Analysis of the Rationale behind Non-performing Loans in Ethiopian Financial Institutions: The Case of Development Bank of Ethiopia and Awash International Bank S.C.)

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1. Background of the Study

Lack of financial resources is usually regarded as a major bottleneck to the development of many developing countries. To control this problem, efforts are made by governments, the public and private sectors to have access to credit funds procured both locally and from abroad. Credit financing has long been recognized as one of the important financial services that contribute to the success of a business venture. This success, in turn, is believed to contribute towards economic development. However, the existence of credit facilities alone does not necessarily result in supporting economic development unless otherwise it is accompanied by the existence of factors conducive to the efficient utilization of credit funds. For instance, a loan has to be repaid on time if the objective of making loan funds available to those who want them for productive purposes on continuous basis is to be met. Repayment performance is a critical feature of credit. When it declines, the consequences for the health of a lending institution can be material, not to say catastrophic.

Persistent poor repayment performance ultimately leads to the inability to cover cost out of interest income and fees in any lending institution. The consequence of this failure contributes to the increasing of provision for bad and doubtful debt expense that reduces profits for the period in which it was made. If the period's result is a loss, the capital of the lender is reduced by the amount of the loss. Reduction of capital may affect the institution's new fund mobilization activities for fresh lending since it increases its debt equity ratio, undermine public confidence in the formal financial markets causing savers to withdraw their funds and increases staff turnover due to doubt on the capability of the institution to stay in the market. Ability to recycle funds constitutes the corner stone of the development of banking industry. If loans are not repaid over the scheduled time; chronic overdues become irrecoverable in course of time; the net worth of the lending institution will be eroded and will have serious impact on the volume of lending. The high incidence of overdues affects the overall liquidity and solvency of credit institutions and impairs their capacity to undertake fresh lending.

DBE, one of the public enterprises, and AIB which is a privately owned bank are engaged in the provision of development credits to all sectors of the economy. Their main objective, among others, is mobilization of funds from national and international sources and provision of short, medium and long-term investment credits. To achieve their stated objective, the two banks have to be sustainable by generating sufficient profits from their operations. This rests on the efficiency and effectiveness of loan fund mobilization, credit provision and ultimate collections of loans, which have direct impacts on the two banks' profitability and liquidity.

1.1 The History of Banking in Ethiopia

The agreement that was reached in 1905 between Emperor Minilik II and Mr.Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking in Ethiopia. Following the agreement, the first bank called Bank of Abyssinia was inaugurated in Feb, 16, 1906 by the Emperor. The bank was totally managed by the Egyptian National Bank with some rights and concessions agreed up on the establishment of Bank of Abyssinia.

In its short period of existence, Bank of Abyssinia had been carrying out limited business such as keeping government accounts, exporting financing and undertaking various tasks for the government. The bank faced enormous pressure because of its inefficient. It was criticized for focusing on pure profit making objectives. As a result they concluded to abandon its operation and to liquidate the banking activity from foreign control and to make the institution responsible to Ethiopia's credit needs. Thus by 1931, shortly after

Emperor Haile Selassie came to power the Bank of Abyssinia was legally replaced by Bank of Ethiopia up until the Italian invasion in 1935.

1.1.1. The Bank of Ethiopia

The new bank, Bank of Ethiopia, which was established by an official decree on August 29th 1931 with a capital of £750,000 was purely an Ethiopian institution and was the first indigenous bank in Africa. The bank of Egypt was willing to abandon its own cessionary rights including its manager in return for £ 40,000 and the transfer of ownership took place very smoothly in the offices and personnel of the Bank of Abyssinia. The Ethiopian government owned 60% of the total shares of the bank and all the tractions were subject to scrutiny by its Minister of Finance.

Bank of Ethiopia took over the commercial activity of the Bank of Abyssinia and was authorized to issue notes and coins. During the invasion, the Italians established branches of their banks namely Banco di Italia, Banco di Roma, Bano di Napoli and Banco di Nazionale de Lavoro, and started operation in the main towns of Ethiopia. (www.gov.nbe.)

1.1.2. The State Bank of Ethiopia

On 15th April 1943, the state Bank of Ethiopia commenced its full operation after 8 months of preparatory activities. In 1963 the Ethiopian monetary and banking law came into force. The law separated the function of the commercial and the central banking. This brought the present National Bank of Ethiopia and Commercial Bank of Ethiopia to be operational. Moreover, it allowed foreign banks to operate in Ethiopia limiting their maximum ownership to 49%, while the remaining balance should be held by Ethiopians.
It started operation on January 1, 1964 with a capital of 20 million Eth. Dollars. Unlike the former State Bank of Ethiopia, the new commercial bank employees were all Ethiopians (www.gov.nbe.).

1.1.3 The Development Bank of Ethiopia

The history of Development Bank of Ethiopia goes back to 1909 when the first attempts of its kind known as the Societe Nationale d' Ethiopie pour le Development de l'a Agriculture et de Commerce (the Society for the Promotion of Agriculture and Trade) was established in the Menilik II era. Since then the bank has taken different names at different times although its mission and business purpose has not undergone significant changes except for occasional adjustments that were necessitated by changes in economic development policies of the country.

1.1.4. Private Banks and the Awash Int. Bank S.C in Ethiopia

Monetary and banking proclamation No.83/1994 and the licensing and supervision of banking business No.84/1994 laid the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank Awash International Bank was established in 1994. Dashen Bank was established in September 1995. Bank of Abyssinia, Wegagen Bank, United Bank, Nib International Bank, Cooperative Bank of Oromiya, Lion International bank, Zemen Bank and Oromiya International Bank have been operational in the private banking industry.

Awash International Bank is the first private bank established in Ethiopia after the liberalization of financial institutions, which we have used as one of the case in this study. Shortly after the proclamation of the liberalization, Awash International Bank was established in November 10, 1994. It started operation in February 1995 by 486 shareholders and with birr 24.2 million paid up capital. By the end of year 2007 the paid up capital of the bank reached birr 282.3 Million. (AIB, Annual Report, 2007.)

2. Statement of the Problem

Providing loan to various sectors in the economy is the lifeblood of banking activity as in the case of DBE and AIB whose aim is to promote investment and facilitates the economic activity in and out side Ethiopia as a whole. The loan extended to the various sectors must be recovered in full otherwise it will be non-performing and becomes a loss to banks. Strong control mechanism on loan recovery enables banks and other financial institutions as a whole to meet the increasing demand for credit and keep the banks in sound financial health state. Both the principal, which is used for re-lending and the interest to meet the operating costs and increasing profitability in its future investment capital, must be recovered. But for the recent two years 2004/05 and 2005/06 the banks loan recovery performance has been very low due to external and internal factors (Annual Report, AIB & DBE 2005 and 2006). This research aims to evaluate the major internal factors which contribute to the non performing loans that are associated with project appraisal, inadequate applicant screening criteria, collateral security and follow up that affect the loan recovery performance of the two banks, i.e. of DBE and AIB.

3. Research Question

In due course this research will answer the following questions:

- How do the banks achieve their financial health, especially on loan recovery?
- What methods are used by the banks to improve the ratio of collectibles to loan recovery?
- What are the internal key success factors for determining effective loan repayment?
- Which internal factors contribute more for the accumulated Non Performing Loans in the financial statements of the two banks?

4. Objectives of the Research

The main objective of the study is to analyze the causes behind non performing loans in the two selected banks i.e. Awash International Bank and Development Bank of Ethiopia. The following are specific objectives

- Evaluating the prevailing conditions to achieve high loan recovery performance of the two the banks.
- To investigate the internal factors contributing to the non-performing of loans.
- Explaining and elaborating those factors related to the problem of uncollectible and suggesting possible solution to these problems.

5. Research Methodology

A descriptive research method was used. Both primary and secondary data were employed as a source of input to perform the research. The population from which representative samples were selected were head office credit analysts, credit departments and loan officers of AIB & DBE. AIB is selected for the purpose of this research because it is the first private bank established in Ethiopia after the liberalization of financial institutions there being the one with the longest experience in the field. Similarly DBE was selected from among the existing government owned banks for the same reason. The sampling method that has been applied in this study was purposive sampling. From Development Bank of Ethiopia, out of the total number of t*wenty four* permanent employees in client relation department, only n*ine* selected respondents were taken for the purpose of the study. Concerning Awash International Bank, out of the total number of twenty six permanent employees in Credit relation department, only t*hirteen* permanent employees were selected.

To collect the primary data, a questionnaire was distributed to some Head Office Credit Analysts, Loan Officers and former credit department staffs (formerly credit officers and currently positioned in other departments) to have an overall insight about non performing loans. The secondary data was gathered from annual audited financial statements, journals, magazines, brochures, directives and other documents about *loan recovery performance.* Ratios and percentages were used in the research to analyze the data and draw conclusions.

6. Data Presentation and Analysis

This section attempts to analyze the factors that contribute to loan recovery performance at Development Bank of Ethiopia (DBE) and Awash International Bank S.C. (AIB). The first section tries to show a guide to DBE and AIB loan requirements. The second section describes the evaluation of Loan Recovery Performance.

6.1 Evaluation of Credit recovery performance

The data obtained from the loan recovery performance report of both Banks is presented as follows**:** (**Source**: - DBE & AIB Annual Audited Reports of the respective years)

Table 1: Summary of DBE and AIB Non Performing Loans Status (2005-2006) in Br

	DBE			AIB		
Description	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
1. Loan & Advances						
Total Portfolio	**4,331,100,000**	**4,911826,000**	**5,376,500,000**	**1,148,976,405**	**1,544,986,744**	**2,464,369,675**
Loan Portfolio %age changes to the base year /2004/	**0**	**13.41 %**	**24.14 %**	**0**	**34.47 %**	**114.48 %**
2. N.P. LOANS						
Non performing Loans	**1,929.900,000**	**1,542,330,000**	**1,908,517,000**	**141,079,249**	**101,875,483**	**128,546,836**
3.Percentage of arrears to Total portfolio(2÷1)	**45%**	**31 %**	**35 %**	**12 %**	**07 %**	**05 %**

As in the case of the Development Bank of Ethiopia the total loan and advances for the period 2004 amounting Birr 4,331 million increased by 13 % to 4,912 million in the year 2005. Furthermore, this amount rose by 24.14 %, amounting to Birr 5,377 million in the year 2006 as compared to the base year 2004. But the 45% of arrears to the total portfolio seems decreasing to 31% and slightly increased to 35% in the subsequent years. This decreasing function doesn't guarantee the bank's recovery rate of non performing loans. The decrease appeared due to a superficial declining in percentage that resulted from the injection of new loans to new clients. These new loans injected will in turn automatically lower the ratio of NPL arrears by raising the total portfolio in the subsequent years.

In the case of the Awash International Bank one can also easily figure out similar decreasing trends. It seems decreasing from 12% of arrears to the total portfolio seems to 07% and then to 05% in the subsequent years. In similar fashion, the new loans injected have in turn automatically lowered the ratio of NPL arrears by raising the total portfolio in the subsequent years. This implies that the non performing loans of the two Banks do not show much of a decreasing trend during the period under consideration.

6.2 Loan Repayment Problems

The data, through questionnaires, was collected from a total population of 50 credit departments' staff in which 24 from DBE and 26, from AIB are represented. To simplify the presentation, tabular presentation is selected for each parameter under consideration.

6.2.1 Banks Performance in Collecting Loans at DBE *and* AIB.

TABLE 2: Performance of Loan Recovery and the Causes for NPLs

Items	Respondents	
	Frequency	Percentage
Degree of Satisfaction on loan recovery		
• Very much Satisfied	1	4.6
• Satisfied	5	22.7
• Dissatisfied	10	45.4
• Very dissatisfied	6	27.3
• I don't know	0	---
TOTAL	**22**	**100**
Degree of contribution to NPL Loans		
• By the bank	10	45.5
• By the client	7	31.8
• Both B and C	3	13.6
• By the 3rd Party	2	9.1
TOTAL	**22**	**100**

As it can be seen from table 2, only 4.6% of the respondents are very much satisfied with the loan recovery performance of the banks, while 22.7% have only been satisfied. 27.3% of them responded as very dissatisfied, whereas, the majority of them i.e. 45.4%, claimed that they are dissatisfied by performance of the bank. This shows that there is unsatisfactory loan recovery in the two banks under study.

When it comes to the degree of contribution to the Non Performing Loan/NPL, only 9.1% of the respondents said that 3rd parties contributed to NPL and 13.6% of them said both banks and clients contribute to the NPL. In addition, 31.8% responded that clients only contribute, while the majority (45.5 %) said banks only contribute to the NPL. The majority of staff agreed that the degree of contribution to NPL by the bank is greater than by the client and the third party.

6.2.2 Do Banks Benefit from the Sale of Collaterals?

Following are tables showing frequency distribution about whether banks benefit from selling collaterals, any other solution to the problem of NPLs that respondents may suggest and the existence of any technical assistance, consultancy, trainings before and after loan grant to the clients.

TABLE 3: Banks' Benefit from the Sale of Collaterals

Items	Respondents	
	Frequency	**Percentage**
Banks benefit from selling collaterals		
• Strongly Agree	1	04.5
• Agree	4	18.2
• Disagree	9	41.0
• Strongly Disagree	7	31.8
• I don't Know	1	04.5
Total	**22**	**100**
Any technical assistance like consultancy, Trainings before & after Loan Grant in banks		
• Yes	6	27.3
• No	15	68.2
• I don't Know	1	04.5
Total	**22**	**100**
Is there any other solution to the Problem of NPL 's		
• Yes	11	50.0
• No	5	22.7
• I don't Know	6	27.3
Total	**22**	**100**

From the total respondents, 4.5% and 18.2% strongly agreed and agreed respectively that banks benefit from sale of collaterals. Others 41 % and 31.8 of the respondents disagreed and strongly disagree, respectively on the same idea. The remaining 4.5% responded that they do not know or understand about it.

Regarding the existence of customer support such as technical assistance, consultancy service, trainings for the business owners, managements and sales promoters of client's before and after loan grant in their setting, only 4.5% of the respondents do not know about it and 27.3% of them responded that the banks have "customer service" and technical assistance, while 68.2% responded that there is no as such "customer service" and technical assistance in their respective bank.

6.3 Analysis of other relevant data's related to loan recovery.

The following list of items which the researchers believe are relevant to loan recovery of banks, has been forwarded to the respondents in the questionnaire. Hence, each respondent is given an equal chance of picking a minimum of 3 opinions given equal value of 1/3 point each opinion.

TABLE 4: Opinions related to loan recovery performance of DBE & AIB staffs.

Description	Respondents	
	Number * 9 choices (1/3 Value)	Percentage
Too long loan process	4	6.1
Loan repayment reschedule	13	19.7
Additional loan grant	13	19.7
Interest arrears Cancellation	2	3.0
High interest rates	13	19.7
No timely Loan information	2	3.0
Under estimation of collaterals -against market value	5	7.6
Unorganized customer Service	13	19.7
Grace period extension	1	1.5
TOTAL	**66**	**100**

As we can see it from the above table, a total of 80% of the respondents said at equal response percent/ 19.7%/ for each of the following points Loan repayment reschedule, Additional loan grant has to be given, High interest rates and Unorganized Customer Service. Others, about a total of 20 % said under estimation of collaterals, too long loan process, No timely Loan information, Interest arrears Cancellation and Grace period extension at 7.6%, 6.1%, 3 %, 3% and 1.5% respectively. We can easily understand see that the respondents Majority of them gave the same reason for the non-repayment of lack or inadequate applicant screening criteria, fund diversion, willful defaulting and project duplication.

7. Summary, Conclusions and Recommendations

7.1 Summary

The aim of this research paper is to analyze factors that contribute to the rationales behind Non Performing Loans in DBE & AIB. Thus based on the findings we can summarize that the Non Performing Loans of the two banks do not show much of a decreasing trend during the period under consideration. In the same way, there is unsatisfactory loan recovery in the two banks. The contribution to NPL by the bank is greater than that of the client and third party. Technical assistance like consultancy and trainings before loan grant in the two banks is very low.

7.2. Conclusions

In light of the findings the following conclusions are drawn:

- Timely and planed recovery of loans contributes to the profitability as well as financial sustainability of any lending institution, the strength of which is believed to enhance economic development efforts. Hence, lending institutions like the Development Bank of Ethiopia and Awash International Bank are expected to have good loan recovery performances comparable to minimize the amount of non performing loan in their counterparts elsewhere.
- As the overall recovery performance of the Development Bank of Ethiopia shows the total demand for the period under review (2005 –2006) was about Birr 9,395 million of which Birr 1,233 million was recovered. The overall average recovery

rate during these periods was only 13%. Apportioning this figure into principal and interest, the average recovery rates come to about 12% and 15%, respectively.

- In the case of Awash International Bank the overall recovery performance shows that the total demand for the same period under review (2005 –2006) was about Birr 76 million of which Birr 6.9 million was recovered. The overall average recovery rate during the two years period was only 10.2 %. Apportioning this figure into principal and interest, the average recovery rates come to about 11% and 13%, respectively.
- Factors affecting recovery performance of the two banks are also the problems associated with project appraisal. This is because appraisal is the comprehensive and systematic assessment of technical, commercial, financial, economical and managerial aspect of the proposed project and it directly influences loan recovery.
- Incapable staffs are unable to appraise projects, due to weakness in exhaustively searching for up-to-date and relevant data on similar projects in the industry. Copying other appraisal reports are also other problems redundantly happening in project appraisal. These problems have highly contributed to improper granting of loans by the financial institutes for unviable projects.
- On the other hand lack of inadequate applicant screening criteria can also be the other major factor to be considered by the two Banks. In order to screen potential, risk taking and dependable applicants, criteria such as portfolio management, credit discipline or repayment history, current capacity to repay loan, personal behavior or character and business experience of applicants should be investigated seriously before approving and disbursing loans. The study shows that these Banks have no adequate applicant screening criteria that are used to identify creditworthy applicants.
- External factors such as diversion of loan, willful defaulting and poor project management capability of clients are identified additional major factors that affect loan recovery performance of the Banks. Granting loans by acquaintance to the loan granting board has also effected in disbursing the loan to undeserving clients or applicants.

7.3 Recommendations

Based on the forgoing findings and conclusions, the followings are recommended for users of this research or perhaps for the managements so as to help the two Banks to improve their loan recovery performance.

- ❖ The long outstanding non-performing loans (inactive loans), which affected the loan recovery performance of the two Banks, well in the books but empty in reality, should be written off from their respective balance sheet.
- ❖ In order to improve the quality of project appraisal reports and to provide sufficient technical assistance to borrowers, the two Banks should allocate sufficient budget or find funds to upgrade the knowledge and skill of its staff.
- ❖ In order to select potential and creditworthy applicants, both Banks should have adequate applicant screening criteria. Criteria such as credit discipline or repayment history, current capacity to repay loan, personal spending pattern behavior and business experience should be considered at the time of applicant screening. Moreover, operational units of the Bank should create a good working relationship with concerned organizations so that they can get enough information about prospective applicants.
- ❖ Similarly to promote the creditworthiness of clients after the project appraisal the banks have to continue providing sufficient technical assistance to borrowers. This can be done by the two banks through training the borrowers' managements, assistance and guidance in market assessment, demanding an annual business plan submission and follow-up of business as per the plan.
- ❖ The two Banks should set conditions that enforce and encourage clients, especially clients with big projects. They should include project execution contract documents and to recruit skilled, professional, managerial and technical staff.
- ❖ Finally, the two Banks should make loan rescheduling to their clients when only it is based on detail assessment, strong justification and convincing cases are presented to the managements and mutually agreed by the client and the banks.

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