ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES
MBA PROGRAM

Assessment of Non-Performing Loans: The Case of the Commercial Bank of Ethiopia

A Thesis Submitted to MBAE General Management For the Award of General Masters of Business Administration

Tirsit Zewdie

(Student Id.N SGS/0273/2007A)

Advisor: Dr. Arega Siyum

February 2017

Addis Ababa

ADDIS ABABA, ETHIOPIA

ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

MBA PROGRAM

Board of Examination Thesis

Approval sheet

Members of the Board of Examiners

External Examiner	Signature	Date
Dr Habitamu Birhanu		February 3, 2017

Internal Examiner	Signature	Date
Dr Assimamaw Gete		February 3, 2017

Advisor	Signature	Date
Dr Arega Siyum		February 3, 2017

CERTIFICATE

This is to certify that the thesis titled "Assessment of Non-Performing Loans: The Case of Commercial Bank of Ethiopia'', submitted to St. Mary university, Department of MBAE General Management for the award of General Masters of Business Administration and is a record of genuine research work carried out by Tirsit Zewdie , under my guidance and supervision.

Therefore, I hereby declare that no part of this thesis has been submitted to any other university or institution for the award of any degree or diploma.

Advisor's Name	**Signature**	**Date**
Dr. Arega Siyum	_______________	February 3, 2017

DECLARATION

I hereby declare that this thesis titled "Assessment of Non-Performing Loans: The Case of Commercial Bank of Ethiopia" has been carried out by me under the guidance and supervision of my Advisor Dr Arega Siyum.

The thesis is original and has not been submitted for the award of any degree or diploma to any university or institutions.

Researcher's Name	**Signature**	**Date**
Tirsit Zewdie	_________________	February 3, 2017

ABSTRACT

This study intends to assessment of nonperforming loans. The mixed research approach was adopted for the study. Survey was conducted with professionals engaged in Commercial Bank of Ethiopia holding different positions using a self administered questionnaire.

The study found that poor risk assessment and unsound lending practices, lack of focused loan monitoring and follow-up, compromised integrity, and fund diversion as the major factors that contribute to loan default.

The study suggest that Bank should put that proactive follow-up and monitoring system to monitor loan performance and check continued viability of operations, 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, Provide training and development to employees involved in credit operations to enhance the aptitudes and abilities of every member.

Acknowledgments

First and for most I am very enchanted to take this opportunity to thank my lord who initiates me to begin and helps me to finish this thesis work.

My sincere and deepest gratitude goes to my advisor and instructor Dr. Arega Siyum (Ato) for his unreserved assistance in giving me relevant comments and guidance throughout the study. My grateful thanks also go to Commercial Bank of Ethiopia employees for their positive cooperation in giving the relevant financial data for the study.

Table of Contents

List of Table

ABBREVIATIONS

CBE Commercial Bank of Ethiopia

NBE National Bank of Ethiopia

FDRE Federal Democratic Republic of Ethiopia

IMF International Monetary Fund

KYC Know Your Customer

NPLs Non-performing Loans

RQ Research Questions

SBB Supervision of Banking Business

CHAPTER ONE

1 Introduction

1.1Background of the Study

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 (Fofack, 2005and Hu, 2006) that the financial banking crises in East Asia and Sub-Saharan African countries were preceded by high NPLs. 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 NPLs when examining financial vulnerabilities.

The issue of non-performing loans (NPLs) has gained increasing attentions in the last few decades. The immediate consequence of large amount of NPLs in the banking system is bank failure. Many researches on the cause of bank failures (e.g. Demirguc-Kunt 1989, Barr and Siems1994) found out that asset quality is a statistically significant predictor of insolvency, and that failing banking institutions always have high level of NPLs prior to failure.

Banks play a very important role in the economic development of every nation. They have Control over a large part of the supply of money circulation and stimulus for the economic progress of a country. The financial sectors contribution to growth lies in the central role, they Plays in mobilizing savings and allocating the resources efficiently to the most productive uses and investments in the real sector(Beck, 2001, cited in Joseph et.al , 2004. p.467)

The lending function is considered by the banking industry as one of the most important function for the utilization of funds. Since, banks earn their highest gross profits from loans; the administration of loan portfolios seriously affects the profitability of banks. Indeed, large number of non-performing loans is the main cause of bank failure.

When we think about Bank's role, their financial health is the most important factor and it requires decisions about what to do with non- performing loans. The solidity of bank's portfolio depends on the health of its borrowers.

In many countries, failed business enterprises bring down the banking system. Among other things a sound financial system requires minimum level of non- performing loans which in turn facilitates the economic development of one country. Non-performing loans have been a hindrance to economic stability and growth of the economies (Beck, 2001, cited in Joseph et.al, 2004).

Because of controllable and uncontrollable factors, it is unlikely to have 100% of collection of loan. Controllable factors are bank specific factors that are controlled by firm level and reflect overall bank credit policy as well as inadequate credit analysis, loan structuring, and loan documentation, etc. Uncontrollable factors are external factors or macro-economic factors that are not controlled by firm level. It reflect adverse economic conditions, adverse change in regulation, environmental change surrounding the borrower's operation, and catastrophic events. So, in reality some of the loan will be nonperforming (Daniel T, 2010).

Commercial banks in Ethiopia provide credit facilities and services to various classes of customers. In the course of their operation, however, they may find themselves with a loan portfolio in which the risk of the loss is greater than they had anticipated when the loan was made. That is a position where the risk is greater than the bank would normally be willing to assume.

1.2. Statement of the problem

Despite the heavy regulation and ongoing efforts made to control the banking industry in general and the lending activities in particular, the NPLs problems are still a worldwide headache and a major concern for both international and local regulators (Boudriga 2009).Given the harmful effects of NPLs on countries economy, in recent years, an issue of preventing NPLs is highly emphasized on the agenda of banking supervisory institution and policymakers throughout the world (Socuvkova 2012).

As far as NPLs problems left unsolved, it can greatly jeopardized the smooth functioning of banks through erosion of banks asset and reduction of income through accumulation of losses and increased provisions to compensate for these losses(Kunt and Detragiache1998). In the worst scenario, a high level of NPLs in a banking system poses a systemic risk, inviting a panic run on deposits and sharply limiting financial intermediation, and subsequently investment and economic growth (Ahmed 2006).

The government owned mass media as well as the private press have repeatedly reported and claimed that the Commercial bank of Ethiopia were facing serious problems with loan recovery for a variety of reasons, lack of financial discipline and outright breach of contract cases etc. The magnitude of the total bad debts of Ethiopia's banking system had reached the staggering sum of 3 billion birr (Addis Tribune, Issue. No. 279, February 06, 1998).

In Ethiopia, the banking environment has undergone many regulatory and financial reforms like other African countries with the aim of improving profitability, efficiency and productivity (Lelissa2007). For instance, in 2003 the biggest state owned Commercial Bank of Ethiopia (CBE) had reported NPLs of 53% of their total loans (NBE 2012).Eventually, the government of Ethiopia being worried about the potential systemic crisis associated with credit risk and imposed restriction on the proportion of NPLs not to exceed 5% of their total loan outstanding (NBE 2008)

Following the2008 NBE declaration, NPLs of Ethiopian commercial banks have shown a significant improvement and lowered to an average of 5 % (NBE 2011). For instance, in 2006 NPLs of CBE were about 22% of their total loan outstanding. Surprisingly however, in 2011 it lowered to an average of 0.86% (NBE 2012).

In connection to this, the 2009/10 survey of NBE revealed that, significant proportion of commercial banks in Ethiopia lack: appropriate risk management strategies and programs, timeframe to review risk management documents, adequate risk management budget, up-to-date and relevant data for informed decisions, risk communication, risk management integration with human resource management and policies, risk management audit review, and initiatives to identify risks.

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 the study is to identify the assessment of NPLs in the case of commercial bank of Ethiopia.

1.3 Basic Research question

The study is designed to seek answers for the following one major research question and five sub research questions.

1. What are the bank specific contributing factors of non-performing loans (NPLs)?

1.1. Is there a relationship between credit assessment and occurrence of NPLs?

1.2. Is there a relationship between credit monitoring and occurrence of NPLs?

1.3. Is there a relationship between collateralized lending and bad debts?

1.4. What is the influence of borrower’s credit culture on occurrences of bad debts?

1.5. Do high lending interest rates entail loans to lead to loan default?

1.4Objectives of the Study

1.4.1 General Objective

The overall objective of the study is to find out bank specific assessment of NPLs in the case of the commercial bank of Ethiopia

1.4.2 Specific objective

With a view to achieve the overall objective stated above, the specific objectives of the study have been to examine relationships between loan default and factors such as; credit assessment, credit monitoring, borrower’s credit culture and collateralized lending, level interest rates.

1.5 Significance of the study

- The current study benefits the researcher to obtain new knowledge about problems under the study and gives clear picture about the discipline.
- This study help to present the current picture of NPLs in commercial bank of Ethiopia
- The study will enable commercial bank of Ethiopia (lender s) how to overcome potential factors that are highly affects the level of nonperforming loan in Ethiopia banking industry.

1.6 Scope of the study

This research study identifying causes and effects of NPLs in commercial bank of Ethiopia focused on Head Office located in Addis Ababa, have six years' experience. Besides, these bank extend credit facilities to almost all major sectors of the economy. Again the nationwide credit operation of the bank presents an opportunity for a national outlook of the issues under study. This research paper also coverage on the possibility of nonperforming loan and factor that influence of nonperforming loan in commercial bank of Ethiopia for the past six consecutive years, from 2009 to 2014.

1.7Limitation of the study

While doing this research, the researcher encounter various problems, from these problems the most dominant ones are owing to the nature of the subject area, i.e., excessive confidentiality, and because of limited access, it wouldn't easy to get all relevant information from respective bank. Budget problem and time constraints were other prominent factors that face the researcher while doing this paper. However, the above resistant factors make this study difficult; the researcher hopes that readers will get some valuable ideas from the outcome of this study.

1.8Organization of Research Report

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.

Chapterthree 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 study.

CHAPTER TWO

2. LITERATURE REVIEW

2.1. Introduction

2.1.1. The Nature of Non-performing Loans

The principal activity of commercial banks is making loans to its customers. In allocating funds, the primary objective of bank management is to earn income while serving the credit needs of its community. Lending represents the heart in banking industry. Loans are the dominant asset and represent fifty percent to seventy five percent to the total amount of banks assets. In most banks loans generate the largest share of operating income and represent banks greater risk exposure (Mac Donald and Koch, 2006).

The recent global financial crisis highlighted the importance of appreciating financial institutions vulnerabilities in the context of managing credit risk. The key motivation for this paper is to improve understanding of the assessment of NPLs. However a lot of research papers can be found regarding the problem or non-performing loan. Many prudential researchers intend to work on NPLs because it is perceived as the foremost aspect of bank's survival.

The question of loan default is related with none recovery or repayment of loans. When a borrower cannot repay interest and or installment on a loan after it has become due, then it is qualified as default loan or non-performing loan (Chowdhury&Adhikary, 2002). It is known as non-performing, because the loan ceases to "perform" or generate income for the bank. The default/non-performing loan is not a "uniclass", rather a "multiclass" concept. It implies that the default NPLs can be classified into three different categories, usually based on the "length of overdue" of the said loan.

These categories are:

i. Substandard – loans overdue for a period of 91 to 180 days

ii. Doubtful – loans overdue for a period of 181 to 360 days

iii. Loss – loans overdue for more than 360 days

The issue of NPLs has gained increasing attentions in the last few decades. The immediate consequence of large amount of NPLs in the banking system is bank failure. Manyresearchers on the cause of banking failure find that asset quality is a statistically significant predictor of insolvency [e.g. Demirguc-kunt 1989, Barr and Siems 1994], and that failing banking institutions always have high level of NPLs prior to failure.

NPLs can lead to efficiency problem for banking sector. It is found by a number of economists that failing banks tend to be located far from the most efficient frontier, because banks don't optimize their portfolio decisions by lending less than demand. What's more, there are evidences that even among banks that do not fail; there is a negative relationship between the non-performing loans and performance efficiency.

The concept of NPLs has been defined in different literatures. According to Patersson and Wasman (2004), NPLs 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 NPL 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.

NPLs 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 have been left unpaid for at least 90 days (Fofack, 2005). NPLs are further defined as loans, whose 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 borrower (Machiraju, Undated).

Machiraju (2001) expresses NPLs as a leading indicator of credit quality. NPLs 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 very sensitive elements of a bank's operation.

According to Brown, Mallett and Taylor (1993), the losses from bad loans (NPLs) caused by reducing the capital resource of the bank affects its ability to grow and develop its business and 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 (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 NPLs 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 build-up of bad loans plays a crucial role in banking crises (Demirguç-Kunt and Detragiache, 1998, and

González-Hermosillo, 1999). It is apparent that insolvency of banks is costly to the macro economy as such, 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.

Under the Ethiopian banking business directive, NPLs 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 directive, 2008)." It further provides that: Loans or advances with pre-established repayment programs are non-performing when principal and/or interest is due and uncollected for 90 (ninety or more consecutive days beyond the scheduled payment date or maturity (NBE directive, 2008).*

According to this directive of NBE, in addition to the aforementioned category of non-performing loans that do not have pre-established repayment program (essentially overdraft loans) shall be non-performing when:

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

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

iii) Deposits are insufficient to cover the interest capitalized during 90 consecutive days or

(iv) The account fails to show 20 percent of the approved limit or less debit balance at least once over 360 days preceding the date of loan review.

According to 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 NPLs is a quantitative criteria based on the number of days passed from loan being due.

2.2. Literature Review

The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers (Auronen, 2003, as cited in Richard, 2011), which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender) (Auronen, 2003, as cited in Richard, 2011). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of NPLs in banks (Bester, 1994; Bofondi and Gobbi, 2003).

Studies show that problem loans are often used as an exogenous variable to explain other banking outcomes such as bank performance, failures, and bank crises (Boudriga et al., 2009). However, some studies investigate problem loans as an endogenous variable (Sinkey and Greenwalt, 1991; Kwan and Eisenbeis, 1997, Salas and Saurina, 2002, as cited in Boudriga et al., 2009).

GDP growth, inflation and interest rates are common macro-economic factors, while size and lending policy are micro-economic variables (Greenidge andGrosvenor, 2010).

These variables are by no means exhaustive, but they provide a useful framework for monitoring the development of non- performing loans (Guy, 2011). More recent researches started studying this problem but with particular reference to both developing countries and emergent economies (Haunerand and Peiris, 2005; Matthewes et al., 2007, as cited in Maggi and Guida, 2009)

Bercoff et al (2002) examine the fragility of the Argentinean Banking system over the 1993-1996 period; they argue that NPLs are affected by both bank specific factors and macroeconomic factors.

To separate the impact of bank specific and macroeconomic factors, the authors employ survival analysis. Using a dynamic model and a panel dataset covering the period 1985-1997 to investigate the assessment of problem loans of Spanish commercial and saving banks, Salas and Saurina (2002) reveal that real growth in GDP, rapid credit expansion, bank size, capital ratio and market power explain variation in non- performing loans.

Furthermore, Jimenez and Saurina (2005) examine the Spanish banking sector from 1984 to 2003; they provide evidence that NPLs are determined by GDP growth, high real interest rates and lenient credit terms. This study attributes the latter to disaster myopia, herd behavior and agency problems that may entice bank managers to lend excessively during boom periods. Meanwhile, Rajiv and Dhal (2003) utilized panel regression analysis to report that favorable macroeconomic conditions and financial factors such as maturity, cost and terms of credit, banks size, and credit orientation impact significantly on the NPLs of commercial banks in India.

Babihuga (2007), in an IMF working paper, explores the relationship between several macroeconomic variables and financial soundness indicators (capital adequacy, profitability, and asset quality) based on country aggregate data. She explained the cross-country heterogeneity by differences in interest rates, inflation, and other macroeconomic factors. However, the study does not consider the impact of industry specific drivers of problem loans.

Most empirical studies examine the influence of the macroeconomic environment on NPLs (Louzis et al, 2011). Rinaldi and Sanchis-Arellano (2006) analyzed household NPLs for a panel of European countries and provide empirical evidence that disposable income, unemployment and monetary conditions have a strong impact on NPLs. Berge and Boye (2007) find that problem loans are highly sensitive to the real interest rates and unemployment for the Nordic banking system over the period 1993–2005.

Lawrence (1995) examines the theoretical literature of life-cycle consumption model and introduces explicitly the probability of default. This model implies that borrowers with low incomes have higher rates of default due to increased risk of facing unemployment and being unable to settle their obligation. Additionally, in equilibrium, banks charge higher interest rates to riskier clients. Rinaldi and Sanchis-Arellano (2006) extend Lawrence's model by assuming that agents borrow in order to invest in real or financial assets. They argue that the probability of default depends on current income and the unemployment rate, which is linked to the uncertainty regarding future income and the lending rates.

Breuer (2006), using Bank scope data, analyzed the impact of legal, political, sociological, economic, and banking institutions on problem bank loans. Nevertheless, her study suffers from a representativeness bias due to the fact that Bank scope data on NPLs are only available for a very limited number of countries and for a few numbers of banks. Other studies focusing on the macroeconomic assessment of NPLs include that of Cifter et al. (2009), Nkusu (2011) and Segoviano et al.(2006).

Carey (1998) argues that the state of the economy is the single most important systematic factor influencing diversified debt portfolio loss rates (Carey, 1998, p. 1382). Quagliarello(2007) finds that the business cycle affects NPLs for a large panel of Italian banks over the period 1985–2002.Furthermore,Cifter et al.(2009) provides empirical evidence for a lagged impact of industrial production on the number of NPLs in the Turkish financial system over the period 2001–2007. Salas and Saurina (2002) estimate a significant negative contemporaneous effect of GDP growth on NPLs and infer the quick transmission of macroeconomic developments to the ability of economic agents to service their loans (Bangia et al., 2002; Carey, 1998).

Nkusu(2011) investigating the macroeconomic assessment of loan defaults through panel regressions and panel vector autoregressive models. Theauthor suggests that hike in interest rates result in deterioration of borrower's repayment capacity and hence, cause of increase in NPLs.

There is significant empirical evidence to suggest that local economic conditions explain to some extent, the variation in NPLs experienced by banks (Keeton and Morris, 1987; Sinkey and Greenwalt, 1991; Salas and Saurina, 2002; Rajan and Dhal, 2003 as cited inGreenidge and Grosvenor, 2010). Research conducted in the Caribbean includes that of Khemraj and Pasha (2009), who examined the assessment of NPLs in Guyana. The empirical results revealed that with the exception of the inflation rate and bank size, all other factors have a significant relationship with the non-performing loan ratio (Greenidge and Grosvenor, 2010).

Causes and treatment of NPLs were studied in detail by Bloem and Gorter (2001). They agreed that "bad loans" may considerably rise due to abrupt changes in interest rates. They discussed various international standards and practices on recognizing, valuing and subsequent treatment of NPLs to address the issue from view point of controlling, management and reduction measures.

A study conducted by Espinoza and Prasad (2010) focused on macroeconomic and bank specific factors influencing NPLs and their effects in the Banking System. After a comprehensive analysis, they found that higher interest rates increase NPLs but the relationship was not statistically significant.

Salas and Saurina (2002) find a negative relation between bank size and NPLs and argue that bigger size allows for more diversification opportunities. Hu et al. (2004) and Rajan and Dhal (2003) reported similar empirical evidence. Another strand of literature has focused on the degree of loan concentration in various sectors, and proposes that vulnerabilities within sectors of high loan concentration tend to exacerbate the non performing ratio (Herring and Wachter, 1999 as cited in Guy, 2011). However, Stiroh (2004) does not find evidence of benefits from diversification in the form of reduced risk, for the US banking system, since non-interest income growth was highly correlated with net interest income during the 1990s.

The moral hazard of too-big-to-fail banks represents another channel relating to bank-specific features with NPLs (Louzis et al, 2011). A policy concern is that too-big-to-fail banks may resort to excessive risk taking since market discipline is not imposed by its creditors who expect government protection in case of a bank"s failure (Stern and Feldman, 2004). Consequently, large banks may increase their leverage too much and extend loans to lower quality borrowers (Louzis et al, 2011). Boyd and Gertler (1994) argue that in the 1980s the tendency of US large banks towards riskier portfolios was encouraged by the US government's too-big-to-fail policy. On the other hand, Ennis and Malek (2005) examine US banks" performance across size classes over the period 1983–2003 and conclude that the evidence for the too-big-to-fail distortions is in no way definite. Hu et al (2006) also show that bank size is negatively related to NPLs.

Berle and Means (1933) in Louzis et al. (2011) argue that dispersed ownership of corporate equity may lead to a poorer performance of the firm as the incentive of shareholders to monitor the management weakens. An opposing view is that an efficient capital market imposes discipline on firm's management and therefore dispersed ownership should not have an effect on firm's performance (Fama, 1980 as cited in Louzis et al., 2011). A strand in the empirical literature tests these contrasting views using loan quality as an indicator of riskiness but evidence is inconclusive (Louzis et al, 2011). Iannotta et al. (2007) find a link between higher ownership concentrations and loan quality using a sample of 181 large banks over the period 1999–2004, thus lending support to the Berle and Means view.

On the other hand, Laeven and Levine (2009) employ data on 279 banks and find a positive association between greater cash flow rights of a large owner and risk taking. Furthermore, Shehzad et al. (2010) present empirical evidence, from a data set comprising 500 banks from 2005 to 2007, that ownership proxied by three levels of shareholding (10%, 20% and 50%) has a positive impact on the NPLs ratio when the level of ownership concentration is defined at 10 percent but a negative impact when the level of ownership concentration is defined at 50 percent.

Therefore they suggest that sharing of control may have adverse effects on the quality of loans extended up to a level, but in cases of a strong controlling owner, bank's management becomes more efficient leading to lower NPLs. Azofra and Santamaria (2011) find that high levels of ownership concentration benefit both the bank's profitability and efficiency for a sample of Spanish commercial banks.

Empirically, Novaes and Werlang (1995) report lower performance for state controlled banks in Brazil and Argentina due to high proportion of problem loans given to government. Micco et al. (2004), analyze 50,000 financial institutions with different ownership types covering 119 countries. They conclude that NPLs tend to be higher for banks withstate ownership than for other groups. Hu et al. (2004) use a panel of Taiwanese banks and find a positive correlation between capital share owned by the state and the level of non- performing loans. Garcia-Marco and Robles-Fernandez (2007) investigate the relationship between risk taking and ownership structure.

They document that commercial banks (mainly private owned) are more exposed to risk than deposit banks (mainly state owned). More recently 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 NPLs.

Using a pseudo panel-based model for several Sub-Saharan African countries, Fofack (2005) finds evidence that economic growth, real exchange rate appreciation, the real interest rate, net interest margins, and inter-bank loans are significant assessment of NPLs in these countries. The author attributes the strong association between the macroeconomic factors and NPLs to the undiversified nature of some African economies.

2.3. Review of Empirical Evidence

2.3.1. Historical Path of Commercial Banking

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.

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).

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
Basque del Idoche	1915-28
Camapagniedel'Africaorientale	1915-36
Banca d' Italia	1936-41
Banco d' Roma	1936-41
BancoNazionale de lavoro	1936-41
Barclays Bank	1941-43

Source: Belay Gidey (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.

To improve the stability of the financial system further, a central bank will act as a banker to the banking and other financial institutions in the country.

Consequently, a central bank can influence the lending policy of commercial banks and thus their debt recovery.

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

2.4. General Lending Procedures and Processing Credit Applications

Although there is no hard and fast rule about the techniques of lending, it is necessary that defined procedures have to be followed by the bank to properly address the credit needs of its customers.

General Lending Procedures:

i. Getting started:-this is the first stage in which either the customer will come to the bank seeking for a loan or the branch manager initiates the customer to take out a loan for his business because the customer may not always know how to obtain credit from a bank.

ii. Preliminary discussion with the customer:-after the first encounter the request for a loan can be processed. Then the borrower’s credit worthiness is assessed. The request may not be processed if it falls outside the domain of the bank’s credit policy. If it is accepted, the customer completes the bank credit application explaining the relevant details to be incorporated therein including the type of collateral he is able to offer.

iii. Processing the credit application:-if the loan request of a borrower can be processed then the branch manager or other lending officers shall follow a detailed procedure in the appraisal of credit request and execution of the necessary documentation. The following general guideline is to be observed by lending officers of the bank whenever a loan request is presented to them.

iv. Loan application: the loan application should be in writing stating the following main points: amount of loan requested, the intended purpose for which the loan is to be used, the proposed collateral, mode of repayment and possible sources, duration of the loan, direct and indirect liabilities, the borrower’s contribution to the project, a brief history of the firm or the borrower and its future plan, and any other information that may assist the lending in appraising the loan proposal.

v. Documentation:-along with the written loan application, the following and other documents should be submitted as may be demanded by the bank:-Trade license, registration certificate, investment certificate from the appropriate ministry or bureau, financial statements (preferably audited and reflecting the current years position) including cash flow statement, especially if the borrower runs a sizable business, feasibility study other documents that may justify the need for the loan as may be required by the bank on the merit of each application.

vi. Bank format: - the bank provides formats on which a customer would complete specific, general and financial information. The bank shall use its own format on which the borrower will have to fill in his assets and liabilities especially if the applicant does not have a ready financial statement or is not able to submit one.

vii. Interview:- after all the documentations are in order, the customer may be called in for interviews to obtain further information that has not been disclosed in the application or documents or that were not made clear to the lending officer. A general interview on his/her business and future plans can provide useful information. It is usually necessary to have prior preparation on the topics to be discussed and this should be to the point. In the interview important information must be skillfully extracted.

viii. Site visits:-if the loan interview indicates that the request for credit sound, a sit visit to the business for a more detailed assessment is necessary. Site visits are useful for many reasons mainly to become acquainted with new customers; to review changes that are taking place when customers have been granted a continuity line of credit; to review such changes when a significant new loan is to be considered and to assess the manner in which the business is organized. Important benefits can accrue from regular and informal visits to seize up the customer, which might reveal his managerial ability at close range.

Any diversification of funds by customer other than for which it was intended should be immediately corrected upon bank's advice.

ix. Credit Information: - if the borrower or the applicant is new to the bank, it is particularly necessary to obtain as much information as possible. Such information may usually berelated to his honesty, ability, stability, managerial capacity, operational efficiency, financial history, etc. The information can be gathered from various sources, including banks, trade partners, suppliers and the like. Credit information from bank must be required at the earliest possible time, while other lending formalities continue to overcome unnecessary delays in processing the loan application.

x. Credit Investigation:-when as much relevant and adequate information is obtained, the credit investigation can be conducted to determine the accuracy and the authenticity of the statements made during interview and at the time when financial position was declared. One must also look for information regarding payment habits and the character of the operator of the business. The Investigation process should be comprehensive and detail sufficiently far into the past to establish all pertinent facts regarding the applicant and his business. There is nothing more important than knowing a potential borrower as thoroughly and as fast as possible before making credit decisions.

xi. Credit analysis:-the next step in the sequence of credit appraisal is conducting credit analysis of the applicant’s financial condition should be done carefully. Ratios should be calculated to determine the applicant's liquidity position and ability to repay the debt. The decision to external credit to the customer should basically depend on such and many other factors outlined above. The nature of the financial analysis is determined by or depends upon the specific interest of the analyst. For example, the banker will focus on the liquidity of the firm if he is considering a short- term loan.

xii. The credit decision:-the final decision as to whether the loan request should be approved or rejected is reached by comparing the statements made by the applicant with the information derived through the investigation process and by analyzing various credit factors such as capacity, capital, collateral, track record for repayments and others.

At this point it is necessary to underline the need for fast processing of credit application so that credit decision is given without undue delay. Undue delay in credit processing leads to losing good borrowers, a situation which must always be avoided.

xiii. Formalizing or Execution of the loan documents:-once the loan approved, the terms and conditions to which the borrower and lender agree should be incorporated in a written agreement.

All documents relative to the transaction should be completed and executed properly. The loan documents include a loan contract, any mortgage or assignments required to secure the indebtedness, evidence of adequate insurance coverage and the like. In particular, the branch manager must ensure that mortgage or the collateral has full legal authority to pledge the collateral offered and the spouse or legal heirs of the borrower, if legally required must sign the mortgage contract. Failure to fulfill this requirement will jeopardize the banks right in the event of default and the branch manager will bear full responsibility of its and other legal requirements if not fulfilled prior to the disbursement of the loan.

In summary, there are several studies exploring the factors contributing to NPLs. However, there is no similar study in the context of Ethiopia. As a result, one can't tell with confidence whether the factors identified by previous research holds true in the Ethiopian context or not. In line with the above theoretical as well as empirical review there is no global standard to define non-performing loans at practical level. Nonperforming loan is loan either in default or close to being in default. Nonperforming loan is not only harm to banks, but also it is danger for the overall economy. Thus, a research undertaken to explore the factors for NPLs in the case of commercial Bank of Ethiopia is something that would help addressing an important research gap.

CHAPTER THREE

Research Methodology

In order to achieve the objectives of the study, the research use descriptive approach, this study describe, compare, contrast and interpret the existing facts and puts the status of NPL in relation to various variables which help to understand the issue and lead to causal analysis.

3.1 Study area

Like other business activities, bank strives to make profit and grow. Presently head office of commercial bank of Ethiopia is located at the capital city, Addis Ababa. The Department that is responsible for provision of loans and advances to individuals and projects is contained at the Head Offices of the bank. Therefore, the study was conducted in consultation with staff involved in credit operations at head offices level using survey design with structured self-administered questionnaires.

3.2 Research Design

In order to achieve the objectives of the study, the research undertakes descriptive approach, using both qualitative and quantitative data. In doing so, the study intends to describe, compare, contrast and interpret the existing facts and puts the status of NPL in relation to various variables which will help to understand the issue and lead to causal analysis. Further the research utilizes a survey as a research method.

Secondary data were obtained from various books, research papers, magazines, newsletters, websites and the like. Primary data were also 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 Officers etc.

3.3 Sampling Method

The study is limited to employees that are directly involved in administration of loans at head offices level as a sampling frame. Such professionals include, loan officers, credit analysts, credit directors, relationship managers and recovery & monitoring officers etc.

Further all positions and respective tasks were listed involving credit processing, loan provisioning, monitoring and follow-ups. Furthermore, professionals were classified based on positions held in the structure of credit department.

3.4 Sample Size

Simple Random sampling technique was used as a Sampling method in which every item of the population has equal probability of being chosen a total sample of 100 professionals working in commercial Bank of Ethiopia related to credit and credit related operations were selected as part of the study.

3.5 Types of Data

Both primary and secondary data were collected and systematically presented and analyzed in this paper. Primary data were collected through questionnaires distributed to respondents and Secondary data were obtained from different Journals, various books, the bank website and the bank annual report and NBE report.

3.6 Methods of Data Collection

Primary data are collected through questionnaires (Appendix I) distributed to respondents that involve Loan recovery Manager and Senior Officers working on loan processing. Such group involves Loan Officers, Credit Analysts, Credit follow-up and Monitoring officers, Credit Directors, Relationship Officer and Recovery/Monitoring Officers etc.

Secondary Data were directly gathered from records of commercial bank of Ethiopia under sample study. The data collected include aggregate loans outstanding balances, NPLs as at the annual closing date, June 30 of each year.

For the purpose of comparison the surveyed bank data for the years between 2009 and 2014 have been collected and considered

3.7 Method of Data Analysis and Interpretation

The data collected from survey questionnaire were thoroughly coded and checked for consistency and entered into SPSS version 20 spreadsheet. Descriptive statistics was employed to analyze the data and the results were tested with non-parametric tests of significance

CHAPTER FOUR

.4. SURVEY RESULTS AND DISCUSSION

In this chapter data analysis results are presented

4.1. General Information

A structured questionnaire (Appendix I) was distributed to one hundred employees, loan officers, credit analysts, credit directors, relationship managers, recovery/monitoring officers and loan recovery manager ,Auditor, Attorney in commercial bank of Ethiopia

The questionnaire was distributed in person to hundred employees. Out of 100 questionnaires 95 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.

Table1. Survey Response rate

Respondents	**Size**
Sample size	100
completed and returned questionnaire	95
Response rate	**95%**

Source: Survey outcome

4.2.Position of Respondents

Respondent’s position discussed as follow

Table2. Respondents position in Commercial Bank of Ethiopia

Position	Frequency	Percent
Loan officer	20	21.0
credit analysis	18	19.0
credit director	5	5.0
Customer relationship officer	30	32.0
recovery/monitoring officer	12	12.6
Attorney	5	5.2
loan recovery manager	1	1.0
Auditor	4	4.2
Total	**95**	**100.0**

Source: Survey outcome

As shown in Table 2 above30 (32 percent) of the respondents were Customer Relationship Officer while 20 (21 percent) were loan officer and 18 (19 percent) were credit analysis . The rest of the respondents belonged to other occupations like Attorney, Auditors (who are not directly involved in credit operations) credit director

Table3. Respondents Experience in Banking industry

Experience in Banking Industry	Frequency	%
less than 1 year	-	
1-5 years	10	10.5
6-10 years	28	29.5
11-15 years	35	36.8
Above 15 years	22	23.2
TOTAL	**95**	**100**

Source: Survey outcome and own computation

In terms of banking experience, the absolute majority (about 89 percent) of the respondents reported to have served the banking industry for more than 5 years, of which close to 60 percent were long-serving employees, having over 10 years of work experience in the industry. On the other hand, about 10 percent of the respondents had as short as one to five years of banking experience.

Table4. Bank lending experience of the respondents

Years of Experience Loan Processing	Frequency	Percent
less than 1 year	10	10.5
1-5 years	22	23.2
6-10 years	35	36.8
11-15 years	15	15.8
Above 15 years	13	13.7
Total	**95**	**100.0**

Source: Survey outcome and own computation

In terms of bank lending experience majority (66 percent) of the respondents had more than five years of experiences particularly in lending or credit activities, of which 29 percent reported to have acquired more than 10 years of exposure in the area. Most of the respondents are getting experience not in other banks. The fact that such a majority of the respondents had sufficient experience in credit activities is believed to have impacted the dependability of the data quite positively

4.3 Factors that affect CBE Lending Process

Table5.Factors considered causing occurrences of NPLs

Factors	Frequency	Percent
Market fluctuation	18	19.0
Management problem	9	9.5
Knowledge Gap	4	4.2
Diversion of Fund	20	21.0
economic condition	11	11.6
poor credit risk analysis	10	10.5
credit policy	8	8.4
short payment time	6	6.3
Not stated	9	9.5
Total	**95**	**100**

Source: Survey outcome and own computation

According to the Table 5 above,21 percent of respondents shared Diversion of fund appeared to be the factor, while factors like Market fluctuation, economic conditions, poor credit risk analysis,(19,11.6,10.5)percent respectively shared by the respondents to be the major causes for occurrences of NPLs in the Commercial Bank of Ethiopians. Moreover, unsound lending practices as well as undesired character Management problem, credit police, knowledge gap ,short payment time were considered to be causes of NPLs by most of the respondents.

Further, respondents were also expected to rank factors causing NPLs in the Commercial Bank of Ethiopian in order of importance (from 1st/highest to 8th/lowest), as tabulated under Table 7 below.

Table6. Ranking of factors affecting occurrences of NPLs in the CBE

Factors	1	2	3	Sub-Total	%	4	5	6	7	TOTAL
Rapid loan growth by Bank	7	5	6	**18**	**19**	9	27	33	8	**95**
High interest rate	2	1	5	**8**	**11**	3	10	4	48	**73**
lenient credit term	6	5	17	**28**	**31**	21	15	10	15	**89**
credit culture	17	19	26	**62**	**67**	22	4		5	**93**
size of the Bank	2	4	5	**11**	**12**	26	17	29	8	**91**
Poor monitoring /follow-up	32	41	9	**82**	**86**	7	2	2	2	**95**
poor risk assessment	65	12	11	**88**	**93**	5	2	2	1	**95**

Source: Survey outcome and own computation

The survey result indicated that poor risk assessment (93 percent), poor monitoring and follow-up of loans ((86 percent), as the top ranking factors causing occurrences of NPLs followed by credit culture (67 percent). The survey results further reflected that the contribution of such factors as High interest rate, size of the Bank, Rapid loan growth by bank occurrences of NPLs is quite minimal, varying from as insignificant as 8 to 18 percent, in the order mentioned.

The following table (Table 7) shows the relationship between credit assessment and occurrences of NPLs. About 94.8 percent (mean 4.7, standard deviation 0.6) of respondents agree that KYC police of CBE lead to high loans quality while, in conformity to this, 92.6 percent (mean 4.6, standard deviation 0.60) of the respondents share the opinion that proper implementation of Poor risk assessment would lead to loan Default.

On the other hand, 76.9 percent (mean3.9 standard deviation 0.8) of the sample respondents agree that good loan processing ensures conducive loan performance, while on the contrary, majority (63.2 percent) of the respondents do not accept the opinion that easily admitted borrowers usually default.

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 bank usually recruits high-value potential customers on the basis of the customers established goodwill and then process/deliver the loans in a very short period of time 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.

Table7. Factors on relation between credit assessment and occurrences of NPLs.

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
Easily admitted Borrowers usually default	10.5	26.3	36.8	21.1	5.3	3.1	1.04
KYC police of CBE lead to high loans quality	73.7	21.1	3.2	2.1	-	4.7	0.6
Good loan underwriting ensures loan performance	21.1	55.8	17.9	4.2	1.1	3.9	0.8
Poor risk assessment would lead to loan Default	68.4	24.2	7.4	-	-	4.6	0.6

Source: Survey outcome and own computation

Based on the results one can easily observe that all responsible officers involved in credit administration have to detailed analysis in order to determine the prospective borrowers businesses.

Further, the importance of employment of know-your-customer (KYC) principle cannot be exaggerated. Respondents agree that bank that employs a determined KYC policy would maintain better loan quality. Such information includes the prospective borrowers business and financial management, organizational setup, credit history or overall track record, and complete profile.

Table8. Factors on relation between credit monitoring and occurrences of NPLs

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
Strict monitoring ensure loan performance	21.1	73.7	3.1	2.1	-	4.1	0.55
poorly assessed and advanced loans may perform well if properly monitored	42.1	33.7	10.5	13.7	-	4.04	1.04
Loan follow up is directly related to occurrence of NPLS	57.9	28.4	6.3	3.2	4.2	4.3	1.02
Higher budget for loan monitoring has lower NPLS	9.5	36.8	15.8	30.5	7.4	3.1	1.16

Source: Survey outcome and own computation

From the above table (Table 8) one can conclude that strict loan monitoring ensures admirable loan performance as asserted by nearly 95 percent (mean 4.1, standard deviation 0.55) of the times. 24 percent (13.7+10.5) of the respondents do not agree with the assertion that loans and advances might perform well if properly monitored despite inadequate assessment during permitting, indicating that loan follow-up can never substitute prudent credit assessment.

Additionally, 86.3 percent (57.9+28.4) of the respondents (with mean 4.3, and standard deviation 1.02)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 46.3 (9.5+36.8)percent agree that bank with higher budget for loan monitoring have lower NPLs .while on the contrary 53.7percent of the respondents do not accept higher budget for loan monitoring has lower NPL

Table9 below shows opinion of respondents regarding the relationship between collateralized loans and occurrences of NPLs

Table9. Factors on relationship between collateralizing loans & occurrences of NPLs

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
Collateralized loans perform well	15.8	47.4	21.1	13.7	2.1	3.6	0.98
collateralizing loans help protect loan default)	26.3	52.6	13.7	6.3	1.1	3.9	0.86
most of the time non collateralized loans are defaulted	6.3	17.9	32.6	42.1	1.1	2.8	0.94

Source: Survey outcome and own computation

The survey results indicated that 79 percent of the respondents are of the view that collateralizing loans helps protect loan default, and 63.2 percent agree with the statement that collateralized loans perform well, while only 24.2 percent of the respondents indicated most of the time non-collateralized loans default.

On the contrary, 75.8 percent of the respondents disagree or were neutral non-collateralized loans usually default. So the relation between NPLs and collateral is positive in view of the respondents.

Table10. Relationship between borrower's orientation and occurrence of NPLs

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
borrower's orientation is related to loan performance	23.2	53.7	14.7	7.4	1.1	3.9	0.87
there is r/s b/n loan default and borrower's culture	8.4	70.5	11.6	5.3	4.2	3.7	0.85
society's culture development leads to good loan performance	23.2	69.5	5.3	1.1	1.1	4.1	0.63

Source: Survey outcome and own computation

From the above Table(table 10) relationship between borrower's orientation/culture and loan performance 93 percent of respondents agree with the assertion that loan performance is related to culture of a society.

Moreover, 76.9 percent of respondents have the opinion that there existed relationship between borrower's orientation and loan default. It could also be noted that 78.9 percent of respondents believed loan default in some areas is ascribed to the culture of the borrower's. This indicates strong relation between culture/orientation and occurrences of NPLs.

Table11. Shows Relationship between Cost of Loan and Loan Default

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
loan with big interest rate tend turn to NPL	4.2	26.3	34.7	29.5	5.3	2.94	0.97
loan price affect loan performance	2.1	30.5	40.0	27.4	-	27.4	0.81

Source: Survey outcome and own computation

However, 69 percent of the respondents disagree loan with big interest rate tend turn to loan default, 67.4 percent of respondent disagree loan price affect loan performance. The average responses to all two factors were close to neutral.

Table12. Credit Terms and Loan Performance

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
borrower's defaults b/c they don't understand credit terms well	3.2	35.8	32.6	28.4	-	3.13	0.87
poorly negotiated credit terms lead to loan non performance	15.8	78.9	3.2	2.1	-	4.08	0.51

Source: Survey outcome and own computation

Slightly above 94.7 percent of the respondents conform to the fact that there is a relationship between loan default and sincerity of negotiation in credit terms set by the bank during loan processing. On the other hand, about 61 percent of the respondents do not agree with the statement that borrowers default because they don't understand credit terms well

Table13. Relationship of credit growth and NPLs

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
Aggressive lending leads to large NPL Volume/ratio	17.9	68.4	2.1	10.5	1.1	3.91	0.84
Bank increased risk appetite is cause for NPLs	26.3	67.4	4.2	2.1	-	4.17	0.6

Source: Survey outcome and own computation

Looking at the responses on the relationship between credit growth and occurrences of NPLs, 86.3 percent of the respondents agreed on the opinion that aggressive lending leads to occurrences of large NPLs volume/rate while nearly 94 percent of the respondents believed bank increased risk appetite would cause occurrences of NPLs. The survey results indicate that when bank follow aggressive lending strategy and experience rapid credit growth they might end up with mountainous of NPLs.

Table14. Relationship between bank size and occurrence of NPLs.

Factors	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	Std Dev.
having large no. of borrowers cause loan default	3.2	10.5	36.8	49.5	-	2.67	0.79
loan default rate is directly related to bank size	1.1	17.9	60	17.9	3.2	2.95	0.72

Source: Survey outcome and own computation

From the above Table14The 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 13.7 percent and 18.9 percent have agreed to the contrary.

4.4. Discussion and Findings

The general objective of Bank 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 bank give different kinds of services amongwhich credit provision is the major one as it is the core function of commercial bank of Ethiopia.

With regards to lending, bank gives 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.

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 commercial bank of Ethiopia and formulated six specific questions (one major question and five sub-questions) to help achieve the objective to identify assessment of NPLs, including relationship among credit assessment, credit monitoring, collateralized lending, borrower's orientation, and credit growth.

In respect of the factors affecting NPLs, the subjective questions in the survey identified factors such as poor credit assessment and monitoring, culture/orientation, bank credit terms, aggressive lending, compromised integrity, and economic condition attribute to the causes of loan default.

Factors are further investigated as follows.

Factors affecting occurrences of NPLs

The study analyzed each factor that has impact on occurrences of NPLs.

Substantial number of respondents believed that poor risk assessment, poor monitoring /follow-up on the part of lending bank and unsound lending practices, compromised integrity are major causes behind unpaid loans (Table 6).

Credit assessment and occurrence of NPLs

The survey results indicate the fact that bank pursue strong KYC principle lead to high loan quality. The survey also indicated that poor risk assessment would lead to loan default. Credit analysis constitutes the critical phase of bank lending process. 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 7).The fact that bank 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.

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 95 percent of the respondents indicated agreement (Table 8) 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.

If loans are not paid as and when due, credit risk is involved on reducing the value of the bank business. In order to continue lending the bank must be able to collect their outstanding loans on time. Once funds are disbursed the concerned bank 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 highest degree and take timely action when necessary. The survey results also indicated that 86.3 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. To protect the interest of lending bank, ensure legal recourse is available at all times legal follow-up should be put into effect. Survey results indicate that bank that incurs big cost for loans follow-up would have comparatively lower NPLs.

Relation between collateralized loans and NPLs

Security is taken to mitigate the bank 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.

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 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.

The survey results indicated that quite majority (79 percent) of the respondents are of the view that collateralizing loans helps protect loan default while, a significant majority (63 percent) of respondent are of the view that collateralized loans perform well and on the other hand (75.8 percent) of the survey respondents disagree or were neutral non-collateralized loans usually default, (Table9)

Impact of Borrower's 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 92.7 percent, 76.9 percent, and 78.9 percent, respectively, indicates existence of strong relationship between each of these factor and NPLs (Table 10).

Cost of loan and loan default

Study 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 69.5percent of the respondents disagree or remained neutral to the assertion that loans with big interest rate would turn to default. Majority (67.4 percent) of the respondents also expressed disagreement became indifferent to the statements charging big interest rate and loan prices affect loan performance (Table 11).

Credit terms and loan performance

Study 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.

The survey results indicate that 94.7 percent of the respondents expressed their agreement to the assertion that poorly negotiated credit terms lead to loan default. However, 61 percent of them expressed disagreement or indifference to the statement that borrowers default because they don't understand credit terms well (Table 12)

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 aggressive lending and bank increased risk appetite constitute86.3 percent, 94 percent of the sample respondents respectively(Table 13).

Bank size and NPL

Studies of Rajan and Dhal (2003), Salas and Saurina (2002), and Berger and DeYoung (1997) indicated that banks size have significance on occurrence of NPLs. The survey results, however, did not support these studies of other countries. About 81.1 percent and 86.3 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 14)

4.5. Summary of Result

The survey was conducted on 95 employees of commercial bank of Ethiopia. The data were collected using self-administered questionnaire. The feedback yielded a response rate of 95 percent.

In terms of experience, 66 percent and 89percent of the respondents had over five years of lending and banking experience respectively.

In response to specific factors causing occurrences of NPLs, the results that diversion of fund indicated by more respondents then followed by market fluctuation and economic condition.

Regarding ranking factors affecting occurrences of NPLs in commercial bank of Ethiopia, poor risk assessment, 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 (94.8 percent) agreed that strict employment of KYC principle, followed by prudent credit assessment leads to high asset quality, (92.6 percent).

Around 95 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.

The response on the relation between loan pricing (interest rate) and occurrences of loan default depicted that 69.5 percent disagree that loans with big interest rate tend to turn to NPLs.

With regard to the impact of culture on occurrence of NPLs, 92.7 percent and 76.9 percent of the respondents agree that loan performance depends on orientation/culture of the society and the borrowers respectively.

Respondents asserted that two 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 and increased risk appetite However, results indicate that factors like size of a bank has no significant impact on occurrences NPLs.

4.6. Causes and Effects of NPLs

Bank is taken in money as deposits on which they pay interest and then lend it out to borrowers who use it to finance trade, investment or consumption. Bank make profit mainly from the different between the interest they pay on deposits and the interest they receive on loans &advances. The problem of NPLs is one of the serious problems of bank. However, for many reasons the loans may turn to non-performing assets**.** Causes for NPLs can be classified into three classes, namely, factors specific to the borrower, factors specific to the lender bank and factors specific to the macroeconomic conditions of the country.

4.6.1.Causes Specific to the Borrower

A borrower may default because of either he/she is unable or unwilling to pay. Inability to pay is related to the financial conditions of the borrower, while unwillingness to pay is mainly related to the enforcement system which could be a legal or social mechanism. In other words, willingness to pay depends on the borrower's honesty, which is shaped by the available legal enforcement mechanisms and other social features such as spiritual and religious norms of the society.

Inability to repay occurs when the borrower's project to be financed by the loan earns a gross return less than the principal, and the interest due on the loan. Thus, poor quality project is one factor that causes loans default. Even if the project is good, if the owner of the project manages it poorly, the loan received to finance the project may become less productive. This may occur if the owner or the manager of the project is illiterate and unskilled to manage the project and the loans received in this regard.

Absence of financial statements and/or cash flows of the investment project financed by the loan create difficulties on planning how much to be earned and hence to repay periodically. Thus, if the borrower doesn't have proper accounting and auditing mechanism, it will be difficult for him to repay his/her periodic repayment timely and properly. In Ethiopia since small firms are not obliged to prepare their financial statements and audit their performances, this is common factor for defaulting.

Lack of adequate knowledge (being illiterate or unskilled) on how to use loans granted may lead to default. In this connection, loan diversion is a problem for such borrowers, because they may employ the loan for other purposes and the investment project will have low returns that could not cover the repayment resulting in default.

Insufficient or inexact loan provision may make the project less productive and repayment could be difficult. Similarly, short period of loan due date makes the periodic repayment so high that the borrower may face difficulties to repay, thus resulting in default.

Some borrowers may default regardless of their financial capabilities. They may default when the cost (consequence) of default is lower than its benefit. Cost of default involves a number of

factors such as: loss of collateral offered, loss of future access to credit, loss of reputation, loss of status in community and if the borrower is not of a limited liability (PLC or corporation) then it may also lose other personal wealth, etc. Irrespective of these, however, some borrowers may have poor personal qualities of dishonesty, fraud, etc., and are unwilling to repay their loans, and become defaulters.

In general, the factors mentioned above are the possible reasons for defaulting (i.e., causes of NPLs) which are specific to the borrower.

4.6.2. Factors Specific to the Lender Bank (Commercial Bank of Ethiopia)

Lender bank need to assess the credit worthiness of their borrowers before they grant loan and need to monitor and follow-up the effective utilization and repayment of the loan after disbursement.

Thus, credit market is information intensive, and bank need to have much information to effectively extend their loans and minimize the losses associated with NPLs.

Since most firms are small and have no financial statements, bank faces scarcity of information. In such cases, finding information to evaluate prospective borrowers and their projects, and encouraging borrowers to willfully repay has significant difficulties. In some cases, it is also difficult to seize collateral, resell it or to use legal action to collect bad debts from defaulters.

Due to fear of default bank charge high lending rates to compensate loan losses, which make cost of borrowing high. When the interest rate is high, the effort on the part of the borrower to make the project successful decreases resulting in default (NPLs). At higher interest rates low-risk borrowers

Would find it almost impossible to borrow and rather prefer not to seek loans while high risk borrowers would take the loan and gamble the proceeds in a risky venture.

Bank makes choices among investments to be financed on the basis of expected return and risk. Good information is needed in order to make those choices, to monitor borrower's behavior after lending and to take appropriate corrective actions if it appears that things are not going as planned. For these matters, bank require reliable data, which in turn depend upon better accounting, auditing and rules on disclosure of financial information. However, the information system in our country is poor that bank often use incomplete information for decision-making, where the probability of default is high.

Scarcity of skilled and experienced manpower in loan processing results in poor loan quality, which will turn out to large NPLs. Lack of adequate trainings and continuous updating of the level of staff competence may create poor credit evaluation, monitoring and recovery.

Excessive dependence on collateral alone would create poor credit allocation. Considering collateral lending as a loan adequately secured where such a loan has no visible cash flow results in difficulties of repayment or default. Similarly, overestimation of the collateral or the fall in its value upon its sale would result in loss of some income to be covered by the collateral in the event of default. A more serious problem is lack of a well-developed second hand markets or saturation of the market for properties pledged as collateral.

Desire of acquiring fast profit by the managers of a bank may also result in lending to poor quality borrower. Competition among the banks to attract borrowers has similar adverse effect of lending to non-promising borrowers. Concentrations of loans of a bank to some specific sectors or industries only are causes of trouble. When a bank lends excessively to some sectors of the economy, the portfolio diversification becomes narrow resulting in high occurrence of risk of defaulting.

Existence of large volume of deposits compared to the relatively low level of outstanding loans in the bank urge the bank to lend even to the undesired borrowers or borrowers of poor project quality. This may lead to high risk of defaulting.

4.6.3. Factors Specific to Macroeconomic Conditions

Banks also suffer from unsound macroeconomic conditions. Unstable prices or substantial variations in prices may cause problem of loan losses because firms for whom the change in price is unfavorable will get difficulties to pay their debts. The overall economic performance of the country will affect banks in their loan provision and collection activities. Inadequate legal system where right and responsibilities under financial contracts may not be clearly spelled out and enforced would create large default of loans because foreclosure of pledged collateral may not be affected easily in absence of strong legal system. Indeed foreclosure is not desirable outcome both for the bank and the borrower, however, the threat of foreclosure is believed to keep borrowers from willful default and the same belief would encourage lenders to lend. Lack or weakness of an adequate basis for drafting and enforcing financial contacts due to poor legal system in the country is believed to increase the volume of NPLs.

Unfavorable macroeconomic conditions that lead to large-scale failures of enterprises of a country may create problems to banks. Since most enterprises are interconnected with banks as borrower lender relationships, failure of these enterprises in large scale would make them unable to repay their loans. Similarly, sudden changes in market conditions, interest rates, exchange rates, etc. would make firms unable to service their loans resulting in large NPLs.

4.7. Effects of NPLs

When a bank holds large volume of NPLs it will suffer from serous liquidity problem. That is, most of its liquid assets (cash and cash equivalents) tend to be lost. At this time the bank will be unable to extend further loans for new loan requests. In the meantime earnings to be collected from the outstanding loans would be denied. Consequently, the bank loses the principal and the interest income from NPLs. Recovery of such bad debts requires effective legal system to realize the value of the collateral security pledged against the loan. Even if it is possible to sell, loss of value up on sale of the collateral will erode profit of the bank and obviously its capital base.

The problem reaches highest stage when the bank becomes unable to meet the day-to-day cash and deposit withdrawal needs of its customers. Since immediate liquidation of large volume of collateral assets is very difficult or involve large capital loss, the liquidity problem of the bank may deteriorate into a solvency problem. The bank is said to be insolvent when its assets value is less than the value of its liabilities and hence, the value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its depositors in full and on time Losses thus will pass to depositors, creditors and shareholders of the bank. Such an event is called bank failure.

Table 15 Correlation Matrix

		Total Asset	Net Deposit	Net Loan	NPL Ratio
Total Asset	Pearson Correlation	1.000	0.989**	0.956**	0.023
	Significance		0.000	0.000	0.856
Net Deposit	Pearson Correlation	0.989**	1.000	0.918**	-0.043
	Significance	0.000		0.000	0.735
Net Loan	Pearson Correlation	0.956**	0.918**	1.000	0.050
	Significance	0.000	0.000		0.698
NPL Ratio	Pearson Correlation	0.023	-0.043	0.050	1.000
	Significance	0.856	0.735	0.698	

** Correlation is significant at the 0.01 level (2Atailed).

Source: Financial data of bank and own computation

As can be observed from Table 15 at the 0.01 level of significance there were statistically significant relationship between net deposit and total asset of bank studied. Same was true for the relationship between net loan and total asset at 0.01 level of significance. So as total deposit or net loans of bank increased the total asset had also increased. Besides, the correlation between deposit and net loans at 0.01 level of significance was strong. So with increase in bank deposit there was also growth in net loans bank advanced.

On the contrary at 0.05 level of significance there were no statistically significant relationships between the total asset and NPL ratio as the Pearson correlation was only 0.023 i.e. very weak. The Pearson correlation between net deposit and NPL ratio was also A0 .043 i.e. very weak negative correlation.

Considering the Pearson correlation between net loans and NPL ratio at 0.05 level of significance was 0.05 indicating that there was no statistically significant relationship between the net loans and NPL ratio. So, though there was growth on size of loans of the bank studied during the period 2009-2014, the NPL ratios had an erratic trend indicating that NPL of bank are not explained by loans size.

As has been indicated earlier the total assets of the bank, which indicate size of bank, have shown growth throughout the period under consideration. However, the outcome of the analysis depict that at 0.05 level of significant, there were no statistically significant relationship between NPL ratio and total assets, which is the indicator bank size. So the study fails to support earlier studies that indicated the relation between bank size and nonperforming loans.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

Conclusion

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. Commercial bank of Ethiopia render different kinds of services; among which provision of credit is the major one as bank lending is the core function. 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.

NPLs 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 basic objective of this research has been to identify borrower bank and macroeconomic specific assessment of NPLs. On the basis of the broad objective one major research questions and five sub research questions were developed and dealt with. For the achievement of the objective the study used survey of employees of commercial bank of Ethiopia.

The study indicated that poor credit analysis on the part of lending bank 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.

Recommendation

Commercial bank of Ethiopia (lending bank) 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 bank 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.

Commercial bank of Ethiopia in order to maintain quality bank should:

- Put in place proactive follow-up and monitoring system to monitor loan performance and check continued viability of operations.
- 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.
- Provide training and development to employees involved in credit operations to enhance the aptitudes and abilities of every member.

REFERENCES

Alton, R. & S., Hanzen (2001). A comparative study of structural models of corporate bond yields: an explanatory investigation. Journal of Banking and Finance, 24: 69-255.

Auronen, L (2003), Asymmetric Information: Theory and Applications. Paper presented in the Seminar of Strategy and International Business as Helsinki University of Technology, May 21st 2003.

Azofra, F. &R.,Santamaria (2011). Credit risk management: a survey of practices. Managerial Finance 32(3): 227-233

Babihuga, R (2007), Macroeconomic and Financial soundness indicators: An empirical investigation, IMF working paper, no.115, 2007.

Bangia, J., Lin, C., Lin, P. & Song, F. (2002). Corruption in bank lending to firms: cross-country micro evidence on the beneficial role of competition and information sharing. Journal of Financial Economics, 91: 361-388.

Barr, P. and Siems (1994). Money and Capital Markets: Financial Institutions and Instruments in a Global Marketplace. 6th Edition, McGraw – Hill International Edition.

Basel Committee. 1997. Core Principles for Effective Bank Supervision. Basel Committee on Banking Supervision.

Beck, H (2001), Banking is essential or not, the future of financial intermediation in the age of the Internet, Netnomics 3, 7-22.

Berge, T.O and Boye, K.G (2007). An analysis of bank's problem loans, Norges Bank Economic Bulletin 78, 65–76.

Bercoff, J. J, Julian di G and Grimard F (2002), "Argentinean Banks, Credit Growth and the Tequila Crisis: A Duration Analysis"

Berger, N. A and De Young R (1997), Problem Loans and Cost Efficiency in Commercial Banks, Washington DC. Journal of Banking and Finance, 21(6, 849-870.

Bester, H (1994). The Role of Collateral in a Model of Debt Renegotiation. Journal of Money, Credit and Banking, 26 (1), 72-86

BexleyJ.BandNenninger S (2012), Financial Institutions and the Economy.Journal of Accounting and Finance, 12(1) 2012.

Carey, M (1998). Credit risk in private debt portfolios. Journal of Finance 53, 1363–1387

C., Brown, D.J. Mallet &M.G. Taylor.1993 Banks: an Industrial Accounting and Auditing Guide. Great Britain: Page Bros Ltd.

Cifter, A, Yilmazer, S and Cifter, E (2009), Analysis of sectoral credit default cycle dependency with wavelet networks: evidence from Turkey. Journal of Economic Modelling, 26, 1382–1388.

Chowdhury, D. &Anhikay P. (2002): Business Research Methods, 8th edition. New York: McGraw-Hill/Irwin.

Deguefe, Teferra (2006). Minutes of an Ethiopian Century. Addis Ababa: Shama Books.

Demirguc-Kunt and EnricaDetragiache, "The Assessment of Banking Crises in Developing and Developed Countries", IMF Staff Paper 45 (1), 1998, 81-109

Espinoza, R. and Prasal, A. (2010). Non-performing loans in the GCC banking system and their macroeconomic effects. IMF working paper: WP/10/224.

Fofack, H (2005), Non-Performing Loans in Sub-Saharan Africa: Causal Analysis and Macroeconomic Implications, World Bank Policy Research Working Paper No. WP 3769.

Garcia, M. & Robles, F. (2007).Bank stability, sovereign debt and derivatives.Emerging Issues Series, Federal Reserve Bank of Chicago.

Gary, H. Stern, Ron J. Feldman (2004). Too Big To Fail: The Hazards of Bank Bailouts, Brookings Institution Press, Washington, DC, 2004, 230 + xiii pp., index, US$ 32.95, ISBN 0-8157-8152-0 .

Gidey, Belay. (1987). Currency & Banking: Addis Ababa.

Greenidge, K and Grosvenor, T (2010), Forecasting Non-performing loans in Barbados.Journal of Business, Finance and Economics in Emerging Economies, 5, 80-107.

Greuning, H and Bratanovic, S.B (2003), Analyzing and Managing Banking Risk: A Framework for Assessing Corporate Governance and Financial Risk. 2nd edition, The World Bank, Washington DC.

International Monetary Fund.(2009). Initial lessons of the crisis. IMF Staff Paper 09/37. International Monetary Fund, Washington, DC.

NBE, 2008, Asset classification and Provisioning Directive No.SBB/43/2008.National Bank of Ethiopia, Addis Ababa Ethiopia.

Appendix I

Questionnaire

ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES
MBA PROGRAM

Dear Respondent

Thank you very much for your willingness to take time to respond to this research questionnaire. It is all about questions pertaining to **Assessment of Non-performing Loans** and related practices in the Commercial Bank of Ethiopia. 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.

Thank you in advance.

TirsitZewdie

Questionnaires to be filled by the employees of CBE

1. Your current position in the Banking industry.

1. Loan Officer
2. Credit analysis
3. Credit Director
4. Relationship manager
5. Recovery/monitoring office

Other, Please specify……………………………………………..

2. Indicate your experience in the Banking industry.

1. Less than 1 year
2. 1-5 years
3. 6-10 years
4. 11-15 years
5. Above 15 years

3. Indicate your experience in the Banking credit process.

1. Less than 1 year
2. 1-5 years
3. 6-10 years
4. 11-15 years
5. Above 15 years

4. Assessment of nonperforming loans are obvious.

1. Agree
2. Neutral
3. Disagree

Section Two – Questions on Assessment of Nonperforming loans.

1. What specific factors do you think are causing the occurrences of NPLs in Commercial Bank of Ethiopia?

----

2. Please rank the factors that cause occurrences of NPLs in the Commercial Bank of Ethiopia by Ranking the factors in order of their importance in contributing to the occurrence of NPLs from 1 – 7.

Factors	Factor that causes occurrence of NPLs	Rank 1=highest ….7=lowest
2.1	Rapid loan growth by bank	
2.2	High interest rate	
2.3	Lenient credit term	
2.4	Credit culture /Orientation	
2.5	Size of the bank	
2.6	Poor monitoring/follow-up	
2.7	Poor risk assessment	
2.8	Other, Please Specify……... ..…………………………………………………	

3. Please indicate your degree of agreement or disagreement to the statement pertaining to credit assessment and the occurrence of NPLs.

Factors		Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree (1)
3.1	Easily admitted borrowers usually default					
3.2	Know You customer (KYC) Policy of bank lead to high Loans quality					
3.3	Good loan underwriting ensures loan performance					
3.4	Poor risk assessment would lead to loan Default					

4. Please indicate your degree of agreement or disagreement to the statements pertaining to credit monitoring and the occurrences of NPLs

Factors		Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree (1)
4.1	Strict monitoring ensures loan performance					
4.2	Poorly assessed and advanced loans may perform well if properly monitored					
4.3	Loan follow up is directly related to occurrence of NPLs					
4.4	Bank with higher budget for loan monitoring has lower NPLs					

5. Please indicate your degree of agreement or disagreement to the statement pertaining to collateral and the occurrence of NPLs.

Factors		Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree (1)
5.1	Collateralized loans perform well					
5.2	Collateralizing loans help protect loan default					
5.3	Most of the time non collateralized loans are Defaulted					

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

Factors		Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree (1)
6.1	Borrower's orientation/culture is related to loan performance					
6.2	There is a relationship between loan default and borrower's culture.					
6.3	Default in some area is ascribed to the culture of the borrowers					
6.4	Society's cultural development leads to good loan performance.					
6.5	Loan with big interest rent tend to turn to NPL					
6.6	Charging big interest rate leads to loan default					
6.7	Loan price affects loan performance					
6.8	Lenient /lax credit term cause loan default					
6.9	Borrows defaults because they don't understand credit terms well					
6.10	Poorly negotiated credit terns lead to loan non performance					

7. Please indicate your degree of agreement or disagreement to the statement pertain got credit Growth and the occurrence of NPLs.

Factors		Strongly Agree (5)	Agree (4)	Neutral (3)	Disagree (2)	Strongly Disagree (1)
7.1	Aggressive lending leads to large NPL volume/ratio					
7.2	Bank whose credit growth is rapid experience huge NPL level					
7.3	Bank great risk appetite is cause for NPL					
7.4	Compromised integrity in lending leads to loan default					
7.5	Having large no. of borrowers causes loan default					
7.6	Loan default rate is directly related to banks size					
7.7	With growth in banks size comes growth on NPL					

8. If you have further comments on the bank specific factors affecting NPLs of the Ethiopian Banks please use the space provided below:

____

____

____

____

____

____

Thank you once again for your participation

Appendix II

Appendix2.1. Surveyed Banks Financial Data from June 30, 2009 to 2014

Particulars	2009	2010	2011	2012	2013	2014
Total Asset '000'	100326.11	102326.13	114265.10	158112.30	195443	247127.81
Total Deposit'000'	648151	710220	89056.60	120115.52	154438.28	194052
Total Loan'000'	NA	100431.18	108283.80	151078.80	185409.01	233035.53
Total NPL'000'	49344.18	75496.60	122992.60	149006.60	200980	310115
NPL Ratio	27.52	22.45	14.52	5.33	3.70	1.70
Profit before TAX	2808	4238.1	7931.6	8561	9949.01	NA

Source: Audited Financial Statement of Bank

NA* the data is not available.