ST. MARY'S UNIVERSITY

FACULTY OF BUSINESS

DEPARTMENT OF ACCOUNTING

AN ASSESSMENT OF LENDING PRACTICE: THE CASE OF COMMERCIAL BANK OF ETHIOPIA, Head Office

BY

BIRTUKAN TADESSE

FEVEN ENGDAWORK

HELEN MUSE

JUNE, 2014

SMU

ADDIS ABABA

AN ASSESSMENT OF LENDING PRACTICE: THE CASE OF COMMERCIAL BANK OF ETHIOPIA, Head Office

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BIRTUKAN TADESSE

FEVEN ENGDAWORK

HELEN MUSE

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APPROVED BY THE COMMITTEE OF EXAMINERS

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Department Head **Signature**

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Advisor **Signature**

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Internal Examiner Signature

________________________ ________________________

External Examiner Signature

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DECLARATION

We, The Undersigned, Declare that this senior essay/project our original work, prepared under the guidance of Ato. Ahmed M. All source of materials used for the manuscript have been dully acknowledged.

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This paper has been submitted for examination with my approval as an advisor.

NAME: ______________________________

SIGNATURE: ______________________

DATE: _____________________________

CHAPTER ONE

INTRODUCTION

1.1. Background of the study

In our world of competition business companies should be head of their competitors to become successful in their business. In particular service giving organizations should market their customers attract potentially customers. Banking is one to among service giving industries in the world.

Commercial banks extend credit to different types of borrowers for many different purposes. For most customers bank credit is the primary source of available debt financing for banks, good loans are the most profitable assets. As with any investment, extending loans to businesses and individuals involves taking risk to earn high returns. Returns come in the form of loan interest, fee income, and investment income from new deposits. Banks also use loans to cross sell other fee-generating services. The most prominent assumed risk is credit risk. Many factors can lead to loan defaults. An entire industry, such as energy, agriculture, or real estate, can decline because of general economic events. Firm-specific problems may arise from changing technology, labor strikes, shifts in consumer preferences, or bad management. Individual borrowers find that their ability to repay closely follows the business cycle as personal income rises and falls. loans as a group thus exhibit the highest charge-offs among bank assets, so banks regularly set aside substantial reserves against anticipated losses.

Interest rate risk also arises from credit decisions. Loan maturities, pricing and the form of principal repayment affect the timing and magnitude of a bank's cash inflows, floating-rate and variable-rate loans, for example, generate cash flow that very closely with variable borrowing costs. Fixed rate balloon payment loans, in contrast, generate fewer cash flows. Longer consumer loans need to be funded with stable deposits to reduce exposure to rate changes.

Loans are the dominant asset in most banks' portfolios, representing on average 50 to 75 percent of total assets. Position varies greatly among banks depending on size, location, trade area, and lending expertise. Although lending practice can do vary significantly for similar sized

banks severalcharacteristics stand out.First, the ratio of net loans to asset is greatest at 66.4 % for banks with $100 million to $1 billion inasset and for savings institution the largest bank have onaverage, reduced their dependence on loans relative to smaller banks. This indicates that many of largest have began to focus on non-credit products and services that generatenon-interest income as the primary source of revenue. Second, Real estate loans represent the largest single loan category for all banks and are highest for saving banks. Overtimereal estate loans continuous to represent an increasing portion of bank loan. Third,residential 1-4 family loans (mostly mortgage loan products) contribute the largest amount of real estate loans for almost for all commercial banks, but commercial real estate is largest for banks with $100 million to $1 billion in asset. Fourth, commercial and industrial loans represent the second highest concentration of loans at bank. Fifth, loans to individual are greatest for banks with more than$ 1billion in asset, butcontribute proportionally less elsewhere .Sixth, farm land and farm loans make up a significant portion of the smallest banks loans but are negligible at largest banks. Seventh, banks invest from 5 to 11.2 % of their assets to finance consumer expenditure. Finally, other loan and leases are significant only at the largest bank. Other loans include primarily loans to other financial institution, Internationalloans, and lease receivable. (Mac Donald and Koch,2006:354)

1.2. Background of the organization

Commercial bank of Ethiopia was established in 1942.CBE pioneer to introduce modern banking to the country. It has 780 branches stretched across the country as of january6/2014.the banks plays a catalytic role in the economic progress development of the country currently the bank has more than 7 million account holders and combines a wide capital base with more than 18,000 talented and committed employees. In general customers could now enjoy speedy processing of account, easy access of fund and improved services from any branch of bank. CBE extends the following credit facilities to its esteemed customs:

Overdraft is a form of credit facility by which customers are allowed to draw cash beyond the deposits of their current accounts for the day to day operational needs of business. Merchandise loan facility is a short term credit facility extended to customers against merchandise or its documentary evidence. Like Railway Receipts, Warehouse Receipts, Airway Bills. Merchandise loan facility is extended to customers for a maximum period of one year and its

maximum advance rate is 80% of the amount of the merchandise. Pre-shipment Export Credit facility is a short term loan extended to customers engaged in export business for purchase of raw material, processing, warehousing, packing, transporting the finished goods to shipment. Revolving export credit facility is an advance extended to exporters upon presentation of acceptable export documents except bill of loading. It is to solve working capital problems of exporters with continuous export transaction emanating from money tied up in goods in transit of shipment. Agricultural input loan is a short term loan granted to customers for the purchase of fertilizers, improved seeds and agro-chemicals. Agricultural investment loan is a short to long term loan granted to customers engaged in commercial farms or agro-processing industries for working capital as well as purchase of agro-processing machineries or equipment for plant, crop and animal production in small medium or large scale farming.

Although, CBE entertain Coffee farming Term Loan Financing and Micro –Finance Institution's Loan (official web site of CBE)

Commercial bank of Ethiopia gives the following credit facilities to its esteemed customers, overdraft, merchandise loan facilities, per-shipment export credit facilities, special truck loan financing, medium and long term loan agriculture investment and micro finance institutions loan *(CBE annual report 2011/12)*

This study tried to assess the lending practice of commercial bank of Ethiopia in case of main branch.

1.3. Statement of the Problem

Loans are the most important asset held banks, lending provides the bulk of bank income. It is equally true that bank loans, as they are profitable, equally risky. Bank loans fluctuate and influenced by the changes in economy policy and the economy in general. Therefore, it is very important for the bank to formulate their loan policies in order of minimize risk associated with them.

CBE plays an important role in the Ethiopian economy that means the bank dominates participate in the country's financial system. The credit contraction and expansion mechanism to destabilize the economy as a whole is mainly done by the CBE. In the provision of loans process to the customers, CBE under takes pre application interview, accepting customers,

official application, collecting necessary documents, credit information inquiry evaluating credit application customer classification, business visit, collateral evaluation, risk analysis, decision on request informing the applicant the credit decision performing administration works like registering the collateral offered by the customer, disbursing the loan and follow up. However, this credit activity which is the important role vested to it, it's becoming area of serious attention .For example 62.9% of the bank outstanding loans and advances are categorized as non-performing loan or bad debts /CBE Annual Report 2012/ even though all these processes are undertaken the following major problems are observed in commercial bank on main branch.

Based on the preliminary study performed by the student researchers the following problems has been observed on the lending practice of the bank; on the collection of detail information about the borrower's, on the evaluation the collaterals to counterfeit with the borrower's request, in assessing the existing credit facility compatible with the borrowers business as well as the market situation and in properly follow up the same steps which is compliance with the bank credit policy and procedure.

1.4. Research Question

1. What are the factors borrowers could not repay loan?
2. What are the steps and procedures that the bank follows to deal with loan?
3. To what extent the existing process of credit facility are compatible to the changing situation?

1.5. Objective of the Study

1.5.1 General Objectives of the Study

The general objectives of the study were to assess the practice of CBE in lending process.

1.5.2 Specific Objectives of the Study

Specifically this study tried to address:

- ✓ To observe steps and procedures' bank follows to deal with loan.
- ✓ To identify factors that cause non repayment of loan.
- ✓ To assess the credit facility of the bank in taking into consideration the changing situation.
- ✓ To evaluate loan treatment and non repayment of loan.

1.6 Scope of the Study

This study was conducted on CBE head office because of there is more access for information and relatively higher number of customers than any other branches. The study focused on the assessment of the lending practice. This study evaluated the effectiveness of the bank's lending practice, its compliance with policies and procedures; national or international standards and the quality of performance in carrying out assigned responsibilities in the bank. Data were observed and reviewed from 2008-2013.

1.7 Significance of Study

This study can help the bank to take it as an input in identifying major problems related with loan process and analysis performance, which are more susceptive for mistake, errors, discrepancies and fraud. In addition, the outcome of the study show the strength and weakness of the bank in applying policies and procedures, rules and regulations, which were in turn, enhance the service giving capacity of bank in efficient and effective way. Moreover, it is significant to the student researchers on overall activities of the bank in lending practice. Finally the study can be used as a reference for further study.

1.8. Research Methodology

1.8.1 Research Design

In order to answer the basic research questions, the student researcher used descriptive research method. Because, it allow describing the research setting as it is and also allows using of both quantitative and qualitative approach.

1.8.2 Types of Data Collected

Both primary and secondary data was collected for the study. The primary data was obtained from employees and borrowers of the bank through questionnaires and interview were made to the manager of credit department respectively. Secondary data source such as the company annual reports, manuals, articles, journals and other published and unpublished documents relevant to the study were used.

1.8.3 Methods of Data Collection

Primary data obtained from both open and close ended questionnaires and by conducting interview. Questionnaires were distributed to the employees and borrowers of the bank: interview was conducted to the manager of the credit department of the main branch. Secondary data source such as the banks' annual reports, manuals, articles, journals and other documents relevant to the study was reviewed and observed.

1.8.4 Population, Sample Size and Sampling Technique

The respondents of the study included employees related with loan of the bank. The student researchers used non-probability sampling approach, particularly judgmentalsampling technique. Accordingly 20 employees and 20 borrowers were selected as representative sample in order to have sufficient and reliable data.

1.8.5 Methods of Data Analysis

The study used both qualitative and quantitative data analysis techniques. The responses that are collected from questionnaires were analyzed by quantitative approach; tabulation and percentage were used. Responses that were obtained through interview were narrated qualitatively.

1.9 Limitation of the Study

There are certain limitations that adversely affect the research undertaking; some of these limitations are

- Lack of availability of reference in the library
- Inability to get the expected respondents especially borrowers which were not found easily.

1.10 Organization of the Paper

The research paper was organized in such a way that the first chapter introduced the over all purpose of the research and explained why the study is important. Chapter two dealt with related literature review on historical perspectives and definition of loan; scope and objective of loan assessment. Chapter three dealt with data analysis, interpretation and presentation. The last chapter summarized the major findings, conclusions and recommendations of the research paper.

CHAPTER TWO

REVIEW OF RELATED LITRATURE

This chapter contains a theoretical aspect of research topics for clear understanding. We review and presented the theoretical view with regarded to the issue of loan from related reference materials.

2.1. Definition of loan

Loans are the most important asset held banks, lending provides the bulk of bank income. It is equally true that bank loans, as they are profitable, equally risky. Bank loans fluctuate and influenced by the changes in economy policy and the economy in general. Therefore, it is very important for the bank to formulate their loan policies in order of minimize risk associated with them.

Loan is: - the thing that is lent especially a sum of money.

"The action of lending something state of being lent. For each lender the loan investment comparable to bonds, stocks or other asset on the other hand for each borrower a loan is debt, an obligation to repay the borrowed money plus interest" (Garry, 2004: 227)

2.2. Types of loans

Secured

A secured loan is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral.

A mortgage loan is a very common type of debt instrument, used by many individuals to purchase housing. In this arrangement, the money is used to purchase the property. The financial institution, however, is given security — a lien on the title to the house — until the mortgage is paid off in full. If the borrower defaults on the loan, the bank would have the legal right to repossess the house and sell it, to recover sums owing to it.

In some instances, a loan taken out to purchase a new or used car may be secured by the car; in much the same way as a mortgage is secured by housing. The duration of the loan period is considerably shorter often corresponding to the useful life of the car. There are two types of auto loans, direct and indirect. A direct auto loan is where a bank gives the loan directly to a

consumer. An indirect auto loan is where a car dealership acts as an intermediary between the bank or financial institution and the consumer.

Unsecured

Unsecured loans are monetary loans that are not secured against the borrower's assets. These may be available from financial institutions under many different guises or marketing packages: credit card debt, personal loans, bank overdrafts, credit facilities or lines of credit and corporate bonds (may be secured or unsecured).

Interest rates on unsecured loans are nearly always higher than for secured loans, because an unsecured lender's options for recourse against the borrower in the event of default are severely limited. An unsecured lender must sue the borrower, obtain a money judgment for breach of contract, and then pursue execution of the judgment against the borrower's unencumbered assets (that is, the ones not already pledged to secured lenders). In insolvency proceedings, secured lenders traditionally have priority over unsecured lenders when a court divides up the borrower's assets. Thus, a higher interest rate reflects the additional risk that in the event of insolvency, the debt may be uncollectible (Anthony and Santomero, 1997:212)

Demand

Demand loans are short term loans that are atypical in that they do not have fixed dates for repayment and carry a floating interest rate which varies according to the prime lending rate. They can be "called" for repayment by the lending institution at any time. Demand loans may be unsecured or secured (Anthony and Santomero, 1997:212).

Subsidized

A subsidized loan is a loan on which the interest is reduced by an explicit or hidden subsidy. In the context of college loans in the United States, it refers to a loan on which no interest is accrued while a student remains enrolled in education (Anthony and Santomero, 1997:212).

Concessional

A concessional loan, sometimes called a "soft loan," is granted on terms substantially more generous than market loans either through below-market interest rates, by grace periods or a combination of both. Such loans may be made by foreign governments to poor countries or may be offered to employees of lending institutions as an employee benefit (Anthony and Santomero, 1997:212).

2.3. Target markets

Personal or commercial

Loans can also be subcategorized according to whether the debtor is an individual person (consumer) or a business. Common personal loans include mortgage loans, car loans, home equity lines of credit, credit cards, installment loans and payday loans. The credit score of the borrower is a major component in and underwriting and interest rates (APR) of these loans. The monthly payments of personal loans can be decreased by selecting longer payment terms, but overall interest paid increases as well. For car loans in the U.S., the average term was about 60 months in 2009.

Loans to businesses are similar to the above, but also include commercial mortgages and corporate bonds. Underwriting is not based upon credit score but rather credit rating (Encyclopedia, 2010).

2.4. The Credit process

The fundamental objective of commercial and consumer lending is to make profitable loans with minimal risk .management should target specific industries or markets in which lending officers have expertise. The somewhat competing goals of loan volume and loan quality must be balanced with the bank's liquidity requirements, capital competing goals of loan volume and loan quality must be balanced with the bank's liquidity requirements, capital, constraints, and rate of return objective. The credit process relies on each bank's systems and controls that allow management and credit officers to evaluate risk and return trade-offs. The credit process includes three functions; business development and credit analysis, underwriting or credit execution and administration, and credit review. Each reflects the bank's written loan policy as determinate by the board of directors (Koch, 1995:354).

Table 1.The Credit process

Business development and credit Analysis	Credit Execution and Administration	Credit Review
●Market research ●Advertising, public relations ●officer call programs ●obtain formal loan request ●obtain financial statements, borrowing resolution, credit reports ●Financial statement and cash flow analysis ●Evaluate collateral ●loan officer makes recommendation on accepting/rejecting loan	●Loan committee reviews proposal/recommendation ●Accept/reject decision made, terms negotiated ●Loan agreement prepared with collateral documentation ●Borrower signs agreement, turns over collateral, receives loan proceeds ●perfect security interest ●File materials in credit file ●Process loan payments, obtain periodic financial statements, call on borrower	●Review loan documentation ●Monitor compliance with loan agreement; _ positive and negative loan covenants _Delinquencies in loan payments _Discuss nature of delinquency or other problems with borrower ●Institute corrective action; _Modify credit terms _obtainadditional capital, collateral and guarantees _call loan

(Koch, 1995:354)

Loan policiesformalizes lending guidelines that employees follow conduct bank business. It identifies preferred loan qualities and establishes procedures for granting, documenting and reviewing loans. Specific elements within each function are listed in the exhibit. Management's credit philosophy determines how much risk the bank will take and in what form. A bank's credit culture refers to the fundamental principles that drive lending activity and how management analyzes risk. There can be large differences between banks in their lending philosophy. Three potentially different credit cultures are; values driven, current-profit driven, and market-share driven.

Values Driven

- Focus is on credit quality with strong risk management systems and controls.
- Primary emphasis is on bank soundness and stability and a consistent market presence.
- Underwriting is conservative and significant loan concentrations are not allowed.
- Typical outcome is lower current profit from loans with fewer loan losses.

Current-Profit Driven

- Focus is on short-term earnings.
- Primary emphasis is bank's annual profit plan.
- Management is often attracted to high-risk and high-return borrowers.
- Outcome is typically higher profit in good times, followed by lower profit in bad times when loan losses in-crease.

Market-Share Driven

- Focus is on having the highest market share of loans among competitors.
- Primary emphasis is on loan volume and growth with the intent of having the largest market share.
- Underwriting is very aggressive and management accepts loan concentrations and above-average credit risk.

Outcome is that loan quality suffers over time, while profit is modest because loan growth comes from below-market pricing and greater risk taking (Koch, 1995: 354).

2.5. Credit Analysis

Once a customer requests a loan, bank officers analyze all availability information to determine whether the loan meets the bank's risk –return objectives. Credit analysis is essential default risk analysis in which a loan officer attempts to evaluate a borrower's ability and willingness to repay. Eric Compton (2000; 245) identified three distinct areas of commercial risk analysis related to the following questions:-

1. What risks are inherent in the operations of the business?
2. What have managers done or failed to do in mitigating those risks?
3. How can a lender structure and control its own risks in supplying funds?

The first question forces the credit analyst to generate a list of factors that indicate What could harm a borrower's ability to repay, the second recognizes that repayment is largely a function of decisions made by a borrower, is management aware of the important risks and has it responded? The last question forces the analyst to specify how risks can be controlled so the bank can structure an acceptable loan agreement.

Traditionally, key risk factors have been classified according to the five Cs of good credit;

- Character refers to the borrower's honesty and trustworthiness. An analyst must assess the borrower's integrity and subsequent intent to repay. If there are any serious doubts, the loan should be rejected.
- Capital refers to the borrower's wealth position measured by financial soundness and market standing. Can the firm or individual with stand any deterioration in its financial position? Capital helps cushion losses and reduces the likelihood of bankruptcy.
- Capacity involves both the borrower's legal standing and management's expertise in maintaining operations so the firm or individual can repay its debt obligations, a business must have identifiable cash flow or alternative sources of cash to repay debt. An individual must be able to generate income.
- Conditions refer to the economic environment or industry-specific supply, production, and distribution factors influencing a firms operation. Repayment sources of cash often vary with the business cycle or consumer demand.
- Collateral is the lender's secondary source of repayment or security in the case of default. Having an asset that the bank can seize and liquidate when a borrower defaults reduces loss, but does not justify landing proceeds when the credit decisions are originally made.

Golden and walker further identify the five Cs of bad credit. Representing things to guard against to help prevent problems:-

- Complacency refers to the tendency to assume that because things were goods in the past they will be good in the future, common examples are an overreliance on guarantors, reported net worth, or past loan repayment success because things have always worked out in the past.
- Carelessness involves poor under writing typically evidenced by in adequate loan documentation lack of current financial information or other pertinent information in the credit

files and a lack of protective covenants in the loan agreement. Each of these makes it difficult to monitor a borrower's progress and identify problems before they are unmanageable.

- Communication ineffectiveness refers to when a bank's credit objective and policies are not clearly communicated. This is when loan problems can arise. Management must effectively communicate and enforce loan polices and loan officers should make management aware of specific problems with existing loans as soon as they appear.
- Contingencies refer to lenders tendency to play down or ignore circumstances in which a loan might default. The focus is on trying to make a deal work rather than identifying downside risk.
- Competition involves following competitors' behavior rather than maintaining the bank's own credit standards. Doing something because the bank down the street is doing it does not mean its prudent business practice.

The formal credit analysis procedure includes a subjective evaluation of the borrower's request and a detailed review of all financial statements. Credit department employees may perform the initial quantitative analysis for the loan officer. The process consists of:

1 .Collecting information for the credit files; such as credit history and performance

2. Evaluating management, the company; and the industry in which it operates; that is evaluation of internal and external factors

3. Spreading financial statements; that is financial statement analysis

4. Projecting the borrower's cash flow and thus its ability to service that debt

5. Evaluating collateral or the secondary source of repayment

6. Writing summary analysis and making a recommendation *(*Donald and Koch, 2006:355).

2.6. Credit Execution and Administration

The process by which the formal credit decision is made varies by bank. It depends on many factors such as the bank's organizational structure, bank size, number of employees and length of experience, and even the types of loans made. The formal decision can be made individually by an independent underwriting department by a loan committee, or a combination of these methods. Formally a bank's board of director has the final say over which loans are approved.

Typically, however, each landing offer has independent authority to approve loans up to same fixed dollar amount.

A loan commit reviews each step of the credit analysis as presented by the loan offer and supporting analysts and makes a collective decision. Once a loan has been approved, the offer notifies the borrower and prepares a loan agreement. this agreement formalizes the propose of the loan ,the terms, repayment schedule, collateral required, any loan convents, and finally what conditions bring about default by the borrower. Conditions of default may include events such as late principal and interest payments, the sale of substantial assets, a declaration of bankruptcy, and the breaking of any restrictive loan convenient. The office then checks that all loan documentation is present and in order .the borrower signs the agreement along with other guarantors, returns over the collateral if necessary, and receives the loan proceeds *(*Donald and Koch, 2006:357).

2.7. Credit Risk in Banking

Credit in bank **is** a contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some later date. *However Credit* risk is defined as the probability that some of a bank‘s assets, especially its loans, will decline in value and possibly become worthless. It arises from non-performance by a borrower, either an inability or an unwillingness to perform in the pre-committed contracted manner (Joan, 1998; 6). Or else as per (Raghavan, 2003;111) Credit Risk is the potential that a bank borrower/counter party fails to meet the obligations on agreed terms. There is always scope for the borrower to default from his commitments for one or the other reason resulting in crystallization of credit risk to the bank.

2.7.1. Components of credit risk in banks:

The credit risk in a bank‘s loan portfolio consists of three components; Transaction Risk , Intrinsic Risk and Concentration Risk.

(1) Transaction Risk: Transaction risk focuses on the volatility in credit quality and earnings resulting from how the bank underwrites individual loan transactions. Transaction risk has three dimensions: selection, underwriting and operations.

(2) Intrinsic Risk: It focuses on the risk inherent in certain lines of business and loans to certain industries. Commercial real estate construction loans are inherently more risky than consumer loans. Intrinsic risk addresses the susceptibility to historic, predictive, and lending risk factors that characterize an industry or line of business. *Historic element*s address prior performance and stability of the industry or line of business. *Predictive elements* focus on characteristics that are subject to change and could positively or negatively affect future performance. *Lending elements* focus on how the collateral and terms offered in the industry or line of business affect the intrinsic risk.

(3) Concentration Risk: Concentration risk is the aggregation of transaction and intrinsic risk within the portfolio and may result from loans to one borrower or one industry, geographic area, or lines of business. Bank must define acceptable portfolio concentrations for each of these aggregations. Portfolio diversify achieves an important objective. It allows a bank to avoid disaster. Concentrations within a portfolio will determine the magnitude of problems a bank will experience under adverse conditions *(*Donald and Koch, 2006:354).

2.8. Risk and profitability

Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. As it was clearly explain before the main source of revenue or main sources of profit of banks came from lending money to their customers. Which means Risk-taking is an inherent element of banking and, indeed, profits are in part the reward for successful risk taking. In contrary, excessive, poorly managed risk can lead to distresses and failures of banks. Risks are, therefore, warranted when they are understandable, measurable, controllable and within a bank‘s capacity to withstand adverse results. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to its bank (Anthony and Santomero,1997; 279).

2.9. Credit Risk Management in Banking Industry

Banks make profit from the spread between the interest rate they charge to borrowers and the interest rate they pay to depositors. Lending has always been the primary functions of banks, and accurately assessing a borrower‘s credit worthiness has always been the only method of lending successfully. To insure reasonable profit, banks attempt to make loans that will be fully

repaid with interest on due date. Therefore, banks are directly concerned about borrowers repaying their loans on a timely basis so that the value of the banks can be maximized.

If banks don‘t manage credit risks effectively, they won‘t be profitable and won‘t be in business very long. Banks can reduce their exposure to credit risk on different loans by applying major credit risk management principles as identified by Fredrick and Mishkin (2004; 217)

These are:

1. Screening and monitoring: Adverse selection in loan market requires the lenders screen out the bad credit from the good ones so that loans are profitable to them. Once a loan has been made, the bank‘s has to monitor or follow up the borrowers‘activities.

2. Long-term Customer Relationship: if the borrower has borrowed previously from the bank, the bank has a record of the loan payments. This reduces the costs of information collection and makes it easier to screen out bad credit risks. Long-term relationship enables banks to deal with even unanticipated moral hazard contingencies.

3. Collateral Requirements: is an important credit risk management tool. Collateral, which is properly promised to the lender as compensation if the borrower defaults, it lesser the lender‘s losses in the case of a loan default.

4. Credit Rationing: is one way of credit risk management that refers refusing to make loans even though borrowers are willing to pay the stated interest rate or even a higher rate (Frederick and Mishkin, 2004: 217).

2.10. Credit Risk Performance Measurement in Bank

The banking industry is not exempted from credit risks at all. There is then a need to implement efficient credit risk performance measurement. Credit risk performance measurement is very important in the industry of banking. In fact, if you would ask any person in the banking industry how important it is, he or she would tell you that this aspect has an impact on the overall success of the bank itself. Thus, banks and other financial institutions, especially the ones that are delving in the business of lending, should pay attention to this aspect.

Risks come in any line of business. In the banking industry, you could safely say that these institutions deal with risks every single workday. Moreover, just about all of these risks are financial in nature. Thus, there is a need to balance risks and returns of investments altogether. With the many options of banks in today‘s market, for a bank to garner a large customer base, it should consider offering a lot of reasonable loan products. This means the loan products would be offered at low interest rates, right? Not necessarily. This is because pegging interest rates that are too low would also incur losses for the bank. After all, banks should have substantial capital in terms of reserves. There should be balance to this, actually. If a bank has too much capital in its reserves, then there is that risk that the bank might miss out on its investment revenue. On the other hand, if a bank has too little capital to begin with, this would only lead to financial instability. Moreover, there is also that risk of regulatory non-compliance that the bank would have to deal with as well. Striking a balance is then very important here. By financial definition, credit risk management pertains to that process of assessing the risks that come with any investment. For the most part, risk comes in the form of investments and the allocation of capital. These risks should be assessed so that a reliable and sound investment decision would be achieved. Risk assessment is also an important factor to consider when you are aiming for a certain position in balancing risks and returns (Frederick and Mishkin, 2004: 226).

Banks constantly have to deal with the risk of a client defaulting payment of his loan. This is one risk that banks would have to expect, however unfortunate the case may be. And this is just one of the many risks that banks have to deal with each day. Thus, it is only logical for banks to keep a substantial portion of its capital in its reserves so as to maintain economic stability and protect its own solvency. We have to take into consideration the second Basel Accords, which states that the more risks the bank, is exposed to, the greater the amount of capital it should hold in its reserves (Frederick and Mishkin, 2004: 228).

The determination of the risks involved here entails several practices. For starters, banks need to come up with certain estimates as to the figures to keep and the ones to make available for loans. Also, banks have to monitor the performance of the bank, as well as evaluate it. Always

remember that portfolio analyses and loan reviews are a must when it comes to efficient credit risk performance measurement (Frederick and Mishkin, 2004: 230).

2.11. Banking Credit Risk Management Guide Lines in Ethiopia

2.11.1. Introduction

Experiences elsewhere in the world suggest that the key risk in a bank has been credit risk. Indeed, failure to collect loans granted to customers has been the major factor behind the collapse of many banks around the world. Banks need to manage credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Additionally, banks should be aware that credit risk does not exist in isolation from other risks, but is closely intertwined with those risks. Effective credit risk management is the process of managing an institution‘s activities which create credit risk exposures, in a manner that significantly reduces the likelihood that such activities will impact negatively on a bank‘s earnings and capital. Credit risk is not confined to a bank‘s loan portfolio, but can also exist in its other assets and activities. Likewise, such risk can exist in both a bank‘s on-balance sheet and its off-balance sheet accounts (Ayalew, 2009; 5).

2.11.2. Board and Senior Management Oversight

Board Responsibilities

The board of directors is responsible for reviewing and approving a bank‘s credit risk strategy and policies. Each bank should develop a strategy that sets the objectives of its credit-granting activities and adopts the necessary policies and procedures for conducting such activities.

Management Responsibilities

Senior management has the responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank‘s activities at both the individual credit and portfolio levels. Senior management must ensure that there is a periodic independent internal or external assessment of the bank‘s credit management functions (Ayalew,2009; 8).

2.11.3. Policies, Procedures and Limits

Credit Policies

The foundation for effective credit risk management is the identification of existing and potential risks in the bank‘s credit products and credit activities. This creates the need for development and implementation of clearly defined policies, formally established in writing, which set out the credit risk philosophy of the bank and the parameters under which credit risk is to be controlled. Measuring the risks attached to each credit activity permits a platform against which the bank can make critical decisions about the nature and scope of the credit activity it is willing to undertake. A cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. Credit policies establish the framework for lending and guide the credit-granting activities of the bank. The policies should be designed and implemented with consideration for internal and external factors such as the bank‘s market position, trade area, staff capabilities and technology; and should particularly establish targets for portfolio mix and exposure limits to single counterparties, groups of connected counterparties, industries or economic sectors, geographic regions and specific products. Effective policies and procedures enable a bank to: maintain sound credit-granting standards; monitor and control credit risk; properly evaluate new business opportunities; and identify and administer problem credits. Credit policies need to contain, at a minimum:

1. A credit risk philosophy governing the extent to which the bank is willing to assume credit risk;
2. General areas of credit in which the bank is prepared to engage or is restricted from engaging;
3. Clearly defined and appropriate levels of delegation of approval, and provision or write off authorities; and
4. Sound and prudent portfolio concentration limits.

The basis for an effective credit risk management process is the identification and analysis of existing and potential risks inherent in any product or activity. Consequently, it is important that banks identify the credit risk inherent in all the products they offer and the activities in which they engage. This is particularly true for those products and activities that are new to the bank

where risk may be less obvious and which may require more analysis than traditional credit-granting activities. Although such activities may require tailored procedures and controls, the basic principles of credit risk management will still apply. All new products and activities should receive board approval before being offered by the bank (Ayalew,2009; 25).

2.12. Non – Performing loans (NPLs)

Lending is the provision of resources (granting loan) by one party to another. The second party doesn't reimburse the first party immediately there by generating a debt, and instead arranges either to repay or return those resources at a later date. Banks function as financial intermediaries, collecting funds from savers in the form of deposit and then supplying to borrowers as loans. Those functions benefit both the banks and the borrowers (Ayalew,2009; 45).

Loans and advances are financial instruments, originated from the banks themselves, by providing money to the debtors and it is one of the most important activities of private commercial banks.

According to NBE , impaired losses are comprise specific provisions against debts identified as bad and doubtful and general provisions against losses which are likely to be present in any loans and advances portfolio. And all private commercial banks follow the National Bank of Ethiopia Supervision of Banking Business Directive Number SBB / 43 / 2008 in determining the extent of provisions for impairment losses accordingly the directive classify loans and advances. And under this directive, non performing loans or advances past due 90 days or more, but less than 180 days are classified as nonperforming loans.

And also , in addition to that ,according to NBEs directive number SBB / 48 / 2010 'non - performing loans' means 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 advance is in question.

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 nonperforming 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. (Ayalew, 2009; 57)

The definition of non-performing loan varies across economies. For Australia and New Zealand, they use the ratio of non-performing assets to total assets in the banking sector. The definitions of non – performing loans as defined by the NBE is that loans that are not repaid in more than three months will be considered as non – performing loans.

It is widely accepted that the quantity or percentage of non-performing loans (NPLs) is often associated with bank failures and financial crises in both developing and developed countries. In fact, there is abundant evidence that the financial/banking crises in East Asia and Sub-Saharan African countries were preceded by high non-performing loans. The current global financial crisis, which originated in the US, was also attributed to the rapid default of sub-prime loans/mortgages. In view of this reality it is therefore understandable why much emphasis is placed on non-performing loans when examining financial vulnerabilities. (Khemraj, 2004; 28)

Usually, in Ethiopian state owned banks, since they give a lot of long term loans and to some extent to they are prone to corruption and large size, they are more exposed to non – performing loans than privately owned banks. However, Private commercial banks are not immune from the exposure of non – performing loans, especially in recent times the National Bank of Ethiopia also issued a provision for private commercial banks to keep a certain amount of their profit for non – performing loans provisions.

Non-performing loans are also sensitive to macroeconomic and bank specific factors. The existing literature provides evidence that suggests a strong association between NPLs and several macroeconomic factors. Several macroeconomic factors are important determinants like the annual growth in GDP, credit growth, real interest rates, the annual inflation rate, real effective exchange rate, annual unemployment rate, broad money supply and GDP per capital etc. (Khemraj, 2004;112)

To be specific there is significant empirical evidence of a negative relationship between the growth in real GDP and NPLs; the explanation provided by the literature for this relationship is that strong positive growth in real GDP usually translates into more income which improves the debt servicing capacity of borrower which in turn contributes to lower non-performing loans. Conversely, when there is a slowdown in the economy (low or negative GDP growth) the level

of NPLs would increase. In addition to that, several studies report that high real interest rate is positively related to these NPLs.

The reason for this high interest rate is, other researchers say that using accounting decompositions, as well as panel regressions, and credit risk and operating inefficiencies (which signal market power) explain most of the variation in net interest margins across ten SSA countries. Macroeconomic risk has only limited effects on net interest margins. Credit risk is the main reason for higher interest rate. (Flamini, 2009;98) .This credit risk is the reason for the high interest rate and this leads to high Non – Performing loans.

Apart from macroeconomic variables, there is abundant empirical evidence that suggests that several bank specific factors (such as, size of the institution, profit margins, efficiency, the terms of credit (size, maturity and interest rate), risk profile of banks (measured by several proxies including total capital to asset ratio and loans to asset ratio) are important determinants of NPLs. (Khemraj , 2004; 159)

Ethiopia also has a foreclosure law which gives banking institutions wider rights than other institutions. Thus unlike other creditors, creditor banks can be authorized by the debtor to sell the property if he does not make the payment on time. In 2011, the National Bank of Ethiopian has established a network of credit information systems for loans. So in this study, the researchers want to revise related literatures review in the context of lending practice of commercial banks.

CHAPTER THREE

PRESENTATION, ANALYSIS AND INTERPRETATION

This chapter deals with data presentation, analysis and interpretation of the data gathered through questionnaire and interview. The student researchers distributed the questionnaires for 20 employees of CBE head office and 20 borrowers of the bank. Out the distributed copies all (100%) of them (both employee's and borrower's) cooperated in filling and returning the questionnaire.

3.1. Analysis of the Questionnaire Distributed to Employees of the Bank

Table 1:- General Background of the Respondents (employees)

No	Questions	Alternatives	Frequencies	%
1	Gender	Male Female	16 4	80 20
		Total	20	100
2	Age	18-30 31-40 41-50 Above 50	5 13 2 -	25 65 10
		Total	20	100
3	Educational status	Diploma B.A. degree M.SC	- 14 6	- 70 30
		Total	20	100
4	Experience	Below 1 year 1-5 years 6-10 years 11-15 years Above 16 years	 3 9 6 2	 15 45 30 10
		Total	20	100

Source: primary data

According to table 1which shows the gender characteristic and the age of respondents indicated that 16(80%) and 4(20%) of the respondents were male and female respectively; 13(65%), 5(25%) and 2(10%) of those respondents were found in the age range of 31-40, 18-30 and 41-50 respectively. Based on the data majority of the respondents were male and were found in the age

range between 31-40 years of age. This implies that most of CBE staffs not only are male but also adults.

As can be seen from the same table which shows the educational status and work experience in the bank are presented. According to the respondents, 14(70%) and 6(30%) of the respondents were degree holders and M.SC. With regard to experience of the respondents, 9(45%) and 6(30%) of the respondents have 6-10 years and 11-15 years of experience. Based on the data majority of the respondents were degree holders and above and most of them have an experience of 6-10 years and above. This implies that the response obtained from the respondents can be used as a reliable and accurate source for the purpose of the research.

3.1.3. Questions Directly Relate with the Research Study

Table 2:- Employees Response Evaluation of Process, Executing and Administering of Loan Analysis of CBE

No	Questions	Alternatives	Respondents	
			Frequency	%
1	How do you evaluate the performance of the bank in processing business development and loan analysis?	Very high	-	-
		High	-	-
		Medium	6	30
		Low	12	60
		Very low	2	10
		Total	20	100
2	How do you evaluate the practice of the bank in executing and administering loan appropriately?	Very high	-	-
		High	-	-
		Medium	8	40
		Low	9	45
		Very low	3	15
		Total	20	100

Source: primary data

According to item 1of table 2 above which shows the performance evaluation of the bank in processing business development and loan analysis; 12(60%) of the respondents evaluated the

performance of the bank in processing business development and loan analysis to be low; while 6(30%) and 2(10%) of the remaining respondents evaluated it as medium and very low. Based on the data majority, i.e. 70% of the respondents indicated that the bank performance in processing business development and loan analysis as below medium.

Item 2 of the same table shows the evaluation on the practice of the bank in executing and administering loan appropriately; 8(40%) of the respondents replied medium regarding the execution and administration of loan appropriately; 9(45%) and 3(15%) of the rest indicated as low and very low. Based on the data majority of the respondents evaluated the practice of the bank in executing and administering loan appropriateness to be below medium.

Once a customer requests a loan, bank officers compile and document all the availabile information to determine whether the loan meets the bank's risk –return objectives. Because credit analysis is essential default risk analysis in which a loan officer attempts to evaluate a borrower's ability and willingness to repay.

Table 3:- review of loan consideration taken the borrower's ability to repay

No	Question	Alternatives	Respondents	
			Frequency	%
1	How do you rate the practice of the bank in reviewing loan?	Very high High Medium Low Very low	- 13 6 1 -	- 65 30 5 -
		Total	20	100
2	The credit analyst performs to generate a list of factors that indicate the borrower's ability to repay.	Strongly agree Agree Neutral Disagree Strongly disagree	6 10 4 - -	30 50 20 - -
		Total	20	100

Source: primary data

Table 3 examines the review of loan consideration taken the borrower's ability to repay; item 1 shows how the respondents rated the practice of the bank in reviewing loan, 13(65%) of the respondents rated the above evaluation as high while the rest 6(30%) and 1(5%) of them rated it as medium and above. Based on the data, the practices of the bank in reviewing loan were rated as above medium by the majority of the respondents. This implies that the review of the loan is important consideration that the bank takes into account so as to know the ability of borrower's to repay their loan. Hence, this could have a positive effect on the lending practice of the bank.

Item 2 of the same table above shows whether the credit analyst performs to generate a list of factors that indicate the borrower's ability to repay. As per 10(50%) and 6(30%) of the respondents agreed and strongly agreed on the statement mentioned above while the rest 4(20%) of them were neutral. Based on the data, the credit analyst generates a list of factors in order to consider the borrower's ability to repay their loan as implicated by 80% of the respondents. This implies that the credit analysts' performance in generating a list of factors in consideration of the repayment program are well performed

Table 4:- the Bank Structure and Control and Collection of Information for Credit Files

No	Question	Alternatives	Respondents	
			Frequency	%
1	How do you evaluate the bank structure and control its own risks in supplying funds?	Very high High Medium Low Very low	- - 7 4 9	- - 35 20 45
		Total	20	100
2	How do you rate the bank in collecting information for the credit files; such as credit history and performance?	Very high High Medium Low Very low	- 3 4 8 5	- 15 20 40 25
		Total	20	100

Source: primary data

As item 1of table 4, shows that on the bank structure and control its own risks in supplying funds 7(35%) of the respondents evaluate as medium, 4(20%) of them as low and 9(45%) of them as very low. Based the data majority of the respondents evaluated the bank structure and control its own risks in supplying funds were below medium.

The values driven focus on credit quality with strong risk management systems and controls, Primary emphasis is on bank soundness and stability and a consistent market presence and on the underwriting is conservative and significant loan concentrations are not allowed. Typical the outcome is lower current profit from loans with fewer loan losses.

Item 2 of the same table, on the bank collecting information for the credit files; such as credit history and performance 3(15%) of the respondents evaluate as high, 4(20%) of them as medium, 8(40%) of them as low and 5(25%) of them as very low. The data indicates that majority of the respondents evaluated the bank in collecting information for the credit files; such as credit history and performance as low.

The credit process of the bank relies on each bank’s systems and controls that allow management and credit officers to evaluate risk and return trade-offs.

Table 5:-evaluation of internal and external factors and financial statement analysis

No	Question	Alternatives	Respondents	
			Frequency	%
1	How do you rate the bank in the evaluation of internal and external factors such as bank's market position, trade area and staff capabilities?	Very high	11	55
		High	7	35
		Medium	2	10
		Low	-	-
		Very low	-	-
		Total	20	100
2	How do you rate the bank in Spreading financial statements; that is financial statement analysis?	Very high	6	30
		High	8	40
		Medium	6	30
		Low	-	-
		Very low	-	-
		Total	20	100
3	How do you rate the bank in theProjecting the borrower's cash flow and thus its ability to service that debt?	Very high	8	40
		High	9	45
		Medium	3	15
		Low	-	-
		Very low	-	-
		Total	20	100

Source: primary data

Item 1 of the table 5 shows that on the bank on the evaluation of internal and external factors, 11(55%) of them evaluate as high and 7 (35%) of them as high while the rest 2(10%) of them evaluated it as medium. The data shows that majority of them evaluate the bank on the evaluation of internal and external factors. This indicates that that bank performance in assessing its external factors(market position and trade area) and its internal factors(staff capabilities and competence) results in credit risk minimization that will enhance the over all service giving capacity of the bank.

Item 2 of the same table above which shows the extent of financial statement analysis: 8(40%) and 6(30%) of the respondents rated the bank financial statement analysis as high and very high respectively; while the rest 6(30%) of them rated it as medium. Based on the data majority of the respondents indicated a high and very high extent of spreading financial statements and analysis by the bank.

The last item, i.e. item 3, of the same table shows the practice of the bank in projecting borrower's cash flow and their ability to service that debt were rated as high and very high by 9(45%) and 8(40%) of the respondents respectively while the remaining 3(15%) of them rated it to be medium. Based on the data, majority of the respondents rated as above medium as far as the projection of the bank on borrower's cash flow and their ability to service that debt is concerned.

Table 6:- evaluation of secondary source of repayment and writing summary and recommendation

No	Question	Alternatives	Respondents	
			Frequency	%
1	How do you rate the bank on the Evaluating collateral or the secondary source of repayment?	Very high	-	-
		High	2	10
		Medium	6	30
		Low	11	55
		Very low	1	5
		Total	20	100
2	How do you rate the bank in Writing summary analysis and making a recommendation?	Very high	6	30
		High	7	35
		Medium	4	20
		Low	3	15
		Very low	-	-
		Total	20	100

Source: primary data

As per table 6; item 1 that evaluates collateral or the secondary source of payment were evaluated as low and very low by 11(55%) and 1(5%) of the respondents respectively; while 6(30%) of the respondents rated it as medium and the rest 2(10%) of the rest rated it as high. Based on the data, the bank evaluation of collaterals and secondary source of repayment was rated to be below medium by the majority of the respondents.

Item 2 of the same table above which shows the extent of the bank in writing summary and analysis and making recommendation were rated high, very high and medium by 7(35%), 6(30%) and 4(20%) of the respondents respectively; while the rest 3(15%) of them rated it as low. The data obtained by the majority the bank were rated to be above medium with regard to writing summary and analysis and making recommendation.

Table 7:-the credit process of the bank with Business development and credit Analysis

No	How do you evaluate the credit process of the bank with the following business development and credit analysis?	Alternatives	Respondents	
			Frequencies	%
1	Market research	Very good	7	35
		Good	8	40
		Moderate	4	20
		Poor	1	5
		Very poor	-	-
		Total	20	100
2	Advertising, public relations	Very good	4	20
		Good	6	30
		Moderate	8	40
		Poor	2	10
		Very poor	-	-
		Total	20	100
3	obtain formal loan request	Very good	7	35
		Good	4	20
		Moderate	5	25
		Poor	4	20
		Very poor	-	-
		Total	20	100
4	obtain financial statements, borrowing resolution, credit reports	Very good	2	10
		Good	11	55
		Moderate	7	35
		Poor	-	-
		Very poor	-	-
		Total	20	100

Source: primary data

Table 7 shows the credit process of the bank with Business development and credit Analysis on the mentioned process of credit: according to item 1, as far as market research were concerned, 8(40%); 7(35%) and 4(20) of the respondents replied good, very good and medium respectively; while 1(5%) of them chose poor. Based on the data market research is conducted with the credit process of the bank in developing business and analyzing credit. This shows that the bank formally follows lending guidelines that employees conduct the business and in identifying preferred loan qualities and established procedure for granting, documenting and reviwing loan.

Item 2 evaluates the credit process with regard to advertizing and public relation; 8(40%) and 2(10%) of the respondents evaluated the business development process as moderate and poor; while the rest 6(30%) and 4(20%) of the evaluated it as good and very good respectively. Based on the data majority of the respondents evaluated the credit process of the bank in advertizing and public relation as moderate and above. This implies that the bank is undertaking advertizing and it public relation practice so as to enhance the service giving capacity of the bank for its customers.

Item 3 of the same table shows the evaluation of the bank in obtaining formal request was rated as very good and good by 7(35%), 4(20%) of the respondents while the rest 5(25%) and 4(20%) of them rated it as moderate and poor accordingly. Based on the data majority of the respondents the bank was good as far as obtaining formal loan request is concerned.

The last item of the same table shows the evaluation of the bank in obtaining financial statements, borrowing resolution, credit reports was evaluated as good, moderate and very good by 11(55%),7(35%) and 2(10%) of the respondents respectively. Based on the data, the bank obtains financial statements, borrowing resolution, credit reports above moderate as indicated by the majority of the respondents.

Focus is on having the highest market share of loans among competitors. Primary emphasis is on loan volume and growth with the intent of having the largest market share. Underwriting is very aggressive and management accepts loan concentrations and above-average credit risk.

Outcome is that loan quality suffers over time, while profit is modest because loan growth comes from below-market pricing and greater risk taking.

Table 8:- credit execution and administration

No	Questions	Alternatives	Respondents	
			Frequencies	%
1	Loan committee reviews proposal/recommendation	Very good	9	45
		Good	10	50
		Moderate	1	5
		Poor	-	-
		Very poor	-	-
		Total	20	100
2	Accept/reject decision made, terms negotiated	Very good	13	65
		Good	4	20
		Moderate	3	15
		Poor	-	-
		Very poor	-	-
		Total	20	100

Source: primary data

As can be seen from Table 8 which evaluate the practice of credit execution and administration of the bank; as per item 1 which shows whether the loan committee reviews proposals/recommendation; 10(50%), 9(45%) and 1(5%) of the respondents evaluated the review of proposals by the loan committee as good, very good and moderate respectively. Based on the data majority of the respondents evaluated the loan committee review of loan proposals to be above moderate.

Item 2of the same table shows the credit execution and administration process of the bank: according to item 1, as far as Accept/reject decision made and terms negotiated concerned, 13(65%); 4(20%) and 3(15) of the respondents replied very good, good and medium respectively. Based on the data Accept/reject decision made, terms negotiated are conducted with the credit process of credit execution and administration process of the bank.

Table 9:- the bank review on loan documentation

No	Question	Alternatives	Respondents	
			Frequency	%
1.	How do you evaluate the credit process of the bank in Reviewing loan documentation	Very good	7	35
		Good	5	25
		Moderate	4	20
		Poor	3	15
		Very poor	1	5
		Total	20	100

Source: primary data

As can be seen from table 9 which shows the evaluation on the credit process of the bank in reviewing loan documentation; 7(35%), 5(25%) and 4(20%) of the respondents evaluated the credit process of the bank in reviewing loan documentation as very good, good and moderate respectively while the rest 3(15%) and 1(5%) of them evaluated it aspoor and very poor. Based on the data, majority of the respondents indicated that the credit process of the bank were above moderate as far as review of loan documentation were concerned.

Table 10:- evaluation on the performance of the bank in monitoring compliance

No	Questions	Alternatives	Respondents	
			Frequency	%
1.	How do you evaluate the credit process of the bank in Monitoring compliance with loan agreement about positive and negative loan covenants?	Very good	11	55
		Good	4	20
		Moderate	2	10
		Poor	3	15
		Very poor	-	-
		Total	20	100
2.	How do you evaluate the credit process of the bank in Monitoring compliance with loan agreement about Delinquencies in loan payments?	Very good	-	-
		Good	2	10
		Moderate	6	30
		Poor	8	40
		Very poor	4	20
		Total	20	100
3.	How do you evaluate the credit process of the bank in monitoring compliance with loan agreement by discussing nature of delinquency or other problems with borrower?	Very good	-	-
		Good	-	-
		Moderate	3	15
		Poor	11	55
		Very poor	6	30
		Total	20	100

Source: primary data

According to table 10 which indicates the evaluation on the performance of the bank in monitoring compliance; item 1 of the above table evaluates the credit process of the bank in Monitoring compliance with loan agreement about positive and negative loan covenants; as per 11(55%) and 4(20%) of the respondents the bank compliance monitoring were evaluated as very good and good while the rest 3(15%) and 2(10%) of them evaluate it as moderate and poor respectively.

Item 2 of the same table, on the credit process of the bank in Monitoring compliance with loan agreement about Delinquencies in loan payments 2 (10%) of the respondents evaluated as very good, 6 (30%) of them as good, 8 (40%) of them as moderate and 4 (20%) of them as poor. The data indicates that the credit process of the bank in Monitoring compliance with agreement about Delinquencies in loan payments.

Item 3 of the same table the credit process of the bank in Monitoring compliance with loan agreement by discussing nature of delinquency or other problems with borrower 3(15%) of them evaluate as moderate, 11(55%) of them as poor and 6(30%) of them as very poor.

Table 11:- Evaluation of the bank's credit process in Instituting corrective action

No	Questions	Alternatives	Respondents	
			Frequency	%
1.	How do you evaluate the credit process of the bank in Instituting corrective action (Modifying credit terms, obtaining additional capital, collateral and guarantees,etc..)	Very good	2	10
		Good	1	5
		Moderate	3	15
		Poor	10	50
		Very poor	4	20
		Total	20	100

Source: primary data

As table 11 shows that 2(10%) of the respondents evaluate as very good, 1(5%) of them as good, 3 (15%) of them as moderate, 10 (50%) of them as poor and 4(20%) of them as very poor for the credit process of the bank in Instituting corrective action (Modifying credit terms, obtaining additional capital, collateral and guarantees, call loan etc..). The data indicates that majority of the respondents evaluated the modifying credit terms, obtaining additional capital, collateral and guarantees and call loan performance of the credit process of the bank in instituting corrective action as poor. This shows the credit process of the bank instituting

corrective action does not incorporate the practice of Modifying credit terms, obtaining additional capital, collateral and guarantees, call loan etc..

3.2. Analysis of the Questionnaire Distributed to borrower's of the Bank

Table 12: -General Background of the Respondents (borrower's)

No	Item	Alternatives	Frequency	Percentage
1	Sex	Male	17	85
		Female	3	15
		Total	20	100
2	For how much years do you working with the bank?	Less than 2 years	2	10
		2 – 5 years	3	15
		5 – 8 years	6	30
		8– 11 years	9	45
		Above 11 years	-	-
		Total	20	100

Source: primary data

As item 1 of table 12 shows that the sex distributions of the respondents 85% of them were male and 15% of them were female. This implies that majority of the credit customers of the bank were males.

Item 2 of the same table shows that,10% of the respondents working with the company for less than 2 years, 15% of them for 2–5 years, 30% of them for 5–8 years and the rest 45 % of them for 8 – 11 years. The data shows that majority of the respondents working with the company for above five years. This implies that they can properly evaluate the lending practice of the bank.

3.2.3. Questions Directly Related with the Research Study

Table 13 the practice of the bank in reviewing loan

No	Item	Alternatives	Frequency	percentage
1	How do you evaluate the performance of the bank in processing business development and loan analysis?	Very high	-	-
		High	-	-
		Medium	5	25
		Low	11	55
		Very low	4	20
		Total	20	100
2	How do you evaluate the practice of the bank in executing and administering loan appropriately?	Very high	2	10
		High	1	5
		Medium	3	15
		Low	7	35
		Very low	7	35
		Total	20	100
3	How do you rate the practice of the bank in reviewing loan?	Very high	-	-
		High	4	20
		Medium	6	30
		Low	8	40
		Very low	2	10
		Total	20	100
4	The credit analyst performs to generate a list of factors that indicate the borrower's ability to repay.	Strongly agree	-	-
		Agree	-	-
		Neutral	6	30
		Disagree	9	45
		Strongly disagree	5	25
		Total	20	100
5	How do you evaluate the bank structure and control its own risks in supplying funds?	Very high	8	40
		High	10	50
		Medium	2	10
		Low	-	-
		Very low	-	-
		Total	20	100

Source: primary data

As can be seen from item 1 of table 13 which shows the performance of the bank in processing business development and loan analysis: 11(55%), 4(20%) and 5(25%) of the respondents evaluated the business development and loan analysis performance of the bank as low, very low and medium respectively based on the data majority of the respondents indicated that the bank operates below medium as far as business development and loan analysis were concerned as per

the borrower's response. This implies that the borrower's of the bank were not satisfied by the bank's practice of processing business development and loan analysis.

Item 2 of the same table shows whether the practice of the bank in executing and administering loan were appropriate: the response shows that 7(35%),7(35%) and 3(15%) of the respondents evaluated as low, very low and medium accordingly; while the rest 2(10%) and 1(5%) of them evaluated it as very high and high. Based on the data, majority of the respondents indicated that the execution and administration of loan appropriateness were below medium. This shows that the existence of non- communication between what the bank expects and what the respondents perceived.

Item 3 of the same table above which evaluates the extent to which the bank practices in reviewing loan; according to the respondents 8(40%) and 2(10%) of the respondents rated the practice of the bank in reviewing loan as low and very low while the remaining 6(30%) and 4(20%) of them rated it as medium and high respectively. Based on the data, the practice of the bank in reviewing loan were medium and below. This shows the bank have a moderate extent of loan revision.

Item 4 of the same table indicate that whether the credit analyst generate a list of factors so as to know the ability of borrower's to repay loan: 9(45%) and 5(25%) of the respondents disagreed and strongly disagreed on the statement mentioned above while the rest 6(30%) of the respondents were neutral. Based on the data, most of the respondents doesn't believe that the credit analyst performs to generate a list of factors that considers their ability to repay their loan. This implies that the bank doesn't take the ability of the borrower's into account while analyzing the credit process.

The last item shows the evaluation of the bank structure in controlling its own risk in supplying its funds: according to10(50%), 8(40%) and 2(10%) of the respondents evaluated it as high, very high and medium regarding the bank‘s structure and controlling risks associated with supplying funds. Based on the data, it is shown that majority of the respondents above medium the bank's structure and controlling its own risks in the flow of funds. This implies that the bank operation in this regard were to undertake loan practice to minimize risky situations when supplying funds.

Table 14 Evaluation of the bank in processing credit

No	Questions	Alternatives	Frequency	Percentage
1	How do you rate the bank in collecting information for the credit files; such as credit history and performance?	Very high	7	35
		High	11	55
		Medium	2	10
		Low	-	-
		Very low	-	-
		Total	20	100
2	How do you rate the bank on the extent of Spreading financial statements; that is financial statement analysis?	Very high	-	-
		High	2	10
		Medium	5	25
		Low	13	65
		Very low	-	-
		Total	20	100
3	How do you rate the bank in Projecting the borrower's cash flow and thus their ability to service that debt?	Very high	-	-
		High	-	-
		Medium	14	70
		Low	6	30
		Very low	-	-
		Total	20	100
4	How do you rate the bank in Evaluating collateral or the secondary source of repayment?	Very high	6	30
		High	9	45
		Medium	5	25
		Low	-	-
		Very low	-	-
		Total	20	100
5	How do you rate the bank's performance in Writing summary analysis and making a recommendation?	Very high	5	25
		High	9	45
		Medium	6	30
		Low	-	-
		Very low	-	-
		Total	20	100

Source: primary data

As can be seen from item 1 of table 14 which shows the performance of the bank in collecting information for the credit files; such as credit history and performance of borrower's: 11(55%), 7(35%) and 2(10%) of the respondents evaluatedin collecting information for the credit files; such as credit history and performance of borrower's as high, very high and medium respectively.Based on the data majority of the respondents indicated that the bank, as far as in

collecting information for the credit files; such as credit history and performance as per the borrower's response. This implies that in collecting information for the credit files; such as credit history and performance of borrower's are well considered by the bank.

Item 2 of the same table shows the evaluation of the bank in Spreading financial statements; that is financial statement analysis: the response shows that 13(65%),5(25%) and 2(10%) of the respondents evaluated it as low, medium and high respectively. Based on the data majority of the respondents indicated that bank in Spreading financial statements; that is financial statement analysis were below medium.

Item 3 of the same table above which evaluates the bank in Projecting the borrower's cash flow and thus their ability to service that debt; according to the respondents 14(70%) and 6(30%) of the respondents rated the practice of the bank in Projecting the borrower's cash flow and thus their ability to service that debt as medium and low. Based on the data, the practice of the bank in projecting the borrower's cash flow and thus their ability to service that debt were medium and below. This shows the bank have a moderate level of projection on the cash flow of borrower's so as to service that debt.

Item 4 of the same table indicate the evaluation of the bank in Evaluating collateral or the secondary source of repayment: 9(45%) 6(30%) and 5(25%) of the respondents rated the performance of the bank in evaluating collateral or the secondary source of repayment as high, very high and medium respectively. Based on the data, most of the respondents believe that the bank evaluates collaterals or the secondary source of repayment as above moderate. This implies that the bank take a series consideration while evaluating collaterals or secondary source of repayment.

The last item shows the evaluation of the bank's performance in Writing summary analysis and making a recommendation: according to9(45%), 6(30%) and 5(25%) of the respondents evaluated it as high, medium and very high regarding Writing of summary analysis and making a recommendation. Based on the data, it is shown that majority of the respondents Writing summary analysis and making a recommendation.

Table 15:- the bank performance in monitoring customers after loan has been approved

No	Evaluation of the bank in monitoring customers after loan has been approved such as:	Alternatives	Frequency	Percentage
1	Assessing, where applicable, collateral coverage relative to the obligor's current condition	Very high	-	-
		High	-	-
		Medium	6	30
		Low	9	45
		Very low	5	25
		Total	20	100
2	Classifying potential credit problems on a timely basis	Very high	3	15
		High	6	30
		Medium	11	55
		Low	-	-
		Very low	-	-
		Total	20	100

Source: primary data

As can be seen from item 1 of table 15 which indicates the assessment of collateral coverage relative to the obligor's current condition were evaluated as low, medium and very low by 9(45%), 6(30%) and 5(25%) of the respondents. Based on the data majority of the respondents evaluated the assessment of collateral coverage relative to the obligor's current condition as medium and below.

Item 2 of the same table evaluate the bank's performance in classifying potential credit problems on timely basis: as per the response obtained 11(55%) of the respondents evaluated it as medium while the rest 6(30%) and 3(15%) of them evaluated potential credit problems on timely basis as high and very high. Based on the data majority of the respondents indicated that the bank have a moderate performance regarding the classification of potential credit problems.

CHAPTER FOUR

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

4.1.Summary of the Major Findings

- Majority, i.e. 70% of the respondents indicated that the bank performance in processing business development and loan analysis as below medium. In addition, the respondents evaluated the practice of the bank in executing and administering loan appropriateness to be below medium. Furthermore, the respondents (borrowers) indicated that the bank operates below medium as far as business development and loan analysis were concerned.
- The data indicates that majority 70% of the respondents evaluated the modifying credit terms, obtaining additional capital, collateral and guarantees and call loan performance of the credit process of the bank in instituting corrective action as poor.
- The practice of the bank in reviewing loan were rated as above medium by the majority of the respondents and also the credit analyst generates a list of factors in order to consider the borrower's ability to repay their loan as implicated by 80% of the respondents. In addition, it is indicated that the execution and administration of loan appropriateness were below medium.
- Majority 65% of the respondents indicated a high and very high extent of spreading financial statements and analysis by the bank. In contrast, the respondents (borrower's) indicated that bank in Spreading financial statements; that is financial statement analysis were below medium.
- The respondents (borrowers) 60% believe that the bank evaluates collaterals or the secondary source of repayment as above moderate.
- 70% of the respondents rated as medium as far as the projection of the bank on borrower's cash flow and their ability to service that debt is concerned and also the bank evaluation of collaterals and secondary source of repayment was rated to be below medium by the majority of the respondents. But as per most of the respondents (borrowers), they don't believe that the credit analyst performs to generate a list of factors that considers their ability to repay their loan.
- Market research is conducted with the credit process of the bank in developing business and analyzing credit.
- The respondents evaluated the credit process of the bank in advertizing and public relation as moderate and above.

- The practice of the bank in Projecting the borrower's cash flow and thus their ability to service that debt were medium and below as indicated by borrower's.

4.2. Conclusions

- The bank performances in processing business development and loan analysis in addition to the practice of the bank in executing and administering loan appropriateness are low. Furthermore, it can be concluded that the bank operation below medium as far as business development and loan analysis were concerned.
- The practice of the bank in reviewing loan and also the credit analyst generates a list of factors in order to consider the borrower's ability to repay their loan as implicated by the respondents. In addition, it is indicated that the execution and administration of loan appropriateness were below medium.
- There is a good extent of spreading financial statements and analysis by the bank. In contrast, the respondents(borrower's) indicated that bank in Spreading financial statements; that is financial statement analysis were below medium.
- The bank conducts projection on borrower's cash flow and their ability to service that debt and also the bank evaluation of collaterals and secondary source of repayment was rated to be below medium. But as per most of the respondents(borrowers), they don't believe that the credit analyst performs to generate a list of factors that considers their ability to repay their loan.
- Market research is conducted with the credit process of the bank in developing business and analyzing credit.
- The credit process of the bank in advertizing and public relation are moderate and below.
- Modifying credit terms, obtaining additional capital, collateral and guarantees and call loan performance of the credit process of the bank in instituting corrective action was poor.

4.3. Recommendations

- The bank should consider improving its performance in processing business development and loan analysis and the practice of the bank in executing and administering loan appropriateness.
- The practice of the bank should take into consideration in reviewing loan and also the credit analyst should generate a list of factors so as to consider the borrower's ability to repay their loan. In addition, the execution and administration of loan should be as appropriate as for both parties (the bank and borrower's interest).
- The extent of spreading financial statements and analysis by the bank is a measure of performance. Therefore, the bank should consider implementing it.
- The bank projection on borrower's cash flow and their ability to service that debt and also the bank evaluation of collaterals and secondary source of repayment, if projected correctly, should give the bank and the borrower's a mutual benefit.
- Modifying credit terms, obtaining additional capital, collateral and guarantees and call loan performance of the credit process of the bank in instituting corrective action should also be given due emphasis in consideration for the borrower's current condition.

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Contributor writers about Loan related issues on "www.google.com"/ December, 18, 2013/ Adam Monotography, Francis Duffy, Malvin Richardesn, Johnson mark, Maroon Saidu, S. Pole Mark, Thomas M. Paringer, Joshua Kennon, Collin Fitzsimmons, Frank J. Fabozzi.

1. How does the lending process of the bank?

The credit process of the bank relies on each bank's systems and controls that allow management and credit officers to evaluate risk and return trade-offs. The credit process includes three functions; business development and credit analysis, underwriting or credit execution and administration, and credit review. Each reflects the bank's written loan policy as determinate by the board of directors.

2. How does the bank performance on the potentially different credit culture of values driven?

The values drivenfocus on credit quality with strong risk management systems and controls,

primary emphasis is on bank soundness and stability and a consistent market presence and on theunderwriting is conservative and significant loan concentrations are not allowed.Typical the outcome is lower current profit from loans with fewer loan losses.

3. What are the market-share driven for the lending practice of the bank?

Focus is on having the highest market share of loans among competitors.Primary emphasis is on loan volume and growth with the intent of having the largest market share.Underwriting is very aggressive and management accepts loan concentrations and above-average credit risk.Outcome is that loan quality suffers over time, while profit is modest because loan growth comes from below-market pricing and greater risk taking.

4. How does the credit analysis performance of the bank?

Once a customer requests a loan, bank officers analyze all availability information to determine whether the loan meets the bank's risk –return objectives. Credit analysis is essential default risk analysis in which a loan officer attempts to evaluate a borrower's ability and willingness to repay.

5. What are the key risk factors that the bank used to evaluate the borrowers?

The borrower’s honesty and trustworthiness.An analyst assess the borrower’s integrity and subsequent intent to repay. If there are any serious doubts, the loan should be rejected.

The borrower’s wealth position measured by financial soundness and market standing. Can the firm or individual with stand any deterioration in its financial position? Capital helps cushion losses and reduces the likelihood of bankruptcy.

The borrower’s legal standing and management’s expertise in maintaining operations so the firm or individual can repay its debt obligations, a business identifiable cash flow or alternative sources of cash to repay debt. An individual must be able to generate income.

The economic environment or industry-specific supply,production,and distribution factors influencing a firms operation. Repayment sources of cash often vary with the business cycle orconsumer demand.

Collateral is the lender’s secondary source of repayment or security in the case of default. Having an asset that the bank can seize and liquidate when a borrower defaults reduces loss, but does not justify landing proceeds when the credit decisions are originally made.