

St. MARY'S UNIVERSITY

FACULTY OF BUSINESS DEPARTMENT OF ACCOUNTING

AN ASSESSMENT OF CONDITIONS AND TRENDS OF NONPERFORMING LOAN IN DASHEN BANK

PREPARED BY

ALEM BERHE

MIHIRET BEKELE

MAHLET BETEMARIAM

MAY, 2014
SMU
ADDIS ABABA

**AN ASSESSMENT OF CONDITIONS AND
TRENDS OF NONPERFORMING LOAN IN
DASHEN BANK**

**A SENIOR RESEARCH SUBMITTED
TO THE DEPARTMENT OF ACCOUNTING**

BUSINESS FACULTY

St. MARY'S UNIVERSITY

**IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF BACHELOR OF ARTS IN
ACCOUNTING**

PREPARED BY

ALEM BERHE

MIHIRET BEKELE

MAHLET BETEMARIAM

**MAY, 2014
SMU
ADDIS ABABA**

St. Mary'S University

AN ASSESSMENT OF CONDITIONS AND TRENDS OF NONPERFORMING LOAN IN DASHEN BANK

PREPARED BY

ALEM BERHE

MIHIRET BEKELE

MAHLET BETEMARIAM

FACULTY OF BUSINESS
DEPARTMENT OF ACCOUNTING

APPROVED BY THE COMMITTEE OF EXMINERS

Department Head

Advisor

Internal Examiner

External Examiner

Signature

Signature

Signature

Signature

Table of Content

ContentsPages

Acknowledgement

List of table

Acronyms

CHAPTER ONE

INTRODUCTION

1.1. Background of the study	1
1.2. Background of the organization	2
1.3. Statement of the problem	3
1.3.1. Research question	4
1.4. Objective of the study	4
1.4.1. General objective	4
1.4.2. Specific objective	5
1.5. Significance of the study	5
1.6. Scope of the study	5
1.7 Limitation of the study	6
1.8. Research Design and Methodology	6
1.8.1 Research design.....	6
1.8.2. Population and area of the study.....	7
1.8.3. Types and source of Data	7
1.8.4. Data collection method	7
1.8.5. Method of data analysis	8
1.9. Organization of the study	8

ContentsPages

CHAPTER TWO

Literature Review

2.1 Introduction	9
2.2 Meaning of bank	9
2.3 Role of bank	9
2.4 History of banking in Ethiopia	10
2.5 Meaning of loan and advance	12
2.6 Non-performing loan	12
2.6.1 Criteria for non performing loans in the international statistics manual	13
2.6.2 Criteria for non performing loan's recommended by banking and accounting institutions	13
2.6.3 Criteria for non performing loans as per directive of National bank of Ethiopia (NBE)	15
2.7 Causes of non performing loans	15
2.8 Bank loan and lending procedure	17
2.8.1 Bank loan	17
2.8.2 Lending procedure	17
2.9 Credit analysis	19
2.10 Credit risk	19
2.11 Credit assessment	20
2.12 Classification of nonperforming loans	23
2.13 Requirement of loan loss provision for non-performing loans	24

ContentsPages

CHAPTER THREE

Data Presentation, Analysis and Interpretations

3.1 Introduction	26
3.2 General characteristics of the respondents.....	26
3.3 Factor that affecting bank lending	28
3.4The causes of NPL in dashen bank.....	31
3.4.1Factor that affecting occurrence of NPLs	31
3.5 Bank loan and lending procedure	36
3.6The effect of NPL in Dashen bank	39
3.7 Impacts of NPL on banks performance of the bank	41
3.7.1Factors believed to cause occurrences of NPL by the interviewees	41
3.7.1.1 Bank internal factor	42
3.7.1.2 Bank external factor	42
3.7.1.3 Customer related factors.....	43
3.7.2Preventive technique method	43
3.8 Methods to check the originality of documents.....	44

CHAPTER FOUR

Summary, Conclusion and Recommendation

4.1Summary	45
4.2Conclusions	46
4.3Recommendation	47

ACKNOLEGEMENT

More credit is due to our advisor Ato Alula Hailu for his ever unforgettable, advice and unreserved time and energy in feeding his comment to us by raising the scratch to be effective and up graded, Secondly we would also like to thank the Co-operation of all Dashen Bank credit Staffs for their unreserved treatment and Provision of every important date at their disposal.

List of table

Table3.1.General characteristics of respondent	26
Table 3.2.Factors that affecting occurrence of NPL are obvious.....	30
Table 3.3.Provision of consultancy and training before loan.....	32
Table 3.4.Credit approval procedure.....	34
Table 3 .5.Effectiveness of credit analysis before loan is granted.....	35
Table 3.6. Ranking of factor that cause occurrence of Non performing loans in dashen bank.....	35
Table3 .7.Factors indicating relationship between credit assessment andloan default.....	36
Table 3.8.Credit monitoring and the occurrence of NPL	36
Table 3.9.Relation between collateralized loans occurrence of NPL.....	38
Table 3.10.Bank follow up and competence of officers	38
Table 3.11.Measurement of bank follow up method.....	39
Table 3.12. Total loans, NPL,NPL as percentage of total loan	40
Table.13.Time Taken To Approve And Disburse The Approved Loan.	40

ACRONYMS/ABREVIATION

IMF International money fund

NBE National bank of Ethiopia

KYC know your customer

NPL Nonperforming

FDRE Federal Democratic Republic of Ethiopia

CHAPTER ONE

1. INTRODUCTION

1.1 Background of the study

"A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank links together customers that have capital deficits and customers with capital surpluses." (<http://en.wikipedia.org>, G. Devies J H Bank - *A history of money: from ancient times to the present day* University of Wales Press, 2002 - Retrieved 2012-05-17)

"In finance, a loan is a debt evidenced by a note which specifies, among other things, the principal amount, interest rate, and date of repayment. A loan entails the reallocation of the subject asset(s) for a period of time, between the lender and the borrower. The borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular installments, or partial repayments; in an annuity, each installment is the same amount." (<http://en.wikipedia.org> Signoriello, Vincent J. (1991), *Commercial Loan Practices and Operations*.)

"Loan is a major asset, income source for banks, and risky area of the industry. Moreover, its contribution to the growth of any country is very clear. Bank credit is the primary source of debt financing available for most customers in the personal, business or corporate market." (Koch & MacDonald, 2003)

For the procedure of giving loan and advances banks face a risk of nonperforming loan. The concept of non-performing loans has been defined in different literatures. According to the International Monetary Fund (IMF, 2009), a non-performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days' worth of interest has been refinanced.

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

The causes for loan default vary in different banks and have a multidimensional aspect, such as economic condition of the country, mismanagement of the bank, poor loan follow-up, and unskillful customer (borrower) to run the business, so and so on.

The research deals with an assessment of conditions and trends of nonperforming loan in Dashen bank and helps to minimize the nonperforming loan. In other words, to increase the capability of the customer (borrower) to settle down his principal and interest.

1.2 Background of the Organization

From the private owned banks, Dashen Bank is one of the present days known bank in our country. Dashen bank was established on September 20, 1995 as a share company in accordance with the “Commercial Code of Ethiopia”, and the “Licensing and Supervision of banking business proclamation No.84/1994.” Dashen came in to existence with an authorized and subscribed capital of Birr 50 million and a paid up capital of birr 14.9 million. The first founding members were 11 business men and professionals that agreed to combine their financial resources and expertise.

Currently, the bank’s capital grown to Birr 1.8 billion. The bank has 120 branches spreading over major towns in Ethiopia and convenient sites in Addis Ababa. (www.dashenbank.com)

Dashen bank classifies the branches in different categories. When a new branch is opened the branch starts its operation with collecting deposits as well as customers. After some time the branches collect more deposits and customers. Then the branch will start to lend money and facilitate import and

export transactions. The bank's grading system is from grade 1 to grade 4 and above grade 4 there is a special grade. According to the deposit amount and, profit and amount of transaction the board will decide to upgrade the branch level from lower to the next upper grade. The higher the grade the higher will the profit and deposit of the bank.

1.3. Statement of the problem

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

Dashen bank is one of the private commercial bank in Ethiopia. The bank plays an important role in the country's economic and social life. The five years (from 2008-2012 G.C) financial report shows as major portion of their income is earned from loans and advances.

Even though the loan that constitutes the major assets is the major source of banks income. It is the most risky area in the bank transactions and as a result it makes credit management one of the most risky and critical activities carried out by Dashen bank. In fact of all the risks banks face, credit risk is considered as the most lethal as bad debts would weaken banks profit. Nonperforming loan arises from uncertainty in a given counterparty's ability to meet its obligations.

In Ethiopia, commercial banks in the country are required to maintain ratio of their nonperforming loans below five percent (NBE, 2008). Despite this, the corporate nonperforming loan position ratio of Dashen bank has shown undesirable increase compared to the previous year (2012). It is increased from 4.5% to 7.17%. The substandard category (As per the national bank of Ethiopia's, directives issued in relation to nonperforming loan or advance past due 90 days or more but less than 180 day's shall at a minimum be classified substandard.) has increased by 107.67% compared to previous year caused by regular account turned to nonperforming loan.

Even though this can be consider as bad performance the figure shows there is a big gap for improvement.

Since loan is the main source of income of the bank, nonperforming loan handled by controlling the process and procedure of the lending.

1.3.1 Research question

Our researches try to address by using the following questions as tools to identify the current reality of conditions and trends of nonperforming loan in Dashen Bank.

- What are the main causes of nonperforming loan?
- What is the process and procedure of lending?
- What types of method does the bank use to certify the originality of information provided by customer (borrower)?
- What are the major impacts of nonperforming loan performed by the bank?
- What is the trend of nonperforming loans in Dashen bank?

1.4 Objective of the study

1.4.1 General objective

The general objective of the study is to assess conditions and trends of nonperforming loan in Dashen bank.

1.4.2 Specific objectives

The following specific objectives were formulated to contribute to meeting the general objective:-

- ❖ To identify the main factors and reasons that affects the nonperforming loan.
- ❖ To assess how the bank lending process and procedure follows.
- ❖ To have clear know how of the methods, information and requirements of loans granted to the customer by the bank.
- ❖ To assess the impact of nonperforming loan on the bank.
- ❖ To examine how the Dashen bank follow up the customers or borrowers.

1.5 Significance of the study

The study has great contribution to the concerned managers of banks with regard to how they properly address the credit need of their customers and it insures the compliance of staff with the rules and regulations of the banks regarding credit. Furthermore, it improves collecting ability of their loans. It also enables them to get insight on what it takes to improve their loan qualities. In addition, the study identifies the problem which reduces the bank profit and effect of nonperforming loan on the bank profitability. In addition to these; it helps the management of Dashen bank to assess the conditions and trends of nonperforming loan. Finally, it helps as a reference to other researchers who are interested to conduct study in this area.

1.6 Scope of the study

The study investigates the assessment of conditions and trends of nonperforming loan in Dashen bank. The researchers took the last Ten years data (2003-2012) of the organization.

1.7 Limitation of the study

The major problems in this study are as follows:-

- Due to the confidential policy of banks, access to customer and banks information except officially disclosed financial information, cannot be possible. The study was limited to bank employees and officials, besides the study were mono-sided.
- The researchers like to work out using branch reference information, the bank from the very beginning has stopped using branch information's references, The researcher are therefore maintain with Dashen bank as a whole.

1.8 Research Design and Methodology

1.8.1 Research Design

For the achievement of the research, the assessment of conditions and trends of nonperforming loan in Dashen bank, the researchers used descriptive type of research. A descriptive type of research is an observational study that simply describes the distribution of characteristics. Because, as this is business research; descriptive type of research is more relevant than the other types of research methods. In addition, to provide accurate information, describe a processes and mechanism the researcher chooses this method.

The data also includes qualitative and quantitative data which have to be simple for analyzing and interpretation.

Qualitative data are data that deals with descriptions that can be observed but not measured in units.

Quantitative data are data that deals with numbers which can be measured in units.

1.8.2 Population and area of the study

The population for this study has 25 officials in the credit department. We took all the officials who are responsible for processing loan in the bank. The population of the study is credit manager, deputy credit manager, credit analyst, and loan officers and clerk loan who are responsible for processing loan in the bank.

1.8.3 Types and source of data

In order to conduct the research both primary and secondary data will be used to undertake the study.

Primary data are collected afresh and for the first time, and thus happen to be original in character.

Secondary data on the other hand, are those which have already collected by some other agency and which have already been processed.

1.8.4 Data collection method

In our study the researcher have collected both primary and secondary data. The researchers used two methods to collect the primary data. The first one is questioner and the second one is personal interview. The researcher use semi structured interview questions. Because of time constraint interview with only three higher officials. Even if we can to interview all staffs they do not allow us to wastage their time with us. So because of the above reasons we give questioner to rest of the staff. Secondary data has been collected from financial interim of the bank from their website.

1.8.5 Method of data analysis

The primary data obtained through interviews will be analyzed using qualitative methods of analysis, and the result will be presented and analyzed through appropriate explanation. The primary data which are collected through questioner will be analyzed using quantitative method of analysis and the result will be presented similar to the qualitative method of analysis. And secondary data will be analyzed through percentage and tabular form.

1.9 Organization of the study

Our study will be organized in to four chapters. The first chapter will deal with introduction (Background of the study & Background of the organization), statement of the problem, research methodology & data sources, significance of the study, general & specific objectives, and provides the general introduction about the whole report. In chapter two will be revisited a review of the literature, third chapter is concerned with data presentation and analysis. The final chapter concerned in summary, conclusion, and recommendation.

CHAPTER TWO

Review of Related Literature

2.1 Introduction

This chapter review meaning of bank, role of bank, the history of bank in Ethiopia, meaning of loan and advance, meaning of nonperforming loan, criteria for nonperforming loan, causes of nonperforming loan, loan and lending procedures, credit analysis, credit risk, credit assessment, classification of nonperforming loan and requirement of loan loss provision for nonperforming loans.

2.2 Meaning of bank

An establishment authorized by a government to accept deposits, pay interest, clear checks make loans, act as an intermediary in financial transactions, and provides other financial services to its customers. (www.businessdictionary.com)

Banks can create new money when they make a loan. New loans throughout the banking system generate new deposits elsewhere in the system. The money supply is usually increased by the act of lending, and reduced when loans are repaid faster than new ones are generated. (<http://en.wikipedia.org>)

2.3 Role of bank

The banking sector makes a meaningful contribution to the economic growth of every country. Banks contribution to the growth lies in the role they play in mobilizing deposits and allocating the resources efficiently to the most productive uses investment in the real sector. So making credit available to borrowers is one means by which banks contribute to the growth of economies. Banks pool resources together for projects that are too large for individual shareholders to undertake (Bagehot, 1873). They are also considered the most important enabler of financial transactions in any country's economy and are the principal source of credit (Rose, 2002). Bank finance is the primary source of debt funding.

Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Saunders & Cornett, 2003).

2.4 History of Banking in Ethiopia

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

Thus by 1931 Bank of Abyssinia was legally replaced by Bank of Ethiopia

Shortly after Emperor Haileselassie came to power, The new Bank, Bank of Ethiopia, was a purely Ethiopian institution and was the first indigenous bank in Africa and established by an official decree on August 29, 1931 with capital of £750,000. It acted as the central Bank of Ethiopia and had a power to issue bank notes and coins as the agent of the Ministry of Finance. In 1945 and 1949 the Bank was granted the sole right of issuing currency and deal in foreign currency. The Bank also functioned as the principal commercial bank in the country and engaged in all commercial banking activities. Then the Ethiopian Monetary and Banking law that came into force in 1963 separated the function of commercial and central banking creating National Bank of Ethiopia and commercial Bank of Ethiopia. Moreover it allowed foreign banks to operate in Ethiopia limiting their maximum ownership to be 49 percent while the remaining balance should be owned by Ethiopians.

Bank of Ethiopia took over the commercial activities of the Bank of Abyssinia and was authorized to The State Bank of Ethiopia had established 21 branches including a branch in Khartoum, Sudan. The National Bank of Ethiopia with more power and duties started its operation in January 1964. The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963

as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.

Following the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. Organizational setups were taken in order to create stronger institutions by merging those that perform similar functions.

Following the demise of the Dergue regime in 1991 that ruled the country for 17 years under the rule of command economy, the EPRDF declared a liberal economy system. In line with this, Monetary and Banking proclamation of 1994 established the national bank of Ethiopia as a judicial entity, separated from the government and outlined its main function.

Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank, Awash International Bank was established in 1994. And Dashen Bank was established on September 20, 1995 as a share company with an authorized and subscribed capital of Birr 50.0 million. (www.nbe.gov.et.)

2.5 Meaning of Loan and advance

An arrangement in which a lender gives money or property to a borrower, and the borrower agrees to return the property or repay the money, usually along with interest, at some future point(s) in time. Usually, there is a predetermined time for repaying a loan, and generally the lender has to bear the risk that the borrower may not repay a loan (though modern capital markets have developed many ways of managing this risk). (www.investorwords.com)

Loans and Advances means any financial assets of a bank arising from a direct or indirect advance or commitment to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds, either

on a specified date or on demand, usually with interest (NBE Directive, SSB/43/008).

2.6 Nonperforming loan

Non -performing loans can be defined as defaulted loans, which banks are unable to profit from. Usually loans fall due if no interest has been paid in 90 days, but this may vary between different countries and actors. Defaulted loans force banks to take certain measures in order to recover and securitize them in the best way. Loans become non-performing when it cannot be recovered within certain stipulated time that is governed by some respective laws so non-performing loan is defined from institutional point of view. (J.Paterson)

According to the National Bank of Ethiopia directory non-performing loans - 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 are in question; or when principal and/ or interest is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity (NBE Directive, SSB/43/008).

2.6.1 Criteria for nonperforming loans in the international statistics Manuals

The 1993 System of National Accounts (SNA) does not provide criteria to decide what should be classified as nonperforming loans and other international statistics manuals are also silent on the subject concerning nonperforming loans. The bottom line in the international manuals seems to be that loans are good unless there is absolute certainty that a loan is not going to be repaid under existing arrangements. Thus, loans remain on the balance sheets until a debt cancellation, write-off or write -down has taken place .a different position is taken by the monetary and financial statistics manual (MFSM). Although the MFSM also records loans without adjustment for expected losses provisions for loan losses enter under other accounts payable

The 1993 SNA does not provide strict criteria to decide at which state exactly a non performing loan should be recorded as not existing anymore, In practice, therefore, one must rely on administrative or commercial accounting conventions as prevailing in a country or internationally recommended.

2.6.2 Criteria for nonperforming loans recommended by banking and accounting institutions

The extents to which authorize have been involved in developing criteria to distinguish b/n good and bad differs substantially b/n countries and as mentioned banking and financial institution have come in to provide guidance on this issue. Some countries use quantitative criteria (e.g. number of days of overdue schedule payments). While other counties exclusively rely on qualitative norms (such as availability of information about the client's financial status, management judgment about feature payments), some counties (Including Germany and U.K) do not give standard criteria at all. Furthermore, it cannot be said that a loan is either good or bad as there is a sliding scale in credit quality from risk free loans to these that do into give any hope for recovery (Adrian, M & Cornelis N. 2001)

To improve the ability to make comparison between banks across countries, the institute of international finance (IIF) report that for worldwide external reporting the following categories be used:-

- **Standard:** - Credit sound principal and interest payments are current. Repayment difficulties are not for seen under circumstances and full payments is expected.
- **Watch:** - Asset subject to conditions, if left on correct, could raise concerns about full payment. These require more than normal attention by credit officers.
- **Sub standards:** - full payment is in doubt due to in adequate protection (Obligor net worth or collateral) or interest or principal or both are more than 90 days overdue, these assets show underlying, well- defined weakness that could lead to probable loss if not corrected and thus risk becoming impaired assets.

- **Doubtful**:- Assets from which collection /liquidation in full is determined by bank management to be improbable due to current condition and interest or principal both are overdue more than 180 days. Assets in this categories are considered impaired but are not yet considered total losses because some spending factors may strengthen the asset quality (Merger, New Banking, or Capital injection)
- **Loss**: - an asset is downgraded to loss when management considers the facility to be virtually uncollectible or when interest or principle or both are overdue more than one year.

This classification may indicate that there are two cases that have to be addressed:-

- I. Loans that are a complete loss and
- II. Loans whose quality significantly impaired (sub standard or doubt full) and for which taken as a group experience source that a considerable portion of the future interest or instrument payments will never be made.(Adriaan, M &Cornelis N.2001)

2.6.3 Criteria for nonperforming loans as per directive of National Bank of Ethiopia (NBE)

As per the national bank of Ethiopia's, directives issued in relation to non-performing loans.

1. Loans and advances with per established repayment program are nonperforming when principal and or interest is due and uncollected for 90 days or more beyond the scheduled payment date or maturity.
2. Loans and advances that don't have a per-established repayment program shall be considered as nonperforming loans when:-
 - A. The debit remains out siding from 90 consecutive days or more beyond the scheduled payment date or maturity.
 - B. The debit exceeds the borrowers approved limit from 90 consecutive days or more.
 - C. Interest is due and uncollected for 90 days or more.
 - D. For over draft the account has been n active for 90 consecutive days and/or deposit is insufficient to cover the interest capitalized during the period.

The entire principal balance of loan or advances outstanding exhibited the characteristics described under 1 and 2 shall be considered nonperforming (NBE, 2002).

2.7 Causes of Non-Performing Loans

The non- performing loans are a result of the compromise of the objectivity of credit appraisal and assessment. The problem is aggravated by the weakness in the accounting, disclosure and grant of additional loans. In the assessment of the status of current loans, the borrower's credit worthiness and the market value of collateral are not taken into account thereby rendering it difficult to spot bad loans. (J.Paterson)

A more or less predictable level of nonperforming loans, though it may vary slightly from year to year, is caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.) Under such circumstances, the holders of loans can make an allowance for a normal share of nonperformance in the form of bad loan provisions, or they may spread the risk by taking out insurance, Enterprises may well be able to pass a large portion of these costs to customers in the form of higher prices, For instance, the interest margin applied by financial institutions will include a premium for the risk of nonperformance on granted loans.(Adriaan, M &Cornelis N.2001)

The amounts involved in nonperforming loans may rise considerably as a result of less predictable incidents, such as when the costs of fuel, prices of key export products, foreign exchange rates, or interest rates change abruptly. A similar effect may be caused by the sudden failure of a major company in an overly optimistic financial market (in this context the term "irrational exuberance" has been used.).If the resulting loss of confidence begins to snowball toward a crisis, at least three effects tend to further aggravate the situation,

- A fall in the prices of loan collaterals (often real estate) may cause more loans to become classified as doubtful.

- Large bad loan portfolios will affect the ability of banks to provide credit, and the resulting liquidity crunch may suffocate otherwise good creditors.
- Depositors and foreign investors may start a run on the banks. Pushing them in to liquidity problems.

The chances for the financial sector to derail usually considered being much higher under conditions of deficient bank management, poor supervision, overoptimistic assessments of credit worthiness during boom economies, and moral hazard that results from (too) generous government guarantees or the expectation of assured bailouts. Large exposure to international financial market can also complicate matters considerably. (Adriaan, M & Cornelis N. 2001)

2.8 Bank Loan and Lending procedure

2.8.1 Bank loan

The principal profit-making 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 (Reed and Gill, 1989). Lending represents the heart of the industry. Loans are the dominant asset and represent 50-75 percent to total amount of assets at most banks, generate the largest share of operating income and represent the banks greater risk exposure (Mac Donald and Koch, 2006).

Loans and advances are defined in the respective laws of different countries. In Ethiopia, under Article 13 (FDRE 592/2008) and (NBE/2008) Article (4.5) loans and advances are defined as:- "any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdrafts, participation in a loan syndication, the purchase of loan from another lender etc.) or commitment to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or on demand, usually with interest. The term includes a contractual obligation of a bank to advance

by the bank on behalf of a person. The term does not include accrued but uncollected interest or discounted interest."

2.8.2 Lending procedure

Making loans is the principal economic function of banks. For most banks, loans account for half or more of their total assets and about half to two-thirds of their revenues.

Risk in banking tends to be concentrated in the loan portfolio. Uncollectable loans can cause serious financial problems for banks.

- The loan portfolio of any bank is influenced by regulation. For example, in the USA, real estate loans cannot exceed the bank's capital, or 70% of its total time and savings deposits. Also, a loan to a single customer cannot exceed 15 % of banks capital.
- The quality of a bank's loan portfolio and the soundness of its lending policies are the areas bank examiners look at most closely when examining a bank. The possible examiner ratings are:
 - strong performance
 - satisfactory performance
 - fair performance
 - marginal performance
 - unsatisfactory performance

Steps in the Lending Process

- The customer fill out a loan application
- An interview with a loan officer usually follows right away
- If a business or mortgage loan is applied for, a site visit is usually made by an officer of the bank to assess the property
- The customer is asked to submit several crucial documents, such as financial statements

- The credit analysis division of the bank analyses the application and prepares a brief summary and recommendation
- Recommendation goes to the loan committee for approval
- If the loan is approved, the loan officer check on the property that is pledged as collateral in order to ensure that the bank has immediate access to the collateral if the loan agreement is defaulted. This is often referred to as perfecting the bank's claim to collateral. (Rose and Hudgins,2005)

2.9 Credit Analysis

A type of analysis an investor or bond portfolio manager performs on companies or other debt issuing entities encompassing the entity's ability to meet its debt obligations. The credit analysis seeks to identify the appropriate level of default risk associated with investing in that particular entity. <http://www.investopedia.com>

Credit analysis is the method by which one calculates the credit worthiness of a business or organization. The audited financial statement of a large company might be analyzed when it issues or has issued bonds or, a bank may analyze the financial statements of a small business before making or renewing a commercial loan. The term refers to either case, whether the business is large or small (Bizuneh, 2002).

2.10 Credit Risk

The risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

The higher the perceived credit risk, the higher the rate of interest that investors will demand for lending their capital. Credit risks are calculated based on the borrowers' overall ability to repay. This calculation includes the borrowers' collateral assets, revenue-generating ability and taxing authority (such as for government and municipal bonds). Credit risks are a vital component of fixed-income investing, which is why ratings agencies such as S&P, Moody's and Fitch evaluate the credit risks of thousands of corporate issuers and municipalities on an ongoing basis. <http://www.investopedia.com>

2.11 Credit Assessment

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

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

A credit analysis is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's (Striscek, 2000).

The Five C's of Credit

Character:

Character refers to the borrower's reputation and the borrower's willingness to settle debt obligations. In evaluating character, the borrower's honesty, integrity

and trustworthiness are assessed. The borrower's credit history and the commitment of the owners are also evaluated (Rose, 2000). A company's reputation, referring specifically to credit, is based on past performance. A borrower has built up a good reputation or credit record if past commitments were promptly met (observed behavior) and repaid timely (Rose, 2002; Koch & McDonald, 2003).

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

The quality of management in the specific business is evaluated by taking reputation, integrity, qualifications, experience and management ability of various business disciplines such as finance, marketing and labor relations into consideration (Sinkey, 2002; Nathenson, 2004).

Capacity

Capacity refers to the business's ability to generate sufficient cash to repay the debt. An analysis of the applicant's business plan, management accounts and cash flow forecasts (demonstrating the need and ability to repay the commitments) will give a good indication of the capacity to repay (Sinkey, 2002; Koch & MacDonald, 2003).

To get a good understanding of a company's capacity evaluating the type of business and the industry in which it operates is also vital. It plays a significant role since each industry is influenced by various internal and external factors. The factors that form the basis of this analysis include: Type of industry, Market share, Quality of products and life cycle, whether the business is labor or capital intensive, the current economic conditions, seasonal trends, the bargaining power of buyers and sellers, competition and legislative changes (Koch & MacDonald, 2003; Nathenson, 2004).

Besides, the financial position is also a critical indication of a business' capacity. The company's financial position is evaluated by assessing past financial performance and projected financial performance. A company's past

financial performance is reflected in their audited financial statements (Koch & MacDonald, 2003).

Capital

Capital refers to the owner's level of investment in the business (Sinkey, 2002). Banks prefer owners to take a proportionate share of the risk. Although there are no hard and fast rules, a debt/equity ratio of 50:50 would be sufficient to mitigate the bank's risk where funding (unsecured) is based on the business's cash flow to service the funding (Harris, 2003).

Conditions

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

Collateral

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

The purpose of security is to reduce the risk of giving credit by increasing the chances of the lender recovering the amounts that become due to the borrower. Security increases the availability of credit and improves the terms on which credit is available. The offer of security influences the lender's decision whether or not to lend, and it also changes the terms on which he is prepared to lend, typically by increasing the amount of the loan, by extending the period for which the loan is granted and by lowering the interest rate (Norton and Andenas, 1998: 144).

Loan Monitoring

After the loan is granted, the loan department must periodically review all loans until they reach maturity. Loan review helps bank management to spot problem loans quickly. This increase the chance to recover the loans and reduce the bank losses.(fbemoodle.emu.edu.tr/mod/resource)

2.12 Classification of nonperforming loans

Any bank loan that is in danger of default is nonperforming loan. Classified loans have unpaid interest and principal outstanding, and it is unclear whether the bank will be able to recoup the loan proceeds from the borrower. Banks usually categorize such loans as adversely classified assets on their books. Classified loans have failed to meet acceptable credit standards according to bank examiners. The credit quality has essentially declined since initial approval was granted. This type of loan has a high rate of borrower default, and raises the cost of borrowing money for the other customers (<http://www.investopedia.com>.)

According to National Bank of Ethiopia directive no SBB/32/2002 As per the issued in relation to classification of non-performing loans.

For purposes of these directives, banks shall classify all loans and advances, whether such loans or advances have pre-established repayment programs or not, into the following five classification categories using the criteria described below:-

Pass: -Loans or advances in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism. In general, any loan or advance, or portion thereof, which is fully secured, both as to principal and interest, by cash or cash-substitutes, shall be classified under this category regardless of past due status or other adverse credit factors. **Special Mention:**-Loans or advances with pre-established repayment programs past due 30 (thirty) days or more, but less than 90 (ninety) days.

Substandard: -Non-performing loan or advance past due 90 days or more but less than 180 day's shall at a minimum be classified substandard.

Doubtful: - loans or advances with pre-established repayment programs: past due 180 (one- hundred-eighty) days or more, but less than 360 (three-hundred-sixty) days.

Loss:- None performing loans or advances with pre-established repayment programs past due 360 (three-hundred-sixty) days or more.

2.13 Requirement of Loan loss provision for non-performing loans

A non-cash expense for banks to account for future losses on loan defaults. Banks assume that a certain percentage of loans will default or become slow-paying. Banks enter a percentage as an expense when calculating their pre-tax incomes. This guarantees a bank's solvency and capitalization if and when the defaults occur. The loan loss provision allocated each year increases with the riskiness of the loans a given bank makes. A bank making a small number of risky loans will have a low loan loss provision compared to a bank taking higher risks. (<http://thefreedictionary.com>)

As per National bank of Ethiopia directive no directive no SBB/32/2002 Provisioning Requirements for Loans or Advances shows as follow:

All banks shall maintain a Provision for Loan Losses Account which shall be created by charges to provision expense in the income statement and shall be maintained at a level adequate to absorb potential losses in the loans or advances portfolio. Indetermining the adequacy of the Provisions for Loan Losses Account, provisions may be attributed to individual loans or advances or groups of loans or advances. The Provisions for Loan Losses Account shall always have a credit balance. Additions to or reductions of the Provisions for Loan Losses Account shall be made only through charges to provisions in the income statement at least every calendar quarter. Banks shall maintain the following minimum provision percentages against the outstanding principal amount of each loan or advance classified in accordance with the criteria for the classification of loans or advances as laid out.

Classification Category Minimum Provision

Pass	1%
Special Mention	3%
Substandard.....	20%
Doubtful	50%
Loss	100%

Where reliable information, such as

(i) Historical loan loss experience,

(ii) Current economic conditions,

(iii) Delinquency trends,

(iv) Ineffectiveness of lending policies and/or collection procedures, or

(v) Lack of timeliness and accuracy in the loan review function, suggests that losses are likely to be more than the above minimum provision percentages, banks may be required to maintain larger provisions.

CHAPTER THREE

DATA PRESENTATION, ANALYSIS AND INTERPRITATION

3.1 Introductions

In the preceding chapters important literatures relating to the topic were reviewed that gives enough understanding about the topic and used to identify knowledge gap on the area. In this chapter the data collected were presented and important analysis findings were discussed.

This study is aimed at exploring an assessment of conditions and trends of nonperforming loan in Dashen bank from 2003 to 2012.

This chapter tries to present the results of the different sources of data. In this study, we tried to show and cover the nonperforming loan (NPL) of Dashen bank in order to show trends of loan provision and clients default. Relevant documents available in Dashen Bank head office were reviewed thoroughly. Questionnaires were used to collect data from the head office of Dashen Bank were the research was conducted. The data gathered were qualitative and quantitative in nature.

In the analysis part we try to see the conditions and trends of NPL in accordance with the objective stated in the research report. According to the observation through questionnaires, discussion and interview with the concerned loan officers, there are many reasons for the loan to be defaulted.

3.2 General characteristics of the respondents

The researchers distributed 25 questioner and the questionnaires were distributed to credit manager, credit analyst, deputy credit manager and loan officers of the head office of Dashen bank. There is no non respondent from the questioner distributed.

Table 3.1 General characteristics of respondents

No	Particular	Character	No of respondents	Percentage
1	Sex	Female	5	20%
		Male	20	80%
2	Educational certificate	Diploma	0	0%
		1st Degree	22	88%
		2nd Degree and above	3	12%
3	Experience	Less than 2 Years	1	4%
		2-5 Years	4	16%
		Greater than 5 Years	20	80%
4	Field of work	Credit Manager	1	4%
		Deputy credit manager	1	4%
		Credit Analyst	10	40%
		Loan officer	13	52%

Source: own survey (2014)

The above table shows that the general characteristics of the respondent's to the questionnaires with regard to educational qualification and experience according to the information given by them.

The table shows that 20 percent of the respondents are females and 80 percent of the respondents are male regarding at the positions of respondents revealed that 4 percent were bank credit managers while 4 percent were Deputy Credit manager and 40 percent were Credit analyst. Besides, about 52 percent of the respondents were bank Loan officer.

In terms of experience, 80 percent of survey respondents indicated that they had greater than 5 years of banking experience. The second larger number of respondents, 16 percent, had banking experience of 2-5 years. The remaining 4 percent respondents had banking experience of less than 2 years.

Almost all the respondents are BA degree holders and relative fields and most of them have more than 2 years working experience. Therefore, the level of qualification and work experience of the respondents are capable of handling

the questionnaires on such topic as an assessment of conditions and trends of nonperforming loan.

3.3 Factors that affect bank lending

Table 3.2 Factors affecting occurrences of NPL are obvious

Factors that occurrences of NPL are affect obvious	Frequency	Percent
	Agree	20
Neutral	3	12%
Disagree	2	8%
Total	25	100%

Source: own survey (2014)

The above table shows that the study tried to assess the factors that affect bank lending in the context of Dashen bank. The study required respondents to show their agreement or disagreement to certain statements dealing with bank specific factors affecting occurrences of nonperforming loans. Examining the results of the study in this connection reveals that about 80 percent of respondents agreed to the statement "factors affecting bank lending are obvious" while the rest disagreed and were neutral about it. These indicate that most the time factor affecting occurrence of nonperforming loan is obvious. From these the researchers agreed that the factors that are obvious for the occurrence of nonperforming loan cannot be avoided but minimized it.

Table 3.3 provision of consultancy and training before loan

Adequate consultancy and training was offered to clients before loan	Frequency	Percentage
Yes	22	88%
No	3	12%
Total		

Source: own survey (2014)

The above table shows that summarize the finding of data collected on issues concerning the availability adequate consultancy and training before loan 88 percent of the respondents believed that the bank gives adequate consultancy and training service. However 12 percent of the respondents don't believe that the consultancy and training before loan given is in adequately.

Training and consultancy before granting loan to customer, makes them to understand the repayment procedure and spend the borrowed money for the proposed project. If the borrowers are aware of these procedures adequately, the collection of money that Dashen bank lends will be easier. According to the percentage (12 percent) the researchers got from the above table, still Dashen bank needs consult and train clients before loan is approved.

Table 3.4 credit approval procedures

There are clear credit approval procedures in Dashen bank	Frequency	Percentage
Strongly agree	15	60%
Agree	9	36%
Disagree	1	4%
Strongly disagree	0	0
Neutral	0	0
Total	25	100%

Source: own survey (2014)

The above table describes concerning the status of the bank credit approval procedure, 60 percent of the respondents strongly agree as the banks has a strong approval procedure, 36 percent of the respondents just agreed on the strangeness of the bank's credit approval procedure the remaining 4percent of the respondents repaid that the bank credit approval is not strong enough to pre-control NPL.

In general most of the respondents (96 percent) agreed that the bank has a clear approval procedure.

However the disagreement which is the 4 percent, shows there is still a slight gap on the loan to become nonperforming loan and it is an indicator to Dashen bank that the credit approval procedure still needs to be strong

Table 3.5 Effectiveness of credit analysis before loan is granted

The effectiveness of credit analysis before loan is granted	Frequency	Percent
Very effective	7	28%
Effective	10	40%
Moderately effective	8	32%
Ineffective	0	0
Neutral	0	0
Total	25	100%

Source: own survey (2014)

The above table describes the effectiveness of credit analysis before loan is granted 28 percent of the respondents agreed that the credit analysis before loan is granted very effectively and 40 percent of the respondents agreed the credit analysis is effective. The remaining 32 percent agreed it is moderately effective.

These indicates that the credit analysis before loan is granted makes the loan very effectives, that means the degree of nonperforming loan will be decreased.

3.4 The causes of NPL in Dashen bank

We mentioned that, NPL is caused by so many unavoidable conditions including effect of the world economy and unexpected price changes.

In case of Dashen bank we observe some additional problems from the given questioner which lead the loan to be nonperforming are the following.

3.4.1 Factors affecting occurrence of nonperforming loans

Credit staffs were also requested to list the causes for the loans to be nonperforming or doubtful and their answer is organized as follows.

Table 3.6 Ranking of factors that cause occurrence of nonperforming loans in Dashen bank.

Factors that cause of NPL	Highest in %	High in %	Medium in %	Low in %	Lower in %
Rapid Loan growth by bank	10%	10%	60%	10%	10%
High interest rate	15%	10%	55%	10%	10%
Credit culture	0	30%	60%	0	10%
Poor monitoring/follow up	0	60%	30%	10%	0%
Poor risk assessment	40%	10%	30%	10%	10%

Source: own survey (2014)

Respondents were also asked to rank factors causing nonperforming loans in Dashen Bank in the order of importance. The results in this regard indicated that 60 Percent of respondents ranked poor monitoring /follow up as high ranking factor causing occurrences of nonperforming loans while credit culture, rapid loan growth by bank and high interest rate are medium factor by 60 percent, 55 percent and 60 percent respectively of the respondents. Thus poor risk assessment, were the top factor ranked to cause occurrences of nonperforming loans by 40 percent. (Table 3.6)

In addition to the above question, respondents were given the opportunity to add any additional information and opinion they have in mind and it is organized as follows:-

- Diversion of funds for the unintended purpose and involvement of so many business types are the main reasons for NPL.
- Easily admitted customers borrowers, misguidance of staff and over treated them are the main reasons of NPL in Dashen bank.
- Poor business evaluation which may lead to over financing or under financing. Both financing are potential reasons for NPL.
- Frequent disagreement between shareholders, conflict of interest and lack of independent management and ownership.

Table 3.7 Factors indicating relation between credit assessment and loan default

Reasons	Strongly Agree in %	Agree In %	Neutral In %	Disagree In %	Strongly Disagree In %
Easily admitted borrowers usually default	20%	42%	14%	20%	4%
Know Your Customer policy of banks lead to high loans quality (KYC)	68%	30%	2%	0	0
Good loan underwriting ensures loan performance	26%	69%	5%	0	0
Poor risk assessment would lead to loan default	94%	6%	0	0	0

Source: own survey (2014)

The above table shows responses on factors indicating the relation between credit assessment and occurrence of the nonperforming loans. Only 42 percent of the respondents agree that easily admitted borrowers. On the other hand 68 percent of the respondents strongly agree that having in place know your customer (KYC) policy lead to high loan quality. With regard to good loan underwriting, 69 Percent of the respondents agree that it ensures loan performance. Poor risk assessment is perceived as lead to loan default by 94 percent of the respondents. From the above result respondents strongly agree that banks that employ a healthy KYC policy in recruiting their customers and also do good risk assessment would have a better loan quality. On the other hand when the loan underwriting is poor, the loans would be exposed to default. Respondents view was nearly neutral to the statement "easily admitted customers usually default". In general the outcome indicates that poor credit risk assessment cause occurrence.

Table 3.8 credit monitoring and the occurrence of NPL

Reason	Strongly Agree In %	Agree In %	Neutral In %	Disagree In %	Strongly Disagree In %
Strict monitoring ensures loan performance	60%	40%	0	0	0
Loan follow up is directly related to occurrence of nonperforming loans	40%	20%	0	20%	20%
Bank with higher budget for loan monitoring have lower non-performing loans.	20%	40%	0	20%	20%
Poorly assessed and advanced loans may perform well if properly monitored	20%	20%	20%	40%	0

Source: own survey (2014)

The above table shows responses on credit monitoring and the occurrence of non-performing loan is 60 percent of the respondents strongly agree 40 percent also agreed on that strictly monitoring insures loan performance borrowers. On the other hand 60 percent of the respondents agree that loan follow up is directly related to occurrence of nonperforming loans. The rest 40 percent don't agree with the idea that Loan follow up is directly related to occurrence of nonperforming loans. With regard to Bank with higher budget for loan monitoring has lower non-performing loans, 60 Percent of the respondents agree that it ensures loan performance. On the other hand poorly assessed and advanced loans may perform well if properly monitored only 40 percent of the respondents agreed. In general, this indicates that loan follow-up can never substitute proper credit assessment. From the foregoing discussion it can be

concluded that credit monitoring is directly related to loan performance. Despite this the respondents didn't support the argument that loan would perform well only by proper monitoring if proper assessment is not carried out while advancing the credit. This indicates that follow up would never substitute credit analysis or assessment.

On the other hand though loan monitoring requires budget, allocating higher budget might not ensure loan performance as a good number of respondents are neutral to the assertion.

Table 3.9 Relation between collateralized loans and occurrence on NPL

Reasons	Strongly Agree In %	Agree In %	Neutral In %	Disagree In %	Strongly Disagree In %
Collateralized loans perform well	30%	30%	30%	0	10%
Collateralized loans help protect loan default	10%	60%	22%	8%	0
Most of the time non collateralized loans are defaulted	0	50%	25	25%	0

Source: own survey (2014)

The above table shows with regard to the relation between collateralizing loans and occurrence of nonperforming loans. 60 percent of the respondents agreed with collateralized loans perform well. Besides, that 70 percent and 50 percent of respondents agree with statement that collateralizing loan protect loan default and non-collateralized loans would be defaulted respectively. However, respondents are of the view that borrowers would service their debt if they have pledged collateral.

The fact that only small portion, 10 percent of the respondents agree with the argument that non collateralized loan are defaulted or only 8 percent agree with the assertion that collateralizing loans help loan performance indicates that the relation between collateralizing loans and loan default is not strong.

However, the respondents are of the view that borrowers would service the loan. If they have pledged collateral in case it would be foreclosed in case of default.

3.5 Bank Loan and Lending procedure

3.5.1 Credit Processing and Procedures

The procedure followed by the bank in extending loan is listed under by the respondents.

- Consultation with the customer.
- Document received as per requirement.
- Analysis made at the branch and sends to head office for approval.
- Loan contract preparation and send to government municipalities for registration.
- Loan credited to their account for the same purpose

Means to check whether the procedure set by the bank is strictly being followed by loan officer in assessing borrower request.

Table 3.10 bank's follow up and competence of loan officers

Proper follow up by the bank and competence of the bank's loan officers	Yes		No	
	Frequency	%	Frequency	%
Means to check whether the procedure set by the bank is being followed	25	100%	0	0
Practical guidelines follow up before and after un collectability occurs	20	80%	5	20%

Source: own survey (2014)

The above table shows that all of the respondents believe that there are means to check whether the procedure set by the bank is strictly being followed by loan officer in assessing borrower request. Whereas none of them do believe that there are Means to check whether the procedure set by the bank is strictly being followed by loan officer in assessing borrower request. This indicates that means to check the procedure set by the bank is strong enough. Also 80 percent of the respondents believe that there are guidelines follow up before and after nonperforming loan occurs the rest 20 percent do not believe that there are guidelines and procedure follow up the loan before or after un collectability occurs. This indicates that there is a significance gap that the banks follow up and competence of loan officers should be improved.

Table 3.11 How you measure your bank’s follows up method

The bank follow up is measured	Frequency	percent
Strong	18	72%
Very strong	5	20%
Medium	0	0%
Weak	2	8%
Neutral	0	0
Total	25	100%

Source: own survey (2014)

As shown the above table describes bank follow up is measured. 72percent of the respondents believed that the banks has a strong follow up 20 percent of the respondents just agreed on the strangeness of the bank’s credit approval procedure is very strong, the remaining 8percent of the respondents repaid that the bank credit approval is weak.

In general most of the respondents (92 percent) agreed that the bank has strong follow up.

However 8 percent of the respondent has a significant influence on the loan to become nonperforming loan and it is an indicator to Dashen bank that thebank

follow up is measured, so the bank should improve the 8 percent of that shows there is a weak follow up.

Document Study

In order to assess condition and trends of the bank data on the total loan and NPL of Dashen bank were used. The relevant data of the banks (from the year 2003 to 2012) audited were collected from Dashen bank that was registered in financial statement of the bank website.

3.6 The effect of NPL in Dashen bank

NPL can lead to efficiency problem for banking service. 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 demanded. What's more, there are evidences that even among banks that do not fail: there is a negative relationship between the nonperforming loans and performance efficiency (Berger and Humphrey, 1992).

On the other hand Tihitina (2009) who studied legal problems in realizing nonperforming loans of Ethiopian Banks also highlighted major problems in realizing nonperforming loans in Ethiopian banks and solutions thereof. In Ethiopia, banks could write-off their NPLs from their balance sheet. This method is employed when the likelihood of recovery becomes remote. As a result, National Bank of Ethiopia issued a guideline for banks to help settle outstanding loans in time following a specified set of rules and improve the financial management of a bank. The guideline will be used as a last resort after reasonable efforts are made to collect receivables.

Table 3.12 Total loans, NPL, NPL as percentage of total loans

Year	Total Loan	NPL	% of NPL (NPL/Total Loan)
2003	1,217,873,555	23,111,000	1.90%
2004	1,627,369,234	15,738,231	0.96%
2005	2,160,632,436	11,758,000	0.50%
2006	3,080,263,248	13,560,111	0.44%
2007	3,889,003,611	7,849,833	0.20%
2008	4,291,704,476	18,248,030	0.43%
2009	4,349,249,994	2,174,504	0.04%
2010	4,938,736,202	11,361,495	0.23%
2011	6,093,873,109	17,060,555	0.27%
2012	7,949,369,597	19,452,480	0.24%

Financial data of banks and own computation (2014)

According to the financial report of the bank there is a remarkable achievement for the bank that once had an amazing non-performing loan for ten years ago, from the year 2003 the nonperforming loan percentage was very high relatively to the other next nine years. The percentage was decreasing until year 2007. But from year 2008 it was 0.43 percent, but after a year non-performing loan of the bank decline to 0.04 percent. the loan granted to borrowers was increasing from year to year. But the nonperforming loan was not uniformly increased or decreased in amount.

As it can be observed from the above table the proportion of NPL first raise with the given total loan disbursed decline from 0.43 percent in year 2008 to 0.04 percent in year 2009, this might indicate that the correlation between amount of NPL and volume of loan goes to in opposite direction. With respect to this place the trend following three years which are year 2010, year 2011 and

year 2012 disprove that as the volume of loan increase does not result increase in NPL; Hence the above data's of table reveals as the volume of loan increase in consecutive year of 2011 and 2012 from the base year of year 2008, the change in NPL decrease to 0.24 percent in year 2012.

From the above table we observe that there is no uniformity of nonperforming loan, in some years as loan granted to the customer increases the amount of nonperforming loan increases, with increasing rate, but in some year's nonperforming loan increases with the decreasing rate. These show that the irregularity of percentage of nonperforming loan can be minimized if the bank follows a careful follow up and analysis.

Interview

3.7 Impacts of NPL on banks performance of the bank

In order to get deep understanding about the factors affecting nonperforming loans, an interview was conducted with credit manager of Dashen bank .All of the interviewees have had over 10 years credit experience in addition to their several years of banking experience. The respondents have so many in common as to what they believed cause occurrence of nonperforming loans. The section that follows present factors believed to cause occurrences of NPL by the interviewees. Besides, the factors that are thought to be most critical for the occurrences on NPL are pinpointed.

3.7.1 Factors believed to cause occurrences of NPL by the interviewees

Respondents indicated that several factors contribute to loan default. As per the outcome of the interview the factors can be categorized as banks' internal situations, external environment and customer related factor are summarizes as follows:-

3.7.1.1 Bank internal factors

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

- Bankers lack of integrity,
- Terms and condition not being set properly,
- Credit analysts capacity limitation,
- Banks aggressive lending to maximize profit,
- Not conducting Know your customers principles properly before lending,
- Over financing,
- Poor collateral valuation
- Poor monitoring and follow up
- Poor or no management information system (MIS)

3.7.1.2 Bank external factors

Bank external factors are factors that were beyond the influence of banks and borrowers. They are presented as follows:

- Intervention of external bodies in credit decision making in case of NBE
- Poor credit culture,
- Macroeconomic factors like inflation, market problems etc.
- Unavailability of data to conduct project analysis,
- Inadequacy of the supervisory authorities policies- loan classification methodology.

3.7.1.3 Customer related factors

These are factors that originate from borrowers and have strong bearing on occurrences of loan default. Under this ground the following were raised:

- Fund being directed to unintended purpose,
- Borrowers not making competitive analysis before engaging in a particular sector,
- Business management problems- most of family owned businesses don't have good management and they also suffer from succession,
- Poor record keeping by businesses,
- Intentional or willful default,

3.7.2 Preventive Techniques Methods

Different factors can be considered for some loans and advances of turn out to be bad loans. One of the main reasons is that borrowers do not use the fund for the purpose they had taken it for. Before granting a loan, credit manager and credit investigator go and visit the working place of the applicant.

However, the loan processing is not considered complete simply because it is processed, approved and disbursed. It should be supported by adequate loan follow up to ensure the best performance of the bank in collections repayments as scheduled. After loan is granted it must be managed to ensure that it is repaid. Loan management is the most important responsibilities of a lending officer. Also the credit risk analysis management considers the following signals before the collateral is approved.

3.8 Methods to check the originality of documents

An in-depth interview wherein credit manager of Dashen bank were interviewed indicated that the documents that are presented by customer (borrower) should be checked their originality by the bank before granting a loan. These are:-

- Visit the customer business area
- Authentication of documents to the concerned authority
- Collateralize
- Checking the capacity of the collateral

CHAPTER FOUR

4. Summary, Conclusions and Recommendation

4.1 Summary

The study conducted survey of employees of all credit department (using self-administered questionnaires) and structured survey of documents and semi-structured interview.

In response to a subjective question as to what cause occurrences of NPL in view of survey participants,

- ❖ The result indicated that fund diversion, poor business evaluation, over/under financing were the most frequently mentioned factors followed by unfair competition among banks, willful default and macroeconomic conditions among others. And some respondents comment that most of the time all banks have financed for few and common customers.
- ❖ In a question where the respondents were requested to rate factors they believed cause occurrences of nonperforming loans in order of importance; poor monitoring by banks, poor risk assessment, credit culture/orientation were rated to be the top three factors causing loan default. On the other hand charging high interest rate and rapid loan growth were rated among the least factors causing occurrences of nonperforming loans.
- ❖ .The inadequacy of consultancy and training service before granting loan is indicated as another weakness of the bank by twelve percent of the respondents.
- ❖ Stating the essentiality of regular monitoring of loan quality, the survey also confirmed the stated study all of the respondents indicated agreement. Lack of loan follow up was also one of the top factors rated to contribute to the occurrences of NPL by the survey and interview participants.

- ❖ Though sixty percent of the survey respondents are of the view that collateralized loan may protect loan default in case the borrowers lose their pledged properties, thirty percent of the respondents were neutral with the assertion that collateralized loan perform well. And twenty five percent of the respondents also neutral about non-collateralized loan are usually defaulted. So the relation between NPL and collateral is neutral in view of the respondents.
- ❖ Though it is beyond the bank's control, the economic problem of the country is all stated as major remarkable problem.

4.2 Conclusions

On the basis of the findings the researcher drew the following conclusions:-

- Nonperforming loan is the major problems of Dashen bank. It can highly affect the major outcome of the bank. In these study, the researchers tried to determine the main causes for nonperforming loan and impacts of the financial performance of Dashen bank.
- The main cause of nonperforming loan are in adequate consultancy and training which was given to the client before loan is granted, poor risk assessment, poor monitoring/follow up are also main cause for nonperforming loan. The research also indicated that over financing due to poor credit assessment was cause for incidences of NPL.
- The bank's credit approval procedure also has an influence on the bank loan to become nonperforming loan.
- Security is taken to mitigate the bank's risk in the event of default. In the banking environment, security is required among others, to ensure the full commitment of the borrower, to provide protection should the borrower deviate from the planned course of action outlined at the time credit is extended, and to provide insurance should the borrower default.
- The impact of nonperforming loan of the bank affect the profitability of the bank, this means the liquidity of the bank will increase.

4.3 Recommendations

After close examination and analysis of the research findings, the following recommendations are suggested:

- The bank should put in place a vibrant credit process that would involve issues of proper customer selection, healthy credit analysis, reliable passing process, positive monitoring and follow up and clear recovery strategies for sick loans.
- Strong follow up by the bank officers can help the bank as to where the customer business status and the collateral position are, which in turn helps the management for sound decision.
- The bank trends need to show improvement on facilitating continuous training to develop the skill of employees, who participate in the loan process. By then, they can minimize the internal causes of default.
- The bank should put in place a clear policy framework that addresses issues of conflict of interest, ethical standards, check and balance in decision making process for all those involved in the credit process ensure its implementation thereof. Policy itself cannot be a guarantee, if they implement the policy without any intervention by loan officer, management and other third party, it will be useless. And also by updating the credit approval policy in accordance with the current economic condition they can minimize the nonperforming loan.
- The bank should follow a balanced approach of profit maximization and risk management lest they engage in aggressive lending and unhealthy competition that would lead to selecting borrowers that would default.
- The bank should give due emphasis it takes to developing the competency of credit operators, information system management pertaining to credit and efficiency of the credit process.
- Prudence of policies that govern bank loans should continuously be ensured in light of international best practices, macroeconomic

situations, level of development of banks and the economy in general by NBE

- By providing the best consultancy to customers, specifically, for what purpose they borrow and how they repay the loan the bank should develop the customer's awareness .And investigate the proposed project by the borrowers with the right professional to avoid inefficient business plan study which results avoid failure of the business.

Bibliography

Anderson R. & S. Sundaresan. 2000. A comparative study of structural models of corporate bond yields: an explanatory investigation. *Journal of Banking and Finance*, 24: 69-255.

Bagehot, Walter, (1962). *Lombard Street*, Homewood; IL: Richard D. Irwin.
Reprint of the 1873 edition

Bizuneh Tariku (2002) *Credit Analysis Prescribed Model and theories Vs the Practice of CBB*. Milan: Giordanon Dell Amore Foundation.

Bloom, A.M and Gorter, C.N (2001, December) The treatment of Non Performing loans in macroeconomics Statistics. Paper Presented at the annual meeting of IMF. Washington D.C

Cade, E. 1999. *Managing Banking Risks*. Chicago: Glenlake Publishing Company, Ltd.

Harris P. 2003: A banker's view of BEE. Briefing to Business Map Foundation members,

International Monetary Fund. (2001). The treatment of nonperforming loans in macroeconomic statistics. IMF Staff Paper 01/209.

Koch TW & Scott MacDonald S. 2003: *Bank Management*, 5th edition. Ohio: South-Western Thompson Learning.

Leply WH. 2003: Bankers, Betas... and the Cs of credit. *The RMA Journal*, 86(4): 62-65.

Mac Donald, S.S. and Koch, T.W. 2006, *Management of Banking*, 6th edition, U.S.A: Thomson - South Western.

Nathenson JL. 2004: A Primer on Deals for Middle-Market Bankers. *The RMA Journal*, 86(8): 46-54.

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

Norton, J., & Andenans, M. 1997. Emerging Financial Markets and Secured Transactions, Kluwer Law International, London

Patersson, Jessica & Isac Wadman. 2004 . Non- Performing Loans-The markets of Italy and

Radha, M & SV. Vasudevan. 1980. A Text Book of Banking: Law, Practice and Theory of banking, S, Chand & Co. Ltd: New Delhi.

Read, E.W. & Gill, E.K. 1989, Commercial banking, Forth edition, New Jersey: Englewoodcliffs.

Rose PS. 2002: Commercial Bank Management, 5 th edition. New York: McGraw-Hill/Irwin

Saunders A & Cornett MM. 2003: Financial Institution Management, 4 th edition. New York: McGraw-Hill/Irwin.

Sinkey JF. 2002: Commercial Bank Financial Management in the Financial-Services Industry, 6 th edition. New Jersey: Prentice Hall.

Strischek D. 2000: The Quotable Five C's, Journal of Lending & Credit Risk Management, 82(7): 47-49. Adrian M. bloem and Cornelis N. Gorter December, 2001

Sweden, Uppsala University thesis, Department of Business Studies.

Websites

1. <http://thefreedictionary.com>, 16 Nov 2013, Troy Adkins, Mack Alvin, James Anderson
2. www.dashenbanksc.com 21 Oct 2013 Dashen Bank
3. www.nbe.gov.et, 22 Oct 2013, National bank of Ethiopia
4. (<http://en.wikipedia.org>, 21 Oct 2013, G. Davies J H Bank - [A history of money: from ancient times to the present day](#) University of Wales Press, 2002 - Retrieved 2012-05-17
5. (<http://en.wikipedia.org> 21 Oct Signoriello, Vincent J. (1991), *Commercial Loan Practices and Operations*,

APPENDIX

St.Mary's University

Business Facility

Department of Accounting

**An assessment of conditions and trends of nonperforming loan in Dashen bank
to be filled by:-Staffs of credit department**

Research questionnaire

This questionnaire prepared by undergraduate degree students in order to collect data .for the research entitled "An assessment of conditions and trends in Dashen bank" to prepared in partial fulfillment of BA degree in accounting. The validity of your response will highly contribute for success of this research paper

Respecting you, we would like to ask your genuine responses and words and assure you that they are highly confidential and will be used for research purpose.The results will be also reported without showing the identity of respondents.The questionnaire takes about 20-30 minutes to complete. we would appreciate yourpositive consideration in completing the enclosed questionnaire and assisting us in our research efforts. If you have any questions please call 0911-51-53-19, 0911-34-03-56 or 0912-75-34-26 email address [alemberhe72@ yahoo.com](mailto:alemberhe72@yahoo.com)

Thank you in advance for all your kind cooperation!

1. Gender

Female male

2. Educational status

2nd degree

1st degree

Diploma

3. Field of work

Credit manager Credit analyst Deputy credit manager loan officer

4. Work experience in the bank

Less than 2yrs

2-5 years

Above 5 years

5. Determinants of nonperforming loans are obvious.

Agree Neutral Disagree

6. Do you believe that your bank gives adequate consultancy and training before granting loan?

Yes no

7. Does Dashen bank have a strong credit approval procedure?

Strongly agree Disagree Neutral

Agree Strongly disagree

8. Please rank the factors that cause occurrence of nonperforming loans in Dashen bank

Factor that causes occurrence of nonperforming loans	Highest	high	Medium	Low	Lower
Rapid Loan growth by banks					
High interest rate					
Credit culture					
Poor monitoring					
Poor risk assessment					

9. What type of pre loan precaution does your bank uses?

10. How effective do you think is the bank's credit analysis before the loan is granted to borrower?

Very effective moderately effective

Effective Inefficient Neutral

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

Reasons	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Easily admitted borrowers usually default					
Know Your Customer policy of banks lead to high loans quality					
Good loan underwriting ensures loan performance					
Poor risk assessment would lead to loan default					

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

	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Collateralized loans perform well					
Collateralizing loans help protect loan default					
Most of the time non collateralized loans are defaulted					

13. What kind of preventive methods does the bank uses?

.....

14. Is there any means to check whether the procedure set by the bank is strictly being followed by loan officer in assessing borrower request?

Yes no

15. Do you think that there are practical guidelines or procedures follow-up the loan before or after un collectability occurs?

Yes no

16. If your answer is yes for Q-15 how can it be implemented?

.....

17. How do you measure your bank's follow up method

Strong medium Neutral
 Very strong weak

18. Lending money to the client is one of major services rendered by the bank. Do you believe that your bank's client repay their obligation per the schedule time

Strongly agree strongly disagree neutral
 Agree disagree

19. If you disagree to Q-18 what are the main causes for the default

Problem by the bank

Problem by the client

Problem by third party

20. To have a smooth loan repayment condition in the bank, is there any separate technical assistance after loan grant to a client by your bank?

.....
.....
.....

21. What are the possible solutions you think for the problem?

.....
.....

22. What is the average time period that takes to client to have their monthly loan statement?

.....
.....
.....

23. How do you rate the adequacy of loan collection effort of your bank

Very adequate Adequate Neutral

Less adequate Inadequate

24. If you have further comments on the bank specific factors affecting Non-performing loans of Dashen Banks please use the space below

.....
.....
.....

Thank you for your participation

INTERVIEW QUESTIONS

1. What are the main causes for loans to become non-performing in Dashen bank?
2. Which are the largest shares when the bank requests the borrowers for collateral?
3. What is the amount of NPL in terms of percentage from the loan and advances portfolios?
4. What are the main problems observed from side of borrowers that could pay their loan and advances?
5. What kind of measures has the bank so far taken to recover NPL?
6. Is there any method to minimize or prevent NPL that are issued by your bank?
7. How does the bank dispose /written off NPL finally?
8. What are precautions should be taken by the bank when borrowers cannot pay their loan and advances collateral?
9. Recommendation/ if any for mitigating occurrence of nonperforming loans proposed by the respondents

Advisee's Declaration

We the undersign ,declare that this senior essay/project is our original work.prepared under the guidance of Ato Alula Hailu all sources of materials used for manuscript have been duly acknowledged,

Name	Signature
1. AlemBerhe	_____
2. MihretBekele	_____
3. MahletBetemariam	_____

Place of Submission SMU

Date of Submission May 2014

Advisor's Declaration

The paper has been submitted for examination with my approval as the University advisor.

Name:- ALULA HAILU (MBA)

Signature:- _____

Date of submission:- _____

