and regulatory environment.³⁴⁸ Accordingly, as mandated by NBE, IFC has analyzed the existing legal and regulatory framework for the capital goods finance business and proposed to the Government of Ethiopia, to revise the existing Capital Goods Leasing Proclamation and enact a comprehensive Proclamation.³⁴⁹ Based on the recommendation, a comprehensive Capital Goods Financing Business Proclamation was drafted in 2023.

The purpose of the Draft Proclamation is to build an efficient, resilient, and well-functioning financial market ecosystem that creates an enabling business environment and provides affordable access to finance for investors, and to reform the existing capital goods financing business legal and regulatory frameworks and address the market challenges to create a conducive environment that fosters the development of capital goods financing as an alternative source of finance.³⁵⁰ The Draft Proclamation applies to any financial institution engaged in capital goods financing including banks, micro-financing institutions, capital goods financing businesses, or any other financial institution duly licensed and/or authorized under Ethiopian law to engage in capital goods financing business.³⁵¹ In this regard, under the Draft Proclamation, banks are authorized to engage in capital goods financing business.

According to the Draft Proclamation, the purpose and activities of a capital goods finance company shall be to raise funds from various sources and provide capital goods financing to lessees, subject to terms and conditions as may be determined by the NBE.³⁵² Accordingly, a capital goods finance company based on the approval of the NBE may engage in activities which include a collection of funds from the public; raising equity on the capital market, issuing corporate bonds and/or debentures; providing access to capital goods to the lessee; provide access to any other forms of asset-based financing; provide insurance service to their lessees, purchase income-generating financial instruments such as treasury bills and other short-term instruments determined by the NBE; acquire, maintain, and transfer any movable and immovable property; and other activities specified by the NBE Directives.³⁵³

³⁴⁸ Interview with the Senior Lease Finance Examiner/Representative Lease Finance Director at the NBE (n 248); IFC diagnostic study International Finance Corporation Legal and regulatory diagnostic report (n 205).

³⁴⁹ Ibid.

³⁵⁰ Draft Capital Goods Financing Business Proclamation (n 219), Preamble.

³⁵¹ Ibid, Art 4.

³⁵² Ibid, Art 3.

³⁵³ Ibid.

According to the Draft Proclamation, except for operating lease(which can be operated based on the Commercial Code or Civil Code of Ethiopia), it is prohibited to engage in capital goods financing without a license from the NBE.³⁵⁴ However, a bank or micro-financing institution may engage in financial leasing (but they cannot do an operating lease) with their existing license with special approval from the NBE.³⁵⁵ Leasing can be conducted with financial leases, hire-purchases, operating leases, interest-free leases, and other forms of asset-based financing modalities.³⁵⁶ Interest-free capital goods financing is defined under the Draft Proclamation as ‘any activity of a capital goods finance company but complying with interest-free principles.’³⁵⁷

The Draft Proclamation also comprises detailed requirements which are found scattered in different NBE directives. In this regard, Draft Proclamation provides about different matters which include licensing requirements;³⁵⁸ conditions for licensing;³⁵⁹ issuance, renewal, and revocation of license;³⁶⁰ commencement of operation;³⁶¹ fit and proper criteria;³⁶² financial requirements;³⁶³ auditing and reporting³⁶⁴ financial records and disclosure of information³⁶⁵ risk management mechanisms³⁶⁶ examination and supervision of a capital goods finance company.³⁶⁷

The Draft Proclamation also provides about the formation of the contract. Parties (the lessor, lessee, and/or borrower) can freely negotiate agreements within the limits of the law. In this regard, the draft proclamation empowers the lessor, and lessee or borrower to derogate from or vary the effect of the proclamation when determining the content of a lease agreement by mutual agreement.³⁶⁸ The Draft Proclamation requires that agreement must be written and include payment terms, conditions for default and termination, and the rights and obligations of the parties. It also provides the special terms and conditions each lease financing modalities

³⁵⁴ Draft Capital Goods Financing Business Proclamation (n 219),, Art 5.

³⁵⁵ Ibid.

³⁵⁶ Ibid, Art 2(6),

³⁵⁷ Ibid, Art 2(16),

³⁵⁸ Ibid, Art 5.

³⁵⁹ Ibid, Art 6.

³⁶⁰ Ibid, Articles 7-9.

³⁶¹ Ibid, Art 10.

³⁶² Ibid, Articles 13-15.

³⁶³ Ibid, Art. 18.

³⁶⁴ Ibid, Articles 16 &17.

³⁶⁵ Ibid, Art. 19.

³⁶⁶ Ibid, Art 23.

³⁶⁷ Ibid, Art 20.

³⁶⁸ Ibid, Art. 24.

(financial lease, hire-purchase, operating lease, and other asset- based financing agreement) shall at a minimum comprise.³⁶⁹

Regarding rights and obligations of the parties, the lessor has the right to receive rental payments, monitor asset usage, terminate agreements, and recover assets upon default. The lessor should purchase and deliver capital goods, keep free and clear from third-party encumbrance to capital goods and transfer the title to the lessee at the end of the lease term, extend to the lessee the benefits of the equipment supplier's promises to the lessor under a supply agreement, perform all and any other obligations provided under a lease agreement.³⁷⁰ The rights of the lessee provided under the Draft Proclamation include: (1) to select the capital goods and supplier(in financial lease), (2) to reject defective goods, (3) to enjoy full use of leased assets, and (4) to request compensation for losses incurred in the case of default or breach by the lessor.³⁷¹ Whereas, the lessee should make timely payments, maintain and use the asset with proper care, and return the assets after the lease expires.³⁷²

The NBE is the only regulatory body provided under the Draft Proclamation. In this regard, an operating lease is excluded under the Draft Proclamation and the conduct of the operating lease shall do so under the Commercial Code and Civil Code of Ethiopia.³⁷³ The proclamation also provide that all security interest in the capital goods lease agreement shall be registered in the Collateral registry Office established by the NBE.³⁷⁴ In this regard, the Draft Proclamation addresses the problems caused by the lack of institutional separation under the leasing proclamations. The Draft Proclamation authorizes foreigners to invest in the country's leasing business,³⁷⁵ introduce among other things interest-free capital goods financing, and the right to capital goods finance company to transform to the bank or any other financial institutions upon authorization by the NBE.³⁷⁶ According to the Draft Proclamation, a capital goods finance company that reinvests its profit is exempted from profit tax.³⁷⁷ In addition, capital goods finance companies are exempted from customs duty to import capital goods per relevant investment

³⁶⁹ Draft Capital Goods Financing Business Proclamation (n 219), Art. 26.

³⁷⁰ Ibid, Art 29.

³⁷¹ Ibid, Art 30.

³⁷² Ibid, Art. 31.

³⁷³ Ibid, Art. 5(2).

³⁷⁴ Ibid, Art 64.

³⁷⁵ Ibid, Art. 57.

³⁷⁶ Ibid, Art. 52.

³⁷⁷ Ibid, Art. 49.

incentives, proclamations, and directives.³⁷⁸ In this regard, the Draft Proclamation is not in line with the IFC recommendation to give special treatment of tax and customs duties to capital goods financing businesses through separate laws.

3.6.2. Formation of National Leasing Association

The national leasing association has great significance in improving coordination and advocacy within the leasing industry. The primary objectives of the leasing association include: representing the interest of leasing companies and financial institutions in policy discussions, standardizing leasing practices and ensuring regulatory compliance, facilitating capacity-building programs for industry players, and creating a platform for knowledge-sharing and market research.³⁷⁹ The Association of Ethiopian Capital Goods Finance was officially launched on 23 May 2024.³⁸⁰ As the absence of well well-organized training program and lack of stakeholder consultation during legal enactments and amendments are among the challenges facing capital goods financing business in the country, the national leasing association will help lobby leasing legislative reforms and enhance the capacity of lessors and employees through well-organized and tailored training. In this regard, National Leasing Association can have an impact on the drafting process of the Draft Proclamation, and other required legal and regulatory improvement initiatives.

³⁷⁸ Draft Capital Goods Financing Business Proclamation (n 219), Art 50.

³⁷⁹ Camellia Catalina, 'Leasing Financing in the Current Global Context' (2020) European Journal of Accounting and Finance and Business, vol 12.

³⁸⁰ Fana Bc (2024), <https://www.fanabc.com/english/association-of-ethiopian-capital-goods-finance-officially-launched-to-encourage-smes/> Accessed on 21 Aug 2024).

Chapter Four

Conclusion and Recommendation

4.1. Conclusion

Lease financing emphasizes the generation of profits through the utilization of assets rather than their ownership. It allows businesses, particularly startups and SMEs with limited credit history of insufficient collateral, to access necessary assets by focusing on cash flow from operations to meet lease payments. The absence of collateral requirements makes leasing advantageous in weak business environments, as the lessor retains ownership and can reclaim assets upon default. Leasing serves as an effective alternative to traditional borrowing, facilitating a tripartite relationship between the lessee, lessor, and the supplier.

Leasing, though historically rooted, has significantly evolved over the past five decades. Modern leasing began in the 1950s in the United States as a specialized financial service, later expanding to Europe, Japan, and developing countries from the mid-1970s. The growth of leasing companies, particularly in developing nations, has accelerated in the last decade due to its economic advantages. Leasing enhances domestic investment, strengthens financial sector, and broadens access to financial instruments for businesses.

In Ethiopia, the first leasing law, the Capital Goods Leasing Business Proclamation No. 103/1998 was enacted to address the equipment and machinery financing needs of SMEs. The Proclamation mandated that leasing companies be licensed and supervised by the MOT and recognized three leasing types: operating lease, financial lease, and hire-purchase. However, only operating leases were commonly practiced, while financial leases and hire-purchase were not fully implemented. This gap led to the amendment of the law, resulting in the Capital Goods Leasing Business (Amendment) Proclamation No. 807/2013, which empowered the NBE to license and regulate capital goods leasing companies. The Amendment Proclamation clarified the distinct responsibilities of the NBE and MOT concerning the licensing, regulation, and supervision of leasing companies, as well as the registration of capital goods and lease agreements. Consequently, the NBE was authorized to license and oversee capital goods finance companies engaged in financial leasing and hire-purchase, while the MOT remained responsible for operating leases and registration. This legal framework strengthened the sector, leading to the

licensing of five capital goods finance companies in early 2014, supported by regional governments and major MFIs. These companies began providing leasing services in their respective region by mid-2014.

To strengthen the leasing sector, the Council of Ministers issued Regulation No. 309/2014, mandating the MOT and regional bureaus to regulate and supervise the registration of capital goods and lease agreements. The regulation emphasizes that unregistered agreements have no legal validity and must be registered to ensure enforceability, especially regarding repossession rights in case of lessee default. In order to regulate and supervise capital goods finance companies, the NBE so far has issued fourteen directives that regulate the minimum paid-up capital requirements, licensing requirements, financial and information reporting modality, capital adequacy ratio requirements, limits on financing exposure to single lessee, penalty for failure to comply with regulatory requirements, operational modality, information technology management requirement, licensing and credit information fee, and opening, relocation, and closure of branches.

The Ethiopian leasing industry continues to face significant challenges despite the introduction of leasing legislation and the allocation of responsibilities to the NBE and the MOT for licensing, regulation, and supervision. These challenges stem primarily from regulatory gaps and institutional inefficiencies. Although the government has initiated efforts to develop comprehensive leasing legislation aimed at shaping the future of lease financing, key regulatory issues and potential reforms remain critical areas of inquiry for this research.

The study identifies several regulatory obstacles in the capital goods lease financing sector, including unclear legal framework regarding the conduct of capital goods lease financing business through interest free leasing modality, prohibition of local commercial banks in the leasing sector, excessive regulation, lack of clear institutional enforcement to registering capital goods and capital goods lease agreement, and limited clarity on tax incentives. Additionally, uncertainty in the regulatory environment and absence of structured training programs for stakeholders and employees further hinder the sectors development.

Findings related to the second research question, indicate that regulatory and legal barriers significantly constrain the growth of lease financing. Nonetheless, recent government initiatives such as the drafting of a comprehensive Capital Goods Financing Business Proclamation and the

formation of a National Leasing Association are regarded as promising steps toward addressing these challenges and advancing the sector.

4.2. Recommendations

- It is recommended that the Ethiopian government adopt a comprehensive approach that incorporates international best practices and experiences in the implementation of leasing regulations. Specifically, the government should consider allowing banks to participate as lessors in the leasing industry to enhance access to finance. Additionally, promoting interest free leasing models would broaden financial inclusion and support divers market needs.
- It is recommended that the Ethiopian government revise the existing regulatory framework to introduce greater flexibility in the leasing industry. A more adaptable regulatory approach would encourage innovation, attract private sector participation, and accommodate divers leasing models, including conventional and interest-free arrangements. By reducing excessive regulatory barriers and allowing room for market-driven practices, the government can create an enabling environment that supports the sustainable growth and competitiveness of the leasing industry in Ethiopia.
- It is recommended that tax provisions and related to lease financing, including custom duty and VAT exemptions, be addressed under separate and dedicated legislation. This would help avoid confusion with other laws and regulations, and ensure clear and consistent implementation of the incentives granted under the leasing Proclamation.
- It is recommended to establish a clear institutional separation between the NBE and MOT regarding the registration of lease agreements and equipment. This will help avoid overlapping responsibilities, minimize bureaucratic delays, and prevent inconveniences for leasing companies during the registration process. Clear mandate and coordination mechanisms should be defined to ensure efficient service delivery and smooth operations for the private sector.
- It is recommended that the NBE establish a well-organized and structured training program for lease financing employees and relevant stakeholders. This program should aim to enhance their knowledge and capacity in lease financing operations, regulatory requirements, IT managements, and best practices. Providing continuous professional

development will strengthen the sector, ensure compliance, and improve service delivery across the industry.

- It is recommended that the NBE conduct thorough stakeholder consultations before the enactment of any Directives related to the leasing sector. Engaging relevant stakeholders including industry players, financial institutions, and other concerned parties will help ensure transparency, enhance predictability, and create Directives that are practical and supportive of the sector's development. This consultative approach will also foster better compliance and alignment with market realities.
- It is strongly recommended that swift action be taken to finalize and enact the draft Capital Goods Financing Business Proclamation. Given the common delays in the legislative process in Ethiopia, fast tracking this proclamation is crucial to create conducive legal framework for the leasing industry. The Proclamation should incorporate key provisions including the exclusion of operating leases, special tax treatments, the inclusion of banks in the leasing industry, allowance for interest-free leasing, and alignment with international best practices. Prompt enactment will enhance sector growth, attract investment, and support the broader economic development goals.

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Interviews

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- Interview with the Legal Director, Liyu Microfinance Institution, 27 August 2024
- Interview with the Legal Director, Vison Fund Microfinance Institution, 28 August 2024
- Interview with the Branch Manager, Addis Capital Goods Finance Company, 17 August 2024
- Interview with Davison Manager, Oromia Capital Goods Finance Company, 17 August 2024
- Interview with Corporate Legal Affairs Directorate Director, Development Bank of Ethiopia, March 18 2025

Interview Questions

Interview Questions for the NBE

1. Why banks are not allowed to engage in capital goods lease financing business in Ethiopia?

2. Did the NBE ever encounter with licensing application for capital goods lease financing business which banks were shareholders?
3. What are the methods employed by the NBE to enact directives?
4. Are there any MFIs engaged in capital goods lease financing business with the existing license?
5. Why MFIs and capital goods lease financing business treated differently toward the minimum paid-up capital requirement?
6. Is there any special training program employed by the NBE for capital goods lease financing business staff/employees and stakeholders?
7. Did the NBE encounter any issue of overlap of institutional power with MOT?
8. What are the regulatory challenges facing capital goods lease financing business in Ethiopia? If any, what is the response of the NBE towards addressing the Challenge?
9. What are the regulatory forms regarding the capital goods lease financing business in Ethiopia?
10. Does Ethio Lease make any contact with the NBE towards reconsidering its decision to voluntary liquidation following the country's change of economic policy to macro economy?

Interview Questions for MFIs

1. Is the MFI you work in engaged in capital goods lease financing business? If yes, in what model, on equity or as a mix of microfinance work? If not, why?
2. What are the regulatory challenges facing capital goods lease financing business in Ethiopia?
3. What are the regulatory reforms regarding the capital goods lease financing business in Ethiopia?

Interview Questions for CGFCs and DBE

1. Do you ever participate as a stakeholder in the legislative drafting process of those Capital Goods Lease Financing Business Directives? If yes, how did the NBE receive the Company reflection on the draft directives?
2. How does the ex-post regulatory impact/challenges to your company report to the NBE, if any?

3. Is there any specialized training program developed by the NBE for your company?
4. Does your company properly benefit from tax incentives provided in-laws?
5. Does the supervision by NBE and MOT create any difficulty in your company's performance?
6. What are the regulatory challenges facing capital goods lease financing business in Ethiopia, and your company in particular?
7. What are the regulatory reforms regarding the capital goods lease financing business in Ethiopia?