ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

THE STATE OF BANK SPECIFIC DETERMINANTS OF NONPERFORMING LOANS IN SELECTED ETHIOPIAN PRIVATE COMMERCIAL BANKS

BY

TESFAYE MARU ABATE

JUNE, 2015

ADDIS ABABA, ETHIOPIA

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A THESIS SUBMITTED TO ST. MARY'S UNIVERSITY, SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

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DECLARATION

I, the undersigned, declare that this thesis is my original work, prepared under the guidance of Zinegnaw Abiy (Dr). All sources of materials used for the thesis have been duly acknowledged. I further confirm that the thesis has not been submitted to any other higher learning institutions for the purpose of earning any degree.

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     Name   **Signature**

St. Mary's University, Addis Ababa   **JUNE, 2015**

ABSTRACT

This study intends to assess Bank specific determinants of nonperforming loans in Ethiopian private commercial banks. The sample size of the study were six banks selected out of those private banks established before 2010G.C in Ethiopia by using purposive sampling technique. The quantitative research approach was adopted for the study and survey conducted with professionals engaged in these private commercial Banks of credit departments using a self-administered questionnaire and in-depth interview. In addition, the study used structured review of documents and records of these banks. The findings of the study shows that poor credit risk assessment, under developed credit culture/orientation, poor understanding of credit terms and conditions, imposing highest interest rate on loan, poor credit monitoring and rapid credit growth or greater risk appetite for the occurrence of nonperforming loans. However, the study outcome did not support the existence of relationship between banks size and occurrences of nonperforming loans. The study suggests that banks should put in place appropriate terms and conditions, impose moderate lending rate, restrain from engaging in aggressive lending, put in place a effervescent credit process, give due emphasis in developing the competency of credit operators, proactive monitoring; organizational capacity enrichment of banks with exerted effort to develop culture of the community towards credit and its management.

Key Words: Non-Performing Loans; Bank-Specific Factors, private commercial Banks of Ethiopia.

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LIST OF ACRONYMS AND ABBREVIATIONS

IMF   International Monetary Fund

NBE   National Bank of Ethiopia

SSA   Sub-Saharan African

KYC   Know Your Customer

NPL   Non-Performance Loans

DBE   Development Bank of Ethiopia

CBB   Construction and Business Bank

MIS   Management Information System

AIB   Awash International Bank

BOA   Bank of Abyssinia

ROA   Returns on Asset

SPSS   Statistical Package for Social Sciences

US   United States

WB   Wegagen Bank

CHAPTER ONE

1. INTRODUCTION

1.1 Background of the study

A strong financial system is very important for a country to flourish. The economic progress of a nation and development of banking is invariably interrelated. The Banking sector is an indispensable financial service sector supporting development plans through channelizing funds for productive purpose (Rajaraman, I. & Vasishtha, G. 2002).

An efficient and well-functioning financial sector is essential for the development of any economy, and the achievement of high and sustainable growth. With this also comes the need to put in place a strong institutional framework to regulate and monitor the banks in order to keep health of the financial sector

Banks play intermediation function in that they collect money from those who have excess fund and lend it to others who need it for their investment. The main source of funding to business activities as well as other projects throughout the country can be taken as one means by which banks contribute to the growth of economies (Bercoff et al. 2002).

The banking industry in Ethiopia has about hundred years of experience; (www.nbe.et) however the sector is yet to develop and is still in its infancy or growing stage. The sector in Ethiopia provide the most basic banking products including deposit facilities, loans and advances, fund transfer (local /global) , import/export facilities, and guarantees.

Banking business in the country is done in accordance to "Banking Business Proclamation No. 592/2008" and different directives on banking business operations issued by the National Bank, which is the governing body of banking industry in Ethiopia. All the banks in the country are now regulated by the National Bank which is the Central Bank of Ethiopia as it plays the most influential role in a country's economic and financial development.

Nevertheless, as any business establishment a bank also seeks to maximize its profit. Since loans and advances are more profitable than any other assets, a bank is willing to lend as much of its funds as possible. Moreover, its contribution to the growth of any country is huge in that they are the main intermediaries between depositors and those in need of fund for their viable projects (creditors) thereby ensure that the money available in the economy is always put to good use (Waweru and Kalini , 2009).

But banks have to be careful about the safety of such advances. Bankers naturally try to balance the issue of maximizing profit by lending and at the same time manage risk of loan default as it would impair profit and thereby the very capital .Thus a bank needs to be cautious in advancing loans as there is a greater risk which follows it in a situation where the loan is defaulted (Radha M, et al., 1980).

In other words loan loss or defaulted loans puts a bank in a difficult situation especially when they are in greatest amount. Despite the fact that banks hold security for the loans they grant they cannot be fully be certain as to whether they are paid or not. It is when such risks materialize that loans turn to be non- performing (Bercoff et al. 2002).

Therefore, managing loan in a proper way not only has positive effect on the banks performance but also on the borrower firms and a country as a whole. In other words, failure to manage loans, which make up the largest share of banks assets, would likely lead to the episode of high level of non -performing loans (Bercoff et al. 2002).

According to the International Monetary Fund (IMF, 2009), a non- performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days' worth of interest has been refinanced. In the Ethiopian banking business directive, non-performing loans are defined as "Loans or Advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advances in question" National Bank of Ethiopia (NBE ,2008).

The determinants for non- performing loans vary in different countries and have a multidimensional aspect both, in developing and developed nations. 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, and lenient terms of credit, credit orientation, high credit growth and risk appetite, and poor monitoring among others. (Bercoff et al.,2002) categorizes causes of nonperforming loans to Bank specific and Macroeconomic conditions.

Thus the study has attempted to explore bank specific determinants of nonperforming loans in Ethiopian private commercial banks and some of the related supportive research abstracts that provide theoretical and conceptual foundation of the study reviewed accordingly.

The remaining part of this chapter is organized into eight sections. Section 1.1 and 1.2 present background of the study and overview of private commercial banking in Ethiopia, section 1.3 discusses problem statement , while sections 1.4 and 1.5 show the broad objectives of the study and scope and limitation of the study respectively. Significance of the study are highlighted in sections 1.6 and operational definitions have been discussed in sections 1.7. Finally, the outline of the research is presented in section 1.8.

1.2 Overview of Private commercial banking in Ethiopia

Banking is a highly regulated industry in Ethiopia for a number of reasons. Some of the reasons include protecting depositors' fund, ensuring safety and stability of the banking system, (that means to limit credit to a single borrower), and limiting or encouraging a particular kind of lending because of expected impact on the economy (NBE, 2008).

Following the enactment of the banking legislations in the country in the 1990s, a fairly good number of private banks have been established. For example, in the 2013/14 fiscal year the total number of banks already operational in the country reached nineteen. Of these banks, sixteen were private and the other three were government owned (NBE 2010).

According to the previous study (Wondimagegnehu, 2012) on the distribution of commercial bank branches throughout the country indicated that one branch of a bank on the average is estimated to serve 95,124 people. In (NBE, 2013), it is revealed that 112 new bank branches were opened which raise the total number of bank branches to 1728. As a result, the ratio of total

bank to total population went dawn to 49,768 from 53,217 from the preceding quarter indicating a significant improvement in financial service outreach. Nevertheless, those banks that have recently joined the sector in addition to the existing banks are expanding their branch network. However, the high people to bank branch ratio indicates that Ethiopia still remains as one of the under banked economies (NBE, 2013).

Table 1.1 List of private commercial banks in Ethiopia

S.No	Private Commercial Banks	Establishment Year G.C
1	Awash International Bank	1994
2	Dashen Bank	1995
3	Abyssinia Bank	1996
4	Wegagen Bank	1997
5	United Bank	1998
6	Nib International Bank	1999
7	Cooperative Bank of Oromia	2004
8	Lion International Bank	2006
9	Oromia International Bank	2008
10	Zemen Bank	2008
11	Bunna International Bank	2009
12	Birhan International Bank	2009
13	Abay Bank	2010
14	Addis International Bank	2011
15	Debub Global Bank	2012
16	Enat Bank	2013

Source: National bank of Ethiopia quarterly report (2013).

1.3 Statement of the problem

The operation of modern and organized financial institution is the most crucial part for any country to ensure the economic growth and development. Therefore, commercial banks are one of the financial institutions which are the main source of funding to business activities as well as

other projects throughout the country. They play a key role in the economy by mobilizing deposits from surplus units to deficit units in the form of loans and advances.

Moreover, banks exist to provide financial intermediation services while at the same time endeavor to maximize profit and shareholders' value. Lending is considered the most important function for fund utilization of Commercial Banks as major portion of their income is earned from loans and advances (Radha, 1980).

Therefore, banks do grant loans and advances to individuals, business organizations as well as government in order to enable them operate on investment and development activities as a means of contributing toward the economic development of a country in general and aiding their growth in particular.

In spite of the fact that loan is one of the major source of banks income and constitute their major assets, it is risky area of the industry. It has to be noted that credit risk arises from uncertainty in a given counterparty's ability to meet its obligations. When uncertainties materialize they would lead to deterioration of loan qualities as banks' loan quality is one of the major causes of financial fragility. That is why credit risk management is one of the most critical risk management activities carried out by firms in the financial services industry. In fact all the risks banks face, credit risk is considered as the most fatal as bad debts would impair banks profit (Radha, 1980).

A sound financial system, among other things, requires keeping a low level of non- performing loans which in turn facilitates the economic development of a country. High level of nonperforming loan is linked with banks failures and financial crisis because it has contagious impact affecting the whole banking business as it has recently been experienced in the USA and other parts of the world (Rose, 2002).

In Ethiopian context, the Banks in the country are required to maintain ratio of their non-performing loans below five percent (NBE, 2008). Despite this national industry average ratio set by national bank of Ethiopia as a bench mark, it has been observed that there is significant

deviation in the provision for doubtful loans of those banks which in turn signify the variation in the ratio of non-performing loans between banks.

These problems as well as the need for continuous research on the loan trends of the banks with regard to determinants of non-performing loan in Ethiopian commercial banks particularly private banks has initiated the researcher to perform this research by focusing on the investigation of bank specific determinants of non-performing loans.

1.4 Objectives of the study

1.4.1 Major Objectives

The aim of this study is to investigate determinants of NPLs in Ethiopian private commercial banks specifically on those bank specific factors that are in turn depicts the soundness of the overall banking business. Therefore, the major objective of this study is identifying the main bank specific determinants of NPLs in Ethiopian private commercial banks.

1.4.2 Specific Objective

The specific objectives of this study are:

- ➢ Investigating whether credit monitoring affects loan default.

- ➢ Assessing the impact of credit culture on loan default.

- ➢ Examining whether credit terms and price or interest affect loan performance.

- ➢ Assessing if there is any relationship between Asset structure and bank size on loan default.

- ➢ Checking whether or not rapid credit growth and greater risk appetite lead to non-performing loans.

- ➢ Assessing the relationship between loan underwriting, risk assessment and non-performing loans.

1.5 Scope and Limitation of the Study

Despite the fact that, in developing and underdeveloped countries, the reasons for default have a multidimensional aspect. Number of Literature categorizes determinants of NPL to macroeconomic and bank specific factors. This study has only been limited to bank specific factors even if macroeconomic determinants have a huge impact on the qualities and performance of loans.

This thesis is adjusted to fit its objectives of examining the determinants of NPLs of private commercial banks in Ethiopia and this is only due to the vast in nature of the issue in accordance to its need of enough time and budget. The researcher decided to limit this study to private commercial banks found in Ethiopia namely, Awash international bank, Bank of Abyssinia, Wegagen bank, Oromia international bank, Lion international bank and Berhan international bank. These banks have been selected with criteria taken as the primary three banks from senior banks expected to have more than ten years of experience on the lending activities and the rest three banks believed to have five to ten years taken as moderate experience.

1.6 Significance of the study

The finding of this study which deals with the determinants of nonperforming loan of commercial bank in Ethiopia is beneficial for different stakeholders such as banking sector (all commercial Banks and National bank of Ethiopia) researchers and for other researchers in such a way that, For National bank of Ethiopia, since such investigation has policy implication, the finding of this study might be used as a directive input in developing regulatory standards regarding the lending policies of commercial banks in the country.

In addition, this study can initiate the commercial Banks management to give due emphasis on the management of an identified variables and provides them with understanding of activities that will enhance their loan performance. This is due to the fact that knowing the variables that determine the nonperforming loan might help the bank manager to concentrate on the quality of loan rather than its quantity. Thus, this study made the management body to visualize the determinants of NPLs.

Furthermore, this study serves as a reference for other researchers who want to undertake research in related area so as to minimize the literature gap in the area of study particularly in Ethiopia.

1.7 Operational Definition

Credit risk – the risk arise as result when the borrower fail to conclude its financial contract according to the agreement with lender. It is an asset default by counter party (Rajan, R. G., 1994).

Borrower: - the one who borrows money from the lender (Bank) (NBE, 2008).

Loan and advances: any financial asset granted by banks to borrower on a contract of an obligation to repay the principal amount with usually its interest either on   due date or demand (NBE, 2008).

Nonperforming loans - a loan whose credit quality has deteriorated and the full collection of principal and/or interest as per the contractual repayment terms of the loan/advances is in question and delayed for more than 90 days (NBE, 2008).

Lending: - provision of loan by one party (lender) to another party (Borrower) (NBE, 2008).

Bank specific factors: - are variables that are under the control of bank management. They can be directly/ indirectly stated in the financial statements of banks (Rajan, R. G. 1994).

Macroeconomic factors: - are variables in which the bank management has no power to control them. Rather, these variables are related with the fiscal and monetary policies of the country (Nkusu, M. 2011).

1.8 Organization of the Research Report

The content of this research report have been organized in to the following chapters. Chapter one discussed Introduction/Background of the study that would give a brief overview of banking industry in Ethiopia. The chapter has also discussed objectives of the study, scope, and significance and limitation of the study and definition of important terms.

In chapter two theoretical and empirical foundation of the study has been presented. This chapter has covered important issues related to the banking business such as lending, theoretical review of nonperforming loans, Ethiopian banking system and regulations. This chapter has also shown an exhaustive literature review conducted on relevant studies. The review has included previous research surveys and studies. Chapter three described all about the research methodology. It explained the research design, the sample population, data collection method, measuring instruments, and data analysis techniques. Similarly, result of the study and summary thereof is presented under Chapter four.

The last chapter which is Chapter five has widely treated interpretation of the research results, discussion and conclusions. And finally based on the conclusion of the research valuable recommendations have been given accordingly.

CHAPTER TWO

2. LITERATURE REVIEW

Background information and overview of banking industry with respect to the research problem, objectives and scope of the study were discussed in chapter one. This chapter presents the theoretical foundation of the study along with issues pertaining to credit assessment, nonperforming loans and its determinants. It is organized into three sections. Section 2.1 deals with theoretical review of Bank loans and lending, Credit assessment followed by the five Cs model, Factors affecting bank loan, NPLs and its determinants are discussed respectively. This is followed by a discussion of Empirical review which deals with the Macroeconomic and Bank specific determinants of NPLs under section 2.2. Finally brief summary and identification of research area on the chapter is presented under section 2.3.

2.1 Theoretical Literature

2.1.1 Overview of Bank Loans and Lending

One of the major functions of any commercial bank is providing loan to the business society so as to channeling this banks collect money from those who have excess money and lend it to others who need it for different purposes. Therefore, banks' intermediary function plays a vital role in the economic activity as it accept customer deposits and use those funds to give loans to other customers or invest in other assets that can yield a return higher than the amount bank pays the depositor (McCarthy et al., 2010). It is apparent that customers' deposit is the primary source of bank loan and hence, increasing or guaranteeing deposits directly has a positive effect on lending. Therefore, bank credit is the primary source of available debt financing for most customers whereas good loans are the most profitable assets for banks.

The principal profit making activity of commercial banks is making loans to its customers. In the allocation of funds to earn the loan portfolio, the primary objective of bank management is to earn income while serving the credit needs of its community (Reed and Gill, 1989) cited in

(Wondimagnehu, 2012).Therefore, like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower. The borrower initially receives an amount of money from the lender to pays back, but sometimes not always in regular installments, to the lender. This service is generally provided at a cost, known as interest on the debt. As one of the principal duties of financial institutions is to provide loans, it is typically the main source of income to banks.

Besides, bank loans and credit also constitute one of the ways of increasing money supply in the economy (Felix and Claudine, 2008). Loans are the largest single source of income for banks. Bank loan involves personal relationships between the bankers and borrowers. It has a highest degree of default risk than other bank assets. Loans yield the higher rate of return among bank assets in compensation for lower liquidity and higher risk (MacDonald, 2006).A loan composition greatly varies among banks based on their size, location, trade area and lending experts.

It is well mentioned that lending is the provision of resources (granting loan) by one party to another. The second party doesn't reimburse the first party immediately there by generating a debt, and instead arranges either to repay or return those resources at a later date. Lending represents the heart of the industry and Loans are the dominant asset and represent 50- 75 percent to total amount at most banks, generate the largest share of operating income and represents the bank`s greatest risk exposure (MacDonald, 2006).

2.1.2 Credit Assessment

Credit analysis is the first step in the process to tailor-make a solution to fit the customer's needs through credit assessment. It starts with an understanding of the customer's needs and capacities to ensure there is a good fit in terms of the financing solution. Credit assessment is the most important safeguard to ensure the underlying quality of the credit being granted and is considered an essential element of credit risk management (Cade, 1999).

The credit quality of an exposure generally refers to the borrower's ability and willingness to meet the commitments of the facility granted. It also includes default probability and anticipated recovery rate (Saunders & Cornett, 2003). Credit assessment thus involves assessing the risks involved in financing and thereby anticipating the probability of default and recovery rate. A credit analysis is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's (Strischek, 2000). Detailed discussion of this model also referred as the five C's are presented as follows.

2.1.3 Five Cs principles on Credit

The five C's model are considered the fundamentals of successful lending and provided an even more comprehensive view and clearer understanding of the underlying risk and resulting lending decision; (Sinkey, 2002). According to Murphey (2004), these principles should be the cornerstone of every lending decision. A credit analysis is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's model:

Character:

Character refers to the borrower's reputation and the borrower's willingness to settle debt obligations. In evaluating character, the borrower's honesty, integrity and trustworthiness are assessed. The borrower's credit history and the commitment of the owners are also evaluated (Rose, 2000). A company's reputation, referring specifically to credit, is based on past performance. A borrower has built up a good reputation or credit record if past commitments were promptly met (observed behavior) and repaid timely. Thus, character is considered the most important and yet the most difficult to assess (Koch & MacDonald, 2003).

In a company's success in connection with this management plays essential role. Critically analyzing quality of management has been one of the ways of assessing character. The history of the business and experience of its management are critical factors in assessing a company's ability to satisfy its financial obligations.

The quality of management in the specific business is evaluated by taking reputation, integrity, qualifications, experience and management ability of various business disciplines such as finance, marketing and labor relations into consideration (Sinkey, 2002). Much of its success can in fact be attributed to competent leadership. However, Companies with strong and competent management teams tend to survive in an economic downturn.

On the other hand privately owned companies are generally managed by its owners. In this instance, succession planning must be in place, as the role of management remains vital to the success of the company (Koch & MacDonald, 2003).

Capacity

Capacity refers to the business's ability to generate sufficient cash to repay the debt. An analysis of the applicant's businesses plan, management accounts and cash flow forecasts (demonstrating the need and ability to repay the commitments) will give a good indication of the capacity to repay (Sinkey, 2002; Koch & MacDonald, 2003).To get a good understanding of a company's capacity evaluating the type of business and the industry in which it operates is also vital .It plays a significant role since each industry is influenced by various internal and external factors.

The factors that form the basis of this analysis includes: Type of industry, Market share, Quality of products and life cycle, whether the business is labor or capital intensive, the current economic conditions, seasonal trends, the bargaining power of buyers and sellers, competition and legislative changes (Koch & MacDonald, 2003). These factors lead the banker to form a view of the specific company and industry.

Besides, the financial position is also a critical indication of a business' capacity. The company's financial position is evaluated by assessing past financial performance and projected financial performance. A company's past financial performance is reflected in their audited financial statements (Koch & MacDonald, 2003). Financial projections consist of projected cash flows demonstrating the need for the facility and the ability to repay the facility (Sinkey, 2002). In this regard at least three years audited financial statements (balance sheet and income statement) are required for data analysis using a financial spreadsheet.

Capital

Capital refers to the owner's level of investment in the business (Sinkey, 2002). Banks prefer owners to take a proportionate share of the risk. Although there are no hard and fast rules, a debt/equity ratio of 50:50 would be sufficient to mitigate the bank's risk. Lenders prefer significant equity (own contribution), as it demonstrates an owner's commitment and confidence in the business venture.

Conditions

Conditions are external circumstances that could affect the borrower's ability to repay the amount financed. Lenders consider the overall economic and industry trends, regulatory, legal and liability issues before a decision is made (Sinkey, 2002). Once finance is approved, it is normally subject to terms, contracts and conditions, which are specifically related to the compliance of the approved facility (Leply, 2003).

Banks normally include covenants along with conditions when credit facilities are granted to protect the bank's interest. The primary role of covenants is to serve as an early warning system whether it can be negative or positive (Sinkey, 2002). Negative covenants stipulate financial limitations and prohibited events (Koch & MacDonald, 2003) where as Positive or affirmative covenants stipulate the provisions that borrower must adhere to (Rose, 2000). One example of positive covenant is audited financial statements must be provided within 90 days of the company's financial year-end.

Conditions normally stipulate that all the security relevant to the loan should be in order before any funds will be advanced.

Collateral

Collateral (also called security) is the assets that the borrower pledges to the bank to ease the bank's risk in event of default (Sinkey, 2002) .It is something valuable which is pledged to the bank by the borrower to support the borrower's intention to repay the money advanced. Security

is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003).

In support of the aforementioned, (Rose, 2002) could define secured lending in banks as the business where the secured loans have a pledge of some of the borrower's property (such as home or vehicles) behind them as collateral that may have to be sold if the borrower defaults and has no other way to repay the lender.

The purpose of security is to reduce the risk of giving credit by increasing the chances of the lender recovering the amounts that become due to the borrower. Security increases the availability of credit and improves the terms on which credit is available. The offer of security influences the lender's decision whether or not to lend, and it also changes the terms on which he is prepared to lend, typically by increasing the amount of the loan, by extending the period for which the loan is granted and by lowering the interest rate (Norton, J., & Andenans, M. 1997). According to (De Lucia and Peters 1998), in the banking environment, security is required for the following three reasons:

- ❖ To ensure the full commitment of the borrower to its operations,
- ❖ To provide protection to which the borrower deviate from the planned course of action outlined at the time credit is extended, and
- ❖ To provide insurance should the borrower default.

The security value of an asset is based on the estimated re-sale value of the assets at the time of disposing of it and the specific type of property is valued by the bank to determine the property's market value for security purposes (Rose, 2000).

Moreover, the physical collateral a third party can provide a suretyship for the debt of the borrower. Should the borrower not be in a position to repay the debt, the bank will then call on the surety for repayment (Koch & MacDonald, 2003). It is normal banking practice for the banks to take the suretyship of the shareholders/directors when funds are advanced to a company (Rose, 2000). 5C's" are well-known credit assessment principles, commercial banks have

developed their own qualitative credit risk assessment models to assess whether the bank will agree to lend to a specific business (Sinkey, 2002).

Based on the credit information obtained about the borrower and credit assessment carried out, either by quantitative or qualitative model (through the use of the five C's) or combination of both, a credit sanctioning is done.

2.1.4 Factors Affecting Bank Loan

Since lending is the principal function of banking industry, the management of banks should give due attention, analyze and take the necessary measures on time on internal and external factors that affect or limit lending. Without lending, banks' incomes especially interest income would highly deteriorate and affect bank survival. In case, since nonperforming loans (NPLs) has a direct reflection of poor asset quality, the factors that influence banks loans have their own impact on NPLs (Rawlin et al., 2012).

According to (Reed and Gill, 1989) therefore, there are worth mentioned factors that might directly and indirectly influence on the growth and quality of bank loans, which in turn put impact on NPLs are:

Capital position: The capital of banks serves as a custom for protection of depositors' funds as the size of capital in relation to deposits influences the amount of risk that a bank can manage in due course. This is to mean that relatively large capital structure can afford loans of longer maturities and greater credit risk.

Profitability: Some banks may emphasize earning more than any other tasks due to this reason banks with greater need of earning might adapt more aggressive lending policies. An aggressive policy might call consumer loans, which normally are made at higher rates of interest than short-term loans.

Stability of deposits: - The fluctuation and type of deposit must be considered to make sure the overall stability of available funds. After adequate provisions on deposits have been made for

reserves, bank can then engage in lending activities. Even though, these reserves designed to take care of predictable deposit fluctuations and loan demands there might arise unpredictable demand forces that banks have to give due consideration for the stability of deposits in formulating loan policy.

Economic conditions: - Stable economy is more conducive to a liberal loan policy than the one that is subject to seasonal and cyclical movements. Deposit of famine economies fluctuate more violently than deposit in an economy noted for its stability and consideration must be given to the national economy. Factors with serious magnitude which adversely affect the nation as a whole may also eventually affect local conditions.

Influence of monetary and fiscal policies: - If monetary and fiscal policies are expansive and extensive, reserves are made available to the commercial banking system then the lending ability of banks shall be increased. Under these policies banks can have a more liberal loan policy. On the other hand whenever there is aloof or reserved monetary and fiscal policies commercial banks shall become choked in their lending capacity.

Ability and experience of bank personnel:-The expertise of lending personnel is not insignificant in the establishment of bank loan policy. The lending processes in the bank are highly requiring skilled manpower to execute quality loan and advance facility. One of the conceivable reasons that banks were slow in entering the consumer lending turf was believed to be lack of skilled personnel.

Credit needs of the area served:- banks specialized experience on different types of loans e.g. Mortgage real-estate, Manufacturing and Industry, construction, term loan ,domestic and trade service e.t.c. The major reasons banks are chartered is to serve the credit needs of their communities and are morally bound to extend credit to borrowers who present logical and economically sound loan requests.

According to (McCarthy, 2010) there are also other factors that might be directly or indirectly affect bank lending and investing activities. These factors include:

The interest rate: represents rate of returns available from the various alternative of lending and investing activities. Fundamental problem of bank management is achieving the proper balance between return and risk.

The liquidity of fund: - it is the amount of liquid funds tied up for further lending and investing activities. So as to maintain adequate liquidity, bank must constantly guard against excessive losses from lending and investing activities, otherwise; if they made too many bad loans, the value of its asset could fall below the amount of its liabilities.

Tax: According to (Albertazzi and Gambacorta, 2006) , corporate income tax rate affect the bank loans in different aspects: The first aspect is that high tax burden enables the banks to shift the tax burden either by increasing lending rate and fees or paying low interest rate on deposits. The second aspect is, corporate income tax rate has output and input substitution effect. The output substitution effect states that increased corporate income tax rate represents a decrease in production in the incorporated sectors. In this case, the demand for loan gets lower whereas input substitution effect represents the substitution of equity with other inputs for instance; debt (Kaplow, 2008).

2.1.5 Nonperforming Loans (NPLs)

There is no one common definition of nonperforming loans (NPLs) recognized for every country since it can possible explained that what is appropriate in one country may not be so in another. There is still some common opinion on this issue. Accordingly the IMF's Compilation Guide on Financial Soundness Indicators, NPLs is defined as:

> "A loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons such as a debtor filing for bankruptcy to doubt that payments will be made in full" (IMF, 2006) Spain: *Financial Sector Assessment Program–*

Technical Note–Stress Testing Methodology and Results, IMF Country Report No.06/216,.

Moreover, the Ethiopian banking regulation also defines NPL as follows:

"Nonperforming loan and advances are a loan whose credit quality has deteriorated and the full collection of principal and/or interest as per the contractual repayment terms of the loan and advances are in question" (NBE, 2008) *Asset Classification and Provisioning Directive No. SBB/43/2008*.

Generally, NPLs are loans that are outstanding both in its principal and interest for a long period of time contrary to the terms and conditions under the loan contract. In other words since loans and advances comprise the lion share of banks any loan facility that is not up to date in terms of payment of principal and interest contrary to the terms of the loan agreement is NPLs. Thus, the amount of nonperforming loan likely measures the quality of bank assets.

2.1.6 Determinants of Nonperforming Loans

Deterioration in banks' loan quality is one of the major causes of financial fragility. Past experience shows that a rapid buildup of bad loans plays a crucial role in banking crises (Demirgüç Kunt and Detragiache, 1998, and González Hermosillo, 1999). In recent years, the global financial crisis and the subsequent recession in many developed countries have increased households' and firms' defaults, causing significant losses for banks. Default culture is not a new dimension in the arena of investment. Rather in the present economic structure, it is an established culture. The redundancy of unusual happening becomes so frequent that it seems people prefer to be declared as defaulters (Sonali, 2001).

Generally, in developing and underdeveloped countries, the reasons for default have a multidimensional aspect. Various researchers have concluded various reasons for loan default.

2.2 Empirical Literature

The literature reviewed concentrate on two grand factors- macroeconomic and bank specific factors. Studies in the western countries and the rest of the world provide this result. For instance, (Bercoff et al., 2002) examine the fragility of the Argentinean Banking system over the 1993-1996 periods; and came up with a finding that NPLs are affected by both bank specific factors and macroeconomic factors. Thus, the rest of this section discusses the empirical literature on determinants of nonperforming loans beginning with macroeconomic and then bank specific factors.

2.2.1 Macroeconomic Determinants of NPL

The macroeconomic determinants of the quality of banks' loans have been area of various researchers during the past two decades. The literature on the major economies has confirmed that macroeconomic conditions matter for credit risk. These literatures among others have investigated the linkage between macroeconomic factors like GDP, inflation, real interest rates, unemployment etc. and loan performance.

(George, 2004) states the fact that large number of the literatures indicates the linkage between the phases of the business cycle with banking stability. Macroeconomic stability and banking soundness are inexorably linked. Both economic theory and empirical evidence strongly indicate that instability in the macroeconomic is associated with instability in banking and financial markets and vice versa.

The researches indicates that the expansion phase of the economy is characterized by a relatively low number of NPLs, as both consumers and firms face a sufficient stream of income and revenues to service their debts. However as the booming period continues, credit is extended to lower-quality debtors and subsequently, when the recession phase sets in, NPLs increase (Geanakoplos , 2009). Studies conducted by (Keeton and Morris 1987) on a sample of nearly 2,500 US commercial banks using simple linear regressions indicate that large portion of loan losses recorded by the banks ascribe to adverse local economic conditions along with the poor performance of certain sectors.

Generally looking, the effect of macroeconomic instability on the financial sector and banking in particular makes it a cause for non- performing loans. Because financial institutions basically deal in forward contacts, whose profitability hinges greatly on the ability to predict future prices, they do not do well in volatile environments that increase uncertainty and make forecasting more difficult. To reduce their risk exposure, the banks collateralize their loans with either the borrowers' estimated future income and/or the estimated future value of specified assets. If either the realized income or realized asset prices fall sufficiently short of the projected values, the borrower may default and generate losses for the bank (Machiraju, 2001).

2.2.2 Bank specific determinants of NPLs

(Bercoff et al., 2002) examine the fragility of the Argentinean Banking system over the 1993-1996 period; they argue that non performing loans are affected by both bank specific factors and macroeconomic factors. Salas and Saurina, (2002) reveal that real growth in GDP, rapid credit expansion, bank size, capital ratio and market power explain variation in non- performing loans. Furthermore, (Jimenez and Saurina, 2005) examine the Spanish banking sector from 1984 to 2003; and provide evidence that non performing loans are determined by GDP growth, high real interest rates and lenient credit terms. Meanwhile, (Rajan and Dhal, 2003) utilize panel regression analysis to report that favorable macroeconomic conditions and financial factors such as maturity, cost and terms of credit, banks size, and credit orientation impact significantly on the non performing loans of commercial banks in India.

There are literatures available on impact of macro-economic factors on NPLs, which are viewed as exogenous forces or external factors influencing the banking industry however they should not be sought exclusively in determining NPLs. In contrast, the typical nature of the banking sector along with the specific policy choices of a particular bank with regard to its efforts to maximize efficiency and improve in its risk management are expected to exert a vital influence on the evolution of NPLs. A fewer studies are available which presents the effect of bank-specific determinants of Non-Performing Loans (NPLs).

This study only considers seven bank specific variables owing to data availability. These are: weak risk assessment, high interest rate, bank size, rapid credit growth, credit culture (orientation), poor loan follow up or monitoring and lenient credit terms.

1) Weak Risk assessment

A weak Risk assessment can also play a role in increasing NPLs. The repute of borrowers to repay loan and the market value of securities are not adequately assessed while giving loans which become key reasons behind NPLs (Peterson and Wadman, 2004). The study shows that the banks use their personal experiences in giving loans rather than using historical data, mature credit portfolio management skills and centralized information system. This causes NPLs to grow at even a higher pace. The banks should access information about creditability of the customers, so that NPLs can be reduced. In this regard responsibilities of banks should be clearly defined. It should be ensured that banks exercise effective policies and adequate risk management capabilities (Basel, 2001).

According to (Peterson and Wadman, 2004), the borrowers can be differentiated with respect to quality on the bases of adverse selection. Low quality borrowers cannot use amount of loan in productive ventures as compared with high quality borrowers. This can result in an increase in NPLs. The Adverse selection problem indicates that when lenders cannot discriminate the good from bad borrowers, all borrowers are charged a standard interest rate that reveals their collective practice. If this rate is elevated than valuable borrowers justify, it will drive some good borrowers out of the borrowing market, forcing in turn to banks charging even higher rates to the remaining borrowers. That's why the banks prefer to choose high quality borrowers. The selection of borrowers is a challenge in order to control NPLs. (Peterson and Wadman, 2004).

2) High Interest Rate

Banks that charge high interest rate would comparatively face a higher default rate or non-performing loans. The impact of real interest rates on NPLs is extensively documented in the literature. In fact, several studies report that high real interest rate is positively related to this

variable. Excessive lending by commercial banks is often identified as an important determinant of NPLs (Salas and Saurina, 2002).

Rajan and Dhal, (2003) who used a panel regression analysis indicates that financial factors like cost of credit has got significant impact on NPLs. Study by (Waweru and Kalini, 2009) on the commercial banks in Kenya using statistical analysis indicates that high interest rate charged by the banks is one of the internal factors that leads to incidence non-performing loans. An increase in interest rate weakens loan payment capacity of the borrower therefore non-performing loans and bad loans are positively correlated with the interest rates (Nkusu, M., 2011).

3) *Rapid Credit Growth*

Studies indicate that loan delinquencies are associated with rapid credit growth (Keeton, 1999) who used data from commercial banks in the United States (from 1982 to 1996) and a vector auto regression model indicate this association between loan and rapid credit growth. (Sinkey and Greenwalt, 1991) who have also studied large commercial banks in the US and found out that excessive lending explain loan –loss rate. (Salas and Saurina, 2002) who studied Spanish banks found out that credit growth is associated with non-performing loans.

Supply-side explanations of the expansion of bank loans frequently suggest a relaxation of underwriting standards, whereas loan contractions are said to suggest a tightening of standards. So with growth of loan size causes poor loan performance ascribing to the relaxed underwriting standard.

4) *Poor Loan Follow-up (Monitoring)*

Regular monitoring of loan quality, possibly with an early warning system capable of alerting regulatory authorities of potential bank stress, is essential to ensure a sound financial system and prevent systemic crises. The banks, which incur more expenses on monitoring and assessing the borrowers, are less efficient in financial operations but these banks have lower NPLs (Agresti et al., 2008).

The need to give due attention to borrower thus need not be overemphasized in order to ensure loan performance. There is a tendency by borrowers to give better attention to their loans when they perceive they got better attention. Some of the loans defaults ascribe to lower level of attention given to borrowers.

Therefore, it is clear that effective credit monitoring involves looking into various operations of the company including operations of the loan, checking whether the company is properly managed, and the environment in which the company is carrying out its business is satisfactory.

5) Lenient Credit Terms

Credit sanctioning that has not duly considered the credit terms would potentially lead to occurrence of poor loan performance. (Jimenez and Saurina, 2005), in the study conducted on the Spanish banking sector from 1984 to 2003 evidenced that NPLs are determined by lenient credit terms. Cause for the lenience is attributed to disaster myopia, herd behavior, moral hazard and agency problems that may entice bank managers to take risk and lend excessively during boom periods as per this study.

(Rajan and Dhal, 2003) who studied the Indian commercial banks also found out terms of credit determines occurrence of Nonperforming loans. (Rajan, 1994) hypothesizes that bank managers have short-term decision horizons because their reputations are strongly influenced by public perceptions of their performance, as evidenced by short-term earnings. Managers' reputations suffer if they fail to expand credit when the economy is expanding and bank earnings are improving. This herd behavior will result in some loans going to customers with higher default risk than would occur otherwise. (Weinberg, 1995) also suggests that bank managers adjust lending standards as market conditions change, seeking to smooth overall lending risk.

Besides study by (Waweru and Kalini, 2009) indicates lack of proper skill amongst loan officials, speedy process of evaluating loans mainly due to external pressure, are among the factors that lead to huge concentration non performing loans.

Commercial banks and other financial institutions experienced an increase in competition in the United States during 1980 and early 1990. This resulted in a change in lending practices. Due to the competition and the pressure to deliver increasing returns, banks increased the granting of credit facilities to marginal borrowers. These facilities were aggressively priced to compensate for the increase in risk. Although the strategy delivered short-term results, credit losses followed and in many cases caused banks to fail (Koch & MacDonald, 2003). The failure of banks can therefore, not only be linked to unfavorable economic environments, but also to the nature of the credit policies they employ.

6) Credit Orientation

Financial sector development goes hand in hand with orientation of the public especially those peoples who have engaged in different business activities and in need of credit to their business should have clear orientation about credit terms and conditions as it one of the cause of nonperforming loans. Study conducted by (Rajan and Dhal, 2003) indicate that credit orientation significantly affects loan default rate as per their panel regression analysis conducted on commercial banks on India.

7) Bank Size

Study by(Cole et al., 2004) used data obtained from the 1993 Federal Reserve National Survey of Small Business Finance and bank financial reports, suggest that smaller banks adopt small business loan underwriting practices that are riskier than those of larger banks, riskier in that small banks prefer to lend to small firms that lack hard financial data to support the lending decision and riskier to the extent that the failure rates of small businesses are higher than those of larger, established firms.

The empirical evidence relating to the impact of bank size on NPLs appears to be mixed. For instance, some studies report a negative association between NPLs and bank size (Rajan and Dhal, 2003). According to these studies, the inverse relationship means that large banks have better risk management strategies that usually translate into more superior loan portfolios vis-à-vis their smaller counterparts.

In the Ethiopian context under the study of (Wondimagegnehu, 2012) findings shows that poor credit assessment, failed loan monitoring, underdeveloped credit culture, lenient credit terms and conditions, aggressive lending, compromised integrity, weak institutional capacity, unfair competition among banks, willful default by borrowers and their knowledge limitation, fund diversion for unintended purpose, over/under financing by banks ascribe to the causes of loan default. However, the study outcome failed to support the existence of relationship between banks size, interest rate they charge and ownership type of banks and occurrences of nonperforming loans.

2.3 Summary and Identification of the Research Area

Studies were done on the determinants of NPLs in different countries. Even though, the determinants of NPLs are still debatable among different researchers that might be due to situational factors like country level factors, bank level factors and the condition of legal and regulatory framework of the country. However, these studies conceptually showed that macroeconomic and bank specific factors determined for the occurrence of nonperforming loans.

Furthermore, bank specific factors like : weak risk assessment, high interest rate, bank size, rapid credit growth, poor loan follow up or monitoring and lenient credit terms are found to be having significant on the determination of NPL. Most of the literature reviewed covered studies both in developed and developing countries' banking sector. However, there were only limited literatures available for this research on African banks, with the exception of studies on Sub Sahara Africa and another on Kenyan commercial banks (Waweru and Kalini, 2009).

In the previous studies of Ethiopia which are directly related to this research i.e. bank specific determinants of non-performing loan are not sufficient and in fact there is a need of auxiliary research intervention like other related researches done in the banking sector and there is still limited number of literatures made in the Ethiopian banking industry, with the exception of a single study made by (Wondimagegnehu, 2012) on the determinants of NPLs of banking industry in Ethiopia.

Moreover, there are continuous changes made by the National Bank of Ethiopia on the overall banking business activities. The bank issues directives which directly or indirectly affect the private commercial banks credit capability. Some of these directives include as follows:

The first directive (MFA/NBE BILLS/001/2011) express on the establishment and operation of National Bank of Ethiopia Bills Market and this directive is only applied on private commercial banks in which banks shall buy the bills allotted to them every month calculated as 27% of the disbursement loan plan of each private commercial banks which intern hamper their long run loan able fund capacity (NBE 2011).

The second directive (MFA/NBE BILLS/002/2013) which is the extension of the first directive as an amendment on eligibility criteria and limitation on portfolio share of short term loan that shall not be less than 40 percent of outstanding loans and advances. These criteria impede commercial banks liquid fund potentials from additional lending and investing activities due to the Bills purchase on loan disbursement allotment resulted in this 40 percent short term loan portfolio allocation which tied up fund to long term investments (NBE 2013).

Thus, given the unique features of banking sector and environment in which they operate and also rapid expansion of private commercial banking institutions in Ethiopia as well as the different NBE directives especially like the above two directives which discriminate government commercial banks with private banks may gear substantial impact on credit capability and implementation among them.

Meanwhile, as to the knowledge of the researcher there is no related research found in connection with the above mentioned issue. Having in mind this and other related factors there is strong wishes to conduct a separate study so as to glance the trends of determinants of NPLs in the private banking sector of Ethiopia.

Therefore, this research has concentrated to look forward in this stare with thorough examination of the factors that affect nonperforming loans of Private commercial banks that are found in the country. Besides, the research would assess the trends of NPLs after the implementation of the above mentioned directives.

CHAPTER THREE

3. RESEARCH DESIGN AND METHODOLOGY

This chapter has discussed the research design and methodology. It is organized in to four sections. The first section 3.1 discusses the research design. The second section discusses Sampling design. Methods of data collection and analysis are presented in section 3.3 and 3.4 respectively.

3.1. Research design

The main objective of this study is to investigate and examine the relationships between NPLs and Bank specific determinants in Ethiopian private commercial banks. The study has employed quantitative research approach which helps us to answer question about relationships among measured variables with the purpose of explaining, predicting and controlling phenomenon.

Quantitative research approach has two strategies of inquiry. The first is survey design which provides a quantitative or numeric description of trends, attitude or opinion of a population by studying a sample of that population. From the sample the researcher generalizes about the population. The second type of design is experimental design used to test the effect of intervention on an outcome, controlling all other factors which may influence that outcome (Creswell, 2009).

In this research the survey research approach has been employed. With this both primary and secondary data are gathered from credit department managers and senior loan officers as well as the financial statements of the private commercial banks under study respectively. For primary data collection the study used structured questionnaire and in-depth interview. Whereas for secondary data, documentary review of the financial statements of banks, and NBE reports along with each bank annual reports have been incorporated.

3.2. Sampling design

Sample design deals with sample frame, sample size and sampling technique. Sampling is a technique of selecting a suitable sample for the purpose determining parameters of the whole population. Population is the list of elements from which the sample may be drawn. A sample is drawn to overcome the constraints of covering the entire population with the intent of generalizing the findings to the entire population (Kottari 2004).

As at June 2014, there are sixteen private commercial banks in Ethiopia. These are Awash international bank(AIB), bank of Abyssinia(BOA), Wegagen bank(WB), United bank(UB), Nib international bank(NIB), Dashen bank(DB), Cooperative bank of Oromia(CBO), Lion international bank(LIB), Zemen bank(ZB), Oromia international bank(OIB), Buna international bank(BIB), Berhan international bank, Abay bank S.C, Addis international bank S.C, Debub global bank,S.C(DGB) and Enat banks(EB). (www.nbe.et) [Accessed: 20, January 2015].

As noted by (Kothari 2004), good sample design must be viable in the context of time and funds available for the research study. Besides, judgmental sampling offers the researcher to deliberately select items for the sample concerning the choice of items as supreme based on the selection criteria set by the researcher.

Accordingly, this study has employed non probability or purposive sampling technique to select the required sample of banks from the above listed banks since it was viable in line with time and funds available for this study. The selection criteria set by the researcher was first, the required banks are only private Commercial banks in Ethiopia. Second, those commercial banks should started operation before 2010/11 having financial statements at least for five consecutive of years.

Therefore, the data for this study was collected from six commercial banks in the country. Out of these six commercial banks, Awash international bank (AIB), bank of Abyssinia (BOA), Wegagen bank (WB), are selected from the first Pear banks that were registered before 2006/07 GC. whereas the remaining three banks Oromia international bank (OIB), Berhan international

bank, Lion international bank(LIB) are those banks from the second pear which were registered before 2010/11 GC by NBE.

This is due to the fact that since the primary aim of this study is to assess the determinants of nonperforming loans of commercial banks in Ethiopia, it is better to make generalization for the banking sector of the country based on data drawn from sample bank by mixing much more experienced with fairly experienced banks in the industry.

3.3. Methods of data collection

In order to carry out any research activity; information should be gathered from proper sources. Hence this research utilized both primary and secondary sources of data. The survey has been conducted using a structured questionnaire, unstructured interview and structured record reviews of selected banks. The questionnaires were prepared in English language and it was classified into two sections.

The first part of the questionnaire was designed to collect participants' profile (background information). The second part, in the questionnaire was related to factors that determine loan default or occurrence of nonperforming loans.

The self-administered questionnaires have been delivered to the selected proffetionals engaged in loan related activities. In order to provide feedback, clarification and ensure response a follow up calls have been carried out.

In order to obtain deeper understanding of the bank specific factors that can determine occurrence of nonperforming loans, unstructured interviews were also conducted with senior bank officials worked around credit areas in the industry.

Accordingly, four experienced bankers who were assumed to have a deeper understanding of credit dynamics in the Ethiopian banking sectors were interviewed. These were from banks that were covered by this survey study and from the uncovered banks. The researcher followed same interview protocol to all the interviewee.

In addition, the study used documentary review, specifically; the financial statements of banks have been surveyed along with their annual report and National Bank's report as well. In this regard financial data of the banks from the year 2010 to 2014 has been used. Moreover, special emphasis has been given to data sources that would provide the total assets, total loans and advances, deposits and respective Provision for doubtful loans of the banks documents so as to augment findings in the questionnaire survey.

3.4 Methods of data Analysis

For descriptive analysis; tables and percentages have been used to analyze the data. The data which have been collected by using questionnaire were carefully coded and checked for consistency and have entered into the SPSS spreadsheet.

Descriptive statistics Mean, Minimum, Maximum and Standard Deviation values have been computed to analyze the general trends of the data from 2010 to 2014 for the variables which were included in the study

CHAPTER FOUR

4. RESULTS AND PRESENTATION

The previous chapters present background of the study, literature review and the research methods adopted in the study. This chapter entirely devoted for the presentation of the results. As discussed in the preceding chapter this study is aimed at exploring bank specific determinants of nonperforming loans and also it tried to present the results of the different sources of data. This chapter is organized into three sections. The first section 4.1 discusses survey results and the second section, 4.2 compiled an interview responses, besides under section 4.3 documentary analyses has been touched. The last section 4.4 summarizes the whole results.

4.1 Survey results

The questionnaire was distributed to credit managers and professionals (including relationship managers, credit analysts, recovery officers, credit directors, loan officers, credit committee members, and risk officers) for the six banks which were selected purposively from all private commercial banks that are operational in Ethiopia and registered before the fiscal year 2010/11.

The questionnaire was physically distributed to 90 employees (whose positions are related to lending as mentioned earlier). Out of 90 questionnaires 81 were completed and collected due to this the response rate was 90 percent. According to (Fowler and Floyd, 1993) researched or survey organization differ considerably in the extent to which they devote time and money to improve response rate. Whatever the case in this regard the researcher found this high response rate very impressive in respect of the poor response culture noticed so far in Ethiopia.

Table 4.1 Survey response rate

Sample size	90
Completed and returned questionnaires	81
Response rate	**90 %**

Source: SPSS output from survey data, 2015.

4.1.1 Respondents' profile

Looking at the educational background of survey respondents it is revealed that 74.1 percent were First degree holder whereas 17.3 percent were diploma holders and the remaining 8.6 percent were having masters degree and above. This figure implies that more than 82 percent of the respondents hold first degree and above that made the response might be reliable enough (Table 4.2).

Table 4.2 Educational back ground

Educational background	Frequency	Percent	Cumulative Percent
Diploma	14	17.3	17.3
First Degree	60	74.1	91.4
Masters and above	7	8.6	100
Total	**81**	**100**	

Source: SPSS output from survey data, 2015

When we see the work experience from the responses 44.4 percent of survey respondents indicated that they had 5-10 years of banking experience which is the highest. The second larger number of respondents, 28.4 percent, had banking experience of 1-5 years. The remaining 27.2 percent respondents had banking experience of above 10 years only. This outcome might depict that respondents had enough experience which would sufficiently contributed to the data quality of the survey (Table 4.3).

Table 4.3 Respondents' experience in the banking sector

Work experience	Frequency	Percent	Cumulative Percent
1-5 years	23	28.4	28.4
5-10 years	36	44.4	72.8
More than 10 years	22	27.2	100.0
Total	**81**	**100.0**	

Source: SPSS output from survey data, 2015

Looking at the positions of survey respondents revealed that 72.8 percent were credit analyst and senior credit officers while 19.8 percent were various credit divisions' managers and 7.4 percent were junior credit officers. As depicted on the Table 4.4. out of the 81 respondents the majority (92.6 %) had a position of more than senior credit officers and are believed to have vast experience and enough knowledge in the credit process to acquaint very well determinants of nonperforming loan in the Ethiopian commercial banks.

Table 4.4 Position of the respondents in bank

Position	Frequency	Percent	Cumulative Percent
Managerial	16	19.8	19.8
Professional	59	72.8	92.6
Junior Officer	6	7.4	100.0
Total	**81**	**100.0**	

Source: SPSS output from survey data, 2015

4.1.2 Factors that affect bank lending

The study tried to assess the factors that affect bank lending to disclose whether the occurrences of nonperforming loans are from apparent sources or not in the context of privately owned

commercial banks in Ethiopia. This study required respondents to show their agreement or disagreement to bank specific factors affecting occurrences of nonperforming loans. Examining the results of the study in fact reveals that about 74 percent of respondents agreed to the statement "factors affecting bank lending are apparent" while the rest disagreed and were neutral about it (Table 4.5).

Table 4.5 Factors affecting occurrences of NPLs are apparent

View Point	Frequency	Percent
Strongly Agree (1)	7	8.64
Agree (2)	53	65.43
Neutral	11	13.58
Disagree (4)	6	7.41
Strongly Disagree (5)	4	4.94
Total	**81**	**100.0**

Source: SPSS output from survey data, 2015

In addition to the above issue it is well known that there are various factors that are believed to be determining for the occurrences of nonperforming loans in lending process. Some of these determinant factors that are widely considered for most of the loan defaults from the previous experience are selected and listed down. Bank specific determinants of nonperforming loans naturally vary across banks due to the uniqueness of each bank which can be explained by one bank might have strength or weakness on particular aspect. This particular issue may or may not be the case in other banks unlike the macroeconomic factors that is typical for all operators in particular country. Thus respondents were asked to identify the causes of nonperforming loans from the under mentioned factors in Ethiopian banks milieu. The agreements and disagreements of the respondents in this regard are summarized and presented as follows (Table 4.6).

Table 4.6 Factors considered the causes for the occurrences of NPL in Ethiopian banks

Determinants	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Fund diversion	5	69	1	2	4
Borrowers poor Business knowledge & management skill	12	57	0	2	10
Poor portfolio diversification	12	53	10	4	2
Unfair competition among banks	10	54	1	10	6
Willful default	8	58	5	5	5
Over/under financing	15	49	4	7	6
Poor customer selection	8	50	15	3	5
Credit staff capacity limitation	5	44	15	7	10
compromise integrity	3	33	25	15	5
Inadequacy of credit policy	10	46	5	14	6

Source: SPSS output from survey data, 2015

From the subjective question given to surveyed banks professionals, various responses have been collected. Some of the responses that might cause for occurrences of NPL were shared by all participants in the surveyed banks. Table 4.6 indicates factors thought to contribute to the occurrences of nonperforming loans. The sum of the first two columns implies degree of agreement in a particular factor that was believed by respondents to have association with the occurrences of NPL. The fact that a particular factor was pinpointed by all surveyed banks which indicates how prevalent that cause could be in the Ethiopian banking industry.

The most prevalent factors indicated for occurrence of NPL were traced by a thorough look into responses of the subjective question provided indicate that some of the factors like, fund diversion, unfair competition among banks, over/under financing, willful default, poor diversification of portfolio, borrowers poor business knowledge & management skill, inadequacy of credit policy, poor customer selection are commonly shared view by more than 50 percents of respondents from all the surveyed banks staff ascribing to occurrence of nonperforming loans

except two factor credit staffs capacity limitation and compromised integrity which are rated below fifty percent. Besides, detail analysis of the data shows those respondents from both experienced and those that had minimal experienced banks staffs in the industry have so much in common.

Further in depth analysis of the response indicates that fund diversion was rated 74 percent which made it highest among other factors to cause occurrences of NPL in all the banks surveyed. The next most rated 69 percent went to borrowers' poor business knowledge & management skill followed by poor portfolio diversification, willful default, unfair competition among banks and over/under financing, poor customer selection and inadequacy of credit policy were rated respectively in a decreasing order. Moreover, compromised integrity and credit staffs capacity limitation were the two factors least rated by the respondents as well.

This in fact had helped capture respondents' views in their own terms as to what cause occurrences of loan default in their own context. However, they were also asked to rank factors causing nonperforming loans in order of importance from one to six. The results in this regard indicated that 27 percent of respondents ranked rapid loan growth by banks the top ranking factor causing occurrences of nonperforming loans while poor monitoring and follow up, highest interest rate, credit culture and credit terms and price are ranked second to forth respectively whereas bank size is the least ranked factor by the respondents. Thus rapid loan growth by banks was the highest factor ranked to cause occurrences of nonperforming loans. On the other hand, the lowest rank of size of the bank implies it has a very minimal contribution for occurrences of nonperforming loans (Table 4.7).

Table 4.7 Ranking factors for occurrence of nonperforming loans

Factors	1st %	2nd %	3rd %	4th %	5th %	6th %
Size of the bank	6	4	3	18	21	29
Rapid loan growth by banks	27	19	14	6	9	6
Credit culture	9	11	22	32	3	4
Poor monitoring/follow up	13	17	21	21	5	4
High interest rate	10	12	24	32	2	1
Credit terms & price	7	23	20	18	11	2

Source: SPSS output from survey data, 2015

Table 4.8 shows responses on factors indicating the relation between credit risk assessment and occurrence of the nonperforming loans. Only 59 percent of the respondents agree good loan underwriting ensures loan performance. On the other hand, 67 percent of the respondents agree with having in place poor risk assessment would lead to loan default. With regard to Know your customer (KYC) policy of Banks, 64 Percent of the respondents agree that it lead to high loan quality. Poorly assessed and easily admitted borrowers are perceived to lead to loan default by 55 percent of the respondents.

Table 4.8 Factors related to credit risk assessment and loan default

	Strongly Agree %	Agree %	Neutral %	Disagree %	Strongly Disagree %	Mean %	Standard deviation %
Poor risk assessment would lead to loan default	31	36	6	6	2	1.91	0.990
Good loan underwriting ensures loan performance	30	29	12	7	3	2.06	1.099
Know your customer (KYC) policy of Banks lead to high loan quality	34	30	4	11	2	1.98	1.118
Easily admitted borrowers usually default	16	39	6	15	5	2.37	1.066

Source: SPSS output from survey data, 2015

From the above result respondents strongly agree that banks that employ a vigorous good loan underwriting policy in recruiting their customers and also do good risk assessment would have a better loan quality. On the other hand, when the Know your customer (KYC) policy of banks are weak and on the other hand when there are poorly assessed and easily admitted borrowers the loans would be prone to default. In reality the outcome favored poor loan underwriting would cause occurrences of nonperforming loans.

From the respondents 66 percent believed that occurrence of nonperforming can be minimized by employing good loan follow up which would ensure better loan performance. The highest respondents 71 percent agree with the assertion that strict monitoring ensures loan performance. However, 50 percent of the respondents agree that banks which allocate higher budget for loan monitoring would result lower nonperforming loans. On the other hand 63 percent of the respondents agree that poorly assessed and advanced loans may perform well if properly monitored despite poor assessment during sanctioning. This indicates that loan follow-up can substitute proper credit assessment to ensure better loan performance. See (Table 4.9).

Table 4.9 Factors indicating credit monitoring and loan default

	Strongly Agree (1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
Strict monitoring ensures loan performance	9	63	4	4	1	2.07	0.685
Poorly assessed and advanced loans may perform well if properly monitored	26	37	7	6	5	2.10	1.125
Loan follow up is directly related to occurrences of nonperforming loans	29	27	13	11	1	2.11	1.084
Banks with higher budget for loan monitoring have lower non performing loans	16	34	7	8	16	2.68	1.422

Source: SPSS output from survey data, 2015

From the foregoing discussion it can be concluded that credit monitoring is more related to loan performance. Despite the fact that respondents did support the argument that loan would perform well by proper monitoring even proper assessment was not carried out before advancing the credit. However, it should also be noted that loan follow up would never substitute credit analysis or assessment. On the other hand though loan monitoring requires budget and allocating higher budget might not ensure loan performance whereas a good number of respondents are positive to the assertion.

With regard to the relation between borrowers' orientation/culture and loan performance, only less than twenty five percent of the respondents disagree with the statement that loan performance is affected by orientation /culture of a society and its development. Thus the result indicated that there is strong relationship between culture/orientation and occurrence of nonperforming loans. From the response it is perceived that most of the factors relating to culture showed agreement. See (Table 4.10).

Table 4.10 Relation between borrower's orientation and occurrence of NPLs

	Strongly Agree (1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
Borrower's orientation/culture is related to loan performance	10	46	5	14	6	2.27	1.037
Default in some areas ascribed to the culture of the borrowers orientation	14	35	4	23	5	2.63	1.239
Cultural development of borrower's leads to good loan performance	11	42	6	15	7	2.57	1.193
There is a relationship between loan default and borrower's culture	15	39	17	8	2	2.30	0.968

Source: SPSS output from survey data, 2015

Only 56 percent (mean 2.42, standard deviation 1.213) of the respondents agree with the statement that loan with higher interest rate tend to turn to NPL. In the same manner only 42 percent (mean 2.74, standard deviation 1.358) of the respondents concur with the argument that charging big interest rate leads to loan default. On the other hand, about 35 percent (mean 3.06, standard deviation 1.258) of the respondents agree that loan price or interest rate might affect loan performance. However, the average responses to all the factors except the higher interest rate tend to turn to NPL were rated lower than 50 percent See Table 4.11

Table 4.11 Relation between price of loan and loan default

	Strongly Agree(1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
Loan price affects loan performance	9	26	5	33	8	3.06	1.258
Loans with higher interest rate would turn to NPL	17	39	5	14	6	2.42	1.213
Charging higher interest rate leads to loan default	19	23	6	26	7	2.74	1.358

Source: SPSS output from survey data, 2015

In connection with those factors related to credit terms (lenient credit terms, poor understanding of credit terms by borrowers and /or negotiated credit terms) find out whether they lead to occurrences of loan default. In this study 67 percent of the respondents (mean 1.98, standard deviation 1.024) agree that borrows default as they do not understand credit terms followed by 58 percent respondents that agree lenient credit term cause loan default and lastly 49 percent of respondents comply with poorly negotiated credit terms lead to nonperformance loan. Responses in this regard were collected from respondents of the banks under study and presented under Table 4.12.

Table 4.12 Credit terms and loan performance

	Strongly Agree(1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
Borrowers default because they don't understand credit terms well	28	39	5	6	3	1.98	1.024
Poorly negotiated credit terms lead to nonperformance loan	22	27	10	15	7	2.48	1.305
Lenient / lax credit term cause loan default	25	33	5	14	4	2.25	1.210

Source: SPSS output from survey data, 2015

When we see to the response on the relation between credit growth and occurrence of nonperforming loans; almost 67 percents of the respondents agree to claim that banks' with greater risk appetite leads to occurrence of large magnitude of NPL. Similarly 60 percent of the respondents thought that aggressive lending would be cause for occurrence of nonperforming loans. Whereas 58 percent of respondents favored to banks with rapid credit growth experience huge NPLs. In response of the relation between compromised integrity and NPL reveals that only 45 percent are in agreement. See Table 4.13.

Table 4.13 Rapid Credit growth relation with NPL

	Strongly Agree(1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
Banks whose credit growth is rapid experience huge NPL level	27	31	9	12	2	2.15	1.119
Bank's great risk appetite is cause for NPL	33	34	2	8	4	1.96	1.134
Compromised integrity of lending leads to loan default	20	25	7	14	15	2.85	0.985
Aggressive lending leads to large NPL volume/ratio	32	28	5	13	3	2.10	1.200

Source: SPSS output from survey data, 2015

From the above response one can understood that when banks pursue aggressive lending strategy having greater risk appetite and thereby experience rapid credit growth, they might heap up large volumes of nonperforming loans. Not only this but also compromised integrity in sanctioning credit is also believed to be cause for occurrence of loan default by respondents.

In relation between having large number of borrowers and bank size the survey response indicates that bank size is not the cause for the occurrence loan default. Responses to questions related to the bank size and occurrences on NPL are inclined towards disagreement. See Table 4.14. Furthermore only 51 percent of the respondents agree that having large number of borrowers claimed to contribute for the occurrence of nonperforming loan. On the other hand number of respondents with 41 percent response comply that loan default rate is related to bank size which is the least among the three.

Table 4.14 Bank size and occurrence on NPL

	Strongly Agree(1) %	Agree (2) %	Neutral (3) %	Disagree (4) %	Strongly Disagree (5) %	Mean	Standard deviation
With growth in banks size comes growth on NPL	18	25	6	15	17	2.85	1.493
Having large number of Borrowers causes loan default	17	34	5	20	5	2.53	1.246
Loans default rate is directly related to banks' size	13	28	5	24	11	2.90	1.357

Source: SPSS output from survey data, 2015

4.2 In-depth interview

In-depth interview was conducted with senior credit officials so as to obtain profound understanding about the factors affecting nonperforming loans on the bases of the research questions. The interviewees had vast experience especially with credit disbursement in addition

to their several years of banking experience. To this effect, credit vice presidents, credit department directors, senior credit committee members were participated. The interviewees were from the banks under study, other private bank.

The section that follows present factors believed to cause occurrences of NPL by the interviewees. Besides, the determinants thought to be critical for the occurrences of NPL are being identified. In addition, factors that ascribe in common with the Ethiopian private commercial banks contributing to the NPL occurrences are also presented accordingly. Furthermore, one can understand from the response that respondents are more or less believed in a similar manner on the causes of occurrence of nonperforming loans in the banking industry.

This is therefore the responses which were gathered using an interview based on the selected factors of the study are summarized and presented under the following subtitles.

4.2.1 Factors assumed to cause occurrences of NPL

Several factors which contribute to nonperforming loan in the banking industry so far were discussed by the respondents and the major indications for the determinants of NPL are traced out consequently. Those indicated factors from the outcome of the interview that were believed to arise are classified under banks' internal situations, the external situation and borrower's orientation and each factor are organized and presented as follows.

Internal determinants

These are factors relating to internal inefficiencies due to systems, governance, human resource issues and other conditions related with the banking credit activities. In this regard most agreed points of the interview participants raised issues are summarized as follows:

Now a day's it is observed that there is stiff market share competition among the banks especially with in the private commercial banks and due to this very nature most of the respondents believed internal determinants are ghosted with this pushing factor and are explained under this premise:

➢ There is poor portfolio diversification as well as excessive lending by banks on a particular sector followed by aggressive lending practices by these banks to maximize profit.

➢ There is also common believes on failure to set properly the terms and condition, poor collateral valuation, over financing and lack of integrity by the staffs as well as the credit approval process not being prudent and failing to comply with the existing bank policies. Moreover, credit analyst's capacity limitation followed by inappropriately conducting Know your customers (KYC) principles before lending are worth mentioned.

➢ The other stated determinants are inadequate institutional capacity – in terms of risk selection and credit risk management, deficiency in check and balance-in loan processing, follow up and monitoring with the help of adequately established management information system (MIS) and finally the overall organizational governance problems also considered by most of the respondents as the internal situations factors.

Factors in relation to borrowers

There are also determinants believed agreeably by most of the respondents as being emanate from borrowers own orientation which would give stance on occurrences of loan default. Despite the fact that there were points raised related to this which are compiled and presented accordingly.

When borrowers are in need of credit there by observed basic business management related problems usually needs to be addressed. They are not making competitive analysis to where the fund being invested before engaging in a particular credit facility commitment rather they have it in mind to direct the fund in to unintended purpose which can convey as intentional or willful default.

Besides, according to the respondents most of the borrowers have poor business management skill and record keeping capability due to this fact when asked they are even unable to provide

the business related enquiries. This is widely happened especially in those family owned businesses.

The external determinants

The external determinants are explained as those factors that were beyond the capacity of banks as well as borrowers. These factors are also expressed as an intervention made by governing bodies and in fact in our case National bank of Ethiopia is decisive body to manage any financial business activities in the country. And there are also deep rooted cultural beliefs of the society. Some of the common contemplating factors raised by the respondents are listed down as follows:

➢ There are profound poor credit and societal culture which morally hinder on buying foreclosed properties of others in same village in some society.

➢ The next most important aspect is macroeconomic factors like defilation, inflation, market problems and so on accompanied by unavailability of data to conduct valuable analysis due to capacity limitation of the governing body.

Supplementary information's in connection with determinants for the occurrences of nonperforming loans were also gathered from the interviewee. In this regard the following basic issues were raised and presented discretely as they inculcate to understand these determinants in a very strategic manner.

The first raised issue to respondents was to know how they rated the factors they believed ranked top in causing occurrences of nonperforming loans from those well mentioned factors. The responses based on their ranking are organized as follows:

The rapid loan growth by banks was the highest factor ranked to cause occurrences of nonperforming loans as has discussed in the previous outcome which might resulted in banks superficial performances in credit analysis, poor monitoring and follow up opted by inadequacy in the competence of credit operators and compromised integrity of credit operators in addition to management capability limitation respectively are given most consideration. Furthermore borrowers lack of knowledge how to manage the credit less compliance by banks to and other banks business environment has also been ranked subsequently.

The second raised issue was to know interviewees outlook towards the factors that are very peculiar to the Ethiopian banking context associated with their significant comportment on occurrences of loan default. Responses of the on factors they believed were organized in the following manner.

There observed clear underdevelopment of institutional capacity of banks in general and human resource capacity in particular followed by underdevelopment of the banking system that can be expressed in a similar manner as inadequacy in the capability of employees remain one of the main challenge of the Ethiopian Banking industry which as a result would lead to compromise on loan underwriting standard that in turn have a huge demeanor on loan performance.

There exists excessive dependency on collateral rather than financing based on the business of the borrowers company which may not default as source of repayment would be properly ascertained before advancing loans.

There also exists inequitable industry competition among banks especially between government and private commercial banks put in danger banks not to recruit prominent customers of their own. Besides in absence of blacklisting of defaulters at a national level sometimes it was seen that non performing loans of one bank were bought by other banks which possibly escort loan default.

An influence of external organ like introduction of credit cap and urged purchase of NBE bills out of disbursed loans made banks to engage in poorly assessed and short term loans which are likely face loan default particularly in private commercial banks.

And finally there exist weak credit orientation or cultural under development which is also supported by an Ethiopian proverb literally that says "A borrower or a lender might die" which would promote loan default.

Moreover as indicated in the literature the interviewees were asked of their view on the relations between price of loan and bank size for the occurrences of loan default in an attempt to discover the survey response through interview. However, almost all of the respondents point out that they saw no relation between loan price and occurrence of nonperforming loans as well as they did not believe any association between bank and loan default.

4 .3 Document Analysis

In order to assess factors affecting nonperforming loans, the relevant data on the total assets, total loans and advances, deposit and Loan to asset ratio of selected banks were applied. In this regard data (from the year 2010 to 2014) were collected from six banks which were registered before the year 2010/11.

There is also evidence in the literature that shows a strong positive relationship between NPLs and the ratio of loans to asset, which captures the risk appetite of banks (Sinkey and Greenwalt, 1991). The supporting rationale is that banks that value profitability more than the cost of higher risk (represented by a high loan to asset ratio) are likely to incur higher levels of NPLs during periods of economic downturn.

This is therefore examination of the trend of nonperforming loan in respect of loan to asset ratio over the period covered by the study reveals luck of uniformity among the banks. In other words the increasing rate an asset of these banks shown from year to year do not concomitantly went with the rate of loan to asset ratio.

When we see the ratio of two banks Awash international bank and Bank of Abyssinia with respect to total asset both exhibit the trend differently the first bank shown increment with raise in an asset whereas the second bank revealed decrease in ratio contrary to increase in an asset and similarly it was also shown an ups and down of this trend on the rest of the other banks.

One can merely understand from this in that asset as one determinant factor of bank seize had not necessarily influenced in loans and advances which indirectly expressed in nonperforming loan as well. According to (Wondemageghehu, 2012) as has discussed in literature review he studied in detail the correlation between bank size and nonperforming loan and found out that no direct relationship between sizes of banks (relatively big, medium and small) and NPL. See (Table 4.15).

Table 4.15 Loan to Asset ratio of Banks

Name of Banks	Year				
	2010	**2011**	**2012**	**2013**	**2014**
Awash International bank	34.9	36	41.9	43.4	40.6
Bank of Abyssinia	50.2	45.6	47.3	46.3	45
Wegagen Bank	43.1	36	43	45	39.3
Oromia International Bank	33	33.7	36.6	41.5	36.7
Lion International Bank	42.8	37.4	39.4	45	46.1
Berhan International Bank	42	38.3	38.9	44.6	42.2

Source: Financial data of banks and own computation

The data also indicate that a total asset of all the banks covered by this study, which shows the size of the banks, was growing for the years under consideration. Even if it is incomparable with total asset increment as shown in the above table total loans and advances by itself depicted an increasing trend. The total asset comparison has been included simply to show the erratic trend of how the private commercial banks are demonstrating in the banking industry.

Table 4.16 Total Assets of Banks (in millions ETB)

Name of Banks	Year				
	2010	**2011**	**2012**	**2013**	**2014**
Awash International bank	9,022	11,089	13,125	17,783	22,106
Bank of Abyssinia	6,279	7,277	8,239	10,160	11,276
Wegagen Bank	5,741	8,060	8,347	10,393	11,528
Oromia International Bank	1,118	1,961	2,787	3,911	6,151
Lion International Bank	1,363	1,808	2,463	2,942	3,613
Berhan International Bank	365	866	1,284	2,197	2,808

Source: Financial data of banks and own computation

4.4 Summary of Results

The study conducted survey of banks' employees (using self-administered questionnaires) and structured survey of documents and unstructured interview. The survey had a response rate of ninety percent. Most of respondents were directly engaged in credit related activities from which more than ninety one percent of respondents had educational background of first degree and above. Twenty seven percent of the respondents had over ten years of experience in banking and more than forty four percent over five years lending experience.

In reaction to a subjective question as to what cause occurrences of NPL in view of survey participants, the result indicated that unfair competition among banks, fund diversion, over/under financing, willful default, poor portfolio diversification were the most frequently mentioned factors followed by inadequacy of credit policy, poor customer selection and borrowers poor business knowledge among others.

In a query where the respondents were requested to rate factors they believed cause occurrences of nonperforming loans in order of importance; rapid loan growth by banks ranked highest, poor monitoring and follow up, highest interest rate, credit terms and price, credit culture/orientation were rated the next top four factors causing loan default. On the other hand bank size were rated the least factors causing occurrences of nonperforming loans.

According to the study measuring scale average response indicated that respondents agree with credit assessment is related to loan default. They also agreed with the fact that good loan underwriting ensures loan performance and is related to occurrence of nonperforming loans. On the other hand the response on relation between poorly assessed and easily admitted borrowers with loan default indicated less agreement. Average response on impact of credit culture /orientation and aggressive lending were in agreement.

The responses on the relation between Know your customer (KYC) policy of Banks, compromised integrity lead to occurrences of NPL and occurrence of loan default depicted agreement. Average view of the respondents on impact of credit terms and loan price /interest

rate/ on loan default were also showed agreement. The response on the relation between bank size and occurrences of loan default indicates disagreement.

In general the respondents view using the above survey methods in relation to occurrence of nonperforming loan that could be supported by literature review with respect to the research problem and question has been summarized and discussed in detail in the subsequent chapter.

CHAPTER FIVE

5. DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

The previous chapter presented descriptive analysis, the results of findings and the examined trends of NPLs of private commercial banks in Ethiopia whereas this chapter is devoted for the discussions of the research findings, conclusions and recommendations. Accordingly, section 5.1 shows the discussion in the context of major objective of the research while sections 5.2 and 5.3 try to present conclusions and recommendations respectively.

5.1 Discussion of the research findings

In chapter one the major objective of this study has been stated as an investigation of bank specific determinants of nonperforming loans in private commercial banks of Ethiopia. Further, the following specific objectives were formulated to contribute in attaining the general objective of the research:

- ➢ Investigating whether credit monitoring determine loan default.

- ➢ Assessing the impact of credit culture on loan default.

- ➢ Examining whether credit terms and price or interest affect loan performance.

- ➢ Assessing if there is any relationship between bank structure and size on loan default.

- ➢ Checking rapid credit growth and greater risk appetite lead to non-performing loans.

- ➢ Assessing the relationship between loan underwriting, credit risk assessment and non-performing loans.

In this study factors that have impact on occurrences of nonperforming loans with the focus of banks specific determinants were been analyzed and findings in light of the literature are discussed. In respect of the determinants affecting NPL, the subjective question in the survey and in-depth interviews recognized factors such as, failed loan monitoring, aggressive lending,

compromised integrity, weak institutional capacity, unfair competition among banks, poor credit assessment, willful default by borrowers and their knowledge limitation, fund diversion for unintended purpose, underdeveloped credit culture, lenient credit terms and conditions over/under financing by banks attribute to the causes of loan default. Hence the study further tried to investigate these factors.

Credit Monitoring and NPLs

A regular credit monitoring is very necessary for loan quality as it would help ensure a sound financial system and thereby prevent systemic crises which otherwise would lead to loan default. This survey also validated the stated study as 71 percent of the respondents indicated agreement (Table 4.9). Poor monitoring or loan follow-up was also one of the top factors rated to contribute to the occurrences of NPL as we can see from the survey result and in depth interview findings. On the other hand respondents had also a positive view to the statement that banks which allocate higher budget for loan monitoring would have a lower NPL. This may implies that, it is better to put in place proactive follow up loans system than allocating higher budget for loan monitoring.

The overall objective of monitoring a loan is assumed to verify whether loan funds are being properly utilized for the intended purpose that the borrowers were granted and confirmed t a proper attention were given to borrowers in repaying their loans. Otherwise borrowers would be tempted to divert the fund to other purposes, as was also learnt through the in-depth interview. Thus failing to monitor loans would lead to default.

Credit Orientation /Culture and NPL

The study outcome on four of the questions posed to find out the relations between credit culture / orientation and NPL in the survey indicated average agreement and it is also confirmed by the interview response (Table 4.10). The socio economic underdevelopment of the country which is also associated with poor access to the formal banking, as depicted by higher bank branch to population ratio (NBE, 2013) implies that credit culture is until now to develop in Ethiopia. There is an Ethiopian proverb "either a borrower or a lender might die" indicating a borrower

shouldn't worry to repay borrowings. Thus it can be concluded as cultural development has a negative impact on loan performance

Credit Terms &Price and NPL

In the survey study it is indicated that 67 percent of the respondents agree that borrows default as they do not understand credit terms and condition would cause loan default (Table 4.12).Capacity limitation of credit operators result in poor loan assessment which might fail letting know borrows the terms and conditions of loan properly. Due to this borrowers might have poor understanding of the terms and conditions of loan which would lead to poor loan performance. Thus the failure to put appropriate terms and conditions would lead to loan default.

On the other hand with regard to price of loan or interest 56 percent of the respondents which is the top agree with the statement that loan with higher interest rate tend to turn to NPL. According to (Waweru and Kalini 2009), indicated that high interest rate charged by banks is associated with loan defaults. The highest response in this study support the above finding that loans with big interest rate would turn to be defaulted in the Ethiopian context.

Bank Size and NPL

Study by Rajan and Dhal (2003), indicated that banks size have significance contributions on occurrence of NPLs. In contrast to this, According to Wondimagegnehu (2012), in his study showed by doing the Pearson correlation between those balance sheet items (Total asset, total deposit and loans advances) and NPL ratios depicted a very weak correlation. Thus the data fails to support the fact that bank size affects or determines occurrences of nonperforming loans.

There is also evidence in the literature that shows a strong positive relationship between NPLs and the ratio of loans to asset, which captures the risk appetite of banks (Sinkey and Greenwalt, 1991). The survey (Table 5.15) however, did not confirm the earlier studies in other countries. When we see the ratio of two banks Awash international bank and Bank of Abyssinia with respect to total asset both exhibit the trend differently the first bank shown increment with raise in an asset whereas the second bank revealed decrease in ratio contrary to increase in an asset

and similarly it was also shown an ups and down of this trend on the rest of the other banks. Thus it can be concluded as bank structure or size has not determined loan default.

Rapid Credit Growth and NPL

The survey study indicated that 67 percents of the respondents agree to claim that banks' with greater risk appetite leads to occurrence of large magnitude of NPL and also 58 percent of the respondents agree that rapid credit growth would contribute to loan default. Similarly 60 percent of the respondents thought that aggressive lending would cause for occurrence of nonperforming loans (Table 5.13). Salas and Saurina (2002) who studied Spanish banks found out that credit growth is associated with non performing loans. It can be understood from the survey study that the greater risk appetite that is reflected in rapid credit growth which in turn supported the association of loan default as indicated in the above finding. No documentary analysis done nor did the in-depth interview confirm this Determinant in line with the literature.

Credit Risk Assessment and NPL

The survey also indicated that 67 percent of the respondents which is the highest of all agree with fact that with having in place poor risk assessment greatly affects occurrences of loan default. Most of the interviewee from the banks under survey was also agree with this view. Credit risk assessment deals with a thorough analysis to the extent which answering the following issues before lending such as what term and conditions, at what price to lend and so on. Thus failing to carry out proper risk assessment would lead to missing any or all of the captioned issues, which has a potential for the occurrence on NPL.

5.2 Conclusions

The broad objective of this research was to investigate bank specific determinants of nonperforming loans. Based on the broad objective a number of specific research questions were developed and quantitative research approach was employed. More specifically, the study used survey of employees of banks, structured survey of documents of bank reports and unstructured interview of senior bankers. The results showed that, based on the respondents' view it was

evident that most likely factors that affect occurrences of nonperforming loans in Ethiopian banks are presented in the paragraphs that follow.

The study indicated that poor credit assessment ascribing to capacity limitation of credit operators which also been reflected with luck of proper discussion with borrowers regarding about terms and conditions had been the cause for occurrences of loan default. In addition the study also found out that due to underdevelopment of credit orientation /culture borrowers engaged in business that they had no depth knowledge, diverted loans advanced for unintended purpose and at times made a willful default. The study also depicted that unfair competition among the banks along with the aggressive lending pursued added to the poor customer selection made in a motive to maximize profit by the banks causes for the loan defaults.

Finally as we can see from the above discussion most of the survey results supported the earlier studies. On the other hand the subjective questions in the survey and in-depth interview conducted discovered additional findings which also might provide insights for further intervention on the subject matter in the future. The determinants thought to contribute to occurrences of NPL drawn from this survey include: poor credit risk assessment, under developed credit culture/orientation, poor understanding of credit terms and conditions, imposing highest interest rate on loan, poor credit monitoring and rapid credit growth or greater risk appetite. On the other hand the study failed to support the existing literature which state occurrences of NPLs is related to bank's size in Ethiopian private commercial banks.

6.3 Recommendations

In order for maintaining financial stability and overall healthy banking business performance in private commercial banks of Ethiopia it is vital to identify determinants of nonperforming loans. Therefore, based on close examination and analysis of the research findings, the following recommendations are suggested to:

> ➢ Bank management has to impose moderate lending rate so as to reduce a loan default arises from charging highest interest rate.

- ➢ Banks should put appropriate terms and conditions of loans in order to prevent poor understanding of borrowers in this regard that would lead to loan default.

- ➢ Banks should restrain from engaging in aggressive lending and potentially devastating competition motivated by profit maximization lead to loan default.

- ➢ Banks should put in place a vibrant credit process that would cover issues of proper customer selection, vigorous credit analysis, proactive follow up and monitoring.

- ➢ Banks should give due emphasis to developing the competency of credit operators, information system management related to credit and also made efficient the credit process in all aspect.

Besides, all banks in the country should be exerted their effort in developing the culture and orientation of the public towards credit and its management of loans that would contribute to the development of an economy at large.

Finally, the focal point of this study was bank specific determinant of nonperforming loans therefore; it is recommended that similar a study shall be conducted on macroeconomic determinants of nonperforming loans in Ethiopian private commercial banks.

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APPENDIX

Appendix I

Research Questionnaire

Part I. Respondent's Background Information

1. Educational Background

   Diploma ☐ 1st Degree ☐ Masters & Above ☐

2. Working Experience (in years)

   1-5 ☐ 5-10 ☐ More than 10 ☐

3. Position

   Managerial ☐ Credit Analysis Professional ☐ Others ☐

Part II. Research Related Questions

		Strongly Agree	Agree	Neutral	disagree	Strongly Disagree
1.	Do you think that bank specific factors for the occurrence of NPL are obvious?					
2.	Do you think that poorly assessed and easily admitted borrowers usually default?					
3.	Do you believe that know your customer (KYC) policy of banks lead to high loan quality?					
4.	Do you think that poor risk assessment would lead to loan default?					
5.	Do you believe that good loan underwriting ensures loan performance?					
6.	Do you think that strict monitoring ensures loan performance?					
7.	Do you agree that poorly assessed and advanced loans may perform well if properly monitored?					
8.	Do you believe that loan fallow up is directly related to occurrence of non-performing loans?					
9.	Do you think that banks with higher budget for loan monitoring would have lower non performing loans?					

10. Which of the following determinants you considered as occurrence of NPL in commercial banks   of Ethiopia? Please put thick mark of your response listed below.

Determinants	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Fund diversion					
Borrowers poor Business knowledge & management skill					
Poor portfolio diversification					
Unfair competition among banks					
Willful default					
Over/under financing					
Poor customer selection					
Credit staff capacity limitation					
compromise integrity					
Inadequacy of credit policy					

		Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
11.	Do you believe that credit culture / borrower's orientation is related to loan default?					
12.	Do you think that there is a relationship between loan default and borrower's culture?					
13.	Do you believe that default in some sectors is ascribed to the culture or the borrowers?					
14.	Do you agree that cultural development of borrowers would lead to good loan performance?					
15.	Do you think that loans with higher interest rate would turn to NPL?					
16.	Do you believe that imposing higher interest rate in some sectors lead to loan default?					
17.	Do you believe that cost of loan affects loan performance?					
18.	Do you think that lax credit /lenient terms cause loan default?					
19.	Do you believe that borrower's loan default is due to poor understanding of credit terms?					

20. Please rank the fallowing determinants causing NPL?

Factors	1st	2nd	3rd	4th	5th	6th
Size of the bank						
Rapid loan growth by banks						
Credit culture						
Poor monitoring/follow up						
High interest rate						
Credit terms & price						

		strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
21.	Do you think that poorly negotiated credit terms' would lead to poor loan performance?					
22.	Do you think that aggressive leading world intensifies NPL?					
23.	Do you agree that banks who have raped growth would experience huge NPL?					
24.	Do you believe that banks with greater risk appetite would lead to NPL?					
25.	Do you believe that compromised integrity in the process of lending results in loan default?					
26.	Do you think that having large number of borrowers causes loan default?					
27.	Do you think loan default rate is directly related to banks' size?					
28.	Do you believe that growth in NPL is concomitant with growth in bank size?					

Thank you for filling out the questionnaire!