

**MEKELLE UNIVERSITY**  
**COLLEGE OF BUSINESS AND ECONOMICS**  
**DEPARTMENT OF ACCOUNTING AND FINANCE**



**DETERMINANTS OF LOAN DEFAULT IN LEASE FINANCING**

**A CASE OF DEVELOPMENT BANK OF ETHIOPIA**

*A Thesis Submitted to the College of Business and Economics;  
Department of Accounting and Finance in Partial Fulfilment of the  
Requirements for the Master of Science (MSc) Degree in Accounting  
and Auditing*

**By: BELAY TAFESSE**

**ID No: CBE/PE/137/11AA**

**ADVISOR: ABEBA KELELEW**  
**(Assistant Professor)**

**September 2024**  
**Addis Ababa, Ethiopia**

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**APPROVAL SHEET**

Approved by:

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Advisor

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Co-Advisor

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Internal examiner

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External examiner

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**COLLEGE OF BUSINESS AND ECONOMICS**  
**DEPARTMENT OF ACCOUNTING and FINANCE**

**CERTIFICATION**

This is to certify that this thesis is entitled “determinants of loan default in lease financing (a case of development bank of Ethiopia)” submitted by me for the award of Masters of Science (MSc) in Accounting and Auditing at Mekelle University, through the department of Accounting and Auditing , done by Belay Tafesse, Id. No. CBE/PE/137/11AA is an authentic work carried out by him under our guidance. The matter embodied in this project work has not been submitted earlier for awards of any degree or diploma to the best of our knowledge and belief.

Principal Advisor: Abeba Kelelew (Asst. Professor) Signature\_\_\_\_\_Date\_\_\_\_2024

Co-advisor: ( ) Signature\_\_\_\_\_Date\_\_\_\_2024

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**DECLARATION**

I, Mr. Belay Tafesse hereby declare that the thesis entitled “determinants of loan default in lease financing (a case of development bank of Ethiopia)” submitted by me for the award of Masters of Science (MSc) in Accounting and Auditing at Mekelle University is my original work and it has not been presented for the award of any other degree, Diploma, Fellowship or any other similar titles of any other university or institutions.

Place: Addis Ababa, Ethiopia

Signature\_\_\_\_\_

Date: September 2024

Name: Belay Tafesse

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## ***ABSTRACT***

This study identifies determinants of lease loan default, including Lessor related, Lessee related and external factors, on lease loan default. The aim of this research was to examine determinants of lease loan default; there is a causal relationship between each factor and lease loan default. The study utilizes primary data collected through a close-ended questionnaire. The study presents the results obtained from 75 survey questionnaires completed by customers of selected districts of DBE. To present and describe the respondents' demographic characteristics, descriptive data analysis using tables was employed. For examining determinants of lease loan independent variable (Lessor related, Lessee related and external factors) on the dependent variable (lease loan default), an explanatory research design is adopted, employing regression analysis. The collected data is analyzed using descriptive statistics, correlation analysis, and regression analysis through SPSS software. The correlation analysis reveals a Moderate association between Lessor related factors, Lessee related factors weakly related with External factors and lease loan default ( $r=0.534$ ,  $0.0617$ , and  $0.0895$  respectively,  $p<0.01$ ). The regression result found that independent variables such as lack of credit monitoring, appraisal, KYC and longer lease processing time, lack of educational literacy, managerial experience and inappropriate business location, political instability, foreign currency fluctuation and inflation, significantly and positively influence lease loan default. Therefore, these factors primarily determine the lease loan default in Development Bank of Ethiopia. Therefore, the Development Bank of Ethiopia should prioritize improving its operations to mitigate the risk of defaults and consider location-based risk assessments when extending leases to lessees, particularly in regions with less favorable economic conditions. It is also crucial for DBE to factor external influences when assessing credit risk and designing lease agreements, and government and policy makers should have to maintain external factors in order to have sound finance through lease.

Key words: Lease loan default, Lack of Monitoring and Controlling, Inappropriate KYC and Appraisal,

# **CHAPTER ONE**

## **1. INTRODUCTION**

### **1.1. Background of the Study**

Investment on a productive sector is the precondition for achieving the economic growth from a country perspective. Capital formation positively supports this investment function. Once a satisfactory level of capital is formed, the option of sound investment comes, that ultimately leads to flow of capital in the future. Financial institutions, mainly banks do these functions through different mechanisms such as loans (Islam, 2009). Provision of resources (granting loan) by one party to another is termed as lending. Lending presumes the fact that the second party doesn't reimburse the first party immediately rather arranges either to repay or return those resources at a later date, making it a debt. Leasing can be traced back 5,000 years to ancient Greece and the Middle East, where it was used in agricultural transactions. The mechanization of agriculture and the Industrial Age brought further specialization to leasing (Bass and Henderson 2000). Leasing was known in ancient Babylon in 2000 BC. Including leasing practice in economic relations took place in the year 1877, when telephone company 'Bell' decided not to sell the telephone appliances made by them, but to lease them. The lease of asset started in the USA and in Europe to business and industry development since World War II. At present thousands of businesses which are long on ideas and short on cash are using leasing as a simple and flexible financing solution to increase productivity and generate profits. Most international capital flows are just exchanges of assets between rich countries and are not flowing to poor countries to enhance their development (Obstfeld and Taylor 2004).

Development finance institution means an institution which is engaged mainly in medium and long term project finance business, with the purpose of promoting development in the industrial, agriculture, construction, services, commercial or other economic sectors (NBE Directive, 2012). Development Banks are state backed financial institutions that are engaged in the provision of long term loans to not only profitable projects but also to socially beneficial ones.

Financial institutions in Ethiopia operate under Conducive regulatory framework and directives to ensure financial stability and financial sector soundness. The micro financing institutions licensed by the National Bank of Ethiopia may engage in capital goods finance business without the need to obtain any additional license (Proc.No. 807/2013).

Accordingly, the credit policy of Development Bank of Ethiopia (2009) details the governing operational principles and guidelines of the Bank for achieving its dual objectives of (1) providing customer focused and efficient credit services and (2) maintaining its own financial health and sustainability (DBE Credit Policy, 2009).

To this end, the Development Bank of Ethiopia (DBE) has developed its internal lease financing policy and procedure to entertain small and medium enterprises (SMEs). Moreover, based on credit policy and procedure of the Bank dated October, 2015, Capital Goods Proclamation No.103/1998 and 807/2013, the Bank has customized and endorsed its lease financing policy and procedure in January, 2016 so as to operate lease financing service.

Poor asset quality leads nonperforming loan that can seriously damage a banks' financial position having an adverse effect on banks operation (Lafuente, 2012). The sustainability of the bank depends not only on domestic and foreign source of fund but also on its loan recovery rate too. One of the measurements by which bank's asset quality can be measured is the default loan ratio (NPLs ratio). Hence, in order to get soft loan from its lenders, DBE's asset quality has to be regularly monitored and assessed whether it is within the acceptable standard or not that is 15% of the total outstanding loan which is set by Association of African Development Finance Institutions. Investigation of the various aspects of loan defaults, source of credit, purpose of the loan, form of the loan, and condition of loan provision are of utmost importance both for policy makers and the lending institutions. Even if default is random and influenced by unpredictable behaviour's or it is influenced by certain factors in a specific situation needs an empirical investigation so that the findings can be used by any financial institutions to manipulate their credit program for the better. Most of the default arose from poor management procedures, poor loan appraisal and unwillingness to repay loans, etc. Because of this, the lenders must give various institutional methods that aimed to reduce the risk of loan default (Ahmmed *et al.*, 2012).

Consequently, to reduce the default rate and to enhance the sustainability of the bank, it is imperative that identifying the various determining factors which significantly affect the lease loan repayment performance.

## **1.2. Problem Statement**

Economic development in any country is impossible without a sound Banking industry (Raman and Visishtha, 2002). On the other hand, loans are the dominant assets and account the highest percentage share of operating income and at the same time it represents Bank's greatest exposure to risk of defaults (Mac Donald and Koch, 2006). Good performance of financial institutions is the symbol of prosperity and economic growth in any country or region and poor performance of these institutions not only hamper the economic growth and structure of the particular region but also affects the whole world (Muhammad et al, 2012). Loan default, as an indicator of poor performance of banks, have gained the attention of scholars in the field in the last three to four decades as increasing NPLs are causing crisis in the banking industry (Barr and Siems, 1994). NPLs are one of the main reasons that cause insolvency of the financial institutions and ultimately hurt the whole economy (Mohammed et al, 2012). The causes of loan default vary in different countries due to differences in macro-economic situations. Both internal and external factors affect the soundness of bank financing. Theoretically, there are so many reasons as to why loans fail to perform. Some of these include depressed economic conditions, high real interest rate, inflation, lenient terms of credit, credit orientation, high credit growth and risk appetite, poor monitoring and other related factors.

It is believed that SMEs play a key role in economic development and make an important contribution to GDP growth and employment creation. More than 95 percent of registered firm involved in SME business account for more than 50 percent of jobs, and contribute more than 35 percent of Gross Domestic Product (GDP) in many emerging markets (WB 2017) which have vital role of one country economic growth and development.

While the lack of decent financial service for SMEs is at the heart of poverty battle in Ethiopia, the fact that SMEs experience greater difficulties in financial market is additional concern and specific unemployment challenges. Financing SMEs are essential in reducing poverty not only because of the direct contribution they make to household welfare but also because such financing minimize income inequality among the society.

The World Bank (2011) revealed that Ethiopia a lags behind other Sub-Saharan Africa's countries and developing countries in terms of lending to SMEs. The share of SME lending in

overall lending portfolio in Ethiopia is in fact only 7 percent, among the smallest shares in Sub-Saharan African Countries as well as far below that of developing economies.

The government of Ethiopia takes its initiative with the enactment of Proclamation no. 807/2013 on Capital Goods Leasing Business (actually an amendment to proclamation no. 103/1998), Directive no. CGEB 102/2013 for the Licensing of Capital Goods Finance Service by the National Bank of Ethiopia(NBE) and the Capital Goods Finance Service Modality issued by the Federal Micro and Small Enterprises Development Agency. These government measures support those investors who have the desire, knowledge, and profession to participate in various investment activities but could not act due to lack of capital and collateral through creating an enabling environment for the establishment of alternative sources of financing.

The major and eye-catching action taken by the government in this respect include the enactment of Capital Goods Leasing Business Proclamation no. 103/1998 and its amendment proclamation no 807/2013, Directive no. CGEB 102/2013 for the licensing of Capital Goods Finance Service by the National Bank of Ethiopia (NBE).

Despite the recognized importance of the SME sector and its intervention by Development Bank of Ethiopia which has been mandated to curb the acute financial constraint of the missing middle group, evidence indicates that SMEs continue to be undersupplied with the lease financing service that are critical to their growth. SMEs that apply for lease financing service failed to access finance to date as result of Banks eligibility criteria in relation to work premise and infrastructure, logistic and supply chain problem, lease financing policy and procedure, limited technical skill to handle machineries, extended lease financing duration, the inability to block 20% equity contribution, character of SMES compared with other business firms are among many reasons that SMEs continue to be undersupplied in lease financing service. DBE is the only government financial institution that engages in lease of small and medium enterprises. June 4 2017 and 2018 Annual reports of the Bank listed out a number of challenges and less performed plan against actual.

In addition to this, as per the Bank annual report of 2019/2020 there are lease projects which fall in default loan that indicated in substandard, Doubtful and loss category , 55 lease projects, 45 lease projects and 38 lease projects accordingly, and the NPL ratio of lease projects reach 27.7% which is above the national Bank limit of 5%.Despite the above facts, as best of the

researcher knowledge, there have been few researches were undertaken to date regarding the Determinants of Non-performing loan/Bad loan in Ethiopia case, (Adamu, (2013), (Mitiku (2014)), and (Tilahun (2010)).

Tilahun (2010) primarily focused on identifying the challenges associated with the management of non-performing loans (NPLs) in privately owned commercial banks of Ethiopia. The study excluded the two largest state-owned commercial banks, which dominate the banking industry in terms of market share. Moreover, Tilahun's work did not investigate the specific determinants of NPLs or delve into the factors contributing to loan defaults in specialized financing services such as lease financing.

In contrast, this research seeks to address a clear knowledge gap in the Ethiopian context: the determinants of lease loan default in lease financing projects. Lease financing is a relatively new and specialized service in Ethiopia, with the Development Bank of Ethiopia (DBE) being the sole provider of this service. Despite its significance in fostering investment and economic growth, there is limited empirical evidence on the factors leading to lease loan default within DBE's portfolio.

By focusing exclusively on DBE's lease financing operations, this study aims to fill this gap by identifying and analyzing the specific determinants of lease loan defaults. Understanding these factors will not only contribute to the academic literature on lease financing but also provide practical insights for improving credit management and operational efficiency within DBE. Therefore, this study seeks to fill the gap by addressing factors which determines lease loan default based on Bank (Lessor) specific factors, borrower (lessees) specific factors and macro- economic factors in Development Bank of Ethiopia.

### **1.3. Research Questions**

1. What is the current status of lease loan default in DBE?
2. What are the causes for lease loan default in DBE?
3. What is the relationship between specific factors with lease loan default in DBE?

### **1.4. Objective of the Study**

#### **1.4.1. General objectives**

The main objective of this study is to examine the determinants of lease loan default in DBE.

#### **1.4.2. Specific objectives**

Specific objectives of the study are:

- 1) To examine the status of default in lease financing service in DBE
- 2) To identify the factors that cause lease loan default in DBE.
- 3) To Analyze lease loan defaulting trend in DBE.

#### **1.5. Scope of the study**

The study was focused on the Development Bank of Ethiopia which is the only bank because of its project based lending culture and providing lease financing service. Moreover, the study gathers information from development bank of Ethiopia Selected Districts in their lease portfolio from the whole Bank lease portfolio.

#### **1.6. Scope and limitation of the study**

The study was focused on the determinants of lease loan default in Development Bank of Ethiopia and limited to DBE selected District lease financing projects. It was covered only the concerned bodies of Lease financing service (Lease follow up Directorate of Head office, selected District Staff and Customers of within Districts)

Even if there are many factors for default in lease financing the study was tried to see the following factors only, Bank (lessor) specific factors, borrower (lessees) specific factors and External factors.

#### **1.7. Organization of the paper**

The rest of the paper were organized as follows: Chapter two present the literature review, chapter three present research methodology, the research results and discussion was presented in chapter four. Conclusion and recommendation of the study was presented in Fifth chapter.

## **CHAPTER TWO**

### **2. LITERATURE REVIEW**

#### **2.1. Theoretical Literature**

The debt financing gap of SMEs has been a point of discussion in the literature for some time now. Some studies focused on SMEs difficulties in accessing finance often called demand side characterization of the problem while others presented the main issues in bank lending practices called supply side characterization. Understanding SMEs problem of access to finance (or financing gap) implies describing the various limitations in both the demand side and supply side. The supply side constraints focus on the source of finance, i.e., if appropriate sources of finance are not available on terms and conditions suitable to SMEs (European Commission 2001). Whereas, the demand side constraints explain if entrepreneurs or firms do not make use of existing financing opportunities due to shortage of good project, lack of persuasive business plans or the legal status of the firms.

In the absence of sufficient financial information especially in developing countries like Africa where there are no credit bureaus, banks generally rely on high collateral values, which according to bank reduces the risks associated with the problems of adverse selection and moral hazards resulting from imperfect information (Nott, 2003). According to this argument, it is clear that banks try to mitigate the lending risks through a capital gearing approach instead of focusing on the future income potential of SMEs. Therefore, collateral has become essential prerequisite to access bank loans (Africa Practice, 2005).

Another way in which banks react to the market imperfection is by reducing the maturity of their outstanding loans. Shorter loans allow banks to monitor more frequently the firms' performance and, if necessary, vary the terms of the contracts before losses have accumulated (Hernández-cánovas and Koëter-Kant, 2008). Consequently bank financing to SMEs in Africa is less significant and more of short term than other developing countries (Martinez Peria, 2009). Small and Medium Enterprises in Africa are less likely to take loans from financial institutions than in any other developing regions; but many of firm and country level covariates explaining access to finance remain the same inside and outside Africa (Beck and Cull, 2014). Bank loans devoted to SMEs in Africa average only 5.4 percent while in other developing countries it amounted around 13.1 percent. And bank lending to such enterprises are costly

compared to other developing countries. Fees charged on SME loans in Africa are almost twice as high as in other developing economies (Martinez Peria, 2009).

Over the years, Leasing has been consented as one of the cornerstones of modern financial sources and a field of crucial decision for corporate organizations globally (Salam, 2013). Small and Medium Enterprises (SMEs) : in the context of DBE, Small and Medium Enterprises shall mean an enterprise in the Agriculture (farming and livestock) other than rain fed farming, Agricultural Mechanization Service, Agro-processing industries, Manufacturing industries, Construction industries, and Mining and quarries that operates with above 6 employees and has total capital from Birr 500,000 to Birr 7.5 million. Farmer unions/cooperatives their paid up capital above Birr 7.5 million and apply for Agricultural mechanization service will be entertained through the lease financing service (DBE Lease manual, 2018).

In most industrial countries, leasing is a key source of investment financing provided by equipment manufacturers, banks, and independent leasing companies. Starting out as a manufacturer's tool for increasing sales, it has evolved into a specialized service that serves most sectors of the economy including agriculture (farm equipment leasing contributes to over 10 percent of the US\$242 billion U.S. leasing industry). In most developing countries equipment leasing is in its infancy (Ajai et al). However, in countries where it has developed significantly, its development impact is estimated to be significant.

Brealey and Myers (2003) define a lease as a rental agreement that extends for a year or more and involves a series of fixed payments. More formally, leasing is a contract between two parties, where the party that owns an asset (the lessor) lets the other party (the lessee) use the asset for a predetermined time in exchange of periodic payments. In leasing, as in the case of simple rentals, legal ownership and use of an asset are separated. Leasing allows enterprises that either do not wish to purchase equipment (because leasing is cheaper) or cannot do so (because they do not have the required funds and lack access to bank finance) the opportunity to use equipment without having to own it. The business philosophy that underlies leasing is that profits are earned through the use rather than the ownership of assets (Gallardo 1997). The contractual agreement represents the lease between the two Parties, the lessee and the lessor, and gives the contract to the lessee the right to use certain assets for a specific time period owned by the lessor in return for periodic payments paid by the tenant for the owner. the use of

leases have largely spread because of the advantages offered by the leases as an alternative to owning originally included leases many magazines including ships, aircraft , land , and building(Annabel et al).Firms achieve their objectives of maximizing shareholders wealth by making successful investment decisions, which generate positive net cash flows. The leasing decisions concerns whether the firm should lease equipment, or borrows money and buy the equipment (Mohammad and Shamsi, 2008).

Leasing has proven to be an suitable funding basis offering economic benefits for the developing private segment in conversion and in low returns areas, and developing regions such as sub Saharan Africa (Fletcher et al.,).According to Osaze (1993) leasing is an agreement between the proprietor of an asset, and the potential customer of the asset, who is the lessee, providing occupant possession and use of asset on payment of rentals over a certain determined time. Leasing, in general, is viewed as a method of financing the acquisition of capital equipment. Leasing involves a contractual relationship in which the owner (lessor) or an asset or property grants to a firm or a person (lessee) the use of the asset's services for a specific period of time, usually for an agreed sum of rent (Weston and Brigham,1978). Leasing, therefore, enables a firm to avail the services of a plant or equipment without making the investment or incurring debt obligation.

The firms can use the asset by paying a series of periodic amounts called "lease payments" or "lease rentals" to the owner of the asset at the predetermined rates and generally in advance (Harm Levy and Marshall Samuel, 1973).The payments may be made monthly, quarterly or annually. Lease contracts have two parties, namely, Lessor and Lessee. A lessor may be a leasing company, a manufacturer, a subsidiary or an associate of a large business organization. A lessee may be a company, cooperative society, a partnership firm, an individual, government or its agencies (Gupta, 1995). Lease financing enables leasing or renting the services of an asset rather than buying it. It is a contract whereby the owner of an asset (the lessor) grants to another party (the lessee) the exclusive right to use the asset, usually for an agreed period of time, in return for the payment of rent. The term lease finance is used in the sense of leasing business assets such as computers, manufacturing plants ships, aircraft, cars, trucks; etc. This enables a business firm to use the services of an asset without buying it. Lease financing in the DBE

context shall mean capital goods financing service availed by the Bank to SMEs under “Hire Purchase” modality (DBE lease manual2018).

### **2.1.1. Classification of Lease**

Leases are broadly of two types: finance leases and operating leases. In a finance lease, the lease period typically extends for a significant period of the equipment’s economic life and risks of equipment obsolescence, maintenance, and insurance are borne by the lessee. Finance leases are usually non-cancellable, making them similar to term-loans (both bind the equipment user to a series of future payments—lease payments in the case of a lease, and interest and principal in the case of a loan (Annabel et al).

The other classification of leases is Finance Lease, Operating lease, and Hire purchase lease. Moreover, the accounting treatment of the transaction, the legal right of the lessor and the lessees, the ownership rights and control of the asset, maintenance and insurance as well as price of rentals are the main difference between them.

#### **a) Finance lease:**

This is also referred to as capital or full pay out lease. Under a financial lease the customer carries the risks and rewards of the asset’s ownership although the lessor remains the legal owner of the asset throughout the contract. In other terms the lessee benefits from the economic life of an asset in a similar way to a legal owner and takes on related risks, such as maintenance and insurance responsibilities. This includes contracts where the length of the lease is close to the useful economic life of the asset, as well as contracts where the lessee has the possibility to become the owner of the asset at the end of the lease, automatically or purchasing the asset for a specified nominal amount (Oxford Economics, 2011). Typically, financial leases are used by firms to finance long lived assets, instead of resorting to long-term borrowing for acquiring these assets (Clarke, 1996). FAS 13 (Ross et al., 2003) states that: the present value of the lease payments is at least 90 percent of the fair market value of the asset at the start of the lease, the lease transfers ownership of the property to the lessee by the end of the term, the lease term is 75 percent or more of the estimated economic life of the asset and the lessee can purchase the asset at a price below fair market value when the lease expires.

#### **b) Operating lease**

An operating lease is typically of a shorter duration than the useful economic life of the asset and the customer has no possibility to purchase it at the end of the contract, or can acquire it at a higher price than under a finance lease. An operating lease is thus essentially a rental contract for the temporary use of an asset (Oxford Economics, 2011; Kraemer- Eis and Lang, 2012)

**c) Hire purchase lease**

As per DBE Revised procedure of Lease Financing 2018, "Hire-purchase" means a type of leasing by which a lessor provides a lessee with the use of a specified capital goods, against payment of mutually agreed instalments over a specified 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.

A hire-purchase which is similar to a finance lease is a way to finance the purchase of equipment. It is normally used for small items like sewing machines and fridges. In hire purchase, part of the ownership is transferred with each payment. Upon payment of the last instalment, the lessee becomes the full owner. However, hire-purchase is a type of instalment purchase, with a well-defined purchase option for the customer, who agrees to pay the cost of the asset over time, including principal amount and interest for the period the asset is used (ILO, 2003).

**d) Financial Leases and Hire Purchase**

In some countries, a distinction is made between lease and hire-purchase transactions. A hire-purchase transaction is usually defined as one where the hirer (user) has at the end of the fixed term of hire, an option to buy the asset at a token value. In other words, financial leases with a bargain buyout option at the end of the term can be called a hire-purchase transaction. Hire-purchase is decisively a financial lease transaction, but in some cases it is necessary to provide the cancellation option in hire-purchase transactions by statute. That is, the hirer has to be provided with the option of returning the asset and walking away from the deal. If such an option is embedded, hire-purchase becomes significantly different from a financial lease as the risk of obsolescence gets shifted to the hire-vendor. Under these circumstances, if the asset were to become obsolete during the hire term, the hirer may off hire the asset and close the contract, leaving the owner (the lessor) with less than a full pay out from the lease. Hire-purchase is of

British origin the device originated long before leases became popular—and spread to countries that were then British dominions. The device is still popular in Australia, Britain, India, New Zealand, Pakistan, and in several African countries. Most of these countries have enacted, in line with the United Kingdom, specific laws addressing hire-purchase transactions.

### **2.1.2. Elements of Lease**

According to International Finance Corporation (IFC, 2005) an explanation of the elements in a lease that is the party's asset, rentals residual value etc. It is impossible to foresee all elements of a lease that may be appropriate, and experience has shown that leasing is most effective when the parties to a lease transaction can tailor deals to suit their own needs and capabilities.

**The transaction:** The transaction of a lease is generally an asset-renting transaction, that is, the separation of legal ownership from economic use. The distinguishing factor between a lease and a loan is that in the latter money is lent out, while in a lease it is the asset that is lent out. Therefore, a lease can be defined generally as a contract where a party being the owner (lessor) of an asset (leased asset) provides the asset for use by the lessee for consideration (rentals) that are either fixed or dependent on certain variables, for a certain period (fixed or flexible lease period). At the end of the lease period, subject to the embedded options of the lease, the asset may be either returned to the lessor or disposed of per the lessor's instructions.

**Parties to a lease:** Both lessor and lessee can be legal entities as well as individuals (sole proprietors). There should not be restrictions allowing only leasing companies or other financial institutions to operate as lessors.

**Two or three party leasing:** Depending on local legislation, there will be at least two parties to a lease the owner and the user (called the lessor and the lessee). In many jurisdictions, a third party may be required, that is, the supplier of the equipment. The existence of the third party (the supplier), who is usually chosen by the lessee and from whom the lessor buys the leased asset upon instructions of the lessee, can be explained by the intention of lawmakers in some jurisdictions wishing to separate leasing from other forms of property hire. The argument is that in a three-party arrangement the lessor is a financial intermediary, and the lessee effectively "hires" the lessor's money rather than the property. The lessor is seen as an investor who makes an investment by purchasing the leased asset and transferring it to the possession and use of the lessee.

**The leased asset:** The leased asset must be non-consumable. Legislation can impose some restrictions to this general rule, for example to prohibit some articles being leased which are in limited free circulation or withdrawn from circulation (for example in some countries, land plots or natural sites cannot be leased). Therefore, anything that one cannot own or hold title to cannot be leased, because to act as a lessor one needs to buy the asset first.

**Lease period:** The term of lease (lease period) is the period for which the agreement of lease shall be in operation. In some jurisdictions, an essential element in a lease is the ability or potential by the lessee to return the asset at the end of the lease period. It may also be necessary, depending on local jurisdictions, to include within the contract a certain period at the start of the lease where the lessee may be given a right of cancellation. Beyond this period, the lessee may be given a right of renewal. It is important to note that a lease cannot be viewed as a lease if it is possible to interpret it as a sale of an asset to the lessee. In financial leases, it is common to differentiate between the primary lease period and the secondary lease period. The former is the period over which the lessor intends to recover its investment, while the latter is intended to allow the lessee to exhaust a substantial part of the remaining asset value. Alternatively, many jurisdictions stipulate that the disposal of the leased asset (either by sale, transfer to the lessee, or return to the lessor) must be specified in the lease contract.

**Lease rentals (or lease payments):** Lease rentals represent the consideration (usually monetary) for the lease transaction, that is, this is what the lessee pays to the lessor. If the lease is a financial lease transaction, the rentals will usually be the recovery of the lessor's principal and a certain rate of return on the outstanding principal. In other words, the rentals can be seen as bundled principal repayments and interest. In many cases, financial lease payments may include other costs such as insurance, regular maintenance, and certain taxes (such as property tax). These payments may be on a "pass-through" basis or otherwise structured.

**Residual value:** residual value is generally defined as market value (at the end of the lease). But in some contexts it may mean amortized (or balance sheet) value, value for tax purposes, or carry other definitions. These values may differ significantly, and these differences may have important implications. Residual value risk is another important term used in leasing and refers to the risk that the actual (realizable) value of the leased asset at the end of the leased term will differ substantially from the estimated residual value at the inception of the lease.

### **2.1.3. Default**

In finance default occurs when a debtor has not met his or her legal obligations according to the debt contract, example has not made a scheduled payment, or has violated a loan covenant (condition) of the debt contract. A default is the failure to pay back a loan. Default may occur if the debtor is either unwilling or unable to pay their debt. This can occur with all debt obligations including bonds, mortgages, loans, and promissory notes. (Wikipedia, 2011)

Loan default can be defined as the inability of a borrower to fulfil his or her loan obligation as at when due (Balogun and Alimi, 1990). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (1980) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

### **2.1.4. Reasons for SME Default**

#### **i. Lack of Planning**

Lack of planning is a major contributor to the failure of many SMEs. Richardson and Richardson (2009:2) define planning as “the design of a desired future and of effective ways of bringing the future about and as examining the future and drawing up a plan of action.”

According to Nieman (2008), planning is a critical managerial function as it helps one to identify the objectives or targets and develop suitable actions or implementation plans. Nieman (2008) further states that there are two terms of references for planning, which are the construction of a business plan and a budget. These two sources, in turn, help to create a strategic view of the business and reduce the risk of business failure. Most SMEs fail because their plans are sales-oriented and they need a transition in outlook in order to meet customer needs. Since small business owners typically do not have management training, they end up planning poorly or not planning at all, which can lead to the failure of SMEs.

## **ii. Financial Management**

According to Nieman (2008), financial management is a very broad term and entails “planning, organizing, activating and control” and it is an important division of a business. For SMEs in the start-up phase, the two critical areas are the financial needs and control of such funding as well as the accountability of such start-up capital. SMEs within the social welfare context increase their chances of obtaining more funding if they maintain their accountability status. Therefore, accurate record keeping is vital as a task under the organizing function, which can assist in avoiding SME failure. SMEs with poor financial management often fail due to poor record keeping and for not obtaining more funding to grow their businesses.

## **iii. Lack of Management Skills**

Zealelem (2007) states that many researchers and practitioners claim that the major cause of small business failure is poor management. Whether the causes are labeled as financing, competition, marketing or inventory, they can be safely avoided if good management is in place.

Although it has become difficult to explain what constitutes poor management, small business owners or managers need to develop basic managerial skills and knowledge. If they are to succeed, managers need to have adequate skills in the area of planning, organizing, directing and controlling organizational resources.

Lack of management skills is one of the factors that contribute to the failure of SMEs. According to Victoria, Samuel, Lloyd and Lazarus (2011), SMEs fail due to a lack of managerial experience. SMEs that lack managerial experience fail because they are unable to tackle issues that require previous knowledge or experience. Similarly, Inkoun (2008) found out that SMEs performance is closely linked to the entrepreneurial skills of the proprietor. He argued that proprietors with business related qualifications tend to survive 30% more than non-qualified proprietors. While, according to Arnold, Grossman, Mwatotele, Stork and Tobias (2010), SMEs growth and survival is linked to the business performance and the business skills possessed by the owner or manager.

## **iv. Lack of Capital and Access to Finance**

SMEs also fail due to a lack of capital. King (2007) states “lack of capital is often the most critical challenge that a successful SME faces as its very success creates this and it quickly becomes a vicious circle.” Without cash flow, management and/or raising more capital,

including debt, the business is often constrained by capital as it grows. Often, the profit in one operating cycle is insufficient to fund the extra working capital required for the next operating cycle. This is especially the case where a business is either inventory or receivables intensive and/or the operating cycle is a long one (i.e. the operating cycle is the average time that it takes from the first receipt of inventory to when the customer pays for the goods). This can be exacerbated when capital goods are required to process the goods and the company cannot finance the acquisition of these capital assets. Many SMEs cannot overcome the obstacles in their businesses cash flow cycle and cannot understand why bankers and other lenders often cannot provide the financing, as SMEs often do not have the security to support the debt.

However, the solution is often more simple than most entrepreneurs realize. It often starts with a plan to determine cash needs are and when cash needs arise. From here, one is in a position to manage and focus on the cash management techniques most likely to be successful in their business. However, failure to stick the above procedures may result in SME failure.

#### **2.1.5. Five C's of Nonperforming/Bad loans**

As noted by MacDonald (2006), there are five Cs of bad credits that represent the issues used to guard against/prevent bad loans). These are:

**Complacency:** refers the tendency to assume that because of the things were good in the past, they will be good in the future. For instance, Assuming the past loan repayment success since things have always worked out in the past.

**Carelessness:** indicates the poor under writing typically evidenced by inadequate loan documentation, lack of current financial information or other pertinent information in the credit files, and lack of protective covenants in the loan agreement. each of these makes it difficult to monitor a borrower`s progress and identify problems before they are unmanageable.

**Communication ineffectiveness:** inability to clearly communicate the bank`s objectives and policies. This is when loan problem can arise. Therefore, the bank management must clearly and effectively communicate and enforce the loan policies and loan officers should make the management aware of specific problems with existing loans as soon as they appear.

**Contingencies:** refers the lenders` tendency to play down/ignore circumstances in which loan might in default. It focuses on trying to make a deal work rather than identifying down side risk.

**Competition:** involves following the competitors` action rather than monitoring the bank`s own credit standards. Banks, however, still have required expertise, experiences, and customer focus to make them the preferred lender for many types of loan. Lending is not just a matter of making loan and waiting for repayment. Loan must be monitored and closely supervised to prevent loan losses (MacDonald, 2006)

#### **2.1.6. Events of Default**

According to the Bank`s lease procedural manual of March,2018 the following shall constitute event of default and the Bank reserves the right to take all appropriate administrative and/or legal measures including repossession of the leased asset in case of any one of the following:

- a) Entering into other agreements with other financial institutions for the same project without the consent of the DBE.
- b) Failure to renew insurance policy of the leased asset on time.
- c) Failure to use the leased asset for the defined purpose or use of leased asset for purposes other than prescribed by the manufacturer.
- d) Failure to keep leased asset in good operating condition or failure to maintain or service the leased asset at the designated service center regularly.
- e) Tampering with the leased asset such as attempt to remove key components or modify the asset or unauthorized actions such as attaching additional items to the leased asset.
- f) Moving the leased asset out of the defined or designated area without the written consent of the Bank.
- g) Any deviation from the agreed terms and conditions will be considered as an event of default.
- h) Over invoicing.
- i) Presentation of falsified documents.
- j) Misrepresentation.
- k) Failure to make scheduled payments wilfully; any delay in payment exceeding 30 days from the time of payment shall be considered as default.

- l) Failure to comply with the agreed terms and conditions as stated in the lease contract.
- m) Refusal to take the machinery/capital goods after procurement
- n) In instances where the events of default mentioned under article “A” through “M” above occur, the Bank reserves the right to cancel all agreements and contracts, repossession of the asset and to take legal measures.
- o) In instances where the events of default mentioned under article “A” through “M” above occur, a legal measure or penalty charge of 3% will be applied. However, the penalty will be applied only when the customer refuses to comply with the proposals forwarded by the Bank to resolve the problem.

### **2.1.7. Credit Analysis Process**

Credit analysis is the process of evaluating an applicant's loan request or a corporation's debt issue in order to determine the likelihood that the borrower will live up to his/her obligations. In other words, credit analysis examines the financial history of an applicant in order to determine creditworthiness. A key element of credit analysis is the prediction of the likelihood a firm will face financial distress. According to the study by Palepo et.al. (2004), the process of credit analysis varies from one lender to another. The following steps however a representative of typical approaches. The steps are in a particular order but they are interdependent.

Understanding the purpose of a loan is important not just for deciding whether it should be granted but also for structuring the loan. Loans might be required for a few months, several years or even as part of a permanent part of a firm's capital structure. The use of the loans varies from replacement of other financing, working capital needs or for acquisitions of long term assets or another firm. The required amount of the loan must also be established. For example in financing an SME, a banker would typically prefer to be the sole financier of the business and in which case the amount of loan should be sufficient to refinance existing debt.

The next step will be to consider the type of loan and available security. The type of loan to be considered is a function of not only its purpose but also the financial strength of the borrower. There are several loan types which include: Open line credit, overdrafts, working capital loan, term loan, mortgage loan and lease financing. Bank lending is done on secured basis with smaller and more highly levered companies. Security will be required unless the loan is short term and the borrower exposes the bank to minimum default risk. Commercial lender estimates

the amounts that could be lent on each of the assets available as security. Lease financing estimates the amount that could be lent on each of the lease project feasibility as security.

Analysing the potential borrower's financial status is very crucial. This involves assessing the firm's ability to service the debt at the scheduled rate. This information is obtained from business strategy analysis, accounting and financial analysis. The key issue in the financial analysis is how likely it is that cash flows will be sufficient to repay the loan. The financial analysis should produce more than just assessment of the risk of non-payment. It should also identify the nature of the significant risk.

Good credit analysis should also be supported by explicit forecasts. The basis for such cash flows will be the management. It should be prepared with a „pessimistic“ scenario. The Z-score model for predicting the likelihood that a firm would go bankrupt can be useful. The model was developed by Altman (1968). This model uses five financial ratios that combine in a specific way to produce a single number. This number, called the Z-Score, is a general measure of corporate financial health. Later, Altman developed a modified version for private manufacturing firms and a second version for use by all businesses.

Finally, the last step in credit analysis is to pull together the detailed structure: type of loan, repayment schedule, loan covenants and pricing. Loan covenants specify mutual expectations of the borrower and lender by specifying actions the borrower will and will not take. It should strike a balance between protecting the interest of the lender and providing the flexibility management needs to run the business. The essence of loan pricing is to assure that the yield on the loan is sufficient to cover, the lender's cost of borrowed funds, cost of administration and servicing the loan, a premium for exposure of default risk and a normal return on the equity capital necessary to support the lending operations.

#### **2.1.8. Determinants of Loan Default**

The term “bad loans” as described by Basu (1998) in Fofack (2005) is used interchangeably with non-performing and impaired loans. Berger and De Young, (1997) also consider these types of loans as “default loan”. In effect, these would be considered bad or toxic assets on the banks books (Bexley and Nenninger, 2012). These descriptions were used interchangeably during the study. According to Berger and De Young (1997), non-performing loans could be injurious to the financial performance of banking institutions. Brownbridge (1998) argues that

the main cause of bank failures is the increased ratio of NPLs. If proper action is not taken in this regard, assets of bank will not be able to generate revenue for the banks.

There exist slightly different definitions of NPLs/Bad Loan. The IMF, for instance, defines a non-performing loan as any loan in which interest and principal payments are more than 90 days overdue; or more than 90days' worth of interest has been refinanced (IMF, 2009). The Basel Committee, on the other hand, defined non-performing loans as loans left unpaid for a period of more than 90 days (Basel Committee, 2001). The theory of asymmetric information tells us that it may be difficult to distinguish well from bad borrowers (Auronen, 2003) in Richard (2011), which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the lessees) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lessor) (Auronen, 2003) in Richard (2011). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of non-performing loans in banks (Bester, 1994; Bofondi and Gobbi, 2003).

Berger and De Young (1997) identified poor management as one of the major causes of problem loans. They argue that managers in most banks with non-performing loans do not practice adequate loan underwriting, monitoring and control. Rouse (1989) identifies that lack of good skills and judgment on the part of the lender is a possible cause of loan defaults. Bloem and Gorter (2001) point out that deficient bank management, poor supervision, over optimistic assessments of creditworthiness during economic booms, and moral hazard that result from generous government guarantees are some of the factors that lead to loan defaults.

Ahmad, (1997), mentioned some important factors that cause loan defaults which include; lack of willingness to pay loans coupled with diversion of funds by borrowers, wilful negligence and improper appraisal by Credit Officers. In addition, Hurt and Fesolvalyi (1998), cited by Kwakwa, (2009) found that, corporate loan default increases as real gross domestic product decline, and that the exchange rate depreciation directly affects the repayment ability of borrowers. Balogun and Alimi (1988) also identified the major causes of loan default as loan

shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes. Thomas (2000) emphasizes that education enhances the borrowers' ability to repay. The better educated borrowers are deemed to have more stable and higher income employment and thus a lower default rate. Borrowers with high level of education are more likely to repay their loan since they occupy higher positions and with high income levels.

The loan default has always been an issue of grave concern for both lenders and policy makers (Saba et al. 2012). The opportunity cost for provisioning of NPLs is quite extreme, Zhu et al. (2014) deployed shadow price to measure the opportunity cost and concluded that they immensely lessen efficiency of the banking sector. In fact, NPLs mark the beginning of banking or financial crisis (Kumar & Woo, 2015). Another aspect of non-performing loan is that bulk of it is related to SMEs (Greenidge & Grosvenor, 2010). Ekanayake and Azeez (2015) intend that the level of NPLs can be ascribed to both macroeconomic environment and banks' specific aspects. They further suggest that larger banks incur lesser loan defaults as compared to smaller banks, and NPLs has negative relationship with the GDP growth rate of GDP and inflation. Beck, Jakubik and Piloiu (2013) conducted econometric analysis of the novel panel data from 75 countries and shows that real GDP growth, lending mark-up rate and exchange rate significantly affect NPLs.

Macroeconomic factors such as GDP growth, unemployment, and inflation are significant explanatory variables of NPLs (Greenidge and Grosvenor, 2010; Klein, 2013; Louzis, Vouldis and Metaxas, 2012; Makri et al., 2014; Saba et al., 2012), and bank-level factors, for example size, quality of the bank's management, and lending policy, are also important determinants of NPLs (Greenidge and Grosvenor, 2010; Klein, 2013; Louziset al., 2012). Shimizu (2011) witnessed that relationship gaps between SMEs and small lending institutions results in bank default. In this study the lease loan default will be measured based on banks internal factors and customer (lessees) related factors.

#### **2.1.9. Effect of Default in Banking Industries**

Research studies have shown that the effect of bad loans on the bank in terms of net financial performance (i.e. return on investment/net profit) and lending potential (i.e. annual loan size)

is practical and realistic. The studies of Karim et al. (2010), Obamuyi, (2007), Nguta&Huka, (2013), Nawaz et al., (2012), Fidrmuc&Hainz (2009), Chelagat (2012) and Aballey (2009) provide such evidence in a foreign countries. The main effect of bad loans on banks is the fact that increasing bad loans limit the financial growth of banks (Karim, Chan & Hassan, 2010; Kuo et al., 2010). This consequence is as a result of the fact that bad loans deprive banks of the needed liquidity and limit their capability to fund other potentially viable businesses and make credit facilities available to individuals. Karim et al. (2010) argues that there are a lot of other viable businesses that the bank cannot explore as a result of the fact that its funds are caught up in bad loans. In the face of these consequences, the bank experiences a shortfall in generated revenues (Ghana Banking Survey, 2013), and this translates into reduced financial performance (Karim et al., 2010; Nawaz et al. 2012; Ghana Banking Survey, 2013).

Another basic effect of bad loans on the bank is a reduction in the bank's lending potential (Karim et al., 2010). Though this has been acknowledged earlier, it is important to discuss it as a primary independent effect. Banks make a greater part of their revenues and profit from lending activities (Karim et al., 2010; Nguta&Huka, 2013). As a result, when banks lose much of their lending capital to bad loans, it is likely that a greater part of their revenue is lost. Once revenue is lost in one financial year, the capability of the bank to provide access to credit facilities to other businesses and individuals would practically fall in the following financial years. This means that the bank would fail to lend, or it would reduce its amount allocated to lending in the next financial year. In this study, the amount located to lending is referred to as annual "loan size". Credit risk leads to capital inadequacy (insolvency). Capital adequacy means the financial capability of the bank to meet up with its financial obligations or uncertainties that may arise and thus will reduce the risk that it may face to some extent. An acceptable capital adequacy position is equivalent to saying that a bank is not over exposed to risks (Gardner, 2007). This is because its primary role or main function is to absorb unexpected and exceptional losses that it might experience especially in situations of uncertainty. The more capital a bank has, the more are its creditors or the government insurance agency protected, and the greater is the capital loss that can be sustained without resulting in bankruptcy (Shah, 1996).

According to Bloem and Gorter, (2001), though issues relating to non-performing loans may affect all sectors, the most serious impact is on financial institutions such as commercial banks and mortgage financing institutions which tend to have large loan portfolios. Besides, the large default loans will affect the ability of banks to provide credit. Huge non-performing loans could result in loss of confidence on the part of depositors and foreign investors who may start a run on banks, leading to liquidity problems. Caprio and Klingebiel (2002) also reported that during the banking crisis in Indonesia, non-performing loans represented about 75% of total loan assets which led to the collapse of over sixty banks in 1997. This means that banks holding huge default loans in their books can run into bankruptcy if such institutions are unable to recover their bad debts. The profitability of a bank is adversely affected by defaults. Provisions for bad and doubtful debts are directly subtracted from the revenues of good loans. Valid, flawless and expressly binding credit documentation reduces the tendency of wilful default and enhances the performance of banks.

The performance of a bank has linear relationship with the credit and recovery process (Asari et al, 2011). Asari et al. (2011) rightly argued that banks are unable to profit from credits in default. The study relating to validity of credit documentation (a medium to abstain defaults) has direct relevance to the performance of a bank. The provisions for loan defaults reduce total loan portfolio of banks and as such affects interest earnings on such assets. This constitutes huge cost to banks. Study of the financial statement of banks indicates that unsecured loans have a direct effect on profitability of banks. This is because charge for bad debts is treated as expenses on the profit and loss account and as such impact negatively on the profit position of banks (Price Water-House Coopers, 2009).

Berger and De Young (1997), indicate that failing banks have huge proportions of bad loans prior to failure and that asset quality is a statistically significant predictor of insolvency. Fofack (2005) also reported banks holding huge loan defaults in their books can run into bankruptcy if such institutions are unable to recover their bad debts. A possible effect of loan defaults is on shareholders earnings. Dividend payments are based on banks performance in terms of net profit. Thus since loan defaults have an adverse effect on profitability of banks; it can affect the amount of dividend to be paid to shareholders. The effect of loan defaults on the amount of

dividend paid to shareholders can also affect capital mobilization because investors will not invest in banks that have huge non-performing loans portfolio.

## **2.2. Empirical Literature Review**

Fergal (2012) stated that typical financial ratios, such as the ratio of the loan to total assets, the current ratio, leverage ratio, liquidity ratio and profitability ratio, are found to be significant predictors of default. Further, the length of time the borrowing firm's owner has been with the firm mitigates the likelihood of default. He used unique borrower-level balance sheet information for a cross-section of 6,000 Irish SME loans.

McCann and McIndoe-Calder (2012) also used Altman's (1968) seminal Z-score for corporate defaults and found out that indebtedness, liquidity, profitability and sector-specific effects are important borrower-level determinants of SME default.

Keeton (1999) uses data from 1982 to 1996 and a vector auto regression model to analyse the impact of credit growth and loan delinquencies in the US. It reports evidence of a strong relationship between credit growth and impaired assets. Specifically, Keeton (1999) shows that rapid credit growth, which was associated with lower credit standards, contributed to higher loan losses in certain states in the US. In this study loan delinquency was defined as loans which are 90 days and above.

Farhan et al. (2012) studied the economic determinants of Non-Performing Loans in 10 Pakistani banks by using a primary data collected via a structured questionnaire from 201 bankers who are involved in the lending decisions or analyse the credit risk or handling NPLs portfolio. Correlation and regression analysis was carried out to analyse the impact of six independent variables on NPLs. According to the results Pakistani bankers perceive that Interest Rate, Energy Crisis, Unemployment, Inflation, and Exchange Rate has a significant positive relationship with the non-performing loans of Pakistani banking sector while GDP growth has significant negative relationship with the non-performing loans of Pakistani banking sector.

Durafe and Singh (2016) deployed multiple regression analysis and exhibited that bank specific variables have significant effect on NPLs, while macroeconomic variables were found to be insignificant in presence of bank specific variables. Nonperforming assets reduce banks' willingness and ability to supply credit because provisioning against NPLs hamper profitability

and arises operating costs, and this creates problems for SMEs with borderline credit quality (Richard, 2011).

Palubinskas and Stough (1999) note that the failure of a bank is mainly seen as a result of mismanagement because of bad lending decisions made with respect to wrong appraisal of credit status, or the repayment of non-performing credits and excessive focus on giving loans to certain customers. Goodhart et al (1998) also state that poor credit control, which results in undue credit risk, causes bank failure. Chimerine (1998) adds that a bad lending tradition leads to a large portfolio of unpaid loans. This results in insolvency of banks and reduces funds available for fresh advances, which eventually causes a financial crisis.

Causes and treatment of non-performing loans were studied in detail by Bloem and Gorter (2001). They agreed that “bad loans” may considerably rise due to abrupt changes in interest rates. They discussed various international standards and practices on recognizing, valuing and subsequent treatment of non-performing loans to address the issue from view point of controlling, management and reduction measures. A study conducted by Espinoza and Prasad (2010) focused on macroeconomic and bank specific factors influencing non-performing loans and their effects in GCC Banking System. After a comprehensive analysis, they found that higher interest rates increase non-performing loans but the relationship was not statistically significant.

Gezu (2014) carried out a study using the panel data from 2002 to 2013 and found out that Capital Adequacy Ratio (CAR) and Return on Equity (ROE) are negatively related with NPLs, while Return on Assets (ROA) and lending rate is positively affecting NPLs. However, this paper revealed that Credit to Deposit (CD) ratio and inflation does not have any relationship with the NPLs of banks in Ethiopia.

In case of Albanian Banking System, NPLs are affected by bank-specific factors such as loan to asset ratio, loan level, net interest margin and return on equity (Shingjergji 2013). This study revealed that Loan to Asset ratio is inversely related to NPLs, indicating that majority of bank’s assets in the form of loans will lead to low NPL ratio. While, the loan level and NPL ratio are positively related to each other, indicating that excessive lending or higher level of loans will increase the NPL ratio. The net interest margin also affects NPL ratio positively. However, Return on Equity (ROE) has a negative relationship with NPLs, indicating that high profit will

result in lower NPL ratio. Panel data regression model was used for this study covering a period from 2002 to 2012.

According to Adamu, (2013), regarding socio-political variable, the researcher had used population size, political regions, literacy level and religion dominancy. The estimation results of population size in the study has shown that the statistical significance of the variable and similar direction of influencing project performance. The socio-political variables, the result of literacy level has shown statistical significance for project failure. Political regions and religion dominancy, which captured by dummy variable are also found statistically insignificant.

Study by Geletta, (2012), on the determinants of nonperforming loan in Ethiopian Commercial Banks using mixed research approach, the found that fund diversion, compromised integrity, over/under Financing were the most frequently mentioned factors followed by unfair competition among Banks, wilful default and macroeconomic conditions. On the other hand charging high interest rate and rapid loan growth were rated among the least factors causing occurrences of nonperforming loan ratios

In view of the above discussions, numerous studies were conducted on the determinants of Non-performing loans. Most of these studies focused on bank specific and macro-economic determinates of NPLs. However, there is no study that has studied customer-specific factors influencing loan default specifically in lease financing service of Development Bank of Ethiopia.

Besides, most of the empirical studies reviewed and discussed in the above paragraphs were made in other countries; and the there is no studies in the Development bank of Ethiopia. Moreover, the study by Adamu, (2013), Mitiku (2014) (2012) and Geletta, (2012), were focused on the determinants of NPLs in macroeconomic and bank specific factors of loan provided by Banks. Therefore, the current study will expected to fill this knowledge gap by assessing the association between bank (lessor)-and customer (lessees)-specific factors of loan default in the Development Bank of Ethiopia, with a particular focus on lease financing service.

### **2.3. Conceptual Framework**

The main objective of this study will be to identify the major determinants, both bank (lessor), borrower (lessees) and External specific determinants, of lease loan default in DBE.

Accordingly, based on the objective of the study, the following conceptual model has been framed. NPL are affected by bank specific, customer specific and macroeconomic factors as discussed in the literature review part. Bank specific factors include poor credit assessment and credit monitoring, credit size, high interest rate, whereas customer/borrower specific causes are loan diversion, poor credit risk management culture of customers, Gender and Age (Joseph *et al.*, 2012) Thus, the following conceptual model will summarize the main focus of this study.

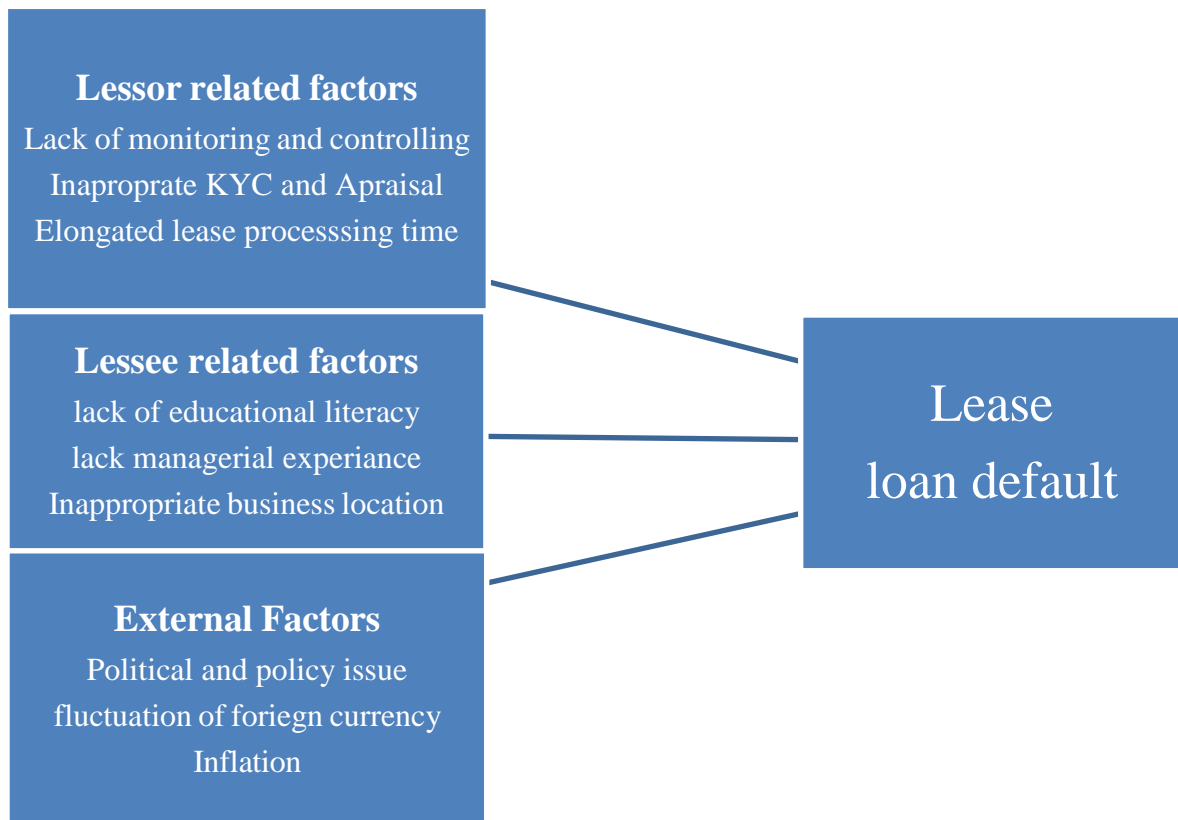


Figure 1. Conceptual framework of the study

## **CHAPTER THREE**

### **3. RESEARCH DESIGN AND METHODOLOGY**

#### **3.1. Research Approach**

Research design is the overall plan that describes the methods and procedures for collecting and analysing the required data. The choice of research design primarily depends on the objectives of the study that are going to be achieved (Adebiyi, 2016). These approaches are quantitative and descriptive research. Causal research design was used to show the relationship between the dependent and independent variables. The dependent variable in this study was measured, lease loan default in DBE. The independent variables include bank (lessor) specific, borrower (lessees) specific and Macro economic factors. Mixed approach was employed to answer the question about the relationships among measured variables with the purpose of explaining, predicting and controlling phenomenon.

The qualitative approach allows for responses which emanate from the knowledge and experience of the participant (Denzin and Lincoln 2003). Close ended questions are used in the survey questionnaire which is the instrument through which the qualitative approach is undertaken. In the context of the present research, close ended questions were administered to the sample population for their responses. This enabled the researcher to undertake strong analysis from the responses to achieve the research objectives. The main intent was to determine what the factors are causing clients to default in lease loans at DBE from the perspective of the clients. This necessitates the need for the researcher to adopt both quantitative and qualitative approaches for the study. Statistics are the major tool that forms the basis for inferences that are resulted from a quantitative research. The method involves the distribution of a build survey, a questionnaire to a sample. The numbers produced from statistical analysis are then interpreted to arrive at significant insights about the phenomenon being probed (Creswell, 1994).

In the context of this research, closed ended questions were administered to the sample population for their responses. This enabled the researcher to undertake strong analysis from the responses to achieve the research objectives.

### **3.2. Population of the Study**

According to Sekaran and Roger (2011) population refers to the entire group people, events, or things of interest that the researcher wishes to investigate. The population of the study was Development bank of Ethiopia selected districts lease NPLs.

The population of the study was the entire customers who have lease loan with DBE selected Districts. Accessible population is the population to which the researcher can apply conclusion. The researcher because of time consumption, area coverage and cost relies on sample to represent the population. Accordingly, the target population of the study was all lease project finance customers that were financed by DBE selected District; and for this study purpose, loan repayment status report which was disclosed on June 30, 2023; this data was generated from T-24 system.

In this study, the population consists of the Development Bank of Ethiopia's selected districts with non-performing lease loans (NPLs). The decision to focus on this specific population is driven by the need to thoroughly examine the factors contributing to lease loan defaults within these districts. By targeting districts with significant lease portfolios, such as Adama, Bahir Dar, Addis Ababa, and Hawassa, the study aims to capture a comprehensive understanding of the determinants affecting lease loan performance.

While it is ideal to study an entire population, practical considerations such as time, resources, and the need for in-depth analysis make it necessary to use a purposive sampling method. Purposive sampling allows the researcher to focus on the most relevant cases, ensuring that the data collected is manageable and directly aligned with the research objectives. In this study, purposive sampling was deemed appropriate because the selected districts represent significant variations in lease portfolios, which are central to the research topic.

The researcher selected four districts—Adama, Bahir Dar, Addis Ababa, and Hawassa—based on their lease portfolios of 317 billion birr, 283 million birr, 223 million birr, and 96 million birr, respectively (DBE Annual Report, June 2023). These districts were chosen as they collectively account for the largest and most diverse lease portfolios, making them highly representative of the key dynamics being studied. The total population for these four districts is 89 Lessee, as outlined in Table 3.1. This figure represents the entirety of the relevant population directly involved in lease operations within the selected districts.

Table 3. 1.Population of the study

<b>Districts</b>	<b>Population</b>	<b>Percentage</b>
Addis Ababa	36	40%
Adama	29	33%
Bahir Dar	12	13%
Hawassa	12	13%
<b>Total</b>	<b>89</b>	<b>100%</b>

**Source: DBE annual report June 2023**

Based on NBE Directive of loan classification non default loans are under pass and special mention loan classification while defaults are under substandard, doubtful, and loss loan classification. This classification is the same for lease project loans.

### **3.3. Data type and collection techniques/ instruments**

To achieve the research objectives and answer the research questions, the researcher used both primary and secondary data. Primary data was collected through questionnaires and interviews. The questionnaires, which were structured as close-ended and self-administered, were distributed to the respective respondents. The respondents filled out the questionnaires on hard copies, which were then collected by the researcher. Additionally, secondary data, including the DBE annual report, brochures, and the periodical "Zenalimat Bank," was used to review the performance of lease financing in previous years.

### **3.4. Data Analysis and Presentation**

The data obtained through surveying was analysed by descriptive statistics, that is, frequency distribution. The researcher analysed the results of quantitative data with descriptive approach to describe the median values of the scores of the responses of the respondents.

### **3.5. Measurement of Variables and Model Specification**

The nature of the data and the variables can determine the type of model to be employed. Especially, to know whether the regression line is linear or non-linear identifying the predicted variable shall be an essential task. When the researcher tried to identify the dependent variable, found that it has a continuous response. This leads to use OLS multiple linear regression model according to (AGRESTI, 2007). The independent variables were measured by a likert scale

ranging from one to five. After, data gathered from the survey the researcher feed into Statistical Package Software for Social Science (SPSS) and analysis through multiple linear regression models. Accordingly, the following multiple linear regression model has been constructed.

$$\text{Lease loan default} = \alpha + \beta_1 \text{lessor related factors} + \beta_2 \text{Lessee related factors} + \beta_3 \text{External factors} + \varepsilon$$

Where:

- ◆  $\alpha$ : is the constant term
- ◆  $\beta_i$  is the coefficient
- ◆ *Lessor related factors*
- ◆ *Lessee related factors*
- ◆ *External factors*
- ◆  $\varepsilon$  is the error term of the model

### 3.6. Study variables

Table 3. 2. Definition of variables (proxies), Symbols and Expected Signs

Symbol	Variables	Description and Measurement	Expected Sign
<b>LMC</b>	Lack of Monitoring and Controlling	Lack of sufficient follow-up and supervision of lease projects, as measured by agreement on statements like "Lack of credit monitoring leads to lease loan default."	Positive (+)
<b>IKYCA</b>	Inappropriate KYC and Appraisal	Poor implementation of Know Your Customer (KYC) processes and inadequate lease project appraisal, as assessed through statements such as "Improper KYC leads to high lease loan default."	Positive (+)
<b>ELPT</b>	Elongated Lease Processing Time	Delays in processing lease loan applications, measured by agreement with statements like "The time taken to process lease loans is significant and reasonable."	Positive (+)
<b>LEDUCL</b>	Lack of Educational Literacy	Limited education or financial literacy among lessees, affecting their ability to manage leased assets. Measured through questions on lessee education levels.	Positive (+)
<b>LMEXP</b>	Lack of Managerial Experience	Inadequate business or managerial experience among lessees, impacting their ability to run	Positive (+)

		successful operations. Measured through lessee self-reports.	
<b>INAPBL</b>	Inappropriate Business Location	Lessee business locations measured by location-related survey statements.	Positive (+)
<b>PPI</b>	Political and Policy Issue	Impact of political instability or unfavorable policies on lease projects, measured through lessee perceptions on policy-related risks.	Positive (+)
<b>FFOREX</b>	Fluctuation of Foreign Currency	Effects of exchange rate volatility on lessee operations, measured by lessee agreement on currency fluctuation risks.	Positive (+)
<b>INF</b>	Inflation	Impact of inflation on lessee business profitability and repayment capacity, measured through lessee perceptions of rising costs.	Positive (+)

Positive (+) sign indicates that the factor is expected to increase the likelihood of lease loan default.

**3.7. Ethical consideration**

The study was in line with the organizations policy in relation to any intellectual property rights of the organization. The researcher has been given full information on the purpose and objectives of the study. Ensure guarantees to the participants concerning confidentiality and only use for academic purposes.

## CHAPTER FOUR

### 4. DATA ANALYSIS, RESULT AND DISCUSSION

#### 4.1. Introduction

This chapter presents the results of the descriptive analysis, diagnostic tests, regression analysis, and interpretation of the study findings. The assessment was based on data collected through a questionnaire survey distributed to 89 respondents, who were lessees involved in lease financing projects across four districts. Out of these, 75 completed and returned the questionnaire, resulting in a response rate of 84%, which is considered sufficient for the study.

The unit of analysis for this study is the lessee, as they are the primary stakeholders directly engaged in lease financing and loan utilization. Their experiences, challenges, and practices provide critical insights into the determinants of lease loan defaults. By focusing on lessees, the study aims to explore how factors such as Lack of Monitoring and Controlling, Inappropriate KYC and Appraisal, Elongated Lease Processing Time, Lack of Educational Literacy, Lack of Managerial Experience, Inappropriate Business Location, Political and Policy Issue, Fluctuation of Foreign Currency, and Inflation contribute to loan performance, offering a comprehensive understanding of lease financing dynamics in the Ethiopian context.

#### 4.2. Demographic Characteristics

This section discusses the demographic characteristics of the respondents. This includes the gender, age, level of education and experience.

##### 4.2.1. Form of ownership of the respondents

*Table 4. 1. Form of Ownership*

	Frequency	Percent	Valid Percent	Cumulative Percent
Sole proprietorship	30	40.0	40.0	40.0
PLC	45	60.0	60.0	100.0
Total	75	100.0	100.0	

**Source: Own survey (2023)**

The businesses in this data set are divided into two main ownership structures - sole proprietorship and PLC. Sole proprietorships are typically smaller businesses owned and operated by one person, while PLCs are larger companies with shared ownership through

publicly traded stocks.

From the above table there are 30 businesses that are classified as sole proprietorships which represent 40.0% of the total businesses 45 businesses classified as PLCs, accounting for 60.0% of the total. This data shows that most businesses in this dataset are PLCs, making up 60% of the total. Sole proprietorships, while less common in this dataset, still account for a significant portion at 40%.

This breakdown can have various implications. For example, it suggests that the business landscape being studied has a significant presence of larger, publicly traded companies (PLCs). On the other hand, the presence of sole proprietorships indicates the diversity of business sizes, potentially including smaller, independent ventures.

This indicates that a significant portion of the dataset comprises responses from corporate entities rather than individuals. The gender distribution among respondents could influence the perspectives and responses gathered in the dataset. The dominance of responses from PLCs might suggest a focus on larger, more corporate entities in the study.

#### 4.2.2. Age of the respondent

This table provides insights into the distribution of respondents across different age groups. The largest group of respondents falls in the 30-40 age range, comprising nearly half (46.7%) of the total respondents. The 20-30 and 40-50 age groups are equal at 20.0% each, respondents older than 50 make up 13.3% of the total.

Table 4. 2. Age of the respondent

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	20-30	15	20.0	20.0	20.0
	30-40	35	46.7	46.7	66.7
	40-50	15	20.0	20.0	86.7
	>50	10	13.3	13.3	100.0
	Total	75	100.0	100.0	

Source: Own survey (2023)

Table 4.3 presents the distribution of respondents across different age groups. The data highlights the prominence of the 30-40 age groups, providing insights into the age demographics of the dataset and suggesting potential areas for further analysis based on age-related differences in responses.

#### 4.2.3. Level of education of the respondent

This table provides insights into the education levels of the respondents. The majority of respondents (68.0%) have at least a First Degree or higher, 25.3% of respondents have a

Diploma, a small portion (6.7%) have education at Grade 12 and above but do not have a Diploma or higher.

Table 4. 3. Level of education

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Grade 12 and Above	5	6.7	6.7	6.7
Valid Diploma	19	25.3	25.3	32.0
Valid First Degree and Above	51	68.0	68.0	100.0
Total	75	100.0	100.0	

**Source: Own survey (2023)**

Table 4.4 presents the distribution of respondents based on their level of education. The data highlights the prevalence of respondents with First Degree and above, indicating a dataset skewed towards higher education levels, with nearly 70% having a First Degree or above. This suggests that the dataset likely includes individuals with specialized knowledge and potentially higher income levels. This information is crucial for understanding the educational background of the respondents and potential implications for the analysis of the dataset.

#### 4.2.4. Business Experience of the respondent/owner

Table 4. 4. Business Experience of the respondent

	Frequency	Percent	Valid Percent	Cumulative Percent
1-5	15	20.00	20.00	20.00
6-10	50	66.70	66.70	86.70
16-20	10	13.30	13.30	100.00
Total	75	100.00	100.00	

**Source: Own survey (2023)**

Table 4.5 presents the distribution of respondents based on their years of business experience. The data highlights the prevalence of respondents with 6-10 years of experience, suggesting that the dataset is largely composed of business owners who have been operating for a moderate amount of time. This information is crucial for understanding the experience level of the respondents and potential implications for the analysis of the dataset.

This table provides insights into the distribution of respondents based on their years of business experience. The majority of respondents (66.70%) fall into the 6-10 years of business experience category, 20.00% of respondents have 1-5 years of business experience, indicating a significant portion of relatively new business owners or respondents. 13.30% of respondents have 16-20 years of business experience. The dataset is primarily composed of respondents with moderate levels of business experience, particularly in the 6-10 years range. This suggests that the dataset may include insights and perspectives from individuals who have likely overcome initial challenges of starting a business and have gained some experience in managing their enterprises.

### 4.3. Reliability test

Cronbach's Alpha is a measure of internal consistency or reliability of a set of scale items. The values range from 0 to 1, with higher values indicating greater internal consistency. Researchers can have confidence that the items within each factor are measuring the same underlying construct reliably. Researchers often use Cronbach's Alpha to ensure that the items in their scales are measuring the intended concepts consistently. A Cronbach's Alpha of above 0.7 is generally considered acceptable, so all three factors in this case meet that criterion. High internal consistency suggests that the items within each factor are well-suited for measuring their respective constructs. Researchers can proceed with analysing the data related to these factors with confidence in their reliability.

Table 4. 5. Reliability Test

Factors	Cronbach's Alpha	N of Items
Lessee Related Factors	0.822	11
Lessor Related Factors	0.916	6
External Related Factors	0.848	3

**Source: Own survey (2023)**

For Lessee Related Factors: Cronbach's Alpha of 0.822 indicates a good level of internal consistency among the 11 items related to lessees. For Lessor Related Factors: Cronbach's Alpha of 0.916 suggests a very high level of internal consistency among the 6 items related to lessors. For External Related Factors: Cronbach's Alpha of 0.848 indicates a good level of

internal consistency among the 3 items related to external factors. These results suggest that the scales used to measure Lessee, Lessor, and External Related Factors have well to very high internal consistency. Reliability test results show good to very high internal consistency for the factors related to Lessee, Lessor, and External factors. This indicates that the items within each factor are reliable measures of their respective constructs, providing a solid foundation for further analysis and interpretation of the data.

#### 4.4. Extent of agreement to factors

One of the objectives of this study was to identify the factors contributing to lease loan default at the Development Bank of Ethiopia (DBE) using a Likert scale. Respondents were asked to indicate their level of agreement with various factors that might lead to lease loan defaults. The average ratings for each factor are discussed in the following sections:-

- ✓ [1-1.5]=strongly disagree
- ✓ [1.5-2.5]=disagree
- ✓ [2.5-3.5]-neutral
- ✓ [3.5-4.5]=agree
- ✓ [4.5-5]=Strongly agree

#### 4.5. Correlation Analysis

Table 4. 6. Correlations

Particulars	Loan Default Amount	lessor related factor (credit monitoring, appraisal, KYC and lease processing time)	lessee related factors (educational status, managerial experience and lessee's location)	external factors (political instability, foreign currency fluctuation and inflation)
Loan Default Amount	1.000	0.534	0.617	0.089
lessor related factor (lack of credit monitoring, appraisal, KYC and longer lease processing time)	0.534	1.000	0.242	0.504
lessee related factors (lack of educational literacy, managerial experience and inappropriate business location)	0.617	0.242	1.000	0.058
external factors (political instability, foreign currency fluctuation and inflation)	0.089	0.504	0.058	1.000

N	75	75	75	75
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Source: Own survey (2023)

These correlations indicate the strength and direction of the relationships between the variables: The Loan Default Amount has a moderate positive correlation with the lessor related factor (0.534) and the lessee related factors (0.617), but a weak positive correlation with external factors (0.089). The lessor related factor has a moderate positive correlation with both the lessee related factors (0.242) and external factors (0.504). The lessee related factors have a weak positive correlation with external factors (0.058).

#### 4.6. Diagnostic tests

##### 4.6.1. Normality test

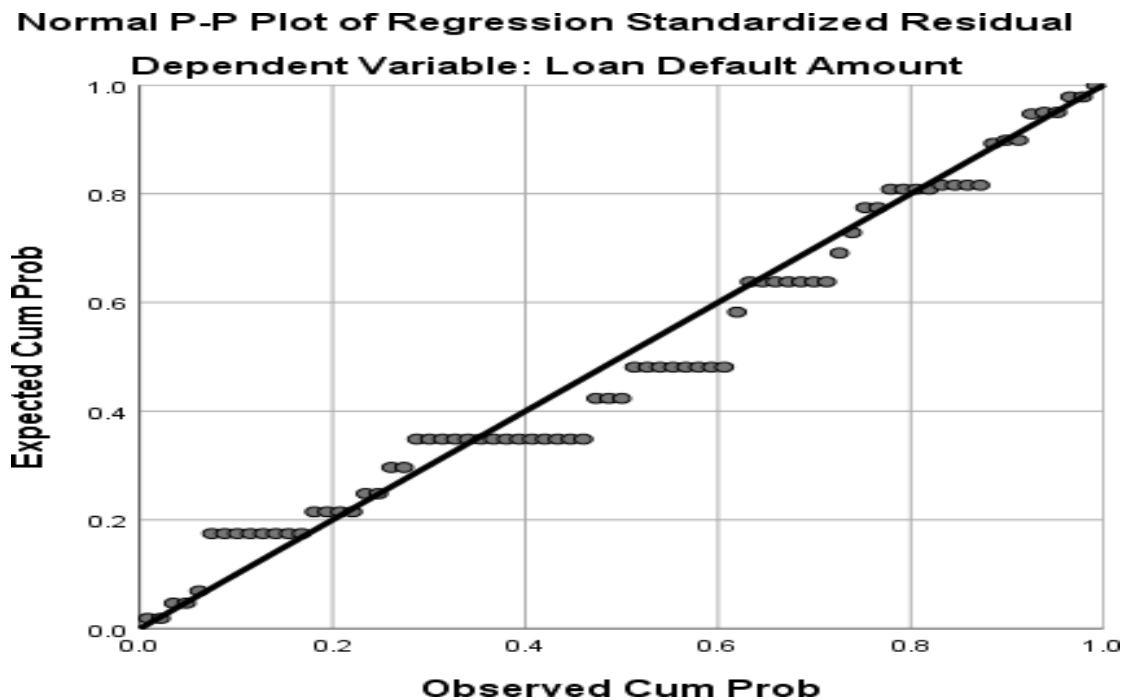


Figure 2. Normal P-P plot for Normality test

A normal P-P (Probability-Probability) plot is a graphical tool used to assess whether a given dataset follows a normal distribution. In the context of loan default amounts, a normal P-P plot would help determine if the distribution of loan default amounts aligns with a normal (Gaussian) distribution.

In a normal P-P plot, the observed data quintiles are plotted against the quintiles of a theoretical normal distribution. If the data points fall along a straight diagonal line, it suggests that the data follows a normal distribution. Deviations from the straight line indicate departures from normality. The loan default amounts closely follow a normal distribution on the P-P plot, it implies that a significant proportion of defaults are around the mean amount and predictive models assuming normality is more appropriate.

#### 4.6.2. Multi-collinearity test

Tolerance measures the proportion of variance in one variable that is not explained by the other independent variables. VIF (Variance Inflation Factor): This is the reciprocal of tolerance, and it indicates how much the variance of an estimated regression coefficient is increased because of collinearity. VIF values above 10 are often considered problematic for multi-collinearity. The tolerances are all above 0.2, which is another indication that there isn't severe multi-collinearity. None of the VIF values are above 10, which is good. It suggests that multi-collinearity is not a significant issue.

Table 4. 7. Multi-collinearity test

Coefficients <sup>a</sup>		
Model	Collinearity Statistics	
	Tolerance	VIF
lessor related factor (credit monitoring, appraisal, KYC and lease processing time)	.700	1.428
lessee related factors (educational status, managerial experience and lessee's location)	.936	1.068
external factors (political instability, foreign currency fluctuation and inflation)	.741	1.349

a. Dependent Variable: Loan Default Amount

Source: Own survey (2023)

#### 4.6.3. Heteroscedasticity test

The Levene's test is used to assess whether the variances of the residuals (unstandardized residuals in this case) are equal across different groups or conditions. The null hypothesis of the Levene's test is that the variances are equal (homoscedasticity). The Levene Statistic is the

test statistic, and it indicates the extent of difference in variances across groups. The larger the value, the greater will be the evidence against homoscedasticity. Degrees of Freedom (df1, df2) represent the degrees of freedom for the test. The p-value (Sig.) associated with the Levene's test is .064. Since the p-value (.064) is greater than the typical significance level of 0.05, we do not have enough evidence to reject the null hypothesis. This suggests that there is no significant difference in the variances of the residuals across the groups or conditions being compared. In other words, the assumption of homoscedasticity is not violated based on this test.

Table 4. 8. Test of Homogeneity of Variances

Unstandardized Residual			
Levene Statistic	df1	df2	Sig.
1.752	17	50	.064

Source: Own survey (2023)

On the other hand, the scatter plot below shows a random pattern of points around the horizontal line at 0 (the mean of the standardized residuals), with no clear curvature or systematic pattern, it suggests that the assumptions of linear regression are met. This means that the model's errors are normally distributed, and there is homoscedasticity (equal variance of errors).

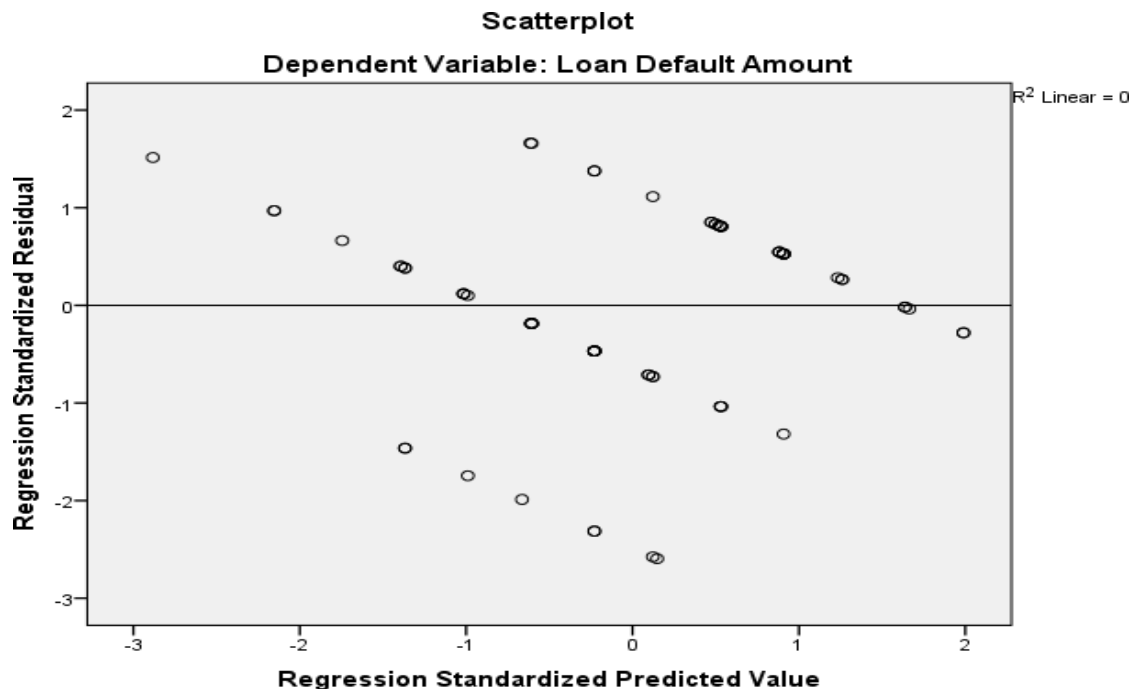


Figure 3. Heteroscedasticity test

#### 4.7. Trend Analysis

Trend analysis is the study of data to identify patterns or trends that can be used to make investment decisions. This type of analysis is typically used to analyse the performance of a particular security, such as a stock or bond, over a given period of time. A trend describes the general direction of change of some variable. It enables the prediction of future market movements, helping investors stay ahead of the curve; by identifying potential risks early, trend analysis allows for better risk management. For example, the diagram below shows the change in the lease loan default over five years. While there is a significant amount of variability over that time, the trend shows that it is increasing in the first year and radically decreases in rest of financing periods. This implies that DBE may take lesson in the first year and take series of proper actions to cut-off lease loan default.

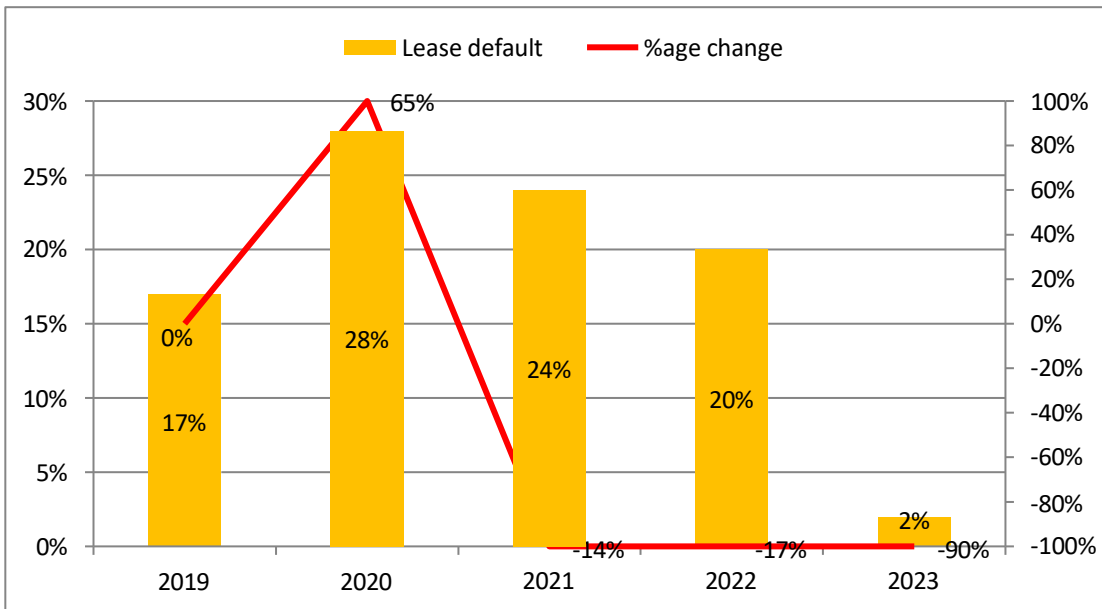


Figure 4. Lease loan default trend analysis

Trend analysis can improve business by helping to identify areas with the organisation that are doing well, as well as areas that are not doing well. In this way it provides valuable evidence to help inform better decision making around our longer-term strategy as well as ways to future proof of lease financing business. It provides valuable insights into the financial health and

direction of a business. Therefore, we can conclude that lease loan default is declining over the period and DBE is at a best position in lease loan financing.(DBE Annual report June 30, 2023)

#### 4.8. Regression Analysis

In the regression model summary R is the multiple correlation coefficients, also known as the correlation coefficient of determination, indicate the strength and direction of a linear relationship between the independent variables and the dependent variable. R Square is the coefficient of determination, which explains the proportion of the variance in the dependent variable that is predictable from the independent variables. It ranges from 0 to 1, where 1 indicates a perfect fit. Adjusted R Square is the R Square adjusted for the number of predictors in the model. It is useful when comparing models with different numbers of predictors. Std. Error of the Estimate: This is the standard error of the estimate, which is an estimate of the average difference between observed values and predicted values.

Table 4. 9. Model Summary

Model Summary <sup>b</sup>								
Model			Std. Error of the Estimate	Change Statistics				
R	R Square	Adjusted R Square		R Square Change	F Change	df1	df2	Sig. F Change
.873 <sup>a</sup>	.762	.752	.333	.762	75.690	3	71	.000

a. Predictors: (Constant), external factors (political instability, foreign currency fluctuation and inflation), lessor related factor (credit monitoring, appraisal, KYC and lease processing time) , lessee related factors (educational status, managerial experience and lessee's location)

b. Dependent Variable: Loan Default Amount

**Source: Own survey (2023)**

The overall model seems to fit the data moderately well, as indicated by an R Square of 0.762. This means that approximately 76.2% of the variance in the dependent variable (Loan Default Amount) is explained by the independent variables in the model. The Adjusted R Square is 0.752, which is slightly lower than the R Square. This suggests that the model may not be significantly improved by adding more predictors. The F Change statistic has a large value of 75.69 with a very small p-value of 0.000. This suggests that the overall model (including all predictors) is statistically significant in predicting the Loan Default Amount.

The ANOVA test in table 4.10 evaluates whether there is a significant difference in the means of the dependent variable (Loan Default Amount) across the different groups or categories formed by the predictors. In this case, the overall model is statistically significant because the p-value (Sig.) associated with the F-statistic is very small ( $p < 0.000$ ). This means that at least

one of the predictors (or a combination of them) has a statistically significant effect on the Loan Default Amount. The model explains a significant amount of the variance in the Loan Default Amount, as indicated by the high F-statistic (75.690).

The Residual row indicates the variability that is not explained by the model. This unexplained variability is the variance of the residuals (0.111), which is the variability left over after accounting for the predictors in the model. The "Predictors" section reminds us of the variables included in the model: external factors, lessee related factors, and lessor related factors. Based on this ANOVA table, the regression model with the predictors provided (external factors, lessee related factors, and lessor related factors) is statistically significant in explaining the variation in Loan Default Amount.

Table 4. 10. ANOVA Test

ANOVA <sup>a</sup>					
Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	25.129	3	8.376	75.690	.000 <sup>b</sup>
Residual	7.857	71	.111		
Total	32.987	74			

a. Dependent Variable: Loan Default Amount

b. Predictors: (Constant), external factors (political instability, foreign currency fluctuation and inflation), lessor related factor (credit monitoring, appraisal, KYC and lease processing time), lessee related factors (educational status, managerial experience and lessee's location)

**Source: Own survey (2022)**

In the table 4.11 below, the model suggests that both lessor and lessee related factors significantly impact default amounts. External factors, while also significant, have a smaller impact on default amounts. Therefore, lenders should consider these factors in risk assessment and decision-making processes.

Table 4. 11. Regression Result

Coefficients <sup>a</sup>	
---------------------------	--

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	95% Confidence Interval for B	
	B	Std. Error	Beta			Lower Bound	Upper Bound
(Constant)	.438	.211	-	2.077	.041	.017	.858
lessor related factor	.455	.065	.552	6.952	.000	.324	.585
lessee related factors	.201	.078	.212	2.559	.013	.044	.357
external factors	.254	.050	.317	5.036	.000	.153	.354

a. Dependent Variable: Loan Default Amount

**Source: Own survey (2023)**

All three factors are statistically significant ( $p < 0.05$ ), indicating that these variables are reliable predictors of Loan Default Amount in this model. The 95% confidence intervals for the coefficients give us a range of values within which we can be 95% confident that the true coefficient lies. For each coefficient (B), the confidence interval does not include zero, further confirming the statistical significance of these coefficients.

Comparing the standardized coefficients (Beta values), lessee related factors appears to have the strongest influence on Loan Default Amount, followed by the lessor related factor. External factors have the least impact among the three. This may be due to the selected study area and cannot be generalized.

Lessor related factors such as credit monitoring, appraisal, KYC, and lease processing time should be carefully considered, as they have a positive impact on the Loan Default Amount. Lessee related factors like educational status, managerial experience, and lessee's location also play a significant role in predicting Loan Default Amount, indicating the importance of assessing lessee characteristics. External factors such as political instability, foreign currency fluctuation, and inflation have a positive impact on Loan Default Amount, suggesting that economic and external market conditions should be monitored closely.

#### **4.9. Discussion of Findings**

The regression model aims to predict the Loan Default Amount based on factors related to the lessor, lessee, and external economic factors. Here are the findings based on the coefficients: The intercept term of 0.438 indicates the expected default amount when all other predictors are zero.

#### **4.9.1. Lessor related factors**

The coefficient for lessor-related factors is 0.455, indicating a strong positive relationship with loan default amounts. This suggests that issues such as lack of strict monitoring and controlling, inappropriate KYC and appraisal processes, and lengthy loan processing times contribute significantly to higher loan defaults. The coefficient is statistically significant ( $p < 0.001$ ), meaning these factors have a notable impact on default amounts. Lessor-related factors have the highest standardized coefficient (Beta = 0.552), highlighting their relatively stronger influence on loan defaults compared to other factors. Credit monitoring practices by lessors to assess lessees' creditworthiness mitigate default risks. Effective credit monitoring involves ongoing evaluation of lessees' financial health, payment history, and adherence to lease terms.

Literature indicates that rigorous credit assessments and monitoring, thorough appraisal processes to assess the creditworthiness of lessees and more comprehensive Know Your Customer (KYC) procedures reduce default risk (Altman, 1968; Berger & Udell, 1995). It allows lessors to identify early warning signs of financial distress, adjust lease terms accordingly, and take proactive measures to recover assets. Jones and Brown (2019) and Wang et al. (2020) support the significance of appraisal procedures in leasing. Proper appraisals help lessors establish competitive lease rates, assess asset quality, and minimize disputes with lessees. Inadequate appraisals, on the other hand, can lead to overvaluation or undervaluation of assets, impacting lease terms and lessor profitability. A study by Altman (1968) found that stronger credit monitoring practices are associated with lower default rates. However, longer lease processing times might indicate higher-value transactions or more complex leases, which could lead to higher default amounts (Berger & Udell, 1995).

#### **4.9.2. Lessee Related Factors**

The coefficient for lessee-related factors is 0.201, indicating a moderate positive relationship with loan default amounts. This suggests that factors such as lack of educational literacy and business know-how, managerial inexperience, and inappropriate business locations contribute to some extent to higher loan defaults. The coefficient is statistically significant ( $p = 0.013$ ), indicating a meaningful impact on default amounts. Lessee-related factors have a lower standardized coefficient (Beta = 0.212) compared to lessor-related factors, indicating a slightly weaker influence. Higher educational status and managerial experience of lessees tend to

decrease default amounts, possibly due to stronger decision making capacity on riskier ventures. Location also plays a role; for example, areas with economic instability might lead to higher defaults (Cole & Sokolyk, 2016).

The educational background of lessees has been found to play a role in their leasing decisions and success. Lessees with higher levels of education may have a better understanding of lease terms, financial implications, and risk management strategies. They are more likely to negotiate favourable lease terms, assess the suitability of leased assets, and make informed decisions regarding leasing versus purchasing. Singh et al. (2018) and Li et al. (2020) suggest that lessees with higher educational qualifications exhibit better financial literacy and decision-making abilities in leasing contexts. They are more adept at evaluating the costs and benefits of leasing, understanding lease documentation, and managing lease-related risks. Conversely, lessees with lower educational levels may face challenges in comprehending complex lease agreements and navigating the leasing process.

Kumar and Sharma (2019) and Zhang et al. (2021) also highlighting that experienced managers are more likely to make sound leasing decisions that align with their business goals. The location of the lessee's operations also plays a role in leasing decisions and outcomes. Lessees located in urban areas with developed infrastructure and market access may have more leasing options and competitive lease rates. Wong and Chan (2017) and Chen et al. (2020) suggest that lessees' location can impact lease costs, asset availability, and operational efficiency.

#### **4.9.3. External Factors**

The coefficient for external factors is 0.254, indicating a moderate positive relationship with loan default amounts. This suggests that factors such as political instability, foreign currency fluctuations, and inflation also contribute to higher loan defaults. The coefficient is statistically significant ( $p < 0.001$ ), indicating a notable impact on default amounts. External factors have a standardized coefficient (Beta = 0.317) between lessor and lessee-related factors, indicating a moderate influence. The positive coefficient suggests that factors like political instability and currency fluctuations increase default amounts, possibly due to caution in risky environments (Stiglitz & Weiss, 1981).

The findings concerning external factors such as political instability, foreign currency fluctuations, and inflation hold significant implications for business performance. Political

instability, characterized by shifts in government, civil unrest, or uncertainties in policies, can detrimentally impact businesses. This was evident in the study by Smith (2017) emphasized that the adverse effects of political instability on business operations, citing disruptions in supply chains, increased risk premiums, and diminished investor confidence.

Similarly, foreign currency fluctuations were identified as a noteworthy factor influencing business performance. This finding is supported by research conducted by Li and Xu (2018), who underscore how currency fluctuations can result in financial losses, decreased competitiveness, and heightened uncertainty in business planning.

Furthermore, inflation diminishes purchasing power, leading to higher costs for raw materials, labour, and other inputs. This situation can compress profit margins and decrease the real value of revenues, particularly if businesses are unable to adjust their prices accordingly. Brown and Smith (2018) and Gupta et al. (2020) corroborate the notion that inflationary pressures can have adverse effects on business operations and profitability.

## **CHAPTER FIVE**

### **5. CONCLUSION AND RECOMMENDATION**

#### **5.1. Summary of Findings**

The study results indicate that lessor related factors lessee related factors and external factors were the main determinants of loan default of lease financing in Development bank of Ethiopia. The study found that the three factors have positive and statistically significant on the likelihood of default of lease financing in Development Bank of Ethiopia.

This means that issues such as lack of strict monitoring and controlling, inappropriate KYC and appraisal processes, and lengthy loan processing times contribute significantly to higher loan defaults. The coefficient is statistically significant ( $p < 0.001$ ), meaning these factors have a notable impact on default amounts. On the other hand factors such as lack of educational literacy and business know-how, lack managerial inexperience, and inappropriate business locations contribute to some extent to higher loan defaults. Additionally, political instability, foreign currency fluctuations, and inflation also contribute to higher loan defaults.

#### **5.2. Conclusion**

The findings of this study provide valuable insights into the factors influencing loan default amounts in the context of lessor and lessee related factors, as well as external factors.

All three categories of factors—lessor related, lessee related, and external factors—show statistically significant relationships with loan default amounts. Lessor-related factors, such as lack of strict monitoring and controlling, inappropriate KYC and appraisal, and lengthy loan processing times, have the strongest influence. Lessee-related factors, including educational literacy, managerial experience, and business location, also play a role but to a slightly lesser extent. The findings demonstrated on external factors such as political instability, foreign currency fluctuations, and inflation also contribute significantly to loan default. Understanding these external forces and their potential effects is essential for organizations to develop robust risk management strategies and adaptability measures to navigate challenging environments. These findings emphasize the importance of addressing these factors to mitigate loan default risks in the lending process.

### **5.3. Recommendation**

Based on the findings of the study, the following policy recommendation can be drawn for further consideration and improvement of lease financing practices in development bank of Ethiopia.

Firstly, the results indicate that lessor-related factors, such as the lack of strict monitoring and controlling, inappropriate KYC and appraisal processes, and lengthy loan processing times, have a substantial impact on loan default amounts. Development bank of Ethiopia needs to prioritize improving these aspects of their operations to mitigate the risk of defaults. By implementing more rigorous monitoring mechanisms, enhancing KYC procedures, and streamlining loan processing, DBE can potentially reduce default rates and improve overall performance.

Secondly, lessee-related factors were found to contribute significantly to loan default amounts. Factors such as the lessee's lack of educational literacy and business know-how, limited managerial experience, and inappropriate business locations were identified as key drivers of defaults. This highlights the importance of lessee education and support programs to improve their understanding of financial obligations and business management practices. Additionally, DBE should consider location-based risk assessments when extending leases to lessees, particularly in regions where economic conditions are less favourable.

Lastly, external factors such as political instability, foreign currency fluctuations, and inflation were also found to impact loan default amounts. The study revealed that organizations operating in regions with higher political instability and volatile currency markets tend to experience higher default rates. Similarly, inflationary pressures were associated with increased default amounts, as rising costs erode lessees' ability to meet their financial obligations. Therefore, government and policy makers should have to maintain these external factors in order to have sound finance through lease. It is also crucial for DBE to factor these external influences when assessing credit risk and designing lease agreements.

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MEKELLE UNIVERSITY  
FACULTY OF BUSINESS AND ECONOMICS  
MASTER OF ACCOUNTING AND AUDITING POST GRADUATE PROGRAM  
*QUESTIONNAIRE*  
*A Survey Questionnaire for a Study on “DETERMINANTS OF LOAN DEFAULT IN  
LEASE FINANCING”*  
A CASE OF DEVELOPMENT BANK OF ETHIOPIA

**Dear Sir/Madam,**

This questionnaire is designed to conduct academic research on “DETERMINANTS OF LOAN DEFAULT IN LEASE FINANCING”“A CASE OF DEVELOPMENT BANK OF ETHIOPIA” as part of the fulfilment of Masters of Accounting and Auditing at Mekelle University.

My name is Belay Tafesse and I am currently working on my thesis for partial fulfillment of Master of Science Degree in Accounting and Auditing at Mekelle University.

The purpose of my study is to identify and examine determinant of Lease loan default in lease financing in case of Development Bank of Ethiopia, to this end, the study intends to gather information from selected lease loan clients and who have credit relation with DBE. The participation is fully voluntary and the response will be confidential the result will be also reported without compromising the anonymity of respondents.

I would appreciate your favorable consideration in completing the enclosed questionnaire and assisting me in the research endeavor.

- In case you have any question please call...+251946903014
- Email Belltaf2007@gmail.com

Thank you in advance  
Belay Tafesse

**Thank you in advance for your cooperation!**

## **QUESTIONNAIRE**

**Please Tick in Appropriate Boxes**

### **Part One – Background Information**

1. 1. Sex \_\_\_\_\_

1) Female

2) Male

2. Age:

1) 20-30    2) 30-40    3) 40-50    4) Above 50 year

3. Level of education:

1) High school 2) Grade 12 and above 3) Diploma 4) 1<sup>st</sup> Degree and above

4. Indicate your experience in the bank credit relation

a) 1 to 5 year

b) 11 to 15

c) 6 to 10

d) 16 to 20

e) Above 20

5. Indicate the type of your Business

a) Sole proprietorship b) Private Limited Company

**Part two:**

<b>Please indicate the extent of your agreement on the following statements in to credit Monitoring</b>						
<b>Descriptions</b>	<b>Strongly Agree (5)</b>	<b>Agree (4)</b>	<b>Neutral (3)</b>	<b>Disagree (2)</b>	<b>Strongly Disagree(1)</b>	
Lack of credit monitoring leads to lease loan Default						
Poorly assessed lease projects may perform well if properly monitored						
Lack of lease Loan follow up is directly related to occurrence of lease loan default						
Higher budget for leas loan monitoring may reduce lease loan default						
Low capacity of lease loan monitoring officers result in higher lease loan default						
<b>Please indicate your degree of agreement or disagreement to the statements pertaining to lessee appraisal, KYC and lease processing time to occurrence of lease loan default</b>						
<b>Descriptions</b>	<b>Strongly Agree (5)</b>	<b>Agree (4)</b>	<b>Neutral (3)</b>	<b>Disagree (2)</b>	<b>Strongly Disagree(1)</b>	
The bank has clear eligibility criteria and documentation for lease project financing at the time of lease loan application						
Proper implementation of know your customer (KYC) lead to high lease loan quality						
Good loan underwriting ensures lease loan Performance						
Poor appraisal of lease projects would lead to lease loan default						
The time taken to process lease project loan is significant and reasonable						

	Prolonged lease processing time leads to lease loan default					
<b>Please indicate your degree of agreement or disagreement to the statements pertaining to lessee educational status, managerial experience and lessee's location to occurrence of lease loan default</b>						
	<b>Descriptions</b>	Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree(1)
	Project location far from financing bank institution may lead to lease loan default					
	The project location suitability or comfortability for project performer may have support to lease loan default					
	The project location inaccessible for market and marketing has contribution to lease loan default					
	Lack of Managerial experience of project manager has impact on lease loan default					
	The probability of defaulting regarding Educated Lessee's may not the same as of illiterate.					
	Educational status of lessee's affect lease loan repayment					
<b>Please indicate your degree of agreement or disagreement to the statements pertaining to political instability, foreign currency fluctuation and inflation to occurrence of lease loan default</b>						
	<b>Descriptions</b>	Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree(1)
	Political instability in the country causes my project to being default					
	Foreign currency fluctuation has high influence on my project to default					
	The increase In the inflation rate of the country has contribution to my project being default					