ASSESSMENT OF 5C's CREDIT APPRAISAL TOOLS AND THE LEVEL OF NONPERFORMING LOANS AND ADVANCES-IN THE CASE OF NIB INTERNATIONAL BANK SC

A RESARCH REPORT SUBMITTED TO St. MARY'S UNIVERSITY IN PARTIAL FULFILMENT FOR THE REQUIREMENTS OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (MBA)

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ADDIS ABABA

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ALEMU SEMAYE GUANGUL

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DECLARATION:

This research project is my original work and has not been presented in any other university for the award of any degree or diploma, and the matters referred in the process have been duly acknowledged.

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ABSTRACT

The study was geared towards discovering the use of 5C's credit appraisal techniques in the approval process of loans and advances and evaluate nonperforming position of Nib International Bank S.C.

The study was conducted through a sample base on 120 respondents (branch managers, division managers, loan officers, customer relations managers, credit analysts and loan follow-up officers) working in branches dispensed throughout the country and at head office.

Data was collected using a structured questionnaire. The data collected was analyzed by descriptive statistics. SPSS version 20 was used in capturing and building the data analysis. The findings of the study were that; NIB International Bank S.C. uses the 5Cs credit appraisal tools in credit risk, evaluation, assessment and appraisal processes.

To remain affluent in business, commercial banks should use the 5Cs credit appraisal tools considering that, credit risk is the major risk that banks attach a lot of importance to. It should be noted that most bank failures worldwide have been attributed to poor credit policies they have employed in their businesses. NIB International Bank S.C. applied the 5C's credit appraisal techniques in credit risk assessment and appraisal processes and the use of the 5Cs credit appraisal techniques enabled it to make remain constant the level of nonperforming loans and advances. Collateral was uncovered the most significant of all the credit appraisal variables followed by character, capacity, capital and condition.

LIST OF ACRONYMS

- NIB: Nib International Bank S.C.
- NPL: Nonperforming loans and advances

- CRM: Customer Relation Manager

CHAPTER ONE:
INTRODUCTION

1. Background to the Study

A strong and vibrant banking sector is important for a flourishing economy. Failure of the banking sector has adverse impacts on other sectors of the economy too. Nonperforming loans and advances are of concern for commercial banks in Ethiopia. Nonperforming loans and advances are credit facilities whose principal and interest is in arrears for a period of ninety and above days. Nonperforming loans and advances reflect the performance of commercial banks in the country. High level of nonperforming loans and advances are indicator of the presence of many credit defaults that affect the profitability and net worth of banks and they erode the value of their assets. The growth of nonperforming loans and advances call for provisions which reduce the overall profits and returns to shareholders. The issue of nonperforming loans has been a subject of discussion at lengths amongst financial systems worldwide. The problem of nonperforming loans and advances are not only affects banks but also the entire economy.

This research helps to understand the theories of credit management, non performing loans and advances and the use of the 5C credit appraisal techniques on the level of non-performing loans and advances on Nib International Bank S.C.

Credit risk is defined as the potential that borrowers will fail to honor the obligation of repaying loans and advances in accordance with the agreed terms when the facility is disbursed. The main goal of credit management is to maximize the banks risk adjusted rate of return, through ensuring that credit exposure is kept within the acceptable norms. Extending loans to businesses and individuals involves taking risks to earn high returns. Banks use loans to cross sell other fee earning services. There are a number of factors that can lead to loan defaults these include: industry decline as a result of the general economic trends, firms' specific problems that may arise from changing technological trends, industrial actions by the union movements and shifts in business cycle as individual incomes rise or fall (MacDonald, et al., 2006).

There is need for commercial banks to manage the credit risk encompassed in the entire portfolio of loans and advances and that is in individual credit transactions. They should determine the relationship between credit risk and other risks. Effective management of credit risk is a crucial component of a comprehensive approach to risk management and an essential ingredient to banks long-term survival. Loans granted by commercial banks are the largest and most obvious source of credit risk in so far as other sources of risk exist throughout their operations. The other sources of risk include: the banking and trading books and the on and off-balance sheet items. Other than loans, commercial banks face credit risk in other financial instruments such as: acceptances, interbank transactions, trade financing, foreign exchange transactions, swaps, bonds, equities, options and in extension commitments, guarantees and settlement transactions (Butterworths,1990).

The fact that exposure to credit continues to be a major problem to banks worldwide, banks and their supervisors should draw lessons from the experience others have gone through and what they have gone through too. They should be keen in identifying, measuring, monitoring and controlling credit risk and ensure that they hold adequate capital against these risks and are adequately compensated for risks incurred, (Basel, 1999). A further example of credit risk relates to the process of settling financial transactions. Where one side of the transaction is settled, and the other fails, a loss may occur which is equivalent to the principal amount of the transaction. In the event whereby one party is late in settling, the other party may incur a loss in relation to missed investment opportunities. Settlement risk hence includes elements of: liquidity, market, operational and credit risk. The level of risk is determined by particular arrangements put in place for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value, settlement finality and the role of intermediaries and clearing house (Edwards, 1997).

Extending credit is a long journey whose success depends on the methods used in evaluation and awarding it. The journey commences from application for credit and terminates with the time the credit is fully paid. Like any other journey undertaken by human beings, the credit management process has its smooth and rough terrains before one gets to the final destination. There is need therefore, to control credit for any success in the accomplishment of the journey to be realized (Clarke, et al, 1999).The most important concern to commercial banks is not to be overwhelmed by marketing or professionally cited reasons when booking a loan but to take the risk reward aspects into consideration. Banks should not only consider the business upswing but also: the downturn swing the borrower may find him or herself in. Furthermore, banks place a great emphasis on outdated financial statements that is further exacerbated by the fact that a descriptive rather than an analytical approach to credit is taken. Hence a forward looking strategy need to be adopted since the loan will primarily be repaid from future cash flows but not historic performance, nevertheless both can provide good repayment indicators (Sufi Faizan Ahmed et al., 2015).

1.1 Statement of the Research Problem

World over, credit has proved to be the most critical of all risks faced by banking institutions. A study of bank failures in New England found that, of the 62 banks in existence and failed from 1989 to 1992 in 58 cases were observed that loans and advances were not being repaid in time (Sabrani, 2002). One of the most crucial causes attributed to these failure was, the high incidence of non-performing loans and advances. Apart from the management failure through instituting poor lending practices, some blame must be borne by the borrowers, especially their failure to repay their loans as per the terms and conditions in the initial agreement. The sudden and unexpected closure of banks comes with some costs. Losses accrue to the shareholders, depositors, unsecured creditors and the deposit insurer. What makes banks failure more crucial particularly for public policy is the fear that the failure may spill over to other banks and even possibly to the financial system as a whole, the domestic macro economy and other countries. This is because banks are closely intertwined financially with each other through lending and borrowing from each other, holding deposit balances with each other and the payments clearing system (George, 1995). Central banks through the prudential guidelines issued to institutions provide tough remedial and punitive administrative sanctions on banks that fail to adhere to specific loan and advance requirements. It is on this premise that banks adopted proper credit assessment evaluation and appraisal measures. The 5Cs credit appraisal tools: **character, capacity, capital, condition and collateral,** may have elements that comprehensively cover the entire areas that affect risk assessment and credit evaluation.

Research/study on non-performing loans and advances are not a new phenomenon. Kabiru (2002) undertook a study on the relationship between credit risk assessment and the level of non-performing loans of commercial banks in Kenya. He looked at some key factors that influence credit decision among which included: reputation/character, leverage/capacity, volatility in earnings/condition and collateral; (4Cs of credit risk assessment) that were borrowers' specific factors and the business cycle and the level of interest that were market specific factors. In his study he did not look at: capital that is also among the key factors influencing credit decisions.

Islam et al. (2005) in his paper entitled nonperforming loans: its causes, consequences and some learning experiences in Bangladesh, dealt with nonperforming loan situations, basically; the causes and consequences. He pointed out the possible steps to handle the situation these included: improved law and order, motivation, where awards could be arranged for the best loan performers, use of recovery agency to collect bad and doubtful debts, less relaxation on the side of banks in loan recovery, development of specific situation model/condition where professional management can be used to develop situation that may help to deal with different situations differently, real timing/control bank staff to be trained so as to handle situations competently, trade off where every bank designs its own investment portfolio especially in areas where default is less, proper monitoring/character banks should ensure periodic monitoring so that borrowers can not reveal any weakness from the banks side. In this study the focus was on the 2Cs of credit risk appraisal. Islam et al did not consider capacity, collateral and capital possible steps that could be adopted to handle the problem of nonperforming loans. Waweru (2009) undertook a study on the commercial bank crises in Kenya causes and remedies. The study focused on the causes of non-performing loans and the steps banks have taken to mitigate the problem. The findings of the study were that: national economic downturn (condition) was perceived to be the most important external factor that causes nonperforming loans and advances, customer failure to disclose vital information during loan application/character was considered to be another main customer specific factor and, he focused on 2Cs of credit evaluation and assessment. Waweru did not focus on capacity to repay, adequate capital (contribution to the business) and collateral as factors that can help in mitigation of the problem. Despite many research conducted by different researchers throughout the world, there is no any researches done on 5C's credit appraisal tools on and the level of non-performing loans and advances in Ethiopian commercial banks in general and NIB International Banks s.c. in particular. Nonperforming loans and advances of Ethiopian commercial banks comprises considerable portion of loans and advances granted to customers, this could have been due to lack of proper credit analysis, particularly they might not use 5Cs credit appraisal tools in proper manner or focus on part of the credit appraisal instrument. NIB Bank, one of the private commercial Banks in Ethiopia approved credit facilities using various credit analysis tools. However, NPL position of the Bank did not reduce significantly, this may be due to lack of emphasis on 5 Cs credit appraisal tools since no research has done in similar manner. Therefore, this study focuses on the practicability of the 5Cs (character, capacity, capital, collateral and condition) credit appraisal tools on the level of non-performing loans and advances.

1.2 Research Questions

The following are the research questions that the study aims to address:

1. To what extent has the 5C's credit appraisal tools been applied by NIB International Bank S.C.?
2. What have been the trend of the level of nonperforming loans and advances in NIB International Bank S.C.?
3. Does the existing credit policy and procedure of the Bank assure the use of 5C's credit appraisal tools on credits advanced by NIB International Bank Sc.?

1.3 Objectives of the Study

1.3.1 General Objective

The main objective of the study was to determine the use of 5C's credit appraisal tools and understand the trend of nonperforming loans and advances in Nib International Bank S.C.

1.3.2 Specific Objective

The specific objectives of conducting this research were:

1. To check whether the Bank was applying all 5c credit appraisal tools in its credit analysis process or not.
2. To discover the trend of the level of nonperforming loans and advances in the Bank.
3. To ensure whether the Bank was required to revise its credit policy and procedures to mitigate the level of its nonperforming loans and advances

1.4 Significance of the Study

This study will provide banks with information that will enable credit managers conduct credit risk assessment with prudence and cultivate the interest of researchers to study more in the area of credit risk assessment. The study will enhance the credit review and recommendations on credit management by the bank's supervisory organ

(National Bank of Ethiopia) to commercial banks. The study will allow the tax authorities understand the causes of non-performing loans that lead to leakages in tax revenue and advance appropriate remedies. The study may encourage the government to fund research in this area that is a threat to the economic growth and development of the country.

1.5 Scope and Potential Limitations of the Study

1.5.1 Scope of the Study

The researcher intended to assess 5C's credit appraisal tools and the level of non-performing loans and advances in NIB Bank. Because of financial and time constraints it was too difficult to take all banks that exist in Ethiopia in detail. Accordingly the findings couldn't be used to generalize the use of 5C credit appraisal tools in other commercial banks in Ethiopia.

The research used data helped only to describe outcomes, despite other research methods was equivalently important.

The questionnaires has distributed to branch managers, division managers, customer relationship managers, loan follow-up officers, credit analysts and loan officers lying throughout the country.

1.5.2 Limitation of the Study

The study focused on financial related variables only and did not consider nonfinancial measure variables which may have influence and might need a further investigation. Financial performance of the bank during the last five years may be affected by different variables in turn influenced the level of nonperforming assets of the Bank which was out of the researcher's focus. Only 73.3% of the replies were collected that could affect the conclusions the researcher has reached. Failure to apply statistical model to quantify the interdependency between asset quality ratio and 5C's was the major limitation. Moreover, shortage of time restricts my research to focus only on information collected through questionnaires than face to face interviews.

1.6 Organization of the Study

The study was organized in five chapters:

The *first* chapter is all about introduction part comprised background of the study that was about the importance of banking sector and the influence of nonperforming loans and advances on the entire economy of the country, statement of the research problem deals about how lending activity results the most significant risk in commercial banks, research questions discusses three questions which answered finally by the researcher, general and specific objectives of the research, significance of the study that how National Bank of Ethiopia and other commercial banks in the country benefits from the research, scope of the study that is the researchers intention to address and limitation of the study.

The *second* chapter is all about literature review, it deals about how different researchers tried to see the level of nonperforming loans and advances and how can be managed, which credit appraisal factors have more impacts on the level of nonperforming loans and advances.

The *third* chapter is about research methodology deals on research design, population and sampling procedure of the study, data gathering instruments, procedure of data collection, validity and reliability tests and method of data analysis.

The *fourth* chapter carried out on: data analysis. This chapter deals about output of the research using descriptive statistics.

The *fifth* chapter is about summary of the findings and conclusions recommendations and suggestions for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Financial stability is considered as sine qua non of sustained and rapid economic progress. Nonperforming loans and advances are assumed critical since it reflects on asset quality, credit risk and efficiency in resource allocation. A common perspective has been that the problem of nonperforming loans and advances is attributed to political, social, economic, technological, legal and environmental factors across countries. With numerous reforms in the financial sector induced by rapid increase in the pace of globalization, advances in technology and structural reform programs, government intervention in credit market can ease problems considerably. Advances in technology has facilitated rapid exchange of information across markets, creation of fewer financial products and enhanced efficiency in operation subsequently strengthening financial institutions and countries have adopted international best practices pertaining to banking and financial sector (Nagaraju, R. C., 2014).

Commercial banks generally serve as financial intermediaries through mobilization of resources from surplus economic units to deficit economic units within the economy. To achieve the profitability objective, banks have a risk to manage this mainly relates to non-performing loans Non performing advances reduce the liquidity of banks, impair credit expansion and have a direct consequence on the overall performance of banks, the firm that defaulted and the economy. It should be noted that lending is all about creation and management of risk assets. Effective management of a lending portfolio requires an articulated lending policy that sets out the banks' lending philosophy, objectives, including modalities for implementation, monitoring, appraisal and review of credit facilities. Well conceived lending practices are vital in facilitating an efficient credit system. The success of the bank entirely depends on the ability of the management to mitigate it against risks through adoption of sound risk management practices. Effective management of loans portfolio has been a problem in the banking industry. Many bank failures have ensued from poor management of their lending portfolios hence they find it difficult to meet their obligation to clients and owners which could render them insolvent. It is clear from the accounts of the failed banks that these banks had in adequate paid up capital ratios, had accumulated bad debt, and were mismanagement. Ratio of the credits to the capital played a critical role in failure.

Capital adequacy control alone could be a critical tool controlling the banks health. (Okan, 2005)

2.2 Risks of Commercial Banks

The past decade has seen banks make huge losses. Companies that had been seen to be performing well suddenly announced big losses due to credit exposures that turned sour and interest rate positions taken. In response commercial banks embarked on upgrading their risk management and control systems.

Pyle (1997) in his paper entitled Bank risk management theory, defined risk as the reduction in the firm value due to changes in the business environment. The major sources of value loss are identified as, market risk, credit risk, operational risk and performance risk. Risk may also be defined as, a combination of specific hazard and the likelihood that the hazard can occur in future though; such hazards can be mitigated rather than present problems that must be immediately addressed.

That likelihood of risk occurring can be expressed as a rate of probability: (Probability) x (hazard) =Risk. Risk can be perceived in so many ways; as long as it combines hazard with the probability of such a hazard to occur. Thus far it has been argued that risk is an essential ingredient in the financial sector, and that some of this risk will be borne by all but the most transparent and passive institutions. In short, active risk management has a place in most financial firms. In light of this, what techniques can be used to limit and proactively manage risk? And, what are the necessary procedures to implement in order to adequately manage the risks which have been identified as the responsibility of firm management? The answers to these questions are straightforward and are the issues to which we now turn. If management is going to control risk, it must establish a set of procedures to obtain this goal. In the financial community this is referred to as a firm-level risk management system. Its goal is to measure and manage firm level exposure to various types of risks which management has identified as central to their franchise. For each risk category, the firm employs a four-step procedure to measure and manage firm level exposure. These steps include: (i) standards and reports (ii) position limits or rules (iii) investment guidelines or strategies (iv) incentive contracts and compensation. George S. Oldfield et al. (1997).

Without effective management of these risks, banks can easily become insolvent. If the bank is perceived to be in financial problems, depositors will run on their deposits, other banks won't lend funds to it. This worsens the banks financial position further. The fear of bank failure was one of the major causes of the 2007-2009 credit crisis and other panics that were observed in the banking sector worldwide. The risks banks face are shared by many other business entities, the major risks being; liquidity, interest rate, operational, strategic and foreign exchange risks.

Liquidity Risk: Liquidity is the ability to generate cash and cash equivalent in a timely manner at a reasonable price to meet obligations as and when they fall due. The basic expectation of the bank is to provide funds on demand. This is with respect to the following circumstances: when a client wants to withdraw money from his or her savings account, when business presents a check for payment, or borrowers who may want to draw on their credit lines. The other need for liquidity arises when payment of bills that are due need to be made (Cornet et al., 2008).The major problem of liquidity management for a bank is that: whereas bills are mostly predictable, both in timing and expected amounts, customers' demands for cash are not, especially from savings deposit and current account deposits. Off-balance sheet items pause another major liquidity risk. These items include loan commitments and letters of credit. A loan commitment is a line credit that the bank provides on demand. Letters of credit include commercial letters of credit, where the bank guarantees that an importer will pay the exporter for imports and a stand by letter of credit which guarantees that issuer of commercial paper or bond will pay back the principal (Clarke et al., 1999). Liquidity risk management is achieved by asset and liability management. Asset management entails keeping cash and keeping liquid assets that can be disposed quickly at low or no cost.

Liability management on the other hand entails management of borrowing practices. The primary purpose of using asset management to provide liquidity; is to maintain a sufficient level of both cash and liquid assets. Liquid assets can be sold quickly at what they are worth net of transaction cost or bid/ask spread. They can therefore be converted into a means of payment for little cost (Pyle, 1997). The primary liquidity solution for banks is to build reserves which the law provides for. Reserves constitutes of: all money held in cash safe vaults, cash held at National Bank of Ethiopia and that held in accounts with other commercial banks. All commercial banks in Ethiopia are required to deposit at all times 5% of Birr and foreign currency deposit liabilities held in the form of demand, saving and time deposits. The deposit is not available for bank operation (National Bank of Ethiopia, 2013). Banks can also keep excess reserves in their accounts at National Bank. Though reserves provide liquidity, they earn little or no money for the bank. By keeping liquid assets, a bank can earn money while maintaining liquidity. The most liquid and safest asset is treasury bill, of which banks are the major buyers. A bank can also increase liquidity by squeezing its lending practices. Many loans that are constantly renewed are mainly short term in nature. By not reviewing such loans, the bank receives the principals and interest all a long until the final installment is settled. However such practices are not undertaken by many banks because most short term borrowers are business customers, of whom by not renewing loans extended to them could prompt them take their businesses elsewhere. A bank can increase its liquidity level by borrowing from another bank or issuing securities. Banks mainly borrow from each other in inter-bank borrowings where banks with excess reserves lend to banks with insufficient reserves. They can also borrow from National Bank of Ethiopia; however this is undertaken as a last resort.

Credit Risk: Credit default risk occurs when a borrower cannot repay the loan. It remains the most important risk to manage to date. The predominance of credit risk is even reflected in the composition of economic capital, which banks are required to keep aside for protection against various risks. Nonperforming loans and advances are indicators of credit risk. Capital adequacy ratio is also another measure of credit risk. Capital adequacy ratio is supposed to act as a buffer against credit loss (Rekha et al., 2005).Banks are required to maintain provision for such accounts to cover up losses. However banks reduce credit risk by screening loan applicants, requiring collateral for a loan, credit analysis and diversification of their loan portfolios (Hempel et al., 1994).

Interest Rate Risk: Banks main source of profit is derived from the conversion of liabilities of deposits and borrowing into assets of loans and securities. They earn profits by paying lower interest on liabilities compared to what they earn on assets. The difference in this rate is referred to as the net margin or spread. **However**, it should be noted that, the term of bank liabilities are usually shorter than the terms of its assets. Interest rate paid on deposits and short term borrowings are sensitive to short term rates, whereas interest earned on long-term liabilities is fixed. This creates interest rate risk, which in this case is the risk that interest will rise making the banks pay more for their liabilities. Excessive interest rate risk may erode banks' earnings and capital base (Saunders, 2002). All short term and floating rate assets and liabilities are interest rate sensitive. Interest received on assets and paid on liabilities changes with respect to the changes in the market rates. Interest rate sensitive liabilities include saving deposits and interest paying short term fixed deposits. For a bank to determine its overall risk to changing interest rates, it must determine how income will change when interest rates change. Gap and duration analysis are the two common tools that are used for measuring the interest rate risk of bank portfolios. Gap analysis is the difference between the values of interest rate sensitive assets and the value of interest rate sensitive liabilities (the gap) multiplied by a change in interest rate. Since interest rate affects prices of bank assets and liabilities; it in the same way affects bonds, bankers also use a tool commonly used in bond portfolio analysis known as duration analysis. Duration measures the change in price of a bond when interest rate changes. Banks calculate their duration gap by subtracting the weighted average duration of their assets less the weighted average duration of their liabilities. Banks can reduce interest risk by matching the terms of their interest rate sensitive assets to liabilities, though this reduces their profits, they can also extend long term loans based on a floating rate, but many borrowers normally demand a fixed rate to lower their risk .Floating rate loans increases credit risk when rates rise because borrowers have to pay more each month on their loans hence making them unaffordable (Hull, 2007).

Foreign Exchange Risk: This risk arises when a bank suffers losses as a result of adverse exchange rate movements during a period in which it has all open position, either spot or forward or a combination of both in an individual foreign currency. The risk tends to be identified with cross border capital flows. Where a bank holds assets denominated in foreign currency whereas liabilities are held in their home currency, if the exchange rate of the foreign currency declines, then interest and principal repayments will be worth less than when the loan was awarded, hence this reduces the banks profits. Banks can however hedge against this risk by using forward and futures contracts that will guarantee an exchange rate at some future date or provide a payment to compensate for the adverse movement in the currency exchange rates. A bank with a foreign branch or subsidiary in the country, can also take deposits in foreign currency, which will match their assets with liabilities (Thygerson, 1995).

Operational Risk: Operational risk arises from the bad business practices or when buildings, equipment and other property required to run the business are destroyed or damaged. Many types of operational risks such as property are covered by insurance. However good management is required to mitigate the banks against bad/faulty business practices, since such losses are not insurable (Pyle, 1997).

Strategic Risk Management: Strategic risk is the current and prospective impact on earnings or capital arising from adverse business decisions or lack of responsiveness to changes in the industry. The post liberalization years have seen increased pressure on banks in developing countries. The main reason behind this has been absence of effective and strategic credit risk management system. Risk selection, as part of the comprehensive strategy that supports and grows from corporate foundation is the basis for future risk management. It entails four steps: establishing corporate priorities, choosing the credit culture, determining the credit risk strategy and implementing risk controls. These strategies focus on reducing the volatility in the credit quality of the bank's credit portfolio and earnings performance. Strategic credit risk management provides banks staff with a clear understanding of the bank's credit culture and the risk acceptable in the loans and advances portfolio. The senior management should manage the process and the portfolio to align them with corporate priories. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve these goals, the resources deployed against those goals and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks and managerial capacities. In strategic management, the organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory and other environment changes (Basel, 1999). The starting point for all effective strategic risk management is to set strategic goals in the form of a mission statement, In order to accomplish their mission banks have concentrated on increasing the clientele base, sensitizing all staff members on the need for customer centricity, improved the balance sheet size and improved the; spread so that the bottom line of the bank remains healthy. The Risk Managers are actively involved in the annual budget exercise and also in mid-term reviews. During such meetings, the Risk Managers comes out with a detailed SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the bank (Clarke et al., 1999).

2.3 Credit Management

Credit management is the process for controlling and collecting payments from clients. A good credit management system reduces the amount of capital held by debtors and minimizes the banks vulnerability to bad and doubtful debts. Good credit management is essential to banks cash flows. It should be noted that, it is possible to be profitable on paper but lack the cash to continue with business operations (Edward, 1997). Credit management minimizes the chances of bad debts through adoption of good credit management practices. The following however should be adhered to, for commercial banks to come up with a comprehensive credit management program, banks should clearly state in writing the terms and conditions of credit and stipulate their credit policies. This should be in tandem with their business. Legal advice should be sought before any final document on the credit sought is released. This is to ensure that no internal inconsistencies arise and all the key aspects on credit are covered. Any illegal terms that could be a recipe to opening court battles should be expunged. Banks should include terms on all contracts, agreements and related documents to safeguard their interests. This should clearly specify the period for which the credit has been extended to the party, and a written acceptance to the agreement along with a written approval of any variations to the original agreement.

Other terms and conditions to include are: Penalties for late payment specifying the interest rate to be charged, under normal circumstances the current bank rates will apply, though the bank reserves a right to charge a higher rate, the bank should have a good title to the assets charged to it as security, the customer should not create any charge mortgage pledge or lien of any kind whether express or implied on them. Upon full settlement of the credit, the security charged should be discharged following laid down legal procedures and the banks credit policy. It should be clearly stated to the borrower that the credit extended is deemed to be a continuing and running account and the agreement signed shall not be discharged or terminated by reason that the said account has been brought into credit at any time or from time to time. Banks should have a right from time to time to apply all the money held by them on behalf of the client in any accounts held by the client be it that they are in credit or debit towards settlement of any amount together with interest thereon which shall be or may become due from the customer.

2.4 Basel Accords on Credit Management

The Basel accords are recommendations on banking issued by the Basel committee on banking. The main objective of the Basel accords is to create an international standard that banking regulators would use when creating regulations in their own countries. These accords are about how much capital the bank should hold to cushion itself against financial and operational risks that they face. The foundation of the Basel accords I is the Cooke ratio. This ratio is defined as the amount of capital to risk weighted assets which must be at least 8%.The risk weighted assets relates to the amount lend by the bank multiplied by the risk weight. Basel I accords allows banks to use their own internal models in measuring credit, hence making it easier for banks use (Basel I, 1999). This simplicity however has opened windows to some unanticipated credit risk that are being experienced globally today; consequently, a new more risk sensitive capital- adequacy framework was issued in 2002. Basel II accord made some improvements over the focus on the three pillars of risk minimization. These are: minimum capital requirement that is expected to determine the amount of capital requirements given the level of: credit risk, market risk and operational risks that the banks are exposed to. Pillar II is on supervisory review-It provides a framework for dealing with all other risks that the bank may face. These includes: systematic risk, concentration risk, strategic risk and reputation risk. Pillar III focuses on market discipline- designed to allow the financial community have a better picture of the overall risk position of the bank by allowing competitors to price and deal effectively (Basel II, 2002).

Although the new accord aims at boosting the safety of the banking system, It is feared by many Central banks worldwide for it may target only internationally active banks with 20% of the business from international operations and significant banks which are defined as those whose market share in total assets of domestic banking exceed 1%.However Basel II accord remains a challenge to the entire banking industry. Banks should be conceptually and academically ready to adopt the new norms. This involves a paradigm shift in the direct supervisory focus away to the implementation issue in many parts of the world. Much of the Basel accords have been instrumental in providing some effective credit management framework thereby avoiding some credit crises. It has become apparent that, some risk measurements have to be strengthened so as to reduce high incidences of non-performing loans. These risks are: risk of corporate governance, special or uncalculated risks caused by factors beyond the expectations of risk undertaking and overheads (Somoye, 2010).

2.5 Credit Risk Management

Risk is the fundamental element that drives financial behavior. Without risk; financial systems would be vastly simplified. However risk is present everywhere in the real world. Financial institutions therefore should manage the risk efficiently so as to survive in the highly volatile world. The future of banking undoubtedly rest on risk management dynamics. Only those banks that have efficient risk management systems will survive in the market in the long run. The effective management of credit risk is a critical component of comprehensive risk management measures essential for long-term success of banking institutions. Credit risk is the oldest and biggest risk that a bank by virtue of its very nature of business inherits. The cornerstone of credit risk management is the establishment of a framework that defines corporate priorities, loan approval process, credit risk rating systems; risk adjusted pricing systems, loan review mechanisms and comprehensive reporting system. The two distinct dimensions of credit risk management can be identified as preventive and curative measures. Preventive measures include risk assessment, risk measurement, early warning signs that will pick early signals of future defaults and better credit portfolio diversification. The curative measures on the other hand aim at minimizing the post-sanction loan losses through such steps as securitization, risk sharing and legal enforcement. It is believed that an ounce of prevention is worth a pound of cure (Rekha et al., 2005).

According to Hempel (1994), the concept of moral hazard and adverse selection provide a framework for understanding the principles that financial institutions managers must follow to minimize credit risk and make successful loans. Adverse selection is problematic in loan markets because borrowers with high credit risk are the ones who usually lineup for loans and those who will provide bad customers are likely to be selected/picked from this group. Moral hazard is a problem in loan market because borrowers may have incentives of engaging in activities that are undesirable from the lenders point of view in such situations; it is more likely that the lender will be exposed to the hazard of default. An attempt by commercial banks to solve these problems helps in explaining a number of principles for managing credit risk such as: screening, monitoring, collateral, compensating balance requirements and credit rationing among others.

Screening: Commercial banks should maintain a checklist to ensure that all the required information in line with credit applications are comprehensively collected. They should set out pre-qualification criteria for screening that should guide the credit officers in determining the type of credit that deem to be acceptable. For instance the criteria could include rejected applications in blacklisted customers all together so as to avoid duplication of effort (Reddy et-al., 2004).

Commercial banks should ensure that the credits extended to its clients are utilized in legitimate ventures in line with the application to avoid usage in fraudulent activities that go against the law of the land. They should avoid extending credit to individuals or companies of questionable integrity or repute (Mishkin, 1998).To save the bank from imminent losses, problematic facilities need to be identified early. A proper monitoring system will provide the basis for taking prompt action when warning signs point towards the deterioration of the financial conditions of the borrower. Such include unauthorized drawings, arrears in repayment of principal and interest and deterioration in the borrower's business environment (Mishkin, 1998).

After screening, the next stage is credit appraisal where the bank assesses the following attributes: the customer's ability to repay the loan, the nature and value of the collateral or guarantee in support of the credit so as to mitigate risk, the working capital financing should not be pegged to the existence of collateral or guarantee. Such financing should be supported by a proper analysis of projected levels of sales and cost of sales, prudential working capital ratios, past experience of working capital financing and the contribution to such capital by the borrower himself. Where the bank is engaged in loan syndication, each of the participating bank should apply its own credit risk analysis based on the information at its disposal to ensure that it does not rely on the analysis undertaken by the leading underwriter (MacDonald et -al, 2006).

Commercial banks must put in place written guidelines with respect to the credit approval process, the approval authorities of individuals or committees and the basis of such decisions. They can also apply credit rationing as gap measures. Credit rationing is twofold: When the financial institution refuses to make a loan to a borrower even if he is willing to pay a higher interest rate and when the financial institution is willing to make a loan but restricts the size of the loan to less than the amount the borrower would like. All credits approved should be at arms lengths. Credit to related parties should be thoroughly scrutinized, analyzed and monitored so that no senior person in the management overrides the established rules for granting credit (Bank of Mauritius Guideline on Credit Risk Management, 2003).

Credit documentation is a pre-requisite for each phase of the credit cycle, credit application, credit approval, credit monitoring, and collateral valuation, and impairment recognition, foreclosure of impaired loans and realization of security. Credit files must be properly maintained with an appropriate system of indexing to facilitate quick review and follow up as and when need arises. Documentation establishes a relationship between the bank and the borrower and it forms a base for any legal action in the courts of law. All contractual agreements with the borrowers should be vetted by the banks legal adviser .Credit applications whether approved or rejected must be properly kept. Copies of critical documents should be kept in credit files while retaining the originals in files kept in secure fire proof cabinets and should never be removed from the banks premises (Edwards, 1997).

Commercial banks must ensure that their credit portfolios are properly managed. Loan agreements are dully prepared, renewal notices are served on time and credit files are updated on a regular basis. Once the credit has been approved, the applicant should be advised of the terms and conditions of the credit through the letter of offer, the duplicate of this letter should be signed and returned to the bank by the customer as an indication of acceptance. Upon receipt of this letter the facility disbursement process should commence. Regarding documentation, the registration of collateral, insurance cover with the banks interest should be properly vetted by the banks legal expert. Under no circumstances should funds be disbursed prior to compliance with the pre-disbursement conditions and approval by relevant authorities of the bank (Sinkey, 1992).

2.6 Requirements for Credit Risk Management

Non-performing loans are the most common causes of bank failures. This has prompted all regulatory institutions to prescribe minimum standards for credit management. Identification of existing and potential risk is prerequisite in successful lending activities. This starts with the identification of potential risks through carefully study of the source of problems or the problem itself. Upon this identification, risk sources are ascertained and analyzed. Risk sources may be external or internal to the system that is the target of risk management, Examples of risk sources include: shareholders of a project, employees of a company or the weather. In the process of analyzing risk sources, problems are identified and subsequently analyzed. In problem analysis, risks are related to identify threats. For example, the threat of losing money as a result of customer defaults in effecting payments. These threats may exist with various entities such as shareholders, customers and the government. Once risks have been identified, risk assessment must be carried out to ascertain the potential severity of the loss and the probability of occurrence. In the assessment process, it is critical to make the best educated guesses possible in order to properly prioritize the implementation of the risk management plan with a view of mitigating the losses. This is through adopting control or counter control measures to measure each risk. Risk mitigation measures need to be approved by the appropriate level of management. For example, a risk concerning high level lending should have the top management decision behind it, usually the board of the bank. A credit risk management plan should propose applicable and effective security controls for managing risks. A good credit risk management plan should contain a schedule for control implementation and responsible persons for those actions. Implementation in credit risk management involves: following all the planned methods for mitigating the effects of the risks. These include: purchase of insurance policies for risks that have been decided to be transferred to an insurer, avoiding all risks that can be avoided without sacrificing (Sinkey, 1992).

Measures to counter credit risk normally comprise clearly defined policies that articulate the banks credit management policies and the parameters within which credit risk is controlled clearly. Specific credit risk management measures included four kinds of policies. One set of policies include those aimed at avoiding the risk by not performing an activity that could carry risk. An example could be lending to a particular sector in the economy. Avoidance would seem to be the best solution to all risks, but avoiding the risk by not performing a certain activity means losing out on potential gains that accepting risk might have allowed. The second set includes the policies of asset classification which exposes the bank to credit risk. These sets of policies are geared towards reducing the severity of the loss from occurring. The third sets of policies include risk retention. This relates to accepting loss when it occurs. This is a viable strategy for small risks where the cost of insuring the risk outweighs the resultant benefits. The forth set of policies include risk transfer. This means causing another party to accept the risk typically by contract or by lending, insurance is typically one type of risk transfer mechanism (Dorfman, 1997).

2.7 Credit Evaluation

Credit evaluation is the process a business or an individual must go through to become eligible for a loan. Granting a loan depends on; the willingness of the bank to lend in the current economy based on its assessment of the ability of the borrower to repay. According to MacDonald, et al (2006) credit evaluation begins with the analysis of the organization and the business structure of the borrower. It should be ascertained whether the borrower is: a holding company or a single entity, whether he or she operates as a partnership or a corporation, when the firm began operations and the geographical market it competes. The evaluation should identify the products or services the borrower deals in and the firm's competitive position in the market as measured by market share, the threat of new entrants, the threats from substitute products, the bargaining power of customer and, the bargaining power of suppliers (Chartered Institute of Bankers, 1997). The analyst should examine the historical sales growth and its relationship with the industry sales, business cycle and the projected forecast for the industry. The analyst should address questions related to: the availability of suppliers for raw materials, the quality of the firm's labor force and employee relations, and; whether the firms fixed assets are standard or obsolete (Gerschick ,2002).

The bank should focus on the management character and quality. The background of the chief executive officer, the finance manager and operating officers should be ascertained in terms of: individual ages, experience in business service with the organization and the apparent succession plan. Top officers in the firm with equity interest and the type of compensation they receive should be identified too. This helps in the identification of the motivating factors underlying the firm's decision. At the end, the analyst should recognize the borrower's loan request, the quality of financial data provided, and the proposed use of the funds, amount of funds requested plus the anticipated source of repayment both primary and secondary. It should also specify whether the financial statements were audited and the type of opinion given by auditors (Thygerson, 1995).

2.8 Credit Control Policies

The objectives of the credit policy are: to optimize the credit and returns envisaged in order that the economic value addition to shareholders is maximized and the interest of all the stakeholders are protected alongside ensuring; corporate growth and prosperity with safety of the banks resources, to regulate and streamline the financial resources of the bank in an orderly manner so as to enable the various channels achieve common goals and objectives, to instill a sense of credit culture enterprise wide and to assist the operating staff, to strengthen the credit management skills namely, pre-sanction, post-sanction monitoring, supervision and follow up measures and maintain quality credit portfolio in the bank, to deal with credit proposals more effectively with quality assessment speed and in full compliance with guidelines and to comply with various regulatory requirements, more particularly on exposure norms, prudential guidelines, capital adequacy and credit risk guidelines of the National Bank of Ethiopia. The banks credit policy should be in tandem with its overall strategy. In a nutshell the factors considered in establishing a credit control policy include: borrowings available that is, scope of allowing credit, what the competitors are doing, the business conditions and prospects, customer mix and possible volumes, market strength whether the bank is the leader or follower and the cost of bad debts verses the net margin it anticipates to maintain (Edwards, 1997).

2.9 Policies to Reduce Credit Risk

Bank regulators have paid a lot of attention to risk concentration by commercial banks in the past. The regulators objective in credit management is to prevent commercial banks from relying heavily on a large borrower or groups of borrowers but not to dictate to them to whom they should lend funds too. The prudential guidelines usually stipulate that banks should not make investments or extend credit facilities to any individual entities in excess of an amount that a prescribed percentage of the bank's capital and reserves provides. Most countries impose a single customer exposure limit of between 10-25% of capital (Greuning et al., 1999).

Lending to a single sector of the economy or to a narrow geographical region represents another dimension of risk concentration. This increases the banks vulnerability in the weakness in the certain sector of the economy or region and increases the risk of failure of clients in that sector or geographical region for one reason or the other. It is often difficult to assess the exposure of banks to various sectors of the economy, as quite a number of them do not report such information (Hempel et al., 1994).

Lending to related parties is another form of credit risk exposure banks are subjected to. These parties include; major shareholders, subsidiaries, parent bank, affiliate companies, directors and chief executives officers. This relationship compromises the ability of the management to exert control or influence the banks policies and decision making on matters appertaining to credit. These calls for a limit to be established for credit extended to related parties. Loan renegotiation refers to either the reduction of either interest or principal owing to the deterioration of the financial conditions of the borrower. Restructuring may involve a transfer from the borrower to the bank of real estate, receivables or any other asset from the third parties to satisfy the loan or addition of a new debtor to the original borrower. The bank should put in place policies to ensure that such items are properly captured from the accounting and control standpoint (Sinkey, 1992).

2.10 Expected Loss /Probability of Default/

Lending institutions need to understand the loss that can be incurred as a result of lending to a company that may default; this is known as **expected loss (EL)**.

EL can be expressed as a simple formula:

EL = PD * LGD * EAD

The total exposure to credit risk is the amount that the borrower owes to the lending institution at the time of default; the **exposure at default (EAD).** Generally, EAD will not be larger than the borrowing facility.

PD & LGD are risk metrics employed in the measurement and management of credit risk. The metrics are used to calculate EL.

The **probability of default (PD**) is the likelihood that a loan will not be repaid and will fall into default. It must be calculated for each borrower. The credit history of the borrower and the nature of the investment must be taken into consideration when calculating PD. External ratings agencies such as Standards and Poor's or Moody's may be used to get a PD; however, banks can also use internal rating methods. PD can range from 0% to 100%. If a borrower has 50% PD it is considered a less risky company vs. a company with an 80% PD.

Loss given default (LGD) is the fractional loss due to default. The way to calculate the actual loss given default (LGD) is LGD = 1 – Recovery Rate (RR)

The **Recovery Rate (RR)** is defined as the proportion of a bad debt that can be recovered. It is calculated as: **RR = Value of Collateral/Value of the Loan.** Expected Loss (EL) is what a bank can expect to lose in the case that their borrower defaults. It is calculated as EL = PD * LGD * EAD.

2.11 Taking Risk as Competitive Edge by Banks

Risk averse banks intentionally expose themselves to risk and increase exposure over time because they believe they can exploit risk to the advantage and generate value. It is true that risk exposes banks to potential losses but risk also provides them with a wide range of opportunities. A simple vision of successful risk taking is that, we should expand our exposure to upside risk while minimizing the potential for downside risk. A bank that is more focused on which risk to take, which one to avoid and which one to pass to its investors may be able to determine which of the existing investments it should keep but at the same time generate higher returns. A risk averse bank that is excessively cautious when investing will have fewer investment avenues and report lower returns from its investments risk is color way to competitiveness (the higher the risk the higher the returns) and hence the ability of the bank to maintain a competitive edge amongst its members in the industry. However, it should be noted that the level of risk increases when the banks looses creep in containing the market needs and when they employ obsolete technology and personnel skills in there operation. It is on this backdrop that for money to be properly managed there is high need for skilled personnel, openness and adequate tools. Risk management has similar attributes but not many banks are convinced that risk control policies can limit undue exposure and give the bank a competitive edge (Mutrwri, 2003).

2.12 Non-Performing Loans and Advances

Nonperforming loans are one of the major causes of economic stagnation. Each non performing loan in the financial sector is viewed as an exact mirror image of an ailing unprofitable enterprise. Hence eradication of non-performing loans and advances is vital for any economic improvement to be realized. During a crisis period, in order to restore credibility amongst creditors and depositors failing financial institutions not only try to expand their equity bases, but also reduce their risk assets or change the composition of their asset portfolio. As a result of such action of defense, corporate debtors are targeted, thus stalling the overall economic growth. The cutback in loans impairs the corporate sector as they have difficulties in expanding their working capital, blocking their chances of resuming normal operation. This unavailability of credit to finance the firms' working capital and investment might trigger the second round of business failure which in turn exacerbates the quality of bank loans, resulting in a re-emergence of banking failure. In a worse case, it triggers an endless vicious liquidity spiral: As a result of poor economic condition and depressed economic growth, the level of non performing advances increases → the weaker corporate sector makes banks more reluctant to provide additional credits → with insufficient capital, the production sector is further weakened, resulting in decreases in aggregate demand which worsens the borrowers conditions hence creating more non performing loans and advances. The most important reason for default could be attributed to the mismatch between the borrower's terms of credit and the creditor's/banks terms of credit. The terms of credit can be as follows: assuming that the borrower makes an internal assessment of his economic activity on which he requires external financing. An optimal configuration for the borrower could involve taking into consideration the following parameters in the contract C(A,r,m,n,s).Where (A) is the amount of finance sought,(r) is the interest rate (m) is the maturity period of the loan ,(n) is the number of installments and (s) is collateral for a profitable economic venture. Based on competing portfolio consideration, the creditor/bank could carve out its contract $C(A_1,r_1,m_1,n_1,s_1)$.It is not possible for a borrower to get the bank that agrees to his terms of credit. Hence he is constrained to agree to the terms stipulated by the bank to access finances. Once this financial constraints have been overcome, the borrowers starts looking into ways of making changes to turn the contract so as to favor him. This involves the decision to default. This decision comes with costs and benefits. The benefits to default can subsequently lead the loan to becoming a non performing loans and advances. This accrues from each of the parameters in the loan contract. Considering the parameter of loan maturity (m). A default entails lengthening the loan maturity period. The defaulter could reduce the real loan burden since the present value of the credit would decrease with increase in the loan maturity. If the borrower anticipates that the rate of interest(r) are bound to rise, a default option would benefit him enjoy the existing facility at a relatively lower interest rate. This provides the borrower an opportunity to use installment payment (n) in other more profitable ventures. The amount of credit (A) could play a critical role in influencing the borrower's decision to default on bank loans. Large amount of loan would involve high present value of the loan burden. The amount of loan will have significant effect on legal cost and may not induce a default under certain circumstances. For a genuine bank borrower default may not be the best option since it is coupled with reputation cost which in turn could affect his recourse to refinancing or accessing fresh financing activities in future (Rajiv et al., 2003).

The amount of credit relative to measure of economic activity and the level of funds of banks rather than credit itself could be important for borrowers (Mohan, 2004). From the cost side, the borrower faces three major costs: reputation cost, legal and bankruptcy cost, plus penalty charged by banks after the disposal of the court case. In view of the above, it is apparent that before choosing the option to default, a rational borrower has to make an assessment of all the costs and benefits that will accrue from his action (Reddy, 2004).

According to Muniaeppan (2002) the problem of non performing advances is related to the external and internal problems confronting the borrowers. The internal factors relate to the diversion of funds from what they were initially destined to other causes such as expansion/diversification /modernization, taking up new projects, time overruns during project implementation stage ,business (product, marketing) failure, inefficient management, strained labor relations, inappropriate technology/technical problems, product obsolescence. Whereas external factors include recession, nonpayment in other countries, inputs or power shortages, price escalations, accidents and natural calamities.

Sergio (1996) in his study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a banks' lending policy adducing to relatively unselective and inadequate assessment of sectoral prospects. This study refuted that business cycle could be a primary reason for the banks non performing advances but emphasized that increases in bad debts as a consequence of recession alone is not empirically demonstrated. It was viewed that the bank borrower relationship will thus prove effective not so much because it overcomes informational asymmetry but because it recoups certain rules of credit appraisal.

Bloem et al., (2001) suggested that more or less predictable level of non performing advances, though may vary from year to year slightly, are caused by inevitable number of wrong economic decisions by individuals or plainly bad luck. Under such circumstances the holder of the loan can make an allowance for a normal share of non performance in the form of bad loan provisions or spread the risk by taking an insurance cover. Banks may be able to pass a large portion of these costs to borrowers in the form of higher interest rates charged on loans that will include a margin premium of risk of non performance of granted loans.

McGoven (1993) in a study on loan losses in the United States of American banks, argued that character has historically been a paramount factor of credit and a major decision in lending. Banks have suffered loan losses through relaxed lending standards, unguaranteed credits. He suggested that banks should carry out a fair character assessment to ascertain the personality morale profile of prospective and current borrowers and guarantors. Apart from considering personal interaction, the bank should; try to draw some conclusions about the borrowers staff morale and loyalty, study the prospective borrowers credit report, carry out trade-credit reference checking, check references from the present and previous bankers, determine how the borrower handles stress. Over and above this the bank can minimize risks by securing the borrowers guarantee, using government guaranteed loan programs, and requiring conservative loan to value ratio.

Mohan (2004) in his presentation on Transforming Indian Banking: In search of a Better Tomorrow observed that lending rates had not come down in India as much as deposit rates and interest rates on government bonds. Whereas banks had reduced their prime lending rates and were extending sub-prime lending rate loans, effective lending rates remained high. This kind of development had adverse systematic implication to a country like India where interest cost as a proportion of sales cost are higher compared to other emerging economies. This kind of scenario is replicated in Ethiopia where banks continue charging high interest rates on loans despite a drastic reduction in the base lending rates by National Bank of Ethiopia. This increases the vulnerability of loan defaults.

Fuentes et al., (1998) undertook an in depth analysis of loan losses due to composition of lending by type of contract, volume lending, cost of credit and default rates in Chile. They examined various variables that may affect loan repayment these included: limitations on to access credit, macroeconomic stability, collection technology, bankruptcy code, information sharing, the judicial system, pre-screening techniques and major changes in financial market regulations. The findings of the study were that a satisfactory performance of the Chilean credit market in terms of loan repayment is underlined in good information sharing system, an advanced macro economic performance and major changes in the financial market regulations. From this finding it can be realized that National Bank of Ethiopia has borrowed a leaf of this through the introduction of the credit information sharing system and revamping the financial market regulations.

Kent, et al. (2002) in their study on The Relationship between Cyclical lending Behaviors of Banks in Australia found that the potential for banks to experience substantial losses on their loan portfolio increases towards the peak of the expansionary phase of the cycle. Towards the top of the cycle, banks appear to be relatively healthy-non performing loans are low and profits are high indicating that even the richest tend to benefit from the booming economic conditions.

2.13 Loans and Advances Classification

Loans and advances classification is a key risk management tool in the banking industry. This is the process whereby advances are assigned a credit risk grade determined by the likelihood that the debt obligation will be serviced in full or liquidated within the stipulated period in the contract. Banks determine asset classification themselves but follow standards that are normally issued by regulatory authorities (Gardiner, et al., 2000).

As per Asset Classification and Provisioning directive no. SBB/43/2008 all loans and advances being classified in the following classes: Pass, Special mention, Substandard, Doubtful and Loss (National Bank of Ethiopia, 2008).

Pass- loans and advances in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism. In general, any loans or advances, or portion thereof which is fully secured both as to principal and interest by cash or cash-substitutes, shall be classified under this category regardless of past due status or other adverse credit factors.

Special mention: loans or advances with pre-established repayment programs past due thirty days or more, but less than ninety days and for overdrafts that do not have pre-established repayment program, if the debt remains outstanding for thirty consecutive days or more beyond the scheduled payment date or less than ninety days; or the debt exceeds the borrower's approved limit for thirty consecutive days or more, but less than ninety days; or interest is due and uncollected for thirty consecutive days or more; but less than ninety days ; or for overdrafts, the account has been inactive for thirty consecutive days or more, but less than ninety days; or the account shows the following debit balance at least once over 360 days preceding the date of loan review; one to four percent of the approved limit effective from June 30, 2009.

Substandard: loans or advances with pre-established repayment programs past due for ninety days or more, but less than one hundred eighty days; overdrafts and loans or advances that do not have pre-established repayment program, if: the debt remains outstanding for ninety consecutive days or more beyond the scheduled payment date or maturity, but less than one-hundred-eighty days; or the debt exceeds the borrowers approved limit for ninety days or more but less than one hundred eighty days or interest is due and uncollected for ninety days or more, but less than one hundred eighty days. For overdrafts, the account has been inactive for ninety consecutive days or more , but less than one-hundred-eighty days; or the account shows the following debit balance at least once over three hundred sixty days preceding to the date of the loan review; five to nineteen percent of the approved limit effective from June 30, 2009.

Doubtful: loans or advances with pre-established repayment programs past due for one hundred eighty days or more, but less than three-hundred-sixty days; overdrafts and loans or advances that do not have pre-established repayment program if; the debt remains outstanding for one hundred eighty consecutive days or more beyond the schedule payment date or maturity but less than three hundred sixty days or; the debt exceeds the borrowers approved limit for one hundred eighty consecutive days or more but less than three hundred sixty days or; interest is due and uncollected for one-hundred-eighty days or more, but less three hundred sixty days or; for overdrafts, the account has been inactive for one-hundred-eighty consecutive days or more, but less than three hundred sixty days; or the count shows the following debit balance at least once over three hundred sixty days preceding the date of loan review: twenty to forty-nine percent of the approved limit effective from June 30, 2009.

Loss: None performing loans or advances with pre-established repayment programs past due for three hundred sixty days or more; overdrafts and loans or advances that do not have a pre-established repayment program if; the debt remains outstanding for three hundred sixty consecutive days or more beyond the scheduled payment date or maturity or; the debt exceeds the borrower's approved limit for three hundred sixty days or more or interest is due and uncollected for three hundred sixty days or more; or for overdrafts, the account has been inactive for three hundred sixty consecutive days or more, or the account shows the following debit balance at least once over three hundred sixty days preceding the date of loan review; fifty percent and above of the approved limit effective from June 30, 2009.

2.14 Loan Loss Provisioning Policy

Advances and loans classification provides a basis for determining an adequate level of provisions for possible loan losses. The policy regarding provisioning varies from country to country and is at the mandate of the regulators. In those countries with fragile economies, regulators have established mandatory levels of provisions in relation to the asset classification (Basel Committee, 1999).

2.15 Causes of Non-performing Loans

According to Islam, et al (2005) default culture is not a new dimension in the arena of investment. Rather in the present economic culture, it is an established culture. The redundancy of unusual happenings becomes so frequent that it seems that people prefer to be declared as defaulters. The reasons for these defaults have a multidimensional aspects ranging from external, customer specific and bank specific factors.

External factors mainly relate to the economic downturn. The economic downturn has eroded the purchasing power of the consumers leading to the proliferation of bad loans. The high level of poverty has highly affected 3 Cs in the credit appraisal tools namely: capacity to pay the loan the value of collaterals and the condition of the economy (Mutrwri, 2003).

Customer specific factors mainly relate to the customer failure to disclose vital information during the loan application process or the borrower blatantly refuses to pay on time or skillfully avoid payment through taking advantage of the weak legal system to restrain the bank from realizing the security (Hempel, et al., 1994). In this case the bank is not able to assess the character of the borrower well.

Bank specific factors are where numerous causes of non performing advances lie. These range from: Loans sanctioned by corruption, reduced attention by the borrowers and moral hazard (Waweru, et al., 2009). Sometimes loan sanctioning authority sanctions loans for satisfying their self interested behavior. Thus they engage themselves with clients and corrupt the total system by giving some benefit for taking something in return. This results from too much politicization and power-relatedness in the institutional system (Islam et al., 2005). There are instances in the past when it was easier to get a loan from a financial institution as long as the borrower had security to be charged to it than the ability to repay (Mutrwri, 2003).Other aspects of the customer such as character were not given sufficient attention. Reduced attention to the borrowers to the fact that the bank is paying attention to them through regular inspections by bank officials on their activities get better results than perception of inattention, of being ignored The adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at a high interest rates to borrowers in the most risky segment of the credit market has precipitated the problem of non performing advances too. Most of the larger local banks such as the Continental Bank, Trade Bank and Pan African Bank involved extensive insider lending, often to politicians (Waweru, et al., 2009).

2.16 Measures of Non-Performing Loans and Advances

The ratio of total non-performing loans and advances to total loans and advances that the bank has disbursed commonly known as the Asset Quality ratio is the best indicator of non-performing loans.

Asset Quality= Total non-performing loans and advances over Total loans and advances. The lower this ratio the better the asset quality (Thygerson, 1995).

2.17. The 5Cs Credit Appraisal tools

There are 5 Cs used in the credit appraisal tools to enable banks achieve the know your customer norms (KYC).This goes down in reducing the level of default risk banks are subjected to in the credit management process. The 5Cs are: character, capacity, collateral, capital and conditions (MacDonald et al., 2006).

Character: This is the general impression made on the potential borrower based primarily on past experience on the current lender or other lenders. A good deal of such information comes from credit bureaus. Issues in line with the character of the borrowers have attracted great attention to banks. It is on this basis that the National Bank of Ethiopia authorized Credit Reference Bureau to circulate vital information among banks. The basic function of the credit bureau is to enable banks share information about borrowers for business decision making. The bureau also keeps a credit history record of the borrowers that can be used in credit scoring purposes based on the available credit history. Honesty and goodwill of the client are the most paramount factors in a successful loan. Dishonest borrowers do not feel committed to repay the loan though they are very determined to get the loan using any means at their disposal including misrepresentation. Loan officers have to spread their time over many loan relationships; they may not leave time to uncover the elaborate schemes of such individuals who are out to defraud the bank (McGoven, 1993).

The bank has a duty of protecting its interests and hence it must protect itself from dishonest, incompetent or overly subjective borrowers through investigating their credit background. Other sources of information that can be used in assessing the borrowers' character are: records held by suppliers and past banking relationship with the customers. Where the client promptly services principal and interest, it is likely that the future loan balance will be adequately repaid. Where the client has been late in servicing past debts, the reason should be sought. Where previous creditors have experienced losses, the loan officer should almost out rightly reject the application (Hempel, et al., 1994).

Capacity: This is measured using information related to income/stability in relation to loan repayments. The bank will always be interested in knowing exactly how the customer intends to repay the loan. Under this circumstance the banks analysts accounting, legal and finance skills are crucial in determining the ability of the borrower to repay the loan from the cash flows generated by the business. For a seasonal working capital loans, cash flows are generated by means of orderly liquidation of built up of inventories and receivables. For term loans, cash flows are generated from earnings and non cash expenses such as depreciation and depletion charged against earnings. The analyst must determine the timing and sufficiency of the cash flows and evaluate the risk of the cash flows falling short. Any other source of repayment other than cash flows from the operations should be viewed with a lot of suspicion or caution. The borrower may plan on a future injection of investor capital to repay the loan, but where the firm fails to produce attractive profits, outsiders would definitely withhold future investment in the firm. Where the borrower may be planning to borrow funds from another bank to repay the loan, unless a formal commitment exists from that bank, the source suffers the same limitation as that of planned equity injection. The future sale of a fixed asset is not a reliable source of loan repayment. If the borrower is unwilling or unable to sell the asset at the time of the loan, a future possibility of forced sale of the asset to repay the loan is highly speculative (MacDonald et al, 2006).

Collateral: These are additional forms of security or guarantee that are provided by the borrower to the bank. They represent those assets the borrower has pledged to the bank that can be sold if he defaults and collection efforts have become futile. Though cash flows from the business operation are deemed to be the main source of loan repayment, where sufficient cash flows fail to materialize, the bank can mitigate loss if it has secured a secondary source of repayment (collateral). Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with an agreement that it will be the main repayment source in case you cannot repay the loan. A guarantee on the other hand is just that; someone else signs a guarantee document promising to repay the loan if the borrower fails to do so. However, collections from guarantors often results in bad blood between the bank, borrower and guarantor. It should be noted that strong collateral should not generally overcome deficiencies in either character or capacity. Banks avoid foreclosing on collateral because foreclosure entails much time and expense. Collateral value should cover the loan amount and the interest due, legal costs of foreclosure and interest during foreclosure proceedings (Yeager et, al 1989).

Capital: According to Matter (1972), some customers expect their banker to provide a substantial part of the capital required in a business. Though the customer may be endowed with the skills, drive, knowledge and an original idea, but with little cash. The customer approaches the bank instead of colleagues or the market for the capital .Prospective lenders/bankers expect the business before asking them to commit any funding, the more of your own money you invest as a down payment or capital the more likely that you will do all you can to maintain your payment obligation. It is not definitely the function of a modern bank to find the capital or invest in the clients business and usually the major stake should be that of long-term lenders. An excessive stake in business implies that the bank is accepting undue risk at the rates too fine to repay such a high risk. The liquidity position of any potential borrower demands that close assessment and the greater the bank debt, actual or prospective, in relation to the capital resources of the business the weaker inherently must be the financial position of the borrower who employs a portion of the short term funds to buy fixed assets. As a general rule, a banker will rarely lend more than the amount of the proprietor's capital, but there are exceptions to this tendency. For instance brokers dealing with market produce in good demand may borrow several times more than their own capital on occasion from banks against the security of the produce, with or without security/collateral support, however, this should be treated as distinct exceptions to a general rule. Lack of capital in business may be overcome from the banking stand point by the deposit of adequate personal security by the proprietors. Instead of investing directly in their business, they support the bank with their own private assets (Abedi, 2002).

Conditions: Some thoughts must be given to the nature and prospects of the business of the borrower with particular reference to the prevailing economic conditions. The natural optimism of every potential borrower has to be discounted and the real prospects of the venture addressed in light of known conditions; allied to this enquiry is the desirability of the advance. Here the field is limited to the possibility of success or otherwise of the venture for which finance is sought from the bank. With the experience or otherwise of the borrower, is the project likely to succeed? If it fails, the bank is likely to fall back on its security to recover its advances and the lending will fundamentally be unsound. If it succeeds, will the development problems be overcome. Would anyone contently lend to a factor to market ice cream to Eskimos or woolen vests to equatorial natives (Matter, 1972). Between the extremes there is much to be considered by the banker in any proposal for accommodation required by a customer. It should be noted that there are no tramlines demanding a prescribed course. It is only a question of considering the business and its prospects in conjunction with all other factors and as it were a vote for or against the proposal (MacDonald et al., 2006).

2.18 The 5Cs Credit Appraisal tools and NPLs and Advances

Nonperforming loans and advances negatively impact on the liquidity position of banks and to an extreme pushes them to closure. Most bank closures ensued from the problem of high incidences of nonperforming loans and advances. To restore confidence in the banking sector, prudential guidelines for institutions licensed under the banking act provides tough remedial and administrative sanctions to banks that can not conform to specific loan and advances requirement. The major requirement being that all the loans be properly appraised through the use of the 5Cs credit appraisal tools. Hence those banks that do not use the 5Cs credit appraisal tools may be victims of closure owing to the increasing levels of nonperforming loans and advances.

2.19 Conclusion

Both theoretical and empirical studies reviewed above on the subject of credit appraisal, evaluation and assessments have shown the impact/effect of credit appraisal on non-performing loans and advances. This study seeks to contextualize these factors in the Nib International Bank.

CHAPTER THREE

RESEARCH DESIGN METHODOLOGY

3.1. Introduction

Various researchers have made different researches to assess 5C's credit appraisal tools and the level of non-performing loans and advances in various commercial banks by applying different research methods. They have employed such research methods in order to investigate and obtain detail evidence on the subject matter. According to the researcher's opinion, it gave deepest understanding on the subject matter as well as helped to address the main problem of the study.

The researcher has exerted his maximum effort to make the data collected was representatives of the overall picture of the Bank or population of the study.

3.2. Research Design

The research design refers to the overall strategy that the researcher chosen to integrate the different components of the study in a coherent and logical way, thereby, ensured the researcher has effectively addressed the research problem; it constituted the blueprint for the collection, measurement, and analysis of data (De Vaus, 2001). Considering this fact, and to achieve the research objectives stated above, the current study employed descriptive research design.

3.3. Population and Sampling Procedure

3.3.1. Population of the Study

Populations considered in the study were: branch managers, division managers, loan officers, credit follow-up officers, customer relation managers, and credit analysts of NIB International Bank SC. As per the data collected from the Bank in February, 2018 the overall number of branches was 207. In those branches there were two hundred and seven branch managers and sixty six loan officers. Moreover, there were seventeen credit analysts, ten credit follow-up officers, three division managers including the researcher, nine customer relation managers who were directly involving in loan processing and two directors under Credit Appraisal and Customer Relationship Management Departments. Samples were taken from the entire population except the two directors.

3.3.2. Population Size Determination

Table 3.1 Types of respondents and population size

S. No	**Respondents**	Population size	Sample size at 10% margin of error and 90% level of confidence and individual elements to be randomly selected	Sampling Technique	Tools of data collection
1	Branch managers	207	52	Stratified sampling	Questionnaire
2	Loan officers	66	34		
3	Credit follow-up officers	10	9		
4	Credit analysts	17	14		
5	Division managers	2	2		
6	CRM Managers	9	9		
		311	120		

3.3.3. Source of Data

In order to achieve the stated research objective, the study used both primary and secondary data sources. Primary data has obtained using close ended structured questionnaire with the intention of meeting ultimate objective of the study. Secondary data has been obtained from internal reports aimed at addressing the issues that cannot be obtained otherwise.

3.4. Data Gathering Instruments

3.4.1 Primary Data

- **Questionnaire**

Primary data has been collected using structured questionnaire distributed to different staff members of the Bank. The questionnaire has two parts. The first was about the demographic characteristics of the respondents and the second part was to capture elements of the credit activities. The questionnaire has arranged in standardized five point Likert's scale.

Procedures:

Step1: Relevant questions that were expected to give appropriate feedback has addressed to all the required respondents. The questions have commented by senior staffs of the Bank who are working in the Credit Appraisal Department.

Step 2: All questions were reviewed by the Advisor.

Step 3: Reliability of all the questions were tested using Cronbach's Alpha.

3.4.2 Secondary Data

Secondary data collected using five years credit reports sent to National Bank of Ethiopia.

3.5. Validity and Reliability Tests

3.5.1 Validity test

Content validity test index (C.V.I) has used to test validity of questionnaire. A five point scale of relevant, highly relevant, fairly relevant, somehow relevant and not relevant has used by selected senior staffs to rate the relevancy of questions. The questionnaire has also commented by senior management staffs of the Bank who have ample experience in the Bank particularly credit related areas.

3.5.2 Reliability tests

Reliability analysis used to test how well the items in a set were positively correlated to one another. Cronbach alpha has used to determine the consistency of scales used to measure study variables. The internal consistency reliability has higher if the Cronbach's alpha was closer to 1. (Howard 2015). The Cronbach's alpha value was used to measure the reliability of the instrument which exceeded the recommended criteria point of 0.7. In order to evaluate 5C's credit appraisal tools and the level of nonperforming loans and advances, secondary data was very important source.

3.6. Method of Data Analysis

The methods of data analysis used was, descriptive, research methods. The data was edited, sorted, coded for completeness, processed and analyzed using computer software called the Statistical Package for Social Scientist (SPSS). This has chosen because it was suitable to compute all the statistical facts that required for the interpretation of the data collected from the questionnaire. On the other hand, the level of non-performing loans and advances has measured using ratio analysis i.e., the ratio of nonperforming loan to total portfolio loans and advances.

3.7. Measurement of Variables

- The assessment of 5C's and level of nonperforming loans and advances at NIB Bank has measured using attitude statements of a 5 – point Likert – scale ranging from strongly disagree, disagree, undecided, agree and strongly agree.
- Loan performance has measured by ratio analysis using five years secondary data obtained from the Bank. The ratio used was: ratio of nonperforming loans and advances to total loans and advances.

The indicator of the level of nonperforming loans and advances in this study was the asset quality ratio.

$$\textbf{Asset Quality Ratio} = \frac{\textbf{Total nonperforming loans and advances}}{\textbf{Total loans and advances}}$$

The lower these ratios the higher the quality of loans and advances and the lower level of nonperforming loans and advances.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

The population under the study was 120 staffs of the Bank (i.e branch managers, division managers, CRMs, credit analysts, credit follow-up officers and loan officers). Out of the 120 questionnaires sent to the respondents, total of 88 were received back representing 73.33% of the response rate. SPSS version 20 was used in capturing the data, building it and subsequently in its analysis. From descriptive statistics, percentiles, means and standard deviations were used widely to arrive at conclusions on the findings.

4.2 Respondents' Demographic Characteristics

4.2.1 Academic Background of Respondents

Respondents were requested to state their academic background and found that 72.7% of them were BA graduate, 25% were MA graduate and only 2.3% were at diploma or equivalent status. From this the researchers understood that the Bank was running its business with qualified staffs.

Table 1. Educational background of respondents

	Frequency	Percent	Valid Percent	Cumulative Percent
Diploma or equivalent	2	2.3	2.3	2.3
BA	64	72.7	72.7	75.0
MA	22	25.0	25.0	100.0
Total	88	100.0	100.0	

Source: Output from survey data 2018.

4.2.2 Work Experience in the Bank.

Respondents were requested to reveal their work experience in the existing and other positions within the Bank and found that 50% and 31.8% of them had 1-4 years experience in the existing and other positions respectively. This means the staff working in credit related areas had no ample experience in credit processing activities.

Table 2. work experience in current position

	Frequency	Percent	Valid Percent	Cumulative Percent
less than 1 year	4	4.5	4.5	4.5
1-4 years	44	50.0	50.0	54.5
5-8 years	23	26.1	26.1	80.7
above 8 years	17	19.3	19.3	100.0
Total	88	100.0	100.0	

Source: Output from survey data 2018.

Table 3. Work experience in other position

	Frequency	Percent	Valid Percent	Cumulative Percent
less than 1 year	18	20.5	20.5	20.5
1-4 years	28	31.8	31.8	52.3
5-8 years	21	23.9	23.9	76.1
above 8 years	21	23.9	23.9	100.0
Total	88	100.0	100.0	

Source: Output from survey data 2018.

4.2.3 Current Position of Respondents in the Bank

Respondents were requested to tell their current position and found that 37.5% of them were branch managers, followed by 27.3% loan officers, followed by 17% credit analyst, followed by 8% each CRM managers and credit follow-up officers and 2.3 division managers. From the table the researcher understood that the population had well represented as planned.

Table 4. Position of respondents

	Frequency	Percent	Valid Percent	Cumulative Percent
Division manager	2	2.3	2.3	2.3
Branch manager	33	37.5	37.5	39.8
Credit follow-up officer	7	8.0	8.0	47.7
Credit analyst	15	17.0	17.0	64.8
Loan officer	24	27.3	27.3	92.0
CRM Manager	7	8.0	8.0	100.0
Total	88	100.0	100.0	

Source: Output from survey data 2018.

4.3 <u>Credit Products Provided by the Bank</u>

Regarding credit products rendered by the Bank, all of the respondents reported that the Bank offered wide range of products including all that they were asked. These included: Agriculture, Manufacturing, Domestic Trade and Services, Personal, Export, Building and Constructions, Hotel and Tourism, Import, Transport, Mine Power & Water and Financial Institutions loans and advances.

Table 5. credit products of the Bank

Availability of credit products	Frequency	Percent	Valid Percent	Cumulative Percent
all	88	100.0	100.0	100.0

Source: Output from survey data 2018.

4.4 <u>Credit Policy and Procedure</u>

Respondents were asked to avow whether the Bank has credit policy and procedure. The finding was that 100% of the respondents reported that they had credit policy and procedure that they utilized in credit risk evaluation, appraisal and assessment.

Table 6. Does the Bank have credit Policy and procedure

Does the Bank have credit Po. & proc	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	88	100.0	100.0	100.0
No	0	0.0	0.0	0.0

Source: Output from survey data 2018.

4.5 **Credit Policy and Procedure Development**

Respondents who were asked to state the factors considered when coming up with credit policy and procedure used in credit evaluation, assessment and appraisal, the findings were as follows; the Bank normally consider the current credit policy when formulating the credit policy that had a mean of 4.26 and standard deviation of 0.694 that was the highest followed by, competitors activity that had a mean of 4.13 and standard deviation of .814, followed by prevailing economic condition that had a mean of 4.10 and a standard deviation of .679, followed by market strength of the Bank that had a mean of 3.95 and standard deviation of 0.815 and lastly funds available for lending that had a mean of 3.81 and standard deviation of .981. Generally current credit policy was the most (94.3%) and funds available for lending was the least (71.6%) considered elements required for credit policy and procedure development as substantiated by respondents who replied for all the elements of credit policy and procedure.

Table 7. Factors most important to develop credit policy and procedure.

	N	Min	Max	Mean	Std. Deviation	Less considered %	Most considered %
prevailing Economic Condition	88	2	5	4.10	.679	6.8	93.2
Competitors Activity	88	1	5	4.13	.814	11.2	89.8
Current Credit Policy	88	2	5	4.26	.634	5.7	94.3
Market Strength of the Bank	88	2	5	3.95	.815	19.3	80.7
Funds available for lending	88	1	5	3.81	.981	29.4	71.6

Source: Output from survey data 2018.

4.6 Review Frequency of the Bank's Credit Policy and Procedure.

The respondents were asked to respond how frequent the Bank was reviewing its credit policy and procedure. Accordingly 44% of the respondents replied that the Bank was reviewing its credit policy and procedure every two years followed by 20.5% every three years, 20.5 every five years, 8% annually and the rest 6.8% every four years.

Table 8. Frequency of credit policy and Procedure review.

	Frequency	Percent	Valid Percent	Cumulative Percent
Annually	7	8.0	8.0	8.0
every 2 years	39	44.3	44.3	52.3
every 3 years	18	20.5	20.5	72.7
every 4 years	6	6.8	6.8	79.5
every 5 years	18	20.5	20.5	100.0
Total	88	100.0	100.0	

Source: Output from survey data 2018.

4.7 The 5Cs Considered for Appraising of Credit Risk

Respondents were asked to specify the factors that they considered in credit evaluation, appraisal and assessment for their customers. According to the response collateral (strength of security) has given priority with a mean of 4.31 and standard deviation of .822 followed by character (quality of borrower or top management) with a mean of 4.01 and standard deviation of .988, followed by Capacity (borrower's cash generating ability over competitors) with a mean of 3.78 and standard deviation of 1.066, followed by Capital (contribution of a borrower to the business) with mean of 3.70 and standard deviation of .937 and lastly conditions (prevailing economic conditions) with mean of 3.68 and standard deviation of .989. By and large collateral is the most (86.4%) and economic condition is the least (63.6%) considered factors required for appraising of loans and advances granted to borrowers as demonstrated by respondents who replied for all credit risk evaluation, assessment and appraisal factors.

Table 9. Factors Considered in Credit Risk/Evaluation/Appraisal and Assessment

	N	Min	Max	Mean	Std. Deviation	Least considered %	Most considered %
Strength of security offered as collateral	88	2	5	4.31	.822	4.5	95.5
character & quality of borrower or top management	88	1	5	4.01	.988	7.9	92.1
Borrower's cash generating capacity over competitors	88	1	5	3.78	1.066	14.8	85.2
Capital base of a borrower	88	1	5	3.70	.937	12.5	87.5
Prevailing economic conditions	88	1	5	3.68	.989	11.4	88.6

Source: Output from survey data 2018.

4.8 Constituents used to measure character of a borrower

Respondents were requested which among the variables used to describe character has most considered by the Bank. Accordingly credit information collected from credit bureau was the most important variable to describe character with a mean of 4.44 and standard deviation of 0.869, followed by willingness to repay with a mean of 4.40 and standard deviation of 0.917, followed by the Bank and borrower past business relationship with a mean of 4.39 and standard deviation of 0.890, followed by the Bank and customer past credit relationship with a mean of 4.34 and standard deviation of 0.933 and lastly followed by opinion collected from other banks with a mean of 3.24 and standard deviation of 1.398.

Table 10. Credit assessment variables used to describe character.

	N	Min	Max	Mean	Std. Deviation
Willingness to repay	88	1	5	4.40	.917
Bank & Customer past r/ship	88	1	5	4.34	.933
Bank & Borrower past bus. r/ship	88	1	5	4.39	.890
Credit info. collected from credit bureau	88	1	5	4.44	.869
Opinion from other Banks	88	1	5	3.24	1.398

Source: Output from survey data 2018.

4.9 Elements used to measure economic conditions

Respondents were asked which among the variables used to describe economic conditions has typically applied by the Bank. Accordingly competitive landscape of borrower was the most important variable to describe conditions with a mean of 3.90 and standard deviation of 0.947, followed by risks associated to industry with a mean of 3.84 and standard deviation of 0.969, and lastly followed by swinging of supply and demand with a mean of 3.70 and standard deviation of 1.041.

Table 11. Credit assessment variables used to describe conditions.

	N	Min	Max	Mean	Std. Deviation
competitive landscape of borrower	88	1	5	3.90	.947
Risks associated to industry	88	1	5	3.84	.969
swinging of supply & demand	88	1	5	3.70	1.041

Source: Output from survey data 2018.

4.10 Elements used to measure capacity of a borrower

Respondents were asked which among the variables used to describe repayment capacity of a borrower has typically applied by the Bank. Accordingly borrower's ability to generate cash from operation was the most important variable with a mean of 4.24 and standard deviation of 0.758, followed by borrower's cash balance in bank with a mean of 4.14 and standard deviation of 0.912, followed by risk of cash flow below expectation with a mean of 3.77 and standard deviation of 0.881 and lastly followed by borrower's ability to generate cash from side bus with a mean of 3.73 and standard deviation of 0.919.

Table 12. Credit assessment variables used to describe capacity.

	N	Min	Max	Mean	Std. Deviation
Borrower ability to generate cash from side bus.	88	2	5	3.73	.919
Borrower ability to generate cash from operation	88	2	5	4.24	.758
Cash flow below expectation	88	2	5	3.77	.881
Borrower cash balance in Bank	88	1	5	4.14	.912

Source: Output from survey data 2018.

4.11 Elements used to measure capital of a borrower

Respondents were asked which among the variables used to describe capital of a borrower has normally applied by the Bank. Accordingly borrower's own capital investment in a business was the most important variable with a mean of 3.88 and standard deviation of 1.004, followed by amount of borrower's own capital contribution against debt with a mean of 3.82 and standard deviation of 1.023, followed by borrower capital to generate sufficient amount of cash with a mean of 3.73 and standard deviation of 1.036 and lastly followed by whether a borrower had any other fund with a mean of 3.42 and standard deviation of 1.069.

Table 13. Credit assessment variables used to describe capital.

	N	Min	Max	Mean	Std. Deviation
Sufficiency of borrower capital to generate cash	88	1	5	3.73	1.036
Borrower own capital investment	88	1	5	3.88	1.004
Borrower own capital contribution against debt	88	1	5	3.82	1.023
Whether a borrower has any other fund	88	1	5	3.42	1.069

Source: Output from survey data 2018.

4.12 Elements used to measure collateral position of a borrower

Respondents were asked which among the variables used to denote collateral of a borrower has typically applied by the Bank. Accordingly value of collateral against the requested loan was the most important variable with a mean of 4.68 and standard deviation of 0.617, followed by type of collateral offered as a security with a mean of 4.65 and standard deviation of 0.662, followed by sufficiency of proposed collateral with a mean of 4.55 and standard deviation of 0.787, followed by availability of secondary market to sell collateral with a mean of 3.99 and standard deviation of 1.067 and lastly followed by personal witness of executives and directors with a mean of 3.95 and standard deviation of 1.113.

Table 14. Credit assessment variables used to describe collateral..

	N	Min	Max	Mean	Std. Deviation
Sufficiency of proposed collateral	88	1	5	4.55	.787
Value of collateral against the loan	88	1	5	4.68	.617
Availability of secondary market	88	1	5	3.99	1.067
Type of collateral offered	88	1	5	4.65	.662
Personal witness of executives & directors	88	1	5	3.95	1.113

Source: Output from survey data 2018.

4.13 Factors greatly contributed to reduce the level of nonperforming loans and advances

Respondents were asked to reply whether the use of 5Cs credit appraisal tools had contribution on the reduction of the level of nonperforming loans and advances. According to the response collateral (securing of each loan and an advance by strong collateral) with a mean of 4.34 and standard deviation of 0.829 was priory important reduced the level of NPL assets, followed by character with a mean of 4.05 and standard deviation of 1.005, followed by capacity with a mean of 3.82 and standard deviation of 1.089, followed by Capital with a mean of 3.74 and standard deviation of 0.953 and lastly condition with a mean of 3.72 and standard deviation of by 1.005

In general collateral was the most (86.4%) and condition was the least (64.8%) important factors to reduce the level of nonperforming loans and advances granted to borrowers as confirmed by respondents.

Table 15. contribution of 5Cs on the level of nonperforming loans and advances

	N	Min	Max	Mean	Std. Deviation	Least considered %	Most considered %
Capacity	88	1	5	3.82	1.089	33.0	67.0
Character	88	1	5	4.05	1.005	22.0	78.0
Capital	88	1	5	3.74	.953	32.9	67.1
Condition	88	1	5	3.72	1.005	35.2	64.8
Collateral	88	2	5	4.34	.829	13.6	86.4

Source: Output from survey data 2018.

4.14 Period of time loans and advances in arrears are considered as defaulted.

Respondents were asked to respond after how long the Bank considers unpaid loans and advances as defaulted. Accordingly loans and advances were considered as defaulted when in arrears for a period of four months as evidenced by a mean of 4.72 and standard deviation of 0.642, followed by three months in arrears supported by a mean of 4.10 and standard deviation of 0.995, followed by two months in arrears with a mean of 2.36 and standard deviation of 0.847 and lastly when it was in arrears for one month with a mean of 1.56 and standard deviation of 0.869.

Table 16. Arrear period to consider loans and advances as defaulted

	N	Min	Max	Mean	Std. Deviation
Four months in arrears	88	1	5	4.72	.642
Three months in arrears	88	1	5	4.10	.995
Two months in arrears	88	1	4	2.36	.847
One months in arrears	88	1	5	1.56	.869

Source: Output from survey data 2018.

4.15 Default Rate and its Determination

To determine the ratio of nonperforming loans and advances, five years secondary data had collected from Credit Information and Portfolio Management Division of the Bank which were sent to National Bank of Ethiopia. As per the information, ratio of nonperforming loans and advances of the Bank was about constant (i.e it ranges from

2.9% to 3.95%) in those five years which was below the standard set by National Bank of Ethiopia.

Table 17. Default rate of the Bank's loans and advances

	June 30, 2013	June 30, 2014	June 30, 2015	June 30, 2016	June 30, 2017
Ratio of nonperforming loans and advances against portfolio balance	3.79%	3.19%	3.13%	3.95%	2.90%

Source: Output from survey data 2018.

4.16 <u>The significance of various risks.</u>

Respondents were asked how the Bank was conscious in the various risks associated to loans and advances. The findings were that: the most important risk was credit risk with a mean of 4.52 and standard deviation of 0.678, followed by liquidity risk with a mean of 4.43 and standard deviation of 0.814, operational risk with a mean of 3.90 and standard deviation of 0.910, foreign exchange risk with a mean of 3.76 and standard deviation of 1.114, strategic risk with mean of 3.50 and standard deviation of 1.124 and lastly followed by interest rate risk that had a mean of 3.38 and standard deviation of 1.075. From the findings, it can be concluded that the Bank had attached significantly to credit risk than any other risks.

Table 18. Significance of various risks.

	N	Min	Max	Mean	Std. Deviation
Credit risk	88	2	5	4.52	.678
Liquidity risk	88	1	5	4.43	.814
Operational risk	88	1	5	3.90	.910
Foreign exchange risk	88	1	5	3.76	1.114
Strategic risk	88	1	5	3.50	1.124
Interest rate risk	88	1	5	3.38	1.075

Source: Output from survey data 2018.

CHAPTER FIVE

SUMMARY OF THE FINDINGS AND CONCLUSIONS RECOMMENDATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

5.1 Summary of the Findings;

The objectives of the study were: to check whether the Bank was applying all 5C's credit appraisal tools in its credit appraisal process (character, capacity, capital, condition and collateral), to assess the level of nonperforming loans and advances and to determine whether the Bank was required to revise its credit policy and procedures to mitigate its nonperforming loans and advances.

Primary data was collected via questionnaire distributed to 120 employees of the Bank. Secondary data was collected from the Bank's reports sent periodically to National Bank of Ethiopia for the period spanning 2013-2017.The data collected was analyzed using descriptive statistics and the conclusions drawn from it was derived/obtained from the descriptive and frequency tables, using percentiles, means and standard deviations.

The Bank was providing credit facilities for customers engaged in eleven economic sectors (Agriculture, Manufacturing, Domestic Trade and Services, Personal, Export, Building and Constructions, Hotel and Tourism, Import, Transport, Mine Power & Water and Financial Institutions) and the borrowers were from every corners of the country. The Bank has approved credit facilities based on its credit policy and procedure in place and regarding fresh credit policy and procedure development, it was typically considered existed credit policy as a source of information. Credit policy and procedure of the Bank were reviewing every two years enabled to align itself with the dynamic economic and political environment. The Bank was approving loans and advances with due consideration of 5C's credit assessment and appraisal factors. Among the 5C's, collateral (strength of security) was the most important factors considered and it was the Bank's belief that strong collateral position encourage borrowers' repayment habit towards their loans and advances since borrowers didn't want to forfeit their properties against amount of credit facilities usually below the value of securities.
The level of nonperforming loans and advances of the Bank was in acceptable range which was below the 5% standard set by regulatory organ (National bank of Ethiopia).

This was due to the Bank's quality properly applied the 5C's credit assessment and appraisal factors.

Character one of the five factors in credit appraisal process was described in various ways; among them credit information collected from credit bureau (National Bank of Ethiopia) was the most important variable asserted character. Economic conditions, one of the 5C's credit appraisal factor was commonly described by competitive landscape of borrowers, capacity the third 5C's factor was normally described by borrowers ability to generate cash from operation, capital the forth factor was described by borrowers own capital investment in a business and the last but not least factor was collateral best described by large amount of collateral value against granted loans and advances.

The level of nonperforming loans and advances of the Bank didn't show significant change either upwards or downwards. This was due to the Bank strongly applied the 5C's credit appraisal elements particularly collateral during its credit approval process. The Bank usually considered any loans and advances as defaulted when both principal and arrears or either of the two was unpaid for a period of four months.

Among the given risks used to face the Bank frequently, it gave significant emphasis for credit risk, since it could result devastative loss on the overall existence of the Bank.

5.2 Conclusions and Recommendations

Risk is prominently related to competitiveness and profitability of banks. The higher the risk the greater will be the profit. Hence it is important for the Bank management to understand how they can edge themselves against the eminent dangers of over exposure to credit risk whose importance cannot be underscored as can impact negatively on its profitability. This can be achieved through strong adherence to the use of 5C's credit appraisal tools. The results of this study were in line with considered view in the banking literature and provide an important insight for the Bank's lending process, appropriate culture and lending policy designed taking into consideration the credit risk evaluation, assessment and appraisal procedures. A diversified portfolio of loan with proper inspection may reduce the amount of nonperforming loans and advances. Proper valuation of the collateral is essential, loan disbursement based on personal undertakings need to be reduced, the Bank can introduce incentive programs to encourage the employees in the recovery section to bring down the nonperforming loans and loan officers and credit analysts must be skilled enough to understand the behavior of borrowers.

5.3 Suggestions for Further Research

Further study need to be conducted in the following areas: The correlation between NPL and 5C's, the impact of unethicality (unfairness) on credit approval process in Nib International Bank S.C. Moral hazard in credit mainly arises from information asymmetry. If information asymmetry is not checked, it will lead to obtaining of improper information that subsequently leads to wrong credit decisions. The effect of portfolio concentration in specific sectors could also result increase of the level of nonperforming loans and advances in the banking sector particularly if some shake happened in particular sector, hence a research should be done in this area.

5.4 Limitations of the study

The study faced some limitations with respect to the time frame applied for collection of data from respondents. Focus only on information collected through questionnaires than face to face interviews was another drawback. Out of the 120 questionnaires sent to the field, 32 were not received back. The receipt of this could have led to an improvement in the conclusions drawn in the study. Moreover failure to apply statistical model to quantify the interdependency between asset quality ratio and 5C's was the major limitation.

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ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

MBA IN GENERAL MANAGEMENT

Questionnaire

Dear respondants, thank you for taking your time to complete these questions. I truly value the information to be provided. Your responses will contribute to my analyses on the "Assessment of 5cs credit appraisal tools and the level of non-performing loans and advances in the case of NIB International Bank S.C.".

Your responses will be exclusively used as an input for a thesis in a partial fulfillment of Master of Business Administration in General Management. Moreover, you are not required to put in your name or any personal detail apart from those mentioned hereunder.

If you have any questions and/or comments, please leave a message on my outlook address alemus@nibbank.com or alemuse@nibbank.com or call me through Mobile telephone No. **0911-465765**

Many thanks,

Part one

Study questions on Personal profile of respondent's

1. What is your sex?

   ☐ Male ☐ Female

2. What is the highest level of education you have completed?

   ☐ High school graduate, ☐ Diploma or the equivalent

   ☐ Bachelor's degree ☐ Master's degree ☐ Doctorate degree

3. Your work experience in the Bank.

   a) Current position

   ☐ Less than one year ☐ One –four years

   ☐ five - eight years ☐ above eight years

   b) Other positions

   ☐ Less than one year ☐ One - four years

   ☐ Five - eight years ☐ above eight years

4. What is your current position in the Bank

☐ Division Manager ☐ Branch Manager ☐ Credit followup officer

☐ Credit Analyst ☐ Loan Officer ☐ CRM Manager

Part two

Study questions on credit appraissal tools:

1. What credit products are rendering by the Bank? Tick where appropriate.

(1) Agriculture loans and advances-- ☐

(2) Manufacturing Industries loans and advances ------------------------ ☐

(3) Domestic Trade and Service loans and advances ------------------- ☐

(4) Personal loans and advances --- ☐

(5) International Trade-Export loans and advances --------------------- ☐

(6) Building and construction loans and advances ---------------------- ☐

(7) Hotel and Tourism loans and advances -------------------------------- ☐

(8) International Trade-Import loans and advances --------------------- ☐

(9) Transport loans and advances --- ☐

(10) Mine, Power and Water loans and advances ----------------------- ☐

(11) Financial Institutions loans and advances-------------------------- ☐

[12] All products are rendering by the bank.............................. ☐

2. Does your bank have written credit policy and procedure?

Tick where appropriate

a) Yes ☐

b) No ☐

3. If the response to the above is “yes”, does the Bank consider the following as an input during policy and procedure development?

	Least Considered				Most Considered
	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. Prevailing economic conditions-----	☐	☐	☐	☐	☐
2. Competitors activities-----------------	☐	☐	☐	☐	☐

3. The current credit policy in place------- ☐ ☐ ☐ ☐ ☐
4. Market strength of the Bank------------ ☐ ☐ ☐ ☐ ☐
5. The funds available for lending--------- ☐ ☐ ☐ ☐ ☐

4. How frequent does your bank review its credit policy and procedure?

Tick where appropriate:

1. Annually-------------------------- ☐
2. Every two years------------------ ☐
3. Every three years----------------- ☐
4. Every four years------------------ ☐
5. Every five years------------------ ☐

5. During the credit evaluation process, do you agree that the following factors were considered?

	Least Considered				most Considered
	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. Capacity of the borrowers business to generate enormous cash flows compared to competitors-	☐	☐	☐	☐	☐
2. Character and quality of borrowers &/or its top management------------------------------------	☐	☐	☐	☐	☐
3. The capital base of the borrower-----------------	☐	☐	☐	☐	☐
4. The prevailing economic conditions in the country--	☐	☐	☐	☐	☐
5. Strength of the security evidenced by collateral diversification---------------------------	☐	☐	☐	☐	☐

6. Do you agree that the Bank considers the following before availing loans and advances to any borrower of the Bank?

(1) Character [go to question 8]

(2) Conditions [go to question 9]

(3) Capacity [go to question 10]

(4) Capital [go to question 11]

(5) Collateral [go to question 12]

7. Character of the borrower;

	Strongly Disagree 1	Disagree 2	Undecided 3	Agree 4	Strongly Agree 5
1.The customer's willingness to repay ---	☐	☐	☐	☐	☐
2.The bank's past relationship with the customer------------------------------------	☐	☐	☐	☐	☐
3. Those the Bank has done business with the prospective borrowers -------	☐	☐	☐	☐	☐
4. Information obtained from credit bureaus --------------------------	☐	☐	☐	☐	☐
5. Opinion sought from other banks ------	☐	☐	☐	☐	☐

8. Conditions

	Strongly Disagree 1	Disagree 2	Undecided 3	Agree 4	Strongly Agree 5
1. borrower in the business environment	☐	☐	☐	☐	☐
2. Risks associated to the industry--------	☐	☐	☐	☐	☐
3. Swinging of supply and demands -------	☐	☐	☐	☐	☐

9. Capacity

	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1.The borrower's ability to generate cash from side business during difficulties----	☐	☐	☐	☐	☐
2.The business ability to generate sufficient cash flows from operations----	☐	☐	☐	☐	☐
3.The risk of cash flows falling short of the Expectation----------------------------------	☐	☐	☐	☐	☐
4.The customer's cash balance in bank Accounts------------------------------------	☐	☐	☐	☐	☐

10. Capital

	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. The availability of sufficient capital that provides cushion to withstand a belief in its ability to generate cash flows-------------------------------------	☐	☐	☐	☐	☐
2. The amount of capital invested by the borrower in the business--------------------	☐	☐	☐	☐	☐
3. The amount of financing being sought compared to the business capital ------------	☐	☐	☐	☐	☐
4. Whether the borrower has any other funds--	☐	☐	☐	☐	☐

11. Collateral

	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. Sufficiency of the proposed collateral--------	☐	☐	☐	☐	☐

2. Value of the collateral against the request -- ☐ ☐ ☐ ☐ ☐

3. Availability of secondary market for the collateral -- ☐ ☐ ☐ ☐ ☐

4. Type of collateral whether inventories, documents or fixed assets------------------- ☐ ☐ ☐ ☐ ☐

5. Availability of personal witness from the executives &/or directors---------------- ☐ ☐ ☐ ☐ ☐

12. Do you agree that appraising of loans and advances using the following 5C's has contribution to reduce the level of nonperforming assets?

	Least Considered				Most Considered
	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. Capacity--	☐	☐	☐	☐	☐
2. Character --	☐	☐	☐	☐	☐
3. Capital--	☐	☐	☐	☐	☐
4. Condition---------------------------------------	☐	☐	☐	☐	☐
5. Collateral---------------------------------------	☐	☐	☐	☐	☐

13. After how long does your Bank consider that a client as defaulter in loans and advances repayment?

	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1.When principal and interest are one month in arrears ---------------	☐	☐	☐	☐	☐
2. When principal and interest are two months in arrears -----------	☐	☐	☐	☐	☐
3. When principal and interest are three months in arrears --------------	☐	☐	☐	☐	☐

4. When principal and interest are four months in arrears------------ ☐ ☐ ☐ ☐ ☐

14. Which of the following risk requires attention by the Bank

	Strongly Disagree	Disagree	Undecided	Agree	Strongly Agree
	1	2	3	4	5
1. Liquidity risk-------------------------------	☐	☐	☐	☐	☐
2. Credit risk -------------------------------------	☐	☐	☐	☐	☐
3. Interest rates risk----------------------------	☐	☐	☐	☐	☐
4. Foreign exchange risk------------------------	☐	☐	☐	☐	☐
5. Operational risk------------------------------	☐	☐	☐	☐	☐
6. Strategic risk----------------------------------	☐	☐	☐	☐	☐