ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

ASSESMENTS OF NON-PERFORMING LOANS: A STUDY ON SELECTED COMMERCIAL BANKS IN ETHIOPIA

BY: FREZER AYELE

JUNE, 2017

ADDIS ABABA, ETHIOPIA

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DECLARATION

I, the undersigned, declare that this thesis is my original work prepared under the guidance of Dr. Arega Seyoum All sources of materials used for this thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

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Name	Signature

St. Marry's University, Addis Ababa June, 2017

ENDORSEMENT

This thesis has been submitted to St. Marry's University, school of Graduate Studies for examination with my approval as a university advisor.

______________________________ ______________________________

Advisor Signature

St. Marry's University, Addis Ababa June, 2017

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Finally I, hope this thesis can contribute to fellow student better understanding of bank specific determinants of NPLs on selected private commercial banks in Ethiopia.

Addis Ababa, June, 2017

____

FEREZER AYELE

Dedication

This thesis is dedicated to my mother W/ro. TIRUWORK MAMMO a loving and wonderful Mother.

Acronyms and Abbreviations

AIB	Awash International Bank
BOA	Bank of Abyssinia
CBE	Commercial Bank of Ethiopia
CAR	Capital Adequacy Ratio
CSA	Center of Statistical Agency
DB	Dashen Bank
EAD	Exposure at default
ETR	Effective Tax Rate
ETB	Ethiopian Birr
FDRE	Federal Democratic Republic of Ethiopia
GDP	Gross Domestic Product
IMF	International Monetary Fund
INFR	Inflation Rate
KYC	Know Your Customer
LGD	Loss given default
LTD	Loan to deposit
MIS	Management Information System
NBE	National Bank of Ethiopia
NIB	Nib International Bank
NPL	Non-Performance Loans

OLS	Ordinary Least square
PD	Probability of default
ROE	Return on Equity
SBB	Supervision of Banking Business
UB	United Bank
WB	Wegagen Bank

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Abstract

As noted by Sharon (2007), loans have a vital contribution towards development of economy. However, its nonpayment also leads to incidence of huge loss on banks in particular and country in general. Hence, this study was conducted to examine bank specific determinants of NPLs on selected commercial banks in Ethiopia. To this end, the researcher has selected six private commercial banks based on their experience in the sector where can give clear picture in the selected topic. Survey was conducted with professionals engaged in these private owned Banks in Ethiopia holding different positions using a self administered questionnaire. In addition, the study used structured review of documents and records of banks and in-depth interview of senior bank officials in these commercial banks. This study used secondary sources of data, which is panel data in nature, over the period 2010-2015

These data were collected from NBE and CSA. This research is an explanatory research design that identifies the cause and effect relationships between the NPLs and its determinants.

The finding of the study shows that poor credit analysis and weak/inadequate follow-up was shared by all six private banks which cause non performing loan. Followed by economic condition, diversion of fund and Absence of wise & sound lending practice ascribe to the causes of loan default. The finding of this study is significant since once identifying the determinants of NPLs might enable management body to make appropriate lending policies that prevent the occurrence of NPLs. Furthermore, the study recommended as bank managers should emphasize the management of current assets and loans than fixed assets in order to reduce the level of nonperforming loans. Besides, it is better for the loan officers to provide financial counseling to the borrowers on the wise use of loan and also to make decision on timely fashion to meet their need.

Key words: *Nonperforming loans, bank specific factors, macroeconomic factors*

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CHAPTER ONE
1. INTRODUCTION

1.1 Back ground of the study

Commercial Banks play an important role in the economic development of the countries. For instance, they allocate resource and channel funds from savers to investors continuously Barr, P. and Siems (1994). They do so, if they get necessary earnings to cover their operational cost they incur. That is to say, for sustainable intermediation function, banks need to be gainful. Beyond the intermediation function, the financial performance of banks has critical implications for economic growth of countries. Good financial performance rewards the shareholders for their investment Barr, P. and Siems (1994). So, its wellbeing and successful operation captures the interest of different researchers and other professionals.

Availing credit to borrowers is one means by which banks contribute to the growth of economies. Lending represents the heart of the banking industry. Loans are the dominant asset and represent 50-75 percent of the total amount at most banks, generate the largest share of operating income and represent the banks greater risk exposure (Mac Donald and Koch,2006). Moreover, its contribution to the growth of any country is huge in that they are the main intermediaries between depositors and those in need of fund for their viable projects (creditors) thereby ensure that the money available in economy is always put to good use.

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

According to the International Monetary Fund (IMF, 2009), a non- performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days worth of interest has been refinanced .On the other hand the Basel Committee1(2001) puts non performing loans as loans left unpaid for a period of 90 days.

Under the Ethiopian banking business directive, non-performing loans are defined as “Loans or Advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advances in question” National Bank of Ethiopia (NBE, 2008).

Non-performing Loans (NPLs) have gained world’s intention in the last three to four decades as these increasing non-performing loans are causing banking crisis which are turning into banking failures (Barr and Siems, 1994). Non-performing loans are one of the main reasons that cause insolvency of the financial institutions and ultimately hurt the whole economy. By considering these facts it is necessary to control non-performing loans for the economic growth in the country, otherwise the resources can be jammed in unprofitable projects and sectors which not only damages the financial stability but also the economic growth. In order to control the non-performing loans it is necessary to understand the root causes of these non-performing loans in the particular financial sector.

The causes for loan default vary in different countries and have a multidimensional aspect both, in developing and developed nations. Theoretically there are so many reasons as to why loans fail to perform. Some of these include depressed economic conditions, high real interest rate, inflation, lenient terms of credit, credit orientation, high credit growth and risk appetite, and poor monitoring among others. Bercoff et al. (2002) categorizes causes of non-performing loans to Bank specific and Macroeconomic conditions.

Nonperforming loans (NPL) are important because they affect the financial intermediation role of commercial banks which constitutes the banks’ main source of their income, and ultimately, the financial stability of an economy (Klein, 2013). For this reason, NPLs have increasingly attracted attention recognizing that a consequence of large amount of NPLs in the banking system is bank failure as well as a symptom of economic slowdown (Lata, 2014). This is largely because the financial performance of any commercial bank is measured in terms of profitability and NPLs have a direct adverse impact on the bottom line due to the provisions which the banks are forced to make on account of the NPLs. Other researchers have commented that an increase in NPLs rate is a reflection of the failure of credit policy (Saba Irum,, Kouser and Azeem, 2012).

Khemraj, T. & S. Pasha (2012) explain that high percentages NPLs are often associated with performance problems of banks and financial crises in both developing and developed countries. Fofack, Hippolyte (2005) associates the occurrence of banking crises with a massive accumulation of NPLs and further observes that the NPLs account for a significant portion of total assets of insolvent banks and financial institutions.

This paper investigates the determinants of nonperforming loans (NPL) in the Ethiopian banking system with the help of panel data modeling. Panel dataset of 6 private owned banks with yearly data spans from the period of 2010 to 2015.

1.2 Statement of the problem

One of the main activities of banks in Ethiopia and other parts of the world is Lending. This is evidenced by the volume of loans that constitute banks assets and the annual substantial increase in the amount of credit granted to borrowers in the private and public sectors of the economy. Loan portfolio is typically the largest asset and the predominant source of income for banks. In spite of the huge income generated from their loan portfolio, available literature shows that huge portions of banks loans usually become non-performing and therefore affect the financial performance of these institutions.

A report on the performance of banks in 2008 indicated that among other factors, higher loan loss provision accounted for a decline in the profitability of some banks in Ethiopia (NBE annual report, 2008). Based on NBE'S classification of advances of the Banking industry, some private Banks annual report 2002-2009 indicates that NPL i.e. under the category of doubtful, special mention and loss has a significant negative impact on the financial performance of the bank. Different studies on issues of non-performing loan indicates that Loan default disallow new applicants access to credit as the banks cash –flow management problems increase indirect proportion to the increasing default problem.

NPLs affect the bank`s liquidity and profitability which are the main components for the overall efficiency of the bank. An increase in NPLs provision diminishes income. Again, mismatch of maturities between asset and liability create liquidity risk for the banks that deteriorate bank`s overall credit rating including its image (Badar and Yasmin, 2013).Therefore, the determinants of NPLs should be given a due consideration because of its adverse effect on survival of banks.

There are a good number of studies that examine the factors leading to NPL. However, there is little empirical study on Ethiopia that has intensively investigated the relationship between bank-specific factors and NPLs. Thus, the motivation for undertaking this study is to identify the determinants of NPLs in the case of Ethiopia.

Banking industry in Ethiopian has its own unique features that distinguish them from other countries financial market. One of the feature is the regulation of the country is not allowed foreign nations or organization to fully or partially acquire share of Ethiopian banks. Besides,

there is no secondary market which has two important functions. First, they make it easier and quicker to sell NPL to raise cash; aimed at stabilizing the banking sector by providing immediate liquidity to the relevant credit institutions. Second, helps assisting defaulting borrowers to restructure their debts more efficiently. Moreover, in the country, a rapidly growing industry is the banking sector. As a result, it is necessary to conduct a study on the determinants of NPLs of commercial banks in Ethiopia which is crucial.

In light of the above facts and research gaps, the purpose of this study is to examine the determinants of NPLs of selected private commercial banks in Ethiopia. To this end, this study tried to provide real information about the determinant factors affecting NPLs of selected commercial banks and feasible recommendation for the impact of identified variables on the levels of NPLs.

1.3 Basic research questions

The research is intended to answer four research questions. These are:-

1. Bank specific determinants of non-performing loans (NPLs) of commercial banks in Ethiopia?
2. Relationship between Rapid loan growth, High interest rate, credit orientation, and cost efficiency level of nonperforming loans?
3. Relationship between poor loan follow-up, poor risk Assessment and Lack of strict admittance.
4. Trend of nonperforming loans (NPLs) of commercial banks in Ethiopia?

1.4 Objectives of the study

1.4.1 General objective

The overall objective of the study is to find out bank specific determinants of NPLs in the case of the selected commercial banks of Ethiopia.

1.4.2 Specific objectives

Specific objectives of the study are;

- To examine the relationship between credit monitoring and occurrence of NPLs
- To see the effect of collateralized lending and non-performing loans
- To identify the impact of credit culture on loan default
- To examine the relationship between high lending interest rates and loan default
- To see the effect of credit terms and price on loan performance
- To identify the influence of borrowers' credit culture on occurrences of bad debts
- To evaluate whether rapid credit growth and greater risk appetite lead to non-performing loans
- To see the relation between bank ownership structure and size and loan default

1.5 Scope and Limitations of the Study

This thesis is adjusted to fit its objectives of examining the determinants of NPLs of selected commercial banks in Ethiopia within the limits of specified time and possibility. The researcher decided to limit this study to the selected private commercial banks found in Ethiopia namely, Awash international bank, bank of Abyssinia, Wegagen bank, United bank, Nib International bank and Dashen bank that were registered by NBE before 2007/08. These banks were selected since they are senior banks and are expected to have more experience on the lending activities. This study was limited to bank specific factors though macroeconomics has a huge impact on qualities and performance of loans. Thus the study did not explore macroeconomic factors determining loan defaults. To this end, this study covers a panel data of these banks over the period 2010 to 2015.

1.6 Significance of the Study

The finding of this study which details with the determinants of nonperforming loan of commercial banks in Ethiopia is beneficial for different stakeholders such as Banking sectors(commercial Banks and National bank of Ethiopia),researcher and for other researchers.

This study thus would help Ethiopian banks get insight on what it takes to improve their loan qualities and the central bank (NBE) to examine its policy in banking supervision pertaining to ensuring asset quality banks maintain. In addition the study would also contribute to the existing body of knowledge regarding the determinants of nonperforming loans and motivate further research on Ethiopian Banking context and more specifically on macroeconomic determinants of nonperforming which is not studied under this research.

1.7 Operational Definitions

Based on Bunna International Bank Procedure Mannual

Loan and advances: *Shall mean any financial assets of a bank arising from a direct or indirect advance. (I.e. Unplanned overdraft, participation in loan syndication, the purpose of loan from other lenders, etc) or commitment to advance funds by the bank to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or on demand usually with interest. The term includes a contractual obligation of a bank to advance funds to or behalf of a person, claim evidenced by a lease financing transaction in which the bank is the lesser and an overdraft facility to be funded by the bank on behalf of a person.* ***OR***
Any financial asset granted by banks to borrower on a contract of an obligation to repay the principal amount with usually its interest either on due date or demand.

Nonperforming loans - *a loan whose credit quality has deteriorated and the full collection of principal and/or interest as per the contractual repayment terms of the loan/advances is in question and delayed for more than 90 days(NBE, 2008).*
Credit risk – *The risk arise as result when the borrower fail to conclude its financial contract according to the agreement with lender. It is an asset default by counter party.*
Borrower: *- the one who borrows money from the lender (Bank).*
Lending*: - provision of loan by one party (lender) to another party (Borrower).*
Bank specific factors*: -are variables that are under the control of bank management. They can be directly/ indirectly stated in the financial statements of banks.*
Macroeconomic factors: - *are variables in which the bank management has no power to control them. Rather, these variables are related with the fiscal and monetary policies of the country.*
National Bank of Ethiopia (NBE)*:- It is the reserve or central bank of Ethiopia. Besides licensing and supervising banks, insurers and other financial institutions, NBE fosters a healthy financial system and undertakes other related activities that are conducive to rapid economic development of Ethiopia. (Proclamation No.592/2008, FDRE, 2008)*

1.8 Organization of the Paper

The research report is organized into five Chapters. The first Chapter is made up of the background of the study, the statement of the problem and research questions, significance of the study, scope of the study, limitation of the study and organization of the study.

In Chapter two theoretical foundation and empirical review of the study is presented. This chapter covers important issues related to the banking literatures, empirical studies, types and natures of credit, principles of good lending, and general lending procedures.

Chapter three describes the research methodology. It explains the study area, research design, population parameter, sampling methods, sample size and methods of data collection and analysis. Results and discussions are contained in Chapter four together with the survey outcomes. Chapter five provides conclusion and recommendations of the stud

CHAPTER TWO

1. LITERATURE REVIEW

2.1 Chapter Overview

The focus of chapter two was to give theoretical and conceptual foundation of the study. This chapter focuses on the review of relevant literature on non-performing loans and other core aspects of the topic under study.

Accordingly, the first subsection, 2.2 Theoretical review of banking presents banking and role of banking in general. The second subsection 2.3 discusses overview of banking system in Ethiopia. The next subsection 2.4 discusses overview of bank loans and lending. Sub-section 2.5 Credit Methodologies. Sub section 2.6 Banking Risks .Finally section 2.7 Nonperforming Loans.

2.2 Theoretical Review of Banking

This section discusses the theory of banking with major focus on role of banks and their lending activities.

2.2.1 Banking

According to Britannica.com, a bank is: an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits and make loans and derive a profit from the difference in the interest rates paid and charged, respectively. Banks are financial institutions that accept deposits from the general public and obtain money from such other sources as may be available to them (the' haves') in order to extended loans to those in need of the money (the' have-nots') . As Goosen et al.(1999) put it, banks provide channel (financial intermediation) for linking those who have excess funds with those who are in need of funds, thus ensuring the money available in economy is always put to good use. In so doing banks earn income when they lend money out at a higher interest rate than they pay depositors for use of their money. A Bank's main source of income is interest. A bank pays out at a lower interest rate on deposits and receives a higher interest rate on loans. The difference between these rates represents the bank's

net income. Banks and other financial institutions exist in order to earn a profit and to ensure that shareholders' value is maximized.

Currently in most jurisdictions commercial banks are regulated by government entities such as central banks and require a special bank license to operate. The requirements for the issue of a bank license vary between jurisdictions but typically include: Minimum capital, Minimum capital ratio (how do we arrive at this ratio?) , 'Fit and Proper' requirements for the bank's controllers, owners, directors, or senior officers, approval of the bank's business plan as being sufficiently prudent and plausible.

2.2. 2 Role of Banking

The banking sector makes a meaningful contribution to the economic growth of every country. Banks contribution to the growth lies in the role they play in mobilizing deposits and allocating the resources efficiently to the most productive uses investment in the real sector.
So making credit available to borrowers is one means by which banks contribute to the growth of economies. Banks pool resources together for projects that are too large for individual shareholders to undertake (Bagehot, 1873). They are also considered the most important enabler of financial transactions in any country's economy and are the principal source of credit (Rose, 2002). Bank finance is the primary source of debt funding.
Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Saunders & Cornett, 2003). Besides, banks are also the custodians of nation's money, which are accepted in the form of deposits and paid out on the client's instructions (Sinkey, 2002; Harris, 2003).
A bank's role has expanded considerably and is no longer limited to the taking of deposits and providing credit.

2.3 Overview of Banking System in Ethiopia

History of banking in Ethiopia dates back to the year 1905 when the first bank, namely "The Bank of Abyssinia" which was owned by the then National Bank of Egypt, was established. The bank was closed for observed inefficiency in its operation in 1931 and replaced by an indigenous bank named Bank of Ethiopia. The Bank of Ethiopia had operated until 1936 and stopped operation afterwards because of the Italian invasion (Gidey, 1987). As Belay Gidey further described after the Italian invasion ended the State Bank of Ethiopia was established and lasted until 1963 serving dual purposes of acting as a central bank and providing commercial banking services to the public. In 1963 the central bank of the country under the name the "National Bank of Ethiopia" was independently established. This period signifies the official separation and segregation of commercial banking activities from duties of central banking and dissolution of State Bank of Ethiopia. Foreign banks like Banco d‟ Napoli, Banco d‟Roma, Barclays Bank and others were operating side by side with local commercial banks. The competition was intense and the Bank of Ethiopia was the first indigenous bank to branch out to overseas to establish offices in Sudan Khartoum and Djibouti (Gidey, 1987, Pankhurst, 2002, Deguefe‟, 2006).

Table 2.1 over sea's banks that had been operating in Ethiopia

Banks	***Period***
Bank of Abyssinia	*1905-31*
Societe National d" Ethiopie	*1908-28*
Banque del Idoche	*1915-28*
Camapagnie del"Africa orientale	*1915-36*
Banca d" Italia	*1936-41*
Banco d" Roma	*1936-41*
Banco Nazionale de lavoro	*1936-41*
Barclays Bank	*1941-43*

Source: Belay Gid**ey (1987)**

Even though these historical events and cyclical developments indicate that banking in Ethiopia has traversed a long historic journey, the sector has yet remained underdeveloped mainly because of economic and political factors. The modern indigenous banking history of Ethiopia has two phases of development. The first phase ranges from 1942-1963 and the second phase starts from 1963-1974. The first phase denotes the earlier times during which the activities of commercial banking and duties of central banking were not separated and the second phase was the time when the fiscal and monetary legislatives were put into effect and they also mark the time when the central bank of the country was established and duties and responsibilities of central banking and commercial banking were separated (Gidey, 1987, Pankhurst, 2002, Deguefe, 2006). Before 1974 commercial banks were operating competitively under values and principles of free market economy. Domestic and overseas banks had been operating with equal access to markets. However, in 1974, the country changed its economic and political policies and orientations to that of the command economy. Despite the symbolic presence of a few private banks prior to the advent of the Derg Regime in 1974, the banking industry in Ethiopia was generally a state domain. On its part, the Derg not only made banking a state monopoly but also used its services for the advancement of socialism. A sharp division of labor was created among the three state-owned banks. The Commercial Bank of Ethiopia (CBE), by far the oldest and biggest in Ethiopia, specialized in short-term lending to trade and industry while the Development Bank of Ethiopia (DBE) was made to concentrate on long-term lending for investment in Agriculture, Industry as well as other sectors of the economy. The Housing and Savings Bank (now known as the Construction and Business Bank, CBB), as the name indicates, served the housing sector. Specialization is naturally meant non-existence of competition. Since the socialist economic policy did not allow private ownership of banks, all commercial banks were merged under one state owned commercial bank, the commercial Bank of Ethiopia. The situation has wiped out competition by creating one single monopolistic commercial bank in the entire nation with the only objective of serving the government. Generally, both profit and competition as business motivators and driving forces were avoided from the political and economic framework of the country (Gidey, 1987, Pankhurst, 2002, Deguefe, 2006).

After nearly two decades of political and economic supremacy of communism, the country has once again experienced another round of change in its politics and economic policy. The country

has officially reinstituted the free market economy since 1991 G.C where the Transitional government of Ethiopia (TGE) made rehabilitation of the war-ravaged economy and streamlining through comprehensive economic and institutional reform program its top priorities. As a result, private investment in banking sector is allowed without any capital limit. This has been congratulatory news for the banking sector to sprout within short period of time. As a consequence the first private bank was established in 1996 and a number of others followed suit and entered the market that has long suffered from deficient financial system in order to reap high profit. This has been an opportunity for the society to get access to better banking services that results in improvement of capital accumulation. The Commercial Bank of Ethiopia, the bank that was enjoying monopolistic status for over a decade has faced new challenges from new comers. Change has become binding to live up to the demand of the competitive environment. Poor banking services are challenged by customers and customer defection to competitors has been daily experience in the banking sector. Striving to improve service delivery and customer handling has become business vogue of the day in order to survive in the business, (Gidey, 1987, Pankhurst, 2002, Deguefe, 2006). All the banks are now regulated by the central bank which is the National Bank of Ethiopia. A central bank plays the most influential role in a country's economic and financial development. Generally, the primary role of a central bank is the same in all countries. It acts as a banker and financial advisor to the government as the nation's monetary authority, and is responsible to the government for promoting monetary stability in the country. Following the departure of Dergue regime, Monetary and Banking proclamation of 1994 established the National bank of Ethiopia as a legal entity. Following this, Monetary and Banking proclamation No.84/1994 and the Licensing and supervision of banking business proclamation No.84/1994 laid down the legal basis for investment in banking sectors (Habtamu, 2012).

Currently, banking sectors in Ethiopia are showing progressive developments in terms of number of branches, total assets, human resource utilization and the like relative to other African developing countries. This indicates as Ethiopia categorized under banked country with limited outreach (Tseganesh,2012).Thus, currently number of banking sectors in Ethiopia were reached nineteen as shown it the following tables.

Table 2.2 ***Banking sectors in Ethiopia***

No	Name of Banks	Year of Establishment
1	Awash International Bank	1994 G.C
2	Commercial Bank of Ethiopia (CBE)	1963 G.C
3	Development Bank of Ethiopia	1951 G.C
4	Construction and Business Bank *	1975 G.C
5	Dashen Bank	1995 G.C
6	Wegagen Bank	1997 G.C
7	Bank of Abyssinia	1996 G.C
8	United Bank	1998 G.C
9	Nib International bank	1999 G.C
10	Cooperative Bank of Oromia	2004 G.C
11	Lion International Bank	2006 G.C
12	Zemen Bank	2008 G.C
13	Oromia International Bank	2008 G.C
14	Buna International Bank	2009 G.C
15	Berhan International Bank	2009 G.C
16	Abay Bank S.C	2010 G.C
17	Addis International Bank S.C	2011 G.C
18	Debub Global Bank S.C	2012 G.C
19	Enat bank	2012 G.C

Source: www.nbe.et

*Construction and Business bank merged with CBE

2.4 Overview of Bank Loans and Lending

Commercial banks are the most important of all depository institution (Leroy and Vanhoos, 2006).They creates money by through lending and purchasing securities (Thomas, 2006). Commercial banks extend credit to different types of borrowers for many different purposes. One of the major functions of any commercial bank is providing loan to the business society. Banks collect money from those who have excess money and lend it to others who need money for different purpose. Therefore, banks' intermediary function plays a vital role in the economic activity. Banks accept customer deposits and use those funds to give loans to other customers or invest in other assets that will yield a return higher than the amount bank pays the depositor (McCarthy et al., 2010) cited in Zewdu (2010). It follows that customers' deposit is the primary source of bank loan and hence, increasing or guaranteeing deposits directly has a positive effect

on lending. Therefore, bank credit is the primary source of available debt financing for most customers whereas good loans are the most profitable assets for banks.

The principal profit making activity of commercial banks is making loans to its customers. In the allocation of funds to earn the loan portfolio, the primary objective of bank management is to earn income while serving the credit needs of its community (Reed and Gill, 1989) cited in Zewdu (2010).Therefore, like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower. The borrower initially receives an amount of money from the lender to pays back, but sometimes not always in regular installments, to the lender. This service is generally provided at a cost, known as interest on the debt. As one of the principal duties of financial institutions is to provide loans, it is typically the main source of income to banks. Besides, bank loans and credit also constitute one of the ways of increasing money supply in the economy (Felix & Claudine, 2008).

Loans are the largest single source of income for banks. Bank loan involves personal relationships between the bankers and borrowers. It has a highest degree of default risk than other bank assets. Loans yield the higher rate of return among bank assets in compensation for lower liquidity and higher risk (Thomas, 2006). A loan composition greatly varies among banks based on their size, location, trade area and lending experts (MacDonald, 2006).

Loans and advances are defined in the respective laws of different countries. In Ethiopia, under Article 13 (FDRE 592/2008) and (NBE/2008) Article (4.5) loans and advances are defined as:

"… any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdrafts, participation in a loan syndication, the purchase of loan from another lender etc.) or commitment to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or on demand, usually with interest. The term includes a contractual obligation of a bank to advance by the bank on behalf of a person. The term does not include accrued but uncollected interest or discounted interest."

2.5 Credit Methodology

Credit methodology encompasses every activity involved in lending including sales, customer selection and screening, the application and approval process, repayment monitoring, and delinquency and portfolio management. It is also linked with the institutional structure pertaining to the credit process. Quality of credit methodology is one of the most determinant factors for the efficiency, impact and profitability of the institutions. Thus getting the credit methodology and product mix right is therefore one of the most demanding as well as rewarding challenges of every financial institutions (banks). The sections that follow discuss major issues in credit methodology that include credit information, credit analysis process, credit approval and credit monitoring processes. Getting these well significantly affect loan performance.

2.5.1 Credit Information

Engagement in financing begins with customer recruitment. An issue of knowing the customer, customarily known as KYC (Know Your Customer) is so vital before proceeding to details. Banks use various means to obtain such information about the existing or potential customer. Use of financial statement, credit report from credit bureau, customers' history if not new is the potential sources of information (Ross et al., 1998).

According to The Federal Reserve (2004) a credit report is the organized presentation of information about an individual's and/or company's credit record that a credit bureau communicates to those who request information about the credit history of an individual's and/or company's experiences with credit, leases, non-credit-related bills, collection agency actions, monetary-related public records, and inquiries about the individual's credit history.
Further according to Ferreti (2007), credit information is usually integrated with data from other sources such as court judgments, electoral rolls and other private information provided by other organizations, which compile additional information referring to a consumer. This naturally is ideal source of input for credit analysis.
The purpose of information sharing is to communicate relationship information from existing lending relationships to outside lenders (Gehrig and Stenbacka, 2007).Credit providers' use credit information to conduct credit risk analysis of prospective borrowers in order to mitigate

credit risk. Kallberg and Udell (2003) highlight that information sharing is useful both at the origination stage and after credit has been extended. Especially at the origination phase, information sharing reduces the problems of adverse selection.
In fact the exchange of credit information improves non-performing loan ratios, leads to fewer losses through write offs and decreases interest rates for good credit risks (Jentzsch, 2008: 538). Jentzsch (2008) further supports that sharing credit information between lenders intensifies competition and increases access to finance. Jappelli and Paggano (2005) indicate that credit information sharing results in improved bank's knowledge of applicant's character, easing adverse selection and reduce the informational rents that banks could otherwise extract from their customers. Credit information also acts as a borrower disciplining device, by cutting insolvent debtors off from credit and eliminates or reduces the borrower's incentive to become over-indebted by drawing credit simultaneously from many banks without any of them realizing it. Further, Gehrig and Stenbacka, (2007) highlight that information sharing reduces adverse selection problems and thereby promotes financial stability; it serves as a borrower disciplining device and it reduces the informational rents that banks can extract within the framework of their established customer relationships. According to Khuzwayo (2008), greater information sharing of trade credit data, particularly in the informal sector, could greatly expand credit access for small and medium enterprises.

In addition, Barth, Lin, Lin & Song (2008) show that information exchange will assist in minimizing lending corruption in banks by reducing information asymmetry between consumers and lenders, improving the bribery control methods and reducing informational rent, and hence the bargaining power of lenders. The exchange of consumer credit information disciplines borrowers to repay loans because borrowers do not want to damage the good report which can make it difficult for them to get credit (Swiss National Bank, 2008). Once credit information on the loan request is obtained bank officers precede with credit assessment. The next section would thus discuss process involved in credit analysis or assessment.

2.5.2 Credit Evaluation and Scoring

Using the Five C's of Credit

A credit analysis is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's (Strischek, 2000). Detailed discussion of this model, also referred as the five C's is done the next section.

1. Character: The history of the business and experience of its management are critical factors in assessing a company's ability to satisfy its financial obligations. Look at how long the business has been under the same control, and check for any previous litigation or bankruptcy information. Also, get a clear understanding of who owns the business, and who is ultimately responsible if a problem arises. Identify the exact business name and legal form of the organization. What products does it sell? And what terms? Is it a seasonal business? What are its margins? Get a sense of the character of the owners and the business's ability to compete in its markets.

2. Capacity: Make sure to assess the capacity of the business to operate as an ongoing concern in every credit decision. Principals in small businesses are often forced to wear many hats. Businesses must be able to allocate resources evenly to the various functions of the organization such as marketing and sales, production and finance. Assess their experience and their ability to manage all aspects of the company without compromising efficiency.

3. Capital: Analyze the financial capacity of the organization in order to determine its ability to meet financial obligations in a timely fashion. Its ability to pay may be much more important. It is critical to understand the difference. Watching customer payment habits over time is an excellent indication of cash flow. Also, check bank and trade references, as well as any pending litigation or contingent liabilities. Check for a parent company relationships. A parent company's guarantee may be available. Intercompany loans might affect financial solvency.

4. Conditions of the times: General economic conditions in the nation, in the community, and in the industry will exert a modifying influence on the financial analysis of an account.
Watch for any news items or special events that could affect the firm's ability to continue asan ongoing concern.

5. Collateral: Collateral (also called security) is the assets that the borrower pledges to the bank to mitigate the bank's risk in event of default (Sinkey, 2002) .It is something valuable which is pledged to the bank by the borrower to support the borrower's intention to repay the money advanced. Security is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003).

2.5.3 Credit Approval

Extending credit is the careful balance of limiting risk and maximizing profitability while maintaining a competitive edge in a complex, global marketplace. Banks go through a thorough process in approving credit to hit the balance. Credit approval is the process of deciding whether or not to extend credit to a particular customer. It involves two steps: gathering relevant information and determining credit worthiness (Ross, Westerfield & Jordan, 1999). The credit analysis process consists of a subjective analysis of the borrower's request and a quantitative analysis of the financial information provided. The individual steps in the credit approval process and their implementation have a considerable impact on the risks associated with credit approval. The quality of credit approval processes depends on two factors, i.e. a transparent and comprehensive presentation of the risks when granting the loan on the one hand, and an adequate assessment of these risks on the other. Furthermore, the level of efficiency of the credit approval processes is an important rating element. Due to the considerable differences in the nature of various borrowers and the assets to be financed as well the large number of products and their complexity, there cannot be a uniform process to assess credit risks.

The quality of the credit approval process from a risk perspective is determined by the best possible identification and evaluation of the credit risk resulting from a possible exposure.

Probability of default (PD)

Default probability is the likelihood that the business will default on its repayment over the term of the facility. Reviewing a borrower's probability of default is basically done by evaluating the borrower's current and future ability to fulfill its interest and principal repayment obligations.

Loss given default (LGD)

Exposure at default is the magnitude or exposure that would be materialized in the event of a default. It addresses what fraction of the exposure may be recovered through bankruptcy proceedings or through some other form of settlement in the event of a default. The loss given default is affected by the collateralized portion as well as the cost of selling the collateral. Therefore, the calculated value and type of collateral also have to be taken into account in designing the credit approval processes.

Exposure at default (EAD)

In the vast majority of the cases described here, the exposure at default corresponds to the amount owed to the institution. Thus, besides the type of claim; the amount of the claim is another important element in the credit approval process.

Once information has been gathered, the firm faces the hard choice of either granting or refusing credit. Many financial managers use the "five C's of Credit" as their guide (Ross, Westerfield & Jaffe, 1999) as discussed earlier and identify and evaluate the credit risk resulting from a possible exposure to sanction the credit.

6. Loan Follow up: Lending decision is made on sound credit risk analysis /appraisal and assessment of credit worthiness of borrowers. But past records of satisfactory performance and integrity are no guarantee future, though they serve as useful guide to project trend in performance. A loan granted on the basis of sound analysis might go bad because of the borrower may not meet obligations per the terms and conditions of the loan contract. It is for this reason that proper follow up and monitoring is essential. Monitoring or follow-up deals with the following vital aspects:

• Ensuring compliance with terms and conditions

• Monitoring end use of approved funds

• Monitoring performance to check continued viability of operations

• Detecting deviations from terms of decision

• Making periodic assessment of the health of the loans and advances by nothing some of the key indicators of performance that might include: profitability, activity level and management of the unit and ensure that the assets created are effectively utilized for productive purposes and are well maintained.

• Ensuring recovery of the installments of the principal and interest in case of term loan as per the scheduled repayment program

• Identify early warning signals, if any, and initiate remedial measures thereby averting from possible default.

Basically there are three types of loan follow up systems. These are: Physical follow up, financial follow up and legal follow up. Each is discussed in section that follows.

Physical Follow –up

Physical follow-up helps to ensure existence and operation of the business, status of collateral properties, correctness of declared financial data, quality of goods, conformity of financial data with other records (such as taxes ,register books), availability of raw materials, labor situation, marketing difficulties observed ,undue turnover of key operating personnel, change in management set up among others.

Financial Follow- up

Financial follow up is required to verify whether the assumptions on which lending decisions was taken continues to hold good both in regard to borrowers' operation and environment , and whether the end use is according to the purpose for which the loan was given.

Legal Follow- up

The purpose of legal follow up is to ensure that the legal recourse available to the Bank is kept alive at all times. It consists of obtaining proper documentation and keeping them alive, registration, proper follow up of insurances. Specific issues pertaining to legal follow up include: ascertaining whether contracts are properly executed by appropriate persons and documents are complete in all aspects, obtaining revival letters in time (revival letters refer to renewal letter for registration of security contracts that have passed the statutory period as laid down by the law), ensuring loan/mortgage contracts are updated timely and examining the regulatory directives, laws, third party claims among others.

2.6 Banking Risks

Shareholder value maximization requires a firm to engage in risk management practices only if doing so enhances the value of the firm and, by implication, its value to shareholders (Ali, 2006) A volatile economy and recent credit crisis show the importance of banks to increase attention on how risks can be measured and kept under control. Bessis (2002:11) defines banking risks as "adverse impacts on profitability of several distinct sources of uncertainty".
Many risks are common to all financial institutions that include: credit, liquidity, market, operational, currency, solvency, and interest rate, country risks among others. The sections that follow discuss the key risks that banks are exposed to.

2.6.1 Credit Risk

According to Valsamakis et al (2005), credit risk is the risk that a financial contract will not be concluded according to the agreement. It is the risk that the counterparty to an asset will default. In other words it is the risk to earnings or capital due to borrowers' late and nonpayment of loan obligations (reference). Credit risk encompasses both the loss of income resulting from the sector inability to collect anticipated interest earnings as well as the loss of principal resulting from loan defaults. Credit risk arises because the possibility that the expected cash flows from advances and securities held, might not be paid in full. Credit risk is considered the most lethal of the risks banks face (Cade, 1999). Credit risk includes both transaction risk and portfolio risk.

Under credit risk are also transaction and portfolio risks. Transaction risk refers to the risk within individual loans transaction risk is mitigated through borrower screening techniques, underwriting criteria and quality procedures for loan disbursement, monitoring, and collection. Portfolio risk refers to the risk inherent in the composition of the overall loan portfolio. Policies on diversification (avoiding concentration in a particular sector or area), maximum loan size, types of loans, and loan structures lessen portfolio risk.

2.6.2 Liquidity Risk

Liquidity risk is the possibility of negative effects on the interests of owners, customers and other stakeholders of the financial institution resulting from the inability to meet current cash obligations in a timely and cost-efficient manner. Liquidity risk occurs when there is a sudden surge in liability withdrawals resulting in a bank to liquidate assets to meet the demand (Bessis, 2002). It usually arises from management's inability to adequately anticipate and plan for changes in funding sources and cash needs. According to Rose & Hudgins (2005) bankers and other financial institutions are concerned about the danger of not having enough cash to meet payment or clearing obligations in a timely and cost effective manner.

Efficient liquidity management requires maintaining sufficient cash reserves on hand (to meet client withdrawals, disburse loans and fund unexpected cash shortages) while also investing as many funds as possible to maximize earnings (putting cash to work in loans or market investments).

2.6.3 Market Risk

Market risk is the risk incurred in the trading of assets and liabilities when interest rates, exchange rates and other asset prices change (Saunders & Cornett, 2003). It is the current and potential risk to earnings and shareholders' equity resulting from adverse movements in market rates or prices. It arises from interest rate, equity and foreign exchange risks (Koch & Macdonald, 2003). According to Bessis (2002) due to increased competition the interest income of banks is declining and banks are concentrating more on non-interest income in order to mitigate this risk.

2.6.4 Operational Risk

It is the risk of loss resulting from inadequate internal processes, people and systems or from external events (Koch and Macdonald, 2003). Operational risk is the possible risk that existing technology or support systems will fail or malfunction. It also includes human errors, fraud and non-compliance with an institution's procedures and policies (Bessis, 2002).

2.6.5 Currency Risk

Concerns the possible impact which fluctuations in exchange rates may have on the foreign exchange holdings or the commitments payable in foreign currencies by business organizations (Valsamakis, et al., 2005). It is the possibility that exchange rate fluctuations can adversely affect the value of a bank's assets and liabilities held in foreign currencies
(Bessis, 2002). Currency risk is one of the market risks banks face.

2.6.6 Capital or Solvency Risk

It is the risk that a bank may become insolvent and fail (Koch & Macdonald, 2003). It isn't considered a separate risk because all of the risks a bank faces, in one form or another, affect a bank's capital.

2.6.7 Interest Rate Risk

A bank is exposed to interest rate risk when the maturities of the bank's assets and liabilities are mismatched (Saunders & Cornett, 2003). Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. If interest rates rise and a mismatch occur in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities.
Also known as asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets).
Bessis,(2002) states that interest rate risk could result in economic losses and insolvency.
Interest rate risk is also one of the market risks.

2.6.8 Country Risk

It is associated with the risk that foreign borrowers cannot repay the debt due to foreign currency shortages, adverse political and economical conditions or interference by the foreign government (Saunders & Cornett, 2003).

Besides the aforementioned risks Rose and Hudgins (2005) state that banks are also exposed to: Compliance risk, Reputation risk, Sovereign risk, Strategic risk, and Legal and regulatory risks. Financial institution managers (and regulators) review these risks in light of i) the institution's potential exposure to loss, ii) the quality of internal risk management and information systems, and iii) the adequacy of capital and cash to absorb both identified and unidentified potential losses. In other words, management determines whether the risk can be adequately measured and managed, considers the size of the potential loss, and assesses the institution's ability to withstand such a loss.

2.6.9 Credit Risk Management

Loan is a major asset, income source for banks, and risky area of the industry. Moreover, its contribution to the growth of any country is very clear. Bank credit is the primary source of debt financing available for most customers in the personal, business or corporate market.
The underlying need for credit varies across these markets. Banks generally also want to increase the base of their income and use credit extension as an opportunity to cross sell other fee generating services when a customer applies for credit facilities (Koch & MacDonald, 2003). Any successful business must meet its customer needs and make a profit. Likewise, successful financial institutions must meet the desperate needs of depositors and borrowers.
Depositors look for high rates, short terms and no risk, while borrowers seek low rates and long terms. Financial institutions are therefore, in the risk intermediation business. To be successful, financial institutions, banks in particular, must properly underwrite risk, manage and monitor the risk assumed (Barrickman, 1990). Credit risk can be defined as the potential for a borrower or counter party to fail to meet their obligations in accordance with the terms of an obligation's loan agreement, contract or indenture (Sobehart, Keenan & Steyn, 2003).

Credit risk is considered the oldest form of risk in the financial markets. Caouette, Altman & Narayanan (1998: 1) state that "credit risk is as old as lending itself", dating back as far as 1800 B.C. The first banks, which started in Florence seven hundred years ago, faced very similar challenges that banks face today. Although managing credit risk is their core competency, many banks failed due to over-extension of credit (Caouette et al., 1998).

The most prominent risk assumed by banks is credit risk. This is due to the various factors that influence a borrower's ability to repay the credit facility. The borrower's ability to repay is closely linked to the general economic conditions of a country. In favorable economic conditions the ability to repay increases, which could be due to a favorable interest rate environment, low inflation, increased income levels or a combination of these factors. The opposite is however true in poor economic conditions. The borrower's ability to repay is adversely effected under these conditions due to a reduction in disposable income (Koch & MacDonald, 2003).

Credit risk arises from uncertainty in a given counterparty's ability to meet its obligations.

The increasing variety in the types of counterparties (from individuals to sovereign governments) and the ever-expanding variety in the forms of obligations (from auto loans to complex derivatives transactions) has meant that credit risk management has jumped to the forefront of risk management activities carried out by firms in the financial services industry (Basel committee,1999).

The risk profile of banks is fundamentally different from that of other financial institutions, like stockbrokers and insurance industry. An integral part of banking is the management of credit risk and it is done through well-diversified portfolios of exposure. Most banks fail because of poorly managed credit risk (Rose, 2002).

Credit risk management primarily focuses on loss avoidance and the optimization of return on risk. Financial institutions in the world are facing two major challenges. Firstly, they need to deliver increasing returns and value to shareholders and secondly, they need to determine how to capitalize on the New Capital Accord's (Basel II) minimal capital requirements (Belmont, 2007). The need to put a strong credit risk management in place cannot overemphasized as failure which lead loan default and thereby crisis on banks. The section that follows discusses non performing loans.

2.7 Nonperforming Loans (NPL)

Loans and advances constitute the primary source of income by banks. As any business establishment a bank also seeks to maximize its profit. Since loans and advances are more profitable than any other assets, a bank is willing to lend as much of its funds as possible. But banks have to be careful about the safety of such advances (Radha .M, et al., 1980). Bankers naturally try to balance the issue of maximizing profit by lending and at the same time manage risk of loan default as it would impair profit and thereby the very capital .Thus a bank needs to be cautious in advancing loans as there is a greater risk which follows it in a situation where the loan is defaulted.

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

The concept of non-performing loans has been defined in different literatures. According to Patersson & Wadman (2004), non- performing loans are defined as defaulted loans which banks are unable to profit from. They are loans which cannot be recovered within stipulated time that is governed by the laws of a country. According to the International Monetary Fund (IMF, 2009), a non- performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days worth of interest has been refinanced. Non-performing loans generally refer to loans which for a relatively long period of time do not generate income; that is the principal and/or interest on these loans has been left unpaid for at least 90 days (Fofac, 2009). Non- performing loans are further defined as loans whose cash flows stream is so uncertain that the bank does not recognize income until cash is received, and loans those whose interest rate has been lowered on the maturity increase because of problem with the borrower (Machiraju, Undated). HR Machiraju expresses nonperforming loans as a leading indicator of credit quality. Non Performing Loans (NPL) or bad loans arise in respect of the loans and advances which are given by banks to the whole range of different projects including but not exclusively retail or wholesale, personal or corporate or short, medium or long term projects. NPLs are a very sensitive element of a bank’s operations.

According to Brown, Mallett & Taylor, the losses bad loans (NPLs) cause, by reducing the capital resource of the bank, affects its ability to grow and develop its business (Taylor, 1993). Disclosure of the extent of these losses in its financial statements may lead to a loss of confidence in the bank's management and a reduction in its credit ratings. This will in turn increase the bank's cost of borrowing in the wholesale market and make it more expensive or more difficult to raise capital. In extreme cases, it can leads to a loss of deposits, the withdrawal of the bank's authorization and ultimately insolvency (M.G. Taylor, 1993). Thus NPL is one of the concrete embodiments of credit risk which banks take. They have greater implication on the function of the banks as well as the overall financial sector development.

Historically, the occurrence of banking crises has often been associated with a massive accumulation of non-performing loans which can account for a sizable share of total assets of insolvent banks and financial institutions, especially during episodes of systemic crises. Deterioration in banks' loan quality is one of the major causes of financial fragility. Past experience shows that a rapid buildup of bad loans plays a crucial role in banking crises (Demirgüç & Kunt & Detragiache, 1998, & González Hermosillo, 1999). It is widely accepted that the quantity or percentage of non-performing loans (NPLs) is often associated with bank failures and financial crises in both developing and developed countries. In fact, there is abundant evidence that the financial/banking crises in East Asia and Sub-Saharan African countries were preceded by high non-performing loans. The current global financial crisis, which originated in the US, was also attributed to the rapid default of sub-prime loans/mortgages. In view of this reality it is therefore understandable why much emphasis is placed on non-performing loans when examining financial vulnerabilities (Sorge, 2004).

It is apparent that insolvency of banks is costly to the macro economy, but this cost can be increased or decreased by the regulators and the policies they use in resolving the insolvencies. The faster banks can be resolved before their economic capital turns negative, the smaller are both losses to depositors and costs to the macro economy (G. Kaufman, 2004). This is why most countries provide their own rules regarding NPLs and its classifications.

The classification of a loan as bad or doubtful may result from a specific act by the borrower, for example, petitioning for bankruptcy, or from circumstances that have the potential to place the

loan at risk. For example, the borrower may have defaulted on one or more of the terms of the loan, or a substantial part of its assets may be in an industrial sector or country that is suffering from an economic recession (M.G. Taylor, 1993). Nonperforming loans could be recognized early from the violation of the terms of agreement by the borrower. When we see the context of Africa, the criterion for identifying non performing loans varies.

Some countries use quantitative criteria to distinguish between "good" and "bad" loans (e.g., number of days of overdue schedule payments), while others rely on qualitative norms (such as the availability of information about the client's financial status, and perspectives about future payments). However, the Basel II Commission emphasizes the need to evolve toward a standardized and internal rating-based approach. Accordingly, the Basel committee puts non performing loans as loans left unpaid for a period of 90 days as has been mentioned in the preceding paragraphs.

Under the Ethiopian banking business directive, non-performing loans are defined as "loans or advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advances in question (NBE, 2008)." It further provides that:

…, loans or advances with pre established repayment programs are nonperforming when principal and/ or interest is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity (NBE, 2008).

In addition to the above mentioned category of non- performing loans, overdrafts and loans or advances that do not have pre-established repayment program shall be non-performing when:

• The debt remains outstanding for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity;

• The debt exceeds the borrower's approved limit for 90 (ninety) consecutive days or more;

• Interest is due and uncollected for 90 (ninety) consecutive days and more; or for the overdrafts,

(i) The account has been inactive for 90 (ninety) consecutive days or

(ii) Deposits are insufficient to cover the interest capitalized during 90 (ninety) consecutive days or (iii) The account fails to show the 20% of approved limit or less debit balance at least once over 360 days preceding the date of loan review.

This is in accordance with the Basel rules. If a loan is past due for 90 consecutive days, it will be regarded as non- performing. The criteria used in Ethiopian banking business to identify non-performing loan is a quantitative criteria based on the number of days passed from loan being due.

The economic and financial costs of these impaired loans are significant. Potentially, these loans may negatively affect the level of private investment, increase deposit liabilities and constrain the scope of bank credit to the private sector through a reduction of banks' capital, following falling saving rates as a result of runs on banks, accumulation of losses and correlative increased provisions to compensate for these losses. These loans also have potential for reducing private consumption, and in the absence of deposit guarantee mechanisms to protect small depositors, can be a source of economic contraction, especially when coupled with declining gross capital formation in the context of a credit crunch caused by erosion of banks' equity and assets (Fofac, 2009). Generally, in developing and underdeveloped countries, the reasons for default have a multidimensional aspect. Various researchers have concluded various reasons for loan default. Literature categorizes determinants of NPL to macroeconomic and bank specific factors. George G (2004) states the fact that large number of the literatures indicates the linkage between the phases of the business cycle with banking stability.

2.7.1 Determinants of Nonperforming Loans

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

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

2.7.1.1 Macroeconomic Determinants of Non Performing Loans

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

George G (2004) states the fact that large number of the literatures indicates the linkage between the phases of the business cycle with banking stability. Macroeconomic stability and banking soundness are inexorably linked. Both economic theory and empirical evidence strongly indicate that instability in the macroeconomic is associated with instability in banking and financial markets and vice versa. The researches indicates that the expansion phase of the economy is characterized by a relatively low number of NPLs, as both consumers and firms face a sufficient stream of income and revenues to service their debts. However as the booming period continues, credit is extended to lower-quality debtors and subsequently, when the recession phase sets in, NPLs increase. (Fisher, 1933; Minsky, 1986; Kiyotaki & Moore, 1997; Geanakoplos, 2009).

A study conducted by Keeton and Morris (1987) on a sample of nearly 2,500 US commercial banks using simple linear regressions indicate that large portion of loan losses recorded by the banks ascribe to adverse local economic conditions along with the poor performance of certain sectors. Similar study by Sinkey and Greenwalt (1991) on large commercial banks in the United States from 1984 to 1987 by employing simple log-linear regression model and data also indicates that depressed regional economic conditions explain the loss-rate of the commercial banks. Other authors who looked at asset-price evidence also found a linkage between credit risk

increases and adverse macroeconomic conditions (Mueller, 2000; Anderson & Sundaresan, 2000; Collin-Dufresne & Goldstein, 2001).

Macro and banking stability are closely linked, so that what happens in one affects the other. The evidence for most countries suggests that, except where the banks are state owned or heavily state controlled, instability generally starts in the macro economy and spills over into the banking sector. The resulting banking instability, in turn, feeds back and amplifies the macro instability. Thus, to enhance overall stability in the economy, it is necessary both to pursue successful contra cyclical macroeconomic policy and to reduce the fragility of banking relative to the magnitude of macro shocks that may be expected in the particular economy (Tandon Committee, 1998). Summing up, the existing empirical evidence shows, quite convincingly, that favorable macroeconomic conditions, such as sustained economic growth, low unemployment and interest rates, tend to be associated with a better quality of bank loans; under favorable economic circumstances, borrowers receive sufficient streams of income and meet their debt obligations more easily. Furthermore, these results are robust to different empirical methodologies and hold across countries.

2.7.1.2 Bank Specific Factors causing Nonperforming Loans

Macroeconomic factors which are viewed as exogenous forces influencing the banking industry should not be sought exclusively in determining NPLs. In contrast, the typical nature of the banking sector along with the specific policy choices of a particular bank with regard to its efforts to maximize efficiency and improve in its risk management are expected to exert a vital influence on the evolution of NPLs. A few literatures have examined the connection between bank-specific factors and NPLs. Literature on bank specific determinants of nonperforming loans are reviewed in the section that follows.

2.7.1.2.1 Rapid Loan Growth

Studies indicate that loan delinquencies are associated with rapid credit growth. Keeton (1999) who used data from commercial banks in the United States (from 1982 to 1996) and a vector auto regression model indicate this association between loan and rapid credit growth. Sinkey and Greenwalt (1991) who have also studied large commercial banks in the US and found out that excessive lending explain loan –loss rate. Salas and Saurina (2002) who studied Spanish banks found out that credit growth is associated with non performing loans. Supply-side explanations of the expansion of bank loans frequently suggest a relaxation of underwriting standards, whereas loan contractions are said to suggest a tightening of standards. So with growth of loan size will come up poor loan performance ascribing to the relaxed underwriting standard.

2.7.1.2.2 High Interest Rate

Banks that charge high interest rate would comparatively face a higher default rate or non performing loans. Study by Sinkey and Greenwalt (1991) on large commercial Banks in US depict that a high interest rate charged by banks is associated with loan defaults. Rajan and Dhal (2003) who used a panel regression analysis indicates that financial factors like cost of credit have got significant impact on NPLs.

2.7.1.2.3 Credit Orientation

Financial sector development goes hand in hand with orientation of the public. Study conducted by Rajan and Dhal (2003) indicate that credit orientation significantly affects loan default rate as per their panel regression analysis conducted on commercial banks on India. 3.3.5 Bank Size Study by Cole et al. (2004) used data obtained from the 1993 Federal Reserve National Survey of Small Business Finance and bank financial reports, suggest that smaller banks adopt small business loan underwriting practices that are riskier than those of larger banks, riskier in that small banks prefer to lend to small firms that lack hard financial data to support the lending decision and riskier to the extent that the failure rates of small businesses are higher than those of larger, established firms.

2.7.1.2.4 Ownership structure

Hu et al (2006) analyzed the relationship between NPLs and ownership structure of commercial banks in Taiwan with a panel dataset covering the period 1996-1999. The study shows that banks with higher government ownership recorded lower non-performing loans. Walter and Werlang (1995) found that state-owned financial institutions underperform the market, because their portfolios concentrate on the non-performing loans indebted by the state.

2.7.1.2.5 Poor Loan Follow-up (Monitoring)

Regular monitoring of loan quality, possibly with an early warning system capable of alerting regulatory authorities of potential bank stress, is essential to ensure a sound financial system and prevent systemic crises. (Agresti et al., 2008).
There is a tendency by borrowers to give better attention to their loans when they perceive they got better attention .Some of the loans defaults ascribe to lower level of attention given to borrowers. Even where there are greater risks that the banks recognize, they only cause a loss after giving a warning sign (Machiraju). More banks lose money because they do not monitor their borrower's property, and fail to recognize warning signs early enough. When banks fail to give due attention to the borrowers and what they are doing with the money, then they will fail to see the risk of loss. The objective of supervising a loan is to verify whether the basis on which the lending decision was taken continues to hold good and to ascertain the loan funds are being properly utilized for the purpose they were granted.

2.7.1.2.6 Poor Risk Assessment

Risk, and the ways, in which it can be identified, quantified and minimized, is key concerns for a bank's management and its auditors when they are considering the need to provide for bad and doubtful loans. No loan is entirely without risk. Every loan, no matter how well it is secured, and no matter who is the borrower, has the potential to generate loss for the lender.
A bank, in considering whether to lend or not, takes into account the quality of a borrower which is reflected in, inter alia, its past and projected profit performance, the strength of its balance sheet (for example, capital and liquidity) the nature of and market for its product, economic and political conditions in the country in which it is based, the quality and stability of its

management and its general reputation and standing. It is important for the bank to know the purpose of the loan, to assess its validity and to determine how the funds required for the payment of interest and the repayment of capital will be regenerated.

The borrower's ability to repay a loan is of paramount importance. Ideally, the loan will be self-financing in that it will be repaid from the cash flow that the borrower is able to generate from employing the proceeds of the loan. A bank will often require security for a loan in the form, say, of a guarantee or mortgage, in which case it will be concerned about the value and title of that security. The decision to grant loan, however, should be based on the prospects and solvency of the borrower and a careful analysis of how the funds to repay the loan will be generated. In general, banks lack effective measures to identify, quantify and control the regional and industrial risk, constrained by obtaining historical data, decentralized information systems and immature portfolio management skills.

2.7.1.2.7 Lack of Strict Admittance Exit Policies

Under the influence of idea of pursuing market share excessively, banks do not establish detailed and strict market admittance policies, which undermine the first risk to prevent gate and weaken the orientation effect of admittance policies to market (Shofiqul Islam, 2005).

During pre-loan investigation, bank officers put little emphasis on authenticity and integrality review on related materials. They don't clarify the true intended usage of the loan (especially when extending short-termed credit) and the review is too optimistic, which does not analyze the potential influence of changes in related factors. There is also no deep review on the market, no enough understanding on enterprises' operation management situation, no thorough risk revaluation; inaccurate assessment, the risk of loans is not fully covered and the risk on group customers and affiliated enterprises are not identified effectively. The factors above damage the loans at the early stage (Brownbrige, 1998).

Furthermore, some banks neglect the fact that the loan procedures are not completed or detailed and the review materials are not enough; some operate in different procedures than the review materials, for instance, signing loan contract before approval of the loan, issuing letter of credit or bank acceptance before approval; consolidated credit is not fully realized, and credit to some group members is not included in the consolidated credit management.

Some extend credit against the rules, i.e. exceeding authority to offer loans, splitting one big number into several small pieces to avoid the authority constraint, issuing bank acceptance to fund enterprises on a rolling basis, or discount without actual trade background.
Most problems in this case relates with accepting guaranty from unqualified institutions, high loan-to-value ratio, providing loans without property registration and transfer of collateral, guaranty for each other between enterprises and legally flawed credit procedures etc. And there are also problems in which that the conditions of the loans are not satisfied and the contracts of loans are not completed.
Though the primary role lies on banks to evaluate their admittance and exit policies, they are subjected to the general laws of a country on banking business. In the Ethiopian Banking context banks are also required to submit reports to NBE on their loan disbursement as well as their outstanding and collected loans showing whether their lending procedure is according to the regulatory guidelines and laws. Thus failure to include strict admittance and exit policies and thereby provisions for accountability in the credit manual of banks would create a loop hole that would eventually lead to occurrence of loan default.
As discussed above, efficient banks and financial markets promote macro development.
This development leads to growth in overall economy and most countries work towards ensuring that development. Accordingly, ensuring sound financial system and creating efficient banks by reducing non- performing loans becomes important. Usually giving solutions to non- performing loans arises from identifying the probable causes for its creation.
Before proceeding to issues pertaining to research methodology in the next chapter, the paragraph that follows touch upon earlier studies made in Ethiopia on the subject of NPL.
Despite the fact that several studies were conducted by different researchers on the Ethiopian Banking sector, empirical studies on determinant of nonperforming loans could hardly be traced with exception of Zewudu (2010) who has indicated the relations between banks health (NPL) and lending. Zewudu also indicated in the study that NPL is also among the factors that are used as performance measurement of the sector in Ethiopia. However, the study was focused on performance measurement of banks that it lacked empirical evidence as to what caused occurrences of NPL. On the other hand Tihitina (2009) who studied legal problems in realizing nonperforming loans of Ethiopian Banks also highlighted major problems in realizing non performing loans in Ethiopian banks and solutions thereof. Tihitan's study also concentrated on

resolving NPL and as such issues of factors that because it was not subject of the research though theoretical review of some of the factors causing NPL were discussed.

CHAPTER THREE

1.1 RESEARCH DESIGN AND METHODOLOGY

3.1 Chapter Overview

This study aims to examine the determinants of NPLs in the commercial banks found in Ethiopia. Accordingly, this chapter discussed the research procedure that will be carried out in this study. It starts by discussing research design and approach followed by sampling design, source of data, data collection methods and instruments of data collection. The subsequent section presents and discusses method of data processing and analysis. Finally, it will describe the research measurement of validity, reliability and assess what ethical issues have to consider.

3.2 Research Design and Approach

According to Kotzar et al., (2005), research design is defined as the plan and structure of investigation and the way in which studies are put together. Cooper et al. (2003) also define research design as the process of focusing on the researcher's perspective for the purpose of a particular study. Leedy & Ormrod (2005) define a research methodology as a means to extract the meaning of data. Research design is a master plan specifying the methods and procedures for collecting and analyzing the required data. The choice of research design depends on objectives that the researchers want to achieve (John, 2007). Since this study was designed to examine the relationships between NPLs and its determinants, a logical reasoning either deductive or inductive is required. Deductive reasoning starts from laws or principles and generalizes to particular instance whereas inductive reasoning starts from observed data and develops a generalization from facts to theory. Besides, deductive reasoning is applicable for quantitative research whereas inductive reasoning is for qualitative research. Thus, due to quantitative nature of data, the researcher used deductive reasoning to examine the cause and effect relationships between NPLs and its determinants in this study.
As noted by Kothari (2004), explanatory research design examines the cause and effect relationships between dependent and independent variables Therefore, since this study was

examined the cause and effect relationships between nonperforming loans and its determinant, it is an explanatory research.

The objective to be achieved in the study is a base for determining the research approach for the study. In case, if the problem identified is factors affecting the outcome having numeric value, it is quantitative approach (Creswell, 2003). Therefore, the researcher employed quantitative research approach to see the regression result analysis with respective empirical literatures on the determinants of Nonperforming loans. Thus, the researcher used a panel data from 2011 to 2015 period. The purpose of this study is to identify and examine factors that determine the occurrence of default. As can be seen from the research problem it is more of explanatory type and tries to assess the relationship between occurrence of NPL and some bank specific factors.

In order to benefit from the advantage of quantitative and qualitative approaches, the mixed method has been in use for this study. It will constitutes assessment of the trend of Non-performing loans of the bank during 2011-2015, will assess the impact of non-performing loan on some bank specific factors during 2011-2015, identifying the causes for loans in becoming non-performing from both borrowers and lending institution side and identifying methods that are used by the bank in managing NPL and thereby reduces the existing size and volume of Non-performing loans of the bank. These five consecutive years would help to have a clear picture of the bank's trend of non-performing loan. To do so, the study will highly focused on both primary and secondary data.

3.3 Sampling Design

Sample design deals with sample frame, sample size and sampling technique. Sampling is a technique of selecting a suitable sample for the purpose determining parameters of the whole population. Population is the list of elements from which the sample may be drawn (John, 2007). A sample is drawn to overcome the constraints of covering the entire population with the intent of generalizing the findings to the entire population.

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

Therefore, the data for this study will be collected from six private commercial banks in the country, Awash international bank(AIB), bank of Abyssinia(BOA), Wegagen bank(WB), United bank(UB), Nib International bank (NIB) and Dashen bank(DB) are private banks that were registered before 2007/08 by NBE. To understand factors that would cause occurrence of loan default because of time and budget constraint to survey all the aforementioned banks a representative sample was selected based on their experience the six banks have in the industry, having large amount of loan outstanding which is viable to determine the cause of loan default and the number of professionals they employed.

This is due to the fact that since the primary aim of this study is to examine the determinants of nonperforming loans of commercial banks in Ethiopia, it is better to make generalization for the banking sector of the country based on data drawn from sample bank which is much more experienced in the industry. Further, lending is not a one night process rather it comes by making operation for some consecutive years since the bank should have to accept deposit to grant loans to reach stage of suffering from poor asset quality.
Thus, the researcher will use 5 years data of selected private commercial banks that provide financial statements consecutively from 2011-2015 periods. To this end, the sample size of this study is not less than specified sample size required for ones' study since the accuracy and validity of the works never guaranteed by increasing the sample size beyond specified limit. This is due to the fact that increasing the number of sample size beyond the specified sample size required for ones' study never add value to the accuracy of the study rather it made information unmanageable due to redundancy(Ayalew, 2011).That is why this study used six experienced private commercial bank in Ethiopia from eighteen banks in the country.

3.3.1 Target Population

Population is the list of elements from which the sample may be drawn (John, 2007).
For this research the target population was all banks registered by the National Bank of Ethiopia (NBE) and under operation before the fiscal year 2015/16. The cut off year was set due to the importance of experience in the industry to understand factors that would cause occurrence of loan default.

3.3.2 Sampling Frame

Accordingly, the commercial banks were classified into two clusters as private owned and stated owned banks. As of June of 2016; there are eighteen banks in Ethiopia. These are commercial bank of Ethiopia (CBE), Development bank of Ethiopia, which are state owned banks. Awash international bank(AIB), bank of Abyssinia(BOA), Wegagen bank(WB), United bank(UB), Nib international bank(NIB), Dashen bank(DB), Cooperative bank of Oromia, Lion international bank, Zemen bank, Oromia international bank, Buna international bank, Berhan international bank, Abay bank S.C, Addis international bank S.C, Debub global bank,S.C and Enat banks, which are private owned banks. However, from all the above listed banks, Development bank of Ethiopia is not Commercial bank (www.nbe.et).

3.3.3 Sampling technique

Accordingly, this study employed judgmental or purposive sampling technique to select the required sample of banks from the above listed banks since it is viable in line with time and funds available for this study. The selection criteria set by the researcher will first, the required banks are only private Commercial banks in Ethiopia. Second, those commercial banks should be senior banks which are more experience on the lending activities.

3.3.4 Sample size

Sample size is determined by time and budget of the researcher. Because of time and budget constraint, the sample will restrict to head offices, and bank branches residing in Addis Ababa. According to NBE (2008) 38 percent of bank branches and all head offices of banks which operate in Ethiopia found in Addis Ababa**.** The sample size for self-administered questionnaires will be 100 employees of banks and delivered physically to all targeted categories. Financial information of all banks collected from head offices of each bank and the NBE. In this regard financial data of the banks from the year 2010 to 2015 will be in used.

A total sample of 100 professionals working in private commercial banks related to credit and credit related operations were selected as part of the study. On average ten professionals were selected from each private bank.

3.3.5 Sampling procedure

From the list of the private commercial banks operating in Ethiopia by using the Judgmental or Purposive sampling technique the researcher select six private commercial banks as its sample size from their NBE list of the banks. The sample banks will be selected based on year of experience, size, and availability of data.

3.4 Sources of Data and Methods of data collection

There are two sources of data; these are primary source of Data and Secondary Source of Data, for this study both primary source of data secondary source of data will use.

Primary data will be collected through questionnaires distributed to respondents that involve Department Managers and Senior Officers working on loan processing. Such group involves Loan Officers, Credit Analysts, Credit follow-up and Monitoring officers, Credit Directors, Relationship Managers and Recovery/Monitoring Officers etc.

Secondary Data are directly will be gathered from records of each private commercial bank under sample study. The data to include aggregate loans outstanding balances, NPLs as at the annual closing date, June 30 of each year. For the purpose of comparison the surveyed banks' data for the years between 2010 and 2015 shall be collected and considered.

3.5 Data collection instrument

The survey will use a structured questionnaire and structured in-depth interview of the selected six private commercial banks. The self administered questionnaire will be delivered to the selected experts engaged in loan related activities. The first part of the questions will be designed to collect participants' profile (background information). The second part of the questions in the questionnaire will be related to the factors that determine loan default or occurrence of nonperforming loans. The third part will be designed in such a way that respondents rate factors that determine non performing loans in order of their importance when compared with other factors in the list.

In addition, the study will use documentary review. Specifically, the financial statements of banks surveyed along with their annual report and central bank's report will use. In this regard financial data of the banks from the year 2010 to 2015 will in use. Special emphasis will be given to data sources that provided the total assets, total loans and advances, deposits and respective non performing loan ratio of the banks surveyed.
The purpose was to review whether there is a relationship between bank size (measured in total asset, deposit and loans and advances) and NPL ratio. The documentary review is believed to boost findings in the questionnaire survey and in depth interview to be carried out.

3.6 Data analysis methods

The quantitative data analysis will include measure of central tendency and test of statistical significance. As measure of central tendency mean will be used. In connection to this, standard deviation of the respective analysis will be calculated to see the nature of the distribution, the variation among the responses. The values will be tested for significance level using one sample t-test. Inferential statistics will be used to analyze the quantitative data. Thematic and chronological analysis will be used in analyzing the qualitative data. Issues will be coded, grouped and analyzed thematically. Occurrences of events will be analyzed and presented following their chronological time.

3.8 Validity and reliability

3.8.1 Validity

Validity refers to the degree to which a study accurately reflects or assesses the specific concept or construct that the researcher is attempting to measure. Content, criterion-related, and construct validity of the survey instrument will be established. Content validity will show the extent to which the survey items and the scores from these questions are representative of all the possible questions about determinants of nonperforming loan in Ethiopia private commercial banks. The wording of the survey items will be examined by the assigned advisor and experts in each selected private commercial banks. This will help to assess whether the survey questions seem

relevant to the subject it is aimed to measure, if it is a reasonable way to gain the needed information, and if it is well-designed.

3.8.2 Reliability

According to Leedy & Ormrod (2005) reliability of a measurement instrument is the extent to which it yields consistent results when the characteristic being measured has not been changed. To ensure the reliability of measurement instrument the researcher will perform first standardize the instrument from one person or situation to another. Second specific criteria will be established to reduce subjective judgments.

3.9 Research Ethics

Due consideration will be given to obtain consent from each participant about their participation in the study. It was strictly voluntary. The researcher respected participant right and privacy. The findings of the research will be presented without any deviation of the reality. The researcher has given full acknowledgements to all the reference materials used for the study.

CHAPTER FOUR

4. SURVEY RESULTS AND DISCUSSION

4.1. Introduction

A structured questionnaire (Appendix I) was distributed to one hundred employees composed of loan officers, credit analysts, credit directors, relationship managers, recovery/monitoring officers and vice presidents in six private commercial banks selected randomly from all banks that are operational in Ethiopia.

The questionnaire was distributed in person to hundred employees (whose positions are related to bank lending). Out of 100 questionnaires 92 were completed and collected (see Table 1 below). As a result, the analysis is made on the valid number of responses. In some incidents analysis and explanation for amounts in the table are given only for most frequented and extreme figures.

Table 4.1 Survey response rate

Respondents	Size
Sample size	100
Completed and returned questionnaire	92
Response Rate	92%

Source: Survey outcome

Table 4.2 Number of Credit Department employees of the six selected commercial banks involved in the study.

S/N	**Banks**	**Date of Establishment**	**Quantity of Questionnaire Completed**	%	**No of Branches**
Private Commercial Banks					
1	Awash International Bank	1994	14	15.22%	202
2	Dashen Bank S.C	1995	18	19.56%	156
3	Bank of Abyssinia S.C	1996	14	15.22%	132
4	Wegagen Bank S.C	1997	12	13.04%	116
5	United Bank S.C	1998	18	19.56%	127
6	NIB International Bank S.C	1999	16	17.40%	105
	Total		92	92%	

Source: Bankers' Association (2014), Volume 1; Survey outcome and own computation

4.2. Profile of Respondents

Profile of the respondents like ownership of the banks they work for, banking experience and specific exposure in bank lending and positions held by respondents are presented and subsequently discussed as follows.

Table 4.3 Respondents by Category

Profile	Frequency	%
Private banks	92	100%
Total	92	100.0

Source: Survey outcome and own computation

In terms respondents profile, all of survey respondents are employed in private banks. Since the process of administration of loans and advances both in private and state owned banks is under taken in compliance with the National Bank of Ethiopia, Banking Supervision Directorate, directives results are comparable and similar results may not be affected variance in the mix of respondents will not have impact on the findings. As depicted above, all of (100 percent) of the respondents belong to the private banks.

Table 4.4 Position of respondents in their respective bank.

Positions	Frequency	%
Credit Relationship Managers	27	29.3
Credit Analysts	21	22.8
Credit Directors	12	13.0
Recovery/Monitoring Officers	10	10.9
Auditors	9	9.8
Loan Officers	6	6.5
Vice President - Operations	1	1.1
Others*	6	6.5
Total	**92**	**100.0**

** Others include: Executive assistant to CEO and Board of Directors,*

Source: Survey outcome and own computation.

As shown in Table 4.4 above, 27 (29.3 percent) of the respondents were Customer Relationship Managers while 21 (22.8 percent) were Credit Analysts and 12 (13 percent) were Credit Directors. The rest of the respondents belonged to other occupations like; Monitoring Officers, Auditors (who are not directly involved in credit operations) Loan Officers and the like.

Table 4.5 Respondents experience in the banking industry.

Experience in Banking Industry	Frequency	%
Less than one year	-	-
1 – 5 years	14	15.2
6 – 10 years	27	29.3
11 – 15 years	27	29.3
Above 15 years	18	19.6
Not Stated	6	6.5
Total	**92**	**100.0**

Source: Survey outcome and own computation

In terms of banking experience, the absolute majority (about 78 percent) of the respondents reported to have served the banking industry for more than 5 years, of which close to 50 percent were long-serving employees, having over 10 years of work experience in the industry. On the other hand, about 15 percent of the respondents had as short as one to five years of banking experience

Table 4.6 Bank lending experience of the respondents

Years of Experience in Loan Processing	Frequency	%
Less than 1 year	8	8.7
1 – 5 years	24	26.1
6 – 10 years	40	43.5
11 – 15 years	10	10.9
Above 15 years	4	4.3
Not Stated	6	6.5
Total	**92**	100.0

Source: Survey outcome and own computation

In terms of bank lending experience majority (59 percent) of the respondents had more than five years of experiences particularly in lending (or credit management) activities, of which 15 percent reported to have acquired more than 10 years of exposure in the area. The fact that such a majority of the respondents had ample experience in credit activities is believed to have impacted the dependability of the data quite positively.

4.3. Factors that Affect Bank Lending

Respondents were solicited to express their agreement or disagreement to certain statements dealing with bank-specific factors affecting occurrences of NPLs. As a result, 77.2 percent of the respondents agreed to the statement *Factors affecting occurrences of NPL are obvious* while 12.0 percent were neutral and 4.3 percent disagreed, and 6.5 percent left the question unanswered

Table 4.7 Factors affecting occurrences of NPLs are obvious

Job Occupation	Agree	Disagree	Neutral	Not Stated
Credit Relationship Managers	18	1	5	3
Credit Analysts	16	1	2	2
Credit Directors	11		1	-
Monitoring/Recovery Officers	8	1	1	-
Auditors	8		-	1
Loan Officers	5	-	-	1
Vice President - Operations	1	-		-
Others	4	1		1
Total	**71**	**4**	**11**	**6**
%	**77.2%**	**4.3%**	**12.0%**	**6.5%**

Source: Survey outcome and own computation

In section two of the structured questionnaire, respondents were expected to express specific factors they think causing NPLs pertaining to the Ethiopian banks. Responses are summarized in the following Table.

Responses were reflected in various ways. Respondents from each bank may reflect their own feelings, based on own policy and procedures in administrating credit facilities. The credit operation process may also take different approaches based on credit culture of each bank. However, expected responses were obtained from all the six surveyed banks. Most of the factors were shared by respondents of each bank. Table 4.8 below reflects common factors that contribute to the occurrence of NPLs. The fact that a particular factor is shared by the respondent bankers reflects how prevalent the cause could be in the banking industry as a whole. However, the response calls for further study to further scrutinize the real causes behind

Table 4.8 Factors considered causing occurrences of NPLs in the Ethiopian banks

Factors	No of Banks	BOA	UB	WB	DB	NIB	AIB
Absence of wise & sound lending practice	*5*	✓	✓	✓	✓		✓
Borrowers‟ poor business knowledge/managerial skill	*3*	✓	✓		✓		
Character & credit culture of borrowers	*4*		✓	✓	✓		✓
Unavailability of complete & correct data for analysis	*4*	✓	✓	✓			✓
Diversion of fund	*5*	✓		✓	✓	✓	✓
Economic conditions & policy	*5*	✓	✓	✓	✓		✓
Poor credit risk analysis/appraisal	*6*	✓	✓	✓	✓	✓	✓
Market factors	*2*			✓			✓
Over/under financing	*2*			✓	✓		
Weak/inadequate follow-up & monitoring of loans	*6*	✓	✓	✓	✓	✓	✓

Source: Survey outcome and own computation

According to the data on Table 4.8 above, *poor credit analysis/appraisal and weak/inadequate follow-up & monitoring of loans* appeared to be the factors shared by all the surveyed six banks,, while factors like *economic conditions* and *policy*, *diversion of fund and* Absence of wise & sound lending practice were shared by the overwhelming majority of the respondents in private owned banks to be the major causes for occurrences of NPLs in the Ethiopians banks. Moreover, Character & credit culture of borrowers and Unavailability of complete & correct data for analysis were considered to be causes of NPLs by most of the respondents.

Further, respondents were also expected to rank factors causing NPLs in the Ethiopian Banks in order of importance (from 1st/highest to 8th/lowest), as tabulated under Table 4.9 below.

Table 4.9 Ranking of factors affecting occurrences of NPL in the Ethiopian banks.

Factors	1st	2nd	3rd	Sub-Total	%	4th	5th	6th	7th	8th	Total
Rapid Loan growth of banks	4	4	4	12	13.3	9 23	23 17	17 8	8 21	2190	90
High interest rate	5	1	7	13	14.4	10	13	16	13	25	90
Lenient/Lax credit terms	7	7	14	28	32.2	18	15	11	8	7	87
Credit culture/ Orientation	15	16	21	52	56.5	18	9	5	3	5	92
Size of the Bank	1	1	3	5	5.7	4	10	21	27	21	88
Poor monitoring/follow up	26	31	16	73	79.3	12	4	2	-	1	92
Ownership type of bank	4	6	5	15	17.0	3	8	11	12	39	88
Poor risk assessment	48	19	9	76	83.5	3	3	3	3	3	91

Source: Survey and own computation

The survey result indicated that *poor risk assessment* (83.5 percent), *poor monitoring and follow-up* of loans and advances ((79.3 percent), as the top ranking factors causing occurrences of NPLs followed by *credit culture/orientation* of borrowers to credit facilities (56.5 percent). The survey results further reflected that the contribution of such factors as *size of bank*, *rapid loan growth of banks, high interest rates* and *ownership type of bank* to occurrences of NPLs is quite minimal, varying from as insignificant as 5 to 13 percent, in the order mentioned.

The following table (Table 4.10) shows the relationship between *credit assessment* and *occurrences of NPLs*. About 98.8 percent (mean 4.6, standard deviation 0.52) of respondents agree that *poor risk assessment* would lead to *loan default* while, in conformity to this, 96.5 percent (mean 4.6, standard deviation 0.60) of the respondents share the opinion that proper implementation of *know your customer (KYC)* principle leads to *high loan quality.*
On the other hand, 71.6 percent (mean 3.6, standard deviation 0.52) of the sample respondents agree that *good loan processing* ensures *conducive loan performance*, while on the contrary, majority (58.3 percent) of the respondents do not share the opinion that *easily admitted borrowers usually default.* Needless to mention that the purpose of this question was to see if

simplicity in customer admittance could involve rush into credit decision, without adequate appraisal of the business as well as the character of the borrower. However, as majority of the respondents reported otherwise, the possible justification for this is that banks usually recruit high-value potential customers (in most cases from competitor banks) on the basis of the customers‟ established goodwill and then process/deliver the loans in a very short period of time (without compromising analytical quality) so as to show them their excellence in service delivery time. Thus, this finding doesn't support the assertion of Brown Bridge (1998) who stated that easily admitted customer's loan would be damaged at the early stage.

Table 4.10 Factors on relation between credit assessment and occurrences of NPLs.

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Easily admitted borrowers usually default	10.7	30.9	32.1	22.6	3.6	3.2	1.13
Know your customer (KYC) policy of banks leads to high loan quality.	62.8	33.7	2.3	1.2	-	4.6	0.60
Good loan processing ensures conducive loan performance	18.5	53.1	22.2	5.0	1.3	3.6	0.52
Poor risk assessment would lead to loan default	59.3	39.5	1.2	-	-	4.6	0.52

Source: Survey and own computation

Further, the importance of employment of know-your-customer (KYC) principle cannot be overemphasized. Respondents agree that banks that employ a stout KYC policy would maintain better loan quality. Such information includes the prospective borrower's business and financial management, organizational setup, credit history or overall track record, and complete profile. Proper review of documents obtained from applicants, including the information inquiry report is quite essential so as to ensure the extent to which the information collected is credible. Obviously, when the loan undertaking is poor, the probability of default is high.

Table 4.11 Factors on relation between credit monitoring and occurrences of NPLs

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Strict monitoring ensures loan performance.	33.3	60.6	4.8	1.3	0.0	4.2	0.88
Poorly assessed and advanced loans may perform well if properly monitored.	3.6	30.1	20.5	39.8	6.0	2.8	1.15
Loan follow up is directly related to occurrence of NPLs	13.1	40.4	20.3	21.4	4.8	3.3	1.20
Banks with higher budget for loan monitoring have lower NPLs.	5.9	39.3	33.4	17.8	3.6	3.2	1.06

Source: Survey and own computation

From the above table (Table4.11) one can conclude that *strict loan monitoring* ensures *commendable loan performance* as asserted by nearly 94 percent (mean 4.2, standard deviation 0. 88) of the times. What is more, close to two-third (6.0%+39.8%+20.5%) of the respondents do not agree with the assertion that *loans and advances might perform well if properly monitored* despite inadequate assessment during sanctioning, indicating that loan follow-up can never substitute prudent credit assessment. Additionally, 53.5 percent (40.4+13.1) of the respondents (with mean 3.3, and standard deviation 1.2) agree that *occurrence of NPLs* is directly related to *loan follow-up*. Should effective follow-up of loans and advances be in place good asset quality is maintained. On the other hand, only 45.2 percent agree that banks with higher budget for loan monitoring have lower NPLs while about one-third of the respondents remain neutral.

Table 12 below shows opinion of respondents regarding the relationship between collateralized loans and occurrences of NPLs.

Table 4.12 Factors on relationship between collateralizing loans & occurrences of NPLs

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Collateralized loans perform well	4.7	39.5	24.4	30.2	1.2	3.2	0.96
Collateralizing loans helps protect loan default	11.6	55.8	14	18.6	0	3.6	0.92
Most of the time non - collateralized loans default	2.3	23.3	33.9	38.2	2.3	2.8	0.94

Source: Survey outcome and own computation

The survey results indicated that 67.4 percent of the respondents were having the view that *collateralizing loans helps protect loan default*, while only 44.2 percent and 25.6 percent agree with the statement that *collateralized loans perform well*, and that most of the time *non-collateralized loans default*. On the contrary, 74.4 percent (33.9%+38.2%+2.3%) and 55.8 percent (30.2%+24.4%+1.2%) of the survey respondents *disagree* or were *neutral* to the assertion that *collateralized loans perform well* and *non-collateralized loans usually default,* respectively. According to the survey I made the relation between NPLs and collateral has no relation so far in view of the respondents.

With regard to relationship between *borrowers' orientation/culture* and *loan performance* (Table 13), about 91 percent of respondents agree with the assertion that *loan performance* is related to *orientation/culture of a society*. This indicates strong relation between culture/orientation and occurrences of NPLs.

Table 4.13 Relationship between borrower's orientation and occurrence of NPLs

Factors	**Strongly Agree** (5) %	**Agree** (4) %	**Neutral** (3) %	**Disagree** (2) %	**Strongly Disagree** (1) %	**Mean**	**Std Dev.**
Borrower's orientation/ culture is related to loan performance	24.1	61.5	12.0	2.4	0.0	3.9	1.00
Default in some areas is ascribed to the culture of the borrowers‟.	11.9	67.9	15.5	4.8	0.0	3.8	.89
Society's cultural development leads to good lending performance	25.6	65.1	7.0	2.3	0.0	4.1	.64

Source: Survey outcome and own computation

Moreover, 85.6 percent of respondents have the opinion that there existed relationship between *borrowers" culture* and *loan default*. It could also be noted that 79.8 percent of respondents believed loan default in some areas is ascribed to the culture of the borrowers. The following table (Table 14) indicates that only 12.8 percent of the respondents *agree* with while 87.2 percent disregard the assertion that *loan with big interest rate tend to turn to NPLs*. In other words, charging big interest rate doesn't necessarily lead to loan default.

Table 4.14 Relationship between Cost of Loan and Loan Default

Factors	**Strongly Agree** (5) **%**	**Agree** (4) **%**	**Neutral** (3) **%**	**Disagree** (2) **%**	**Strongly Disagree** (1) **%**	**Mean**	**Std Dev.**
Loan with big interest rate tend to turn to NPLs.	2.3	10.5	46.5	37.2	3.5	2.8	0.80
Loan price affects loan performance.	2.8	31.2	35.9	30.1	0	3.0	1.00

Source: Survey outcome and own computation

However, 34 percent of the respondents agree with the statement that loan price affects loan performance. The average responses to all three factors were close to neutral.

The following table (Table 15) indicates factors related to cost of loan and default.

Table 4.15 Credit Terms and Loan Performance

Factors	**Strongly Agree** (5) **%**	**Agree** (4)%	**Neutral** (3) **%**	**Disagree** (2) **%**	**Strongly Disagree** (1) **%**	**Mean**	**Std Dev.**
Borrowers default because they don't understand credit terms well	2.3	25.6	34.3	35.5	2.3	2.9	0.94
Poorly negotiated credit terms lead to non- performance	10.5	76.7	8.1	4.7	0	3.9	0.61

Source: Survey outcome and own computation

Slightly above 87 percent of the responses *conform* to the fact that there is a relationship between *loan default* and sincerity of *negotiation in credit terms* set by the banks during loan processing. On the other hand, about 72 percent of the respondents *do not agree* with the statement that *borrowers default because they don't understand credit terms well.*

Table 4.16 below tabulates the relationship between credit growth and volume/ratio of NPLs.

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Aggressive lending leads to large NPLs volume/ ratio	11.7	60.0	13.0	15.3	0.0	3.6	.96
Bank's increased risk appetite is cause for NPLs	4.8	58.7	18.8	16.5	1.2	3.5	.94
Compromised integrity in lending leads to loan default	17.8	57.2	17.8	7.2	0.0	3.8	.98

Source: Survey outcome and own computation

Looking at the responses on the relationship between credit growth and occurrences of NPLs, 75 percent of the respondents *agreed* that *compromised integrity in lending leads to loan default*, while nearly 72 percent were of the opinion that *aggressive lending leads to occurrences of large NPLs volume/rate*. Similarly, about 64 percent of the respondents believed *bank's increased risk appetite* would cause *occurrences of NPLs.* The survey results indicate that when banks follow aggressive lending strategy and experience rapid credit growth they might end up with mountainous of NPLs.

Table 17 below is about relationship between bank size and occurrence of NPLs.

Table 4.17 Bank size and occurrence of NPLs

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Having large number of borrowers causes loan default	2.3	14.2	30.5	51.8	1.2	2.6	0.87
Loan default rate is directly related to bank size	1.2	14.0	29.0	51.1	4.7	2.6	0.84

Source: Survey outcome and own computation

The survey responses on the relationship between having *large number of borrowers* and *bank's size* indicate that *neither* of them is significant factor for the occurrence of *loan default,* as only 16.5 percent and 15.2 percent have agreed to the contrary.

Finally, Table 18 below attempts to see if there is a relationship between type of bank ownership and occurrence of NPLs.

Table 4.18 Bank ownership type and occurrence of NPLs

Factors	Strongly Agree (5) %	Agree (4) %	Neutral (3) %	Disagree (2) %	Strongly Disagree (1) %	Mean	Std Dev.
Loan default is not related to banks ownership type (Private/ State Owned)	20.9	36.0	20.9	20.9	1.3	3.5	1.11

Source: Survey outcome and own computation

The survey results indicate that about 57 percent of the respondents agree that loan default is not related to banks ownership type. However, 20.9 percent of them remained neutral, while 22.2 percent disagree.

4.4 In-depth interview

In order to get deep understandings about the factors affecting nonperforming loans, in-depth interview was conducted with senior bank officials. All of the interviewees have had over 14 years credit experience in addition to their several years of banking experience. In terms of profile, a president, credit vice presidents, senior credit committee members participated. The interviewees were from private, state owned and central banks. Some of the interviewees were not from banks that were covered by the survey conducted. The respondents have so many in common as to what they believed cause occurrence of nonperforming loans.

The section that follows present factors believed to cause occurrences of NPL by the interviewees. Besides, the factors that are thought to be most critical for the occurrences on NPL are pinpointed. In addition, factors that ascribe to the very nature of the Ethiopian banking industry contributing to the NPL occurrence are specifically presented.

4.4.1 Factors believed to cause occurrences of NPL by the interviewees

Respondents indicated that several factors contribute to loan default. As per the outcome of the interview the factors can be categorized as banks' internal situations, the external environment and borrowers related. The factors are organized and presented under the respective subtitles.

4.4.1.1 Banks internal factors

These are factors relating to internal inefficiencies due to systems, governance, human resource issues and the related. Under theme this most of the interview participants raised the following issues:

- Bankers lack of integrity,
- Terms and condition not being set properly,
- Credit analysts capacity limitation,
- Banks aggressive lending to maximize profit,
- Not conducting Know your customers (KYC) principles properly before lending,
- Over trading/over financing,
- Not understanding and seeing critically the macroeconomic environment,
- Excessive lending by banks on a particular sector – poor portfolio diversification,
- Poor collateral valuation,
- In adequate institutional capacity – in terms of risk selection,
- Policies that failed to consider the macroeconomic environment,
- Poor monitoring and follow up
- The credit approval process not being prudent and failing to comply with the existing bank policies,
- Inadequacy of credit risk management-from identifying, measuring and monitoring
- Governance problems associated with loan administration.
- Poor or no management information system (MIS),
- Absence check and balance-in loan processing, follow up and monitoring

4.4.2 Factor that are uniquely associated to Ethiopian banking context

Responses of the interviewees on factors they believed were very peculiar to the Ethiopian Banking environment and have significant bearing on occurrences of loan default are organized in the following manner.

- Inadequacy in the capability of employees remain one of the main challenge of the Ethiopian Banking industry which as a result would lead to compromise on loan underwriting standard that in turn have a huge bearing on loan performance,
- Regulatory environment- introduction of credit cap earlier by the central bank ; borrowers think they may not get back a loan and fail to perform,
- External influence – the change of the national economic policy from command to market led had impact earlier despite the fact that 25 years seems long time the industry still threatened by external influence.
- Absence of blacklisting of defaulters at a national level. This would have served as a deterrent factor helping protect loan default,
- Excessive dependency on collateral – if financing is based on the business of the company borrowers may not default as source of repayment would be properly ascertained before advancing loans,
- Cultural under development- weak credit culture. There is an Ethiopian proverb that says “A borrower or a lender might die” which would encourage loan default.
- The environment being unsupportive – Policy, rules and regulation (macroeconomic policy).
- Unfair industry competition among banks- endangering banks not select goo customers. Sometimes non performing loans of other banks are bought by other banks.
- Limited capacity of the central bank’s supervision capability,
- Interventions and influences- operators at times lack professional independence,
- Underdevelopment of institutional capacity of banks in general and human resource in particular,

4.5. Discussion of Findings

The general objective of Banks is to deliver efficient and customer focused domestic and international banking services with the aim of attaining customer satisfaction and fostering sustainable growth and profitability. All these banks give different kinds of services; among which credit provision is the major one as it is the core function of commercial banks. It is commonly said that the successful banker is the successful lender.

With regards to lending, banks give different kinds of loans. These include term loans (short, medium & long term), over draft facilities, revolving credit, real estate loans, consumer loans, agricultural loan, import and export loans etc. It is noted that when a bank lends to a customer there are principles that should be considered; i.e., safety, liquidity, effective utilization of loan proceeds, profitability and diversification of advances. Even if the procedures of loan processing differ from one bank to another, in general, lending procedures include: primary discussion with the customer, processing the credit application, interview, site visit, credit information, credit investigation, credit analysis and credit decision making.

The health of commercial banks often is measured by the amount of sick loans they have in their books. The regulatory agency in particular requires the banks to put provision against these types of loans and in order to protect the huge public fund with them. When the amount of provision put aside by banks is declining, this partly indicates an improvement in their loan collection. On the other hand, when the provision put by banks are increasing; it indicates their NPLs are on the rise.

The following points are drawn as conclusion based on the analysis made on primary and secondary data and the findings about problems of NPLs.

As has been stated in chapter one, the study has intended to identify causes behind the unpaid loans that literally exist in six private Commercial banks and formulated seven specific questions (one major question and six sub-questions) to help achieve the broad objective to identify determinants of NPLs, including relationship among credit assessment, credit monitoring,

collateralized lending, borrower's orientation, and credit growth vis-à-vis occurrences of NPLs. In respect of the factors affecting NPLs, the subjective questions in the survey identified factors such as poor credit assessment and monitoring, culture/orientation, banks credit terms, aggressive lending, compromised integrity, and economic condition attribute to the causes of loan default. Further, the research questions stated under the "Statement of the Problem and Research Questions" (Chapter 1) were formulated to contribute meeting the general objective of the research.

Factors are further investigated as follows.

Factors (specific determinants) affecting occurrences of NPLs

The study analyzed each factor that has impact on occurrences of NPLs. Bercoff et al (2002) indicated that NPLs are affected by both bank specific factors and macroeconomic factors. Focus of this study being banks specific determinants of NPLs, the findings in light of related literature are discussed.

Substantial number of respondents believed that poor credit analysis on the part of lending banks and unsound lending practices are major causes behind unpaid loans (Table 8). Failure to consider credit worthiness of borrowers, truck record, proven integrity, applicants' management profile etc before admitting new customers indulge to recruiting borrowers with poor track record, inadequate business management, excessively risk venture that would eventually lead to poor credit performance.

Credit assessment and occurrence of NPLs

The survey also indicated that poor risk assessment would lead to loan default. Credit analysis constitutes the critical phase of bank lending process. Credit facility requests are analyzed by assessing the five Cs - Character, Capital, Collateral, Capacity and Condition. Thus failing to carry out proper risk assessment would lead to missing any or all of the mentioned issues, which has the potential for the occurrences of NPLs (Table 10). Ning (2007) indicated the impact of poor risk assessment on loan quality. Furthermore, the survey results indicate the fact that banks pursue strong KYC principle lead to high loan quality. The fact that banks pursue a loose KYC

before admitting a new customer indulge them to recruiting a borrower with poor track record, inadequate business management, excessively risky and/or unviable venture that would eventually led to poor credit performance. The results do not support the statement of Brown Bridge (1998) who stated that easily admitted customer's loan would be damaged at the early stage. The outcomes of the in-depth interview support this view.

Relation between credit monitoring and NPLs

The importance of regular monitoring of loan quality, Agresti et al. (2008) stated that it would help insure a sound financial system and there by prevent systemic risk that otherwise would lead to loan default. This survey also confirmed the stated study as 94 percent of the respondents indicated agreement (Table 11) to the assertion that strict monitoring of loans and advances ensures performance and poorly assessed and advanced loans may fail to perform well even if properly monitored. Thus failing to properly monitor loan would lead to loan default.
Since the "know-Your-Customer"(KYC) principle needs constant updating, proactive management of credit risk before serious problems arise is the hallmark of credit monitoring. Its objective is to verify whether the advanced loan does not deviate from terms and conditions of approval and utilized for the purpose they were granted. All involved in the credit processing ought to be alert to sick signals, such as, deterioration in the key financial indicators of the borrowers, lack of management on the part of management, sluggish periodic loan repayments, frequently bounding cheques etc. If loans are not paid as and when due, credit risk is involved on reducing the value of the bank's business. In order to continue lending the banks must be able to collect their outstanding loans on time. Once funds are disbursed the concerned banks cannot afford to rest on their laurels and expect all payments to come in on the due dates without problem. Hence, in order to minimize the occurrence of bad loans every effort of follow-up must be carried to the utmost degree and take timely action when necessary. The survey results also indicated that 52.3 percent of the respondents agree that occurrence of NPLs is directly related to loan follow-up. Effective loan follow-up need to be in place should good asset quality is maintained. Loan follow-up involves confirmation of repayment of currently maturing debts but also continuity of repayments for loans duration. Under physical follow-up existence and operation of the borrowers' business is ensured. Whether the end use of the borrowed fund is according to the purpose for which the loan was granted should be ascertained by financial

follow-up. To protect the interest of lending banks, ensure legal recourse is available at all times legal follow-up should be put into effect. Survey results indicate that banks that incur big cost for loans follow-up would have comparatively lower NPLs. Otherwise borrowers would be tempted to divert the fund to other purposes, as was also learnt through the in-depth interview. Thus failing to monitor loans would lead to default.

Relation between collateralized loans and NPLs

Collateral refers to assets that the Bank holds to mitigate default risk. It is a security that a borrower gives to a Bank to guarantee repayment of a loan. It depends on the Bank's policy that all loans shall be backed by acceptable collateral. It is a second way-out and it should never be a substitute for credit worthiness, which is the existence of adequate cash flow to repay the loan. Security is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003). In the banking environment, security is required among others, to ensure the full commitment of the borrower, to provide protection should the borrower default from the planned course of action outlined at the time credit is extended, and to provide insurance should the borrower default.
The survey results indicated that quite majority (67.4 percent) of the respondents are of the view that collateralizing loans helps protect loan default while, on the other hand, a significant majority (74.4 percent) and (55.8 percent) of the survey respondents disagree or were neutral to the assertion that collateralized loans perform well or non-collateralized loans usually default, respectively (Table 12).

Impact of Borrowers' orientation/culture and NPLs

The fact that the respondents who agree with the assertion that: society's cultural development also leads to loan performance, the borrowers‟ culture/orientation is related to loans performance, and default in some areas is ascribed to the culture of the borrowers - constitute over 90.7 percent, 85.6 percent, and 79.8 percent, respectively, indicates existence of strong relationship between each of these factor and NPLs (Table 13). The in-depth interview also confirmed the outcome of the survey and earlier studies.

Cost of loan and loan default

Study by Greenwalt (1991) and Rajan and Dhal (2003), Waweru and Kalini (2009), Berger and DeYoung,(1997), Jimenez and Saurina (2006), Quagliariello,(2007) Pain, 2003, Bikker and Hu, (2002) indicated that high interest rate charged by banks is associated with loan defaults. This study fails to support this finding as 87.2 percent of the respondents disagree or remained neutral to the assertion that loans with big interest rate would turn to default. Majority (67 percent) of the respondents also expressed disagreement became indifferent to the statements - charging big interest rate and loan prices affect loan performance (Table 14). None of the interview participants believed that interest rate is related to occurrences of loan default in the Ethiopian context.

Credit terms and loan performance

Researches indicate that failure to put appropriate credit terms and conditions would lead to loan default. Rajan and Dhal (2003) who studied the Indian commercial banks found out that terms of credit determines occurrences of NPLs. Jimenez and Saurina (2005) also stated that NPLs are determined by lenient credit terms.

Consistent with this, 87.2 percent of the respondents expressed their agreement to the assertion that poorly negotiated credit terms lead to loan default. However, 72.1 percent of them expressed disagreement or indifference to the statement that borrowers default because they don't understand credit terms well (Table 15). Same has been confirmed by interviewee participants. Bank managers at times indulge in a moral hazard that they grant loans to those who don't meet the criteria set. Such loans would hardly be repaid.

Relationship between credit growth and NPLs

Salas and Saurina (2002) who studied Spanish banks found out that credit growth is associated with NPLs. As far as the survey results are concerned, the concentration of respondents who attributed occurrence of NPLs to: compromised integrity, aggressive lending and banks‟ increased risk appetite constitute - 75 percent, 72 percent and 64 percent of the sample respondents (Table 16). Nor did the in-depth interview confirm the literature in this line.

Bank size & ownership type and NPL

Studies of Rajan and Dhal (2003), Salas and Saurina (2002), and Berger and De Young (1997) indicated that banks size have significance on occurrence of NPLs. The survey results, however, did not support these studies of other countries. About 85 percent and 84 percent of the respondents express their disagreement to the statements that occurrence of NPLs is attributed to bank size and number of borrowers respectively (Table 17). On the other hand, type of ownership of a bank is supposed to impact occurrence NPLs as reported by majority (56.9 percent) of the respondents, 21 percent remaining neutral (Table 18). Interview response by few indicate that willful defaulters might hesitate to default at state owned banks while others did not see of any association between loan default and ownership type.

4.6. Summary of Major Findings

The study conducted survey of banks' employees (using self administered questionnaires) and unstructured interview. The survey was conducted on 92 employees of 6 banks (private owned). The data were collected using self administered questionnaire. The feedback yielded a response rate of 92 percent. In terms of experience, 85 percent and 65.2 percent of the respondents had over five years of lending and banking experience respectively. In response to specific factors causing occurrences of NPLs, the results indicated that poor credit analysis and weak/inadequate follow-up & monitoring of loans was shared by all banks, followed by economic condition, diversion of fund and Absence of wise & sound lending practice. Regarding ranking factors affecting occurrences of NPLs in Ethiopian banks, poor risk assessment, and poor monitoring and follow-up and credit culture/orientation of borrowers were rated to be the top three critical factors causing loan default.

Nearly all respondents (98.8 percent) agreed that prudent credit assessment leads to high asset quality, followed by strict employment of KYC principle (79.3 percent). Around 94 percent of the respondents agreed that strict loan monitoring and follow-up ensures conducive loan performance and. On the other hand, quite majority of the respondents were of the opinion that holding collateral backup helps protect loan defaults. The response on the relation between loan pricing (interest rate) and occurrences of loan default depicted that 87.2 percent disagree that loans with big interest rate tend to turn to NPLs. With regard to the impact of culture on

occurrence of NPLs, 91 percent and 85.6 percent of the respondents agree that loan performance depends on orientation/culture of the society and the borrowers respectively. Respondents asserted that there is a cause-and-effect relationship between sincerity of negotiation in credit terms and occurrence of NPLs. Respondents also agreed to the assertion that aggressive lending increased risk appetite and compromised integrity lead to loan default. However, results indicate that factors like size and ownership of a bank has no significant impact on occurrences NPLs. An in-depth interview wherein senior executives in the Ethiopian banking sector were interviewed indicated that the critical factors causing occurrences of nonperforming loans include : poor credit analysis by banks, borrowers lack of knowledge entrepreneurship gap (engaging in unstudied business and management capability limitation), lack of competency of credit operators, not keeping apt with national and global business environment by banks and borrowers ,compromised integrity of credit operators, poor monitoring and follow up of loans by lending banks and limitations in the policy environment (Central bank's and others).

CHAPTER FIVE

5. CONCLUSION AND RECOMMENDATIONS

5.1 CONCULUSION

When a bank disburses a loan, the loan may not be collected because of many factors and those uncollected loans are said to be NPLs or bad loans. All commercial banks render different kinds of services; among which provision of credit is the major one as bank lending is the core function of commercial banks. It is commonly said that the successful banker is the successful lender. It is also noted that when a bank lends to a customer there are principles that should be considered in terms of safety, liquidity, effective utilization of the fund, profitability and diversification of investment and business. Even if the procedures of loan processing differ from one bank to another, in general, the procedures include: prior discussion or interviewing the customer, site visits, processing the credit application, gathering of credit information, detail credit analysis and appraisal, credit decision making, contact signing, registration of collaterals (is applicable), and then disbursement .

Non Performing Loans are serious problem that need to be accorded careful attention. A loan is identified and segregated as non-performing depending on the number of days a repayment is delayed or discontinued. According to National Bank of Ethiopia's Directive No SBB/43/2008 Asset Classification and Provisioning Directive, *Non-performing* means loans or advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with contractual repayment terms of the loans or advances is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity.

The broad objective of this research was to identify bank specific determinants of nonperforming loans. Based on the broad objective a number of specific research questions were developed.

To achieve this broad objective, the study used mixed research approach. More specifically, the study used survey of employees of banks and unstructured interview of senior bankers. The results showed that, based on the respondents' view it was evident that most likely factors that

affect occurrences of nonperforming loans in Ethiopian banks are presented in the paragraphs that follow.

The study indicated that poor credit analysis on the part of lending banks, unsound lending practices, failure in loan monitoring and follow-up, borrowers' undesired culture, compromised integrity, fund diversion, and the like are the major causes behind NPLs.

In-depth interview also indicated that underdevelopment of supervisory authority competence in formulating policies, monitoring capability also ascribe to occurrences of nonperforming loans earlier.

On the other hand the study did not support the existing literature that state occurrences of NPL is related to bank's size, interest rate banks charge and ownership type of banks (private/state owned).

5.2 RECOMMENDATION

The resultant effect of a business organization is measured in its monetary achievement /profitability and efficient management. The greater extent of its success depends on the efficient management of its financial resources. Thus management of finance in credit area is a very sensitive and complex issue in the operation of banks where one should be well aware of minimizing risk in the course of administering loans and advances. As deposits of banks are usually payable on demand or on a short notice, banks should also limit the time for which loans are granted and ensure that they are repaid within that period of time.

Lending banks should be aware of the dangers involved in maintaining bad loans in their books of accounts and make advance preparations as to how disbursed loans should be collected timely. Collection plans are not to be initiated after approval or disbursement. It has frequently been said that a good banker collects a loan at the time of its disbursement; meaning - a loan properly analyzed and scheduled at the outset is virtually self-servicing.

Administration of loans involves the entire process starting from credit application to final resolution. Therefore, lending banks need to develop and put in place prudent credit processing, encompassing appropriate exercise of KYC for proper customer selection and assessment of credit worthiness of borrowers. Robust credit analysis from the point of view of what contribution the loan will yield to the customer's business, to the bank's income/profit as well as to the overall economic development of the country needs to be accorded earnest concern of the pertinent stakeholders.

In order to maintain asset quality banks should:

- Provide training and development to employees involved in credit operations to enhance the aptitudes and abilities of every member,
- Put in place a clear policy framework and working procedures that effectively address the issues of KYC,
- Develop and put in place framework for the entire credit management process and set objectives, standards and parameters to guide credit personnel in the overall credit processing.

- Institute proper loan processing, and essentially prudent analysis and appraisal system,
- Put in place proactive follow-up and monitoring system to monitor loan performance and check continued viability of operations,
- Develop and implement corporate code of conduct, fraud prevention policy, and proper check-and-balance in credit decision making processes, and
- Identify early warning signals, if any, and initiate remedial measures thereby averting loss from possible default,
- Exert effort to develop borrowers‟ culture towards credit, and to shape employees involved in credit operations towards ensuring integrity, making them free of undesired internal and external pressures.

1.1 Recommendations for further studies

- Macroeconomic determinants of nonperforming loans

The focus of this study was bank specific determinant of nonperforming loans, it is, therefore, recommended that a similar study be conducted on macroeconomic determinants of nonperforming loans.

- Bank specific determinants of NPL

  In addition, assessing the statistical relationship between all bank specific factors and nonperforming loans in Ethiopia could be a future research agenda.

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ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

MBA PROGRAM

Thank you very much for your willingness to take time to respond to this research questionnaire. The study is being conducted by a postgraduate student at St. Mary's University School of Graduate Studies, MBA General Management Program.

It is all about questions pertaining to **Determinants of Non-performing Loans** in the Ethiopian banks. To this end, it intends to gather information from pertinent bank employees involved in credit and related activities (i.e.; credit managers, analysts, recovery/monitoring officers, risk management officers, credit committee members .. etc).

The participation is fully on voluntary basis, and your accurate and frank responses are imperative for the successful accomplishment of the study.

Please be assured that your responses will be treated in a strictly confidential manner, and the results will be used only for the purpose of this research, presented only at aggregate level without focusing on individual bank.

Kindly, therefore, return the questionnaire upon completing each item appropriately. Thank you in advance. Respectfully;

Frezer Ayele

Appendices

QUESTIONNAIRE (Appendix 2)

(Please tick appropriate boxes)

SECTION ONE – BACKGROUND INFORMATION

1. Your current position in the Banking industry

1. Loan Officer ☐ 4. Relationship Manager ☐ .

2. Credit analyst ☐ 5. Recovery/monitoring ☐ .

3. Credit Director ☐ 6. Vice president ☐ .

Other, please specify ____________________

2. Indicate your experience in the banking industry

1. Less than 1 year ☐ 4. 11-15 years ☐ .

2. 1-5 years ☐ 5. Above 15years ☐ .

3. 6-10 Years ☐ .

3. Indicate your experience in bank credit processes

1. Less than one year ☐ 4. 6-10 years ☐ .

2. 1-5 year's ☐ 5. Above 15-years ☐ .

3. 11-15 years 3 ☐ .

4. Determinants of nonperforming loans are obvious.

1. Agree ☐ 2. Neutral ☐ 3. Disagree ☐ .

SECTION TWO – QUESTIONS ON THE DETERMINANTS OF NONPERFORMING LOANS

6. What bank specific factors do you think are causing the occurrence of Nonperforming loans in Ethiopian banks?

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7. Please rank the factors that cause occurrence of nonperforming loans in Ethiopian banks.

N.B Rank the factors in order of their importance in contributing to the occurrence of nonperforming loans from 1-8

Factor that causes occurrence of nonperforming loans	Rank 1=highest ……8=lowest

Rapid Loan growth by banks	
High interest rate	
Poor monitoring/follow up	
Credit culture / Orientation	
Size of the Bank	
Ownership type of bank	
Poor risk assessment	
Lenient /Lax credit terms	
Others, Please specify____________________ ___________________________ ____________________________	

Please indicate your degree of agreement or disagreement to the statements pertaining to credit assessment and the occurrence of NPL

		Strongly Agree	Agree (2)	Neutral (3)	Disagree (4)	Strongly Disagree

		(1)				Agree (5)
8	Easily admitted borrowers usually default					
9	Know Your Customer (KYC) policy of banks lead to high loans quality					
10	Good loan underwriting ensures loan performance					
11	Poor risk assessment would lead to loan default					

Please indicate your degree of agreement or disagreement to the statements pertaining to credit monitoring and the occurrence of NPL

		Strongly Agree (1)	**Agree (2)**	**Neutral (3)**	**Disagree (4)**	**Strongly Disagree (5)**
12	Strict monitoring ensures loan performance					
13	Poorly assessed and advanced loans may perform well if properly monitored					
14	Loan follow up is directly related to occurrence of nonperforming loans					
15	Banks with higher budget for loan monitoring have lower non performing loans					

Please indicate your degree of agreement or disagreement to the statements pertaining to Collateral and the occurrence of NPL

		Strongly Agree (1)	**Agree (2)**	**Neutral (3)**	**Disagree (4)**	**Strongly Disagree (5)**
16	Collateralized loans perform well					

17	Collateralizing loans help protect loan default					
18	Most of the time non collateralized loans are defaulted					

Please indicate your degree of agreement or disagreement to the statements pertaining to borrower's orientation and the occurrence of NPL

		Strongly Agree (1)	**Agree (2)**	**Neutral (3)**	**Disagree (4)**	**Strongly Disagree (5)**
19	Borrower's orientation/culture is related to loan performance					
20	There is a relationship between loan default and borrower's culture					
21	Default in some area is ascribed to the culture of the borrowers					
22	Society's cultural development leads to good loan performance					
23	Loans with big interest rate tend to turn to NPL					
24	Charging big interest rate leads to loan default					
25	Loan price affects loan performance					
26	Borrowers default because they don't understand credit terms well					
27	Poorly negotiated credit terms lead to loan non performance					

Please indicate your degree of agreement or disagreement to the statements pertaining to Credit size and the occurrence of NPL

		Strongly Agree (1)	**Agree (2)**	**Neutral (3)**	**Disagree (4)**	**Strongly Disagree (5)**
28	Aggressive lending leads to large NPL volume/ratio					

29	Banks whose credit growth is rapid experience huge NPL level					
30	Bank's great risk appetite is cause for NPL					
31	Compromised integrity in lending leads to loan default					
32	Having large number of borrowers causes loan default					
33	Loans default rate is directly related to banks' size					
34	With growth in banks size comes growth on NPL					
35	Loan default is not related banks ownership type (private/state owned)					

Instrument for In-depth interview (Appendix 2)

1. Summary of the respondent profile (age, education level, banking experience, experience on credit, current status and the related)

2. Views of the respondents on the factors that determine occurrence of nonperforming loans in general and Ethiopian banks in particular.

3. Views of respondents on which factors answered in Q2 stand at the top and rating of the factors thereof in relation to the other.

4. Opinion of respondents on the impact of the Ethiopian Banking context that might have any bearing on the occurrence of loan default.

5. Recommendation/ if any for mitigating occurrence of nonperforming loans proposed by the respondents.

Assets and NPL ratio of Banks Surveyed (Appendix 3)

Bank- AWASH INTERNATIONAL BANK
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	6,105	8,044	9,564	13,104	16,117	18,520
2	Net Loan	3,182	3,986	5,511	7,737	9,176	12,265
3	Total Asset	9,022	11,089	13,125	17,783	22,106	25,211

4	Deposit to Loan Ratio	1.92	2.02	1.74	1.69	1.76	1.51
5	NPL Ratio	4.7	3.7	1.9	2.6	2.3	1.51

Bank- DASHEN BANK
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	10,144	11,841	14,065	15,851	17,681	19,814
2	Net Loan	5,033	6,141	8,042	8,836	9,607	11,333
3	Total Asset	12,353	14,614	17,520	19,747	21,962	24,763
4	Deposit to Loan Ratio	2.02	1.93	1.75	1.79	1.84	1.75
5	NPL Ratio	3.0	3.3	2.4	5.5	1.7	0.77

Bank- BANK OF A BYSSINIA
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	5,138	6,075	6,771	8,496	9,096	11,118
2	Net Loan	3,153	3,315	3,897	4,675	5,061	5,905
3	Total Asset	6,279	7,277	8,239	10,160	11,276	13,667
4	Deposit to Loan Ratio	1.63	1.83	1.74	1.82	1.80	1.88
5	NPL Ratio	7.0	4.0	3.8	2.8	1.8	2.7

Bank- WEGAGEN BANK
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	3,923	5,957	5.758	7,551	8,385	10,217
2	Net Loan	2,376	2.778	3,479	4,585	4,528	6,072
3	Total Asset	5,742	8,061	8.347	10,394	11,529	13,711
4	Deposit to Loan Ratio	1.65	2.14	1.66	1.65	1.85	1.68
5	NPL Ratio	3.5	1.86	1.05	NA*	0.4	0.3

Bank- UNITED BANK
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	4,725	6,402	6,757	7,698	8,909	11,164
2	Net Loan	2,518	3,186	4,085	4,623	4,996	6,776
3	Total Asset	5,896	8,787	8,787	9,985	11,876	14,361
4	Deposit to Loan Ratio	1.88	2.01	1.65	1.67	1.78	1.65
5	NPL Ratio	3.35	2.10	1.30	1.97	1.03	1.12

Bank- NIB INTERNATIONAL B ANK
(In millions ETB)

S/N	Particular	2010	2011	2012	2013	2014	2015
1	Net Deposit	4,127	5,157	5,838	6,655	7,923	9,774
2	Net Loan	2,447	2,652	3,608	4,429	5,407	6,894
3	Total Asset	5,971	7,111	8,275	9,144	10,747	13,256
4	Deposit to Loan Ratio	1.69	1.94	1.62	1.50	1.47	1.42
5	NPL Ratio	7.4	5.2	2.5	5	5.3	5.7