

**ST. MARY'S UNIVERSITY  
BUSINESS FACULTY  
DEPARTMENT OF ACCOUNTING**

**AN ASSESSMENT ON THE IMPACT OF NON PERFORMING LOAN  
ON BANKS PROFITABILITY: IN THE CASE OF DASHEN BANK S.CO**

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**JUNE 2014**

**SMU**

**ADDIS ABABA**

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**A SENIOR ESSAY SUBMITTED TO THE DEPARTMENT OF  
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**BY**

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## **STATEMENT OF DECLARATION**

We, the undersigned declare that this study is our original work, has not been presented for award in any other university and that all sources of materials used for the study has been duly acknowledged.

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# CHAPTER ONE

## INTRODUCTION

### 1.1. Background of the Study

The history of banking in Ethiopia goes as far back as 1905, when the first bank - the bank of Abyssinia was established under the arrangement between the emperor Menelik II and European banking group which was behind the National Bank of Egypt. The establishment of financial institution in Ethiopia designed to collect and channel savings to productive investment dates back to 1942, when the State Bank of Ethiopia was created by the imperial charter. The bank combined the function of central bank and commercial bank until December 1963 when it was split into the National Bank and Commercial Bank of Ethiopia. The central Banking function was thus taken over by the national bank of Ethiopia. This period also characterized by emergent of specialized banks like Agricultural Bank of Ethiopia and Investment Bank of Ethiopia and private banks like Banco De Roma (Ethiopia) and Banco De Napoli (operate in Asmara for many years). (Mersha, 2002:165)

In the post revolution period, financial sector institutions were nationalized and consolidated into specialized banks. At that period the country was followed the socialist economic system. Hence, all banks including National Bank of Ethiopia (NBE) were thought to function as government to favor and promote the development and sustenance of the socialized sectors (cooperatives). (NBE, 2008)

In the reform period, after 1991, the Ethiopian financial sector structure adjusted in the form of re-establishing the already existing banks in new form and allows privatization of financial institutions. Along with this reform all private banks began operating on the objective of making profit as other business. And NBE as sole regulator and supervisory organ set rules and regulation in order to maintain the operation of all banks should be to the

aim of integrating the economic growth of the country. (bride and Harvey,1 998:36)

One of the important factors of economic is the establishment of strong financial sector. In his work, the theory of economic growth has noted the need to develop domestic financial institution and patterns of behavior necessary to generate and mobilize scarce domestic capital is key condition for economic growth. In this regard, one of the main objectives of financial institutions is mobilize resources and channeling to the investors and generate a profit out of it.

In the competitive environment, more and more lines of business, which need a huge investment, are being opened. Some these huge investments are financed through commercial bank's loans. With this respect, banks play a major role in the overall economic development of a country. However, in this process of extending credit to itself into the economy at large. Hence, prudent banks are concerned about the quality customers; a bank should have a way of scrutinizing its borrowers so that it would minimize the risk of default. The effect of default, non-performing loans, is not limited to that of affecting the profit of one particular bank but it has a ripple effect that extends of their loan and the effectiveness of their risk management processes in order to safeguarding their business as well as the overall economy.

Dashen bank is a privately owned company established in 1995 in accordance with the "Licensing and Supervision of Banking Business proclamation no.84/1994" of National Bank of Ethiopia to undertake commercial banking activities. The Bank obtained its license from the National Bank of Ethiopia on 20 September 1995 as a share company with an authorized and subscribed capital of birr 50 million and 14 million respectively. It started normal business activities on the first of January 1996. Presently, it operates through its head office in Addis Ababa and 117 Area Banks (branches) established within and outside Addis Ababa. The deposit of the Bank has reached 15.9 billion, total number of depositor is

1,037,000 and number of staff is 3,690. Among the government and privately owned commercial Banks, Dashen Bank, is the one, which contributes greater role in the development of the Nation's Economy. (Dashen Bank, 2013:11)

Loans are the most important assets held by banks, and bank lending provides the bulk of bank income. It is equally true that bank loans, as they are profitable, are equally risky. Among other things, Bank loans fluctuate and influenced by the changes in economic policy and the economy in general. Therefore, it is very important for the banks to formulate their loan policies in order to minimize the risk associated with them. Besides, sound and complete loan policy has great advantage to the banks. It helps the officials to handle loan issues uniformly, avoid confusion and misunderstanding and ease management. Transparency in lending practices emanates from sound loan policy. (Temesegen, 2007:67)

"In as much as mount Dashen excels all other mountains in Ethiopia, Dashen Bank continue to prove unparalleled in banking service" is the vision of the Bank.

"Provide efficient and customer focused domestic and international banking service, overcoming the continuous challenges for excellence through the application of appropriate technology" is the mission of the bank.

The values of the Dashen Bank are the following:

- **Develop banking habit in the community**
- **Assist continuous growth of customers**
- **Sustainable growth and stability**
- **High integrity and accountability**
- **Esteemed customers satisfaction**
- **Non-stop openness for community access**
- **Brightened and trained employees**
- **Attend customers constructive outlook**
- **Normative confidentiality**
- **Keen to consciously build professionalism and service quality**

## **1.2. Statement of the Problem**

Lending activities require banks to make judgment related to the credit worthiness of a borrower. However, the judgment does not always prove to be accurate and the credit worthiness of a borrower may decline overtime due to various factors. Consequently, banks face credit risks that the borrower may fail to meet the terms of the underlining loan agreement.

Although the bank has work for the better position of Non-performing loans, it still needs great attention because of two reasons. One is loan is the major source of profit for banking. And the other one is, banking in one country economy used as a channel for the conversion of saving into capital then investment. However there is a gap between loan processes and credit collection. Due to this the bank risk exposure is very high when it compared with other private banks in Ethiopia. Out of these risks, Non-performing loans are take the major part as the borrower of the bank become large and large overtime. The low collection performance carried-forward has transformed to undesirable NPL position due to uncontrolled credit migration. All Area Banks should rigorously work on enhancing the loan collection performance and NPL reduction as the performance in this particular activity is measured against the corporate target of 3%.

## **1.3. Basic Research Questions**

In order to find out the impact of Non Performing Loan on the company profitability the following basic questions have been raised and treated:

- ^ To what extent that non-performing loan affects the bank's profitability?
- ^ How does Dashen Bank follow up the customers or the borrowers?
- ^ What are the major causes of Non Performing Loans?
- ^ To what extent the Bank manage its credit distribution?

#### **1.4. Objective of the Study**

##### **1.4.1. General Objective**

The main objective of this study is to identify the position of Non-performing loans in Dashen bank and assess the problems associated with it, specially its effect on the banks profitability.

##### **1.4.2. Specific Objective**

Specifically the purpose of this study attempted:

- ^ To evaluate in what extent the non-performing loan affects the banks profitability.
- ^ To examine how Dashen Bank follow up the customers or borrowers.
- ^ Identify the major causes of non-performing loan in the bank.
- ^ Identify the distribution of non-performing loan based on different economic sectors.

#### **1.5. Significance of the Study**

The study focus on finding out the problem which reduces the Bank profit and effective of non performing loan on the bank profitability and economic growth furthermore, it would be helpful for administrator of Dashen Bank to assess the factor causing non performing loan.

This study is therefore intended:

- ^ To help others who are interested in this area as a preliminary study.
- ^ To develop knowledge that the student researcher have got by theoretical aspects through practice.
- ^ The importance of this study to outsiders is that it will help as reference for further research on this area of the study.
- ^ It helps us for the fulfillment of students' researcher bachelor degree in Art.

## **1.6. Delimitation/Scope of the Study**

The problem of non-performing loan is not limited to one bank. But for simplifying the study we have been selected Dashen Bank as representative of other private banks. The Bank has 60 branches in Addis Ababa, but the researcher limited only to three Branches which include Main, Bole and Bole Medhanialem Branches based on location and due to time and budget constraints. The study covers the period from 2009 G.C to 2013 G.C.

As the nature of the issue raised on the study we are also limited to the lender's-Dashen bank side i.e. we didn't collect data from the borrower's side, this is because the borrowers are not willing to provide the information that the researcher needs.

## **1.7. Research Design and Methodology**

### **1.7.1. Research Design/Method**

As most researchers do, the study under consideration has attempted apply the research method which could be suitable for the successful accomplishment of the research design in such a way that could provide the proper performance of the research based on the data which are relevant for the study the research design is supposed to be flexible enough to avoid unnecessary delay, the design includes descriptive and analytical data which have to be simple for analyzing and interpretation.

### **1.7.2. Population and Sampling Technique**

From three Area Banks information was gathered from 15 concerned individuals of credit department employees. That would have been taken as population size. The sampling techniques that would be applied in survey of data are purposive sampling. Purposive sampling is one type of a non random sampling that conforms to certain criteria. In other words it occurred when the researcher selected sample members or respondents to conform some criteria.

### 1.7.3. Types of data to be collected

In conducting this study, both primary and secondary sources of data were used.

### 1.7.4. Method of Data Collection

In order to collect the necessary data the student researcher used the following sources:

- ^ Primary source - Distributing questionnaires for some branch managers and credit analysts to have overall insight about non-performing loans and certain matters for which there is no written documents.
- ^ Secondary Source - the majority of data for the study have been taken from secondary sources. These secondary sources are annual financial reports, annual bulletins, books, internal reports, literatures and different internet cites of the bank were employed to come up with the necessary results.

### 1.7.5. Data Analysis Method

In attempting to assess the study, the data collection and analysis sources are interpret in terms of percentages, tables and mathematical calculations by observing the manual and financial statements, reports for the last five years on process of loans and Non Performing Loans.

### 1.8. Limitation of the study

When conducts the study of this project the researchers have limitation to fully indicate the effect on non-performing loan in Dashen Bank S.co. this mainly because of the lack of willingness by the bank to give extensive data about NPLs, lack of time to gather the required information, delay of the respondents to responded the questionnaires at appropriate time period and the researchers limited experience in executing researches before. However,

regardless of this fact we are tried our best to gather all data relevant to the study.

### **1.9. Organization of the Paper**

This paper compiled into four chapters. The first chapter includes the background, statement of the problem, delimitation/scope of the study, objective of the study and organization of the paper. The second chapter focuses on the literature review followed by the third chapter data analysis. The last chapter presents summaries, conclusions and recommendations of the study.

## **CHAPTER TWO**

### **REVIEW OF RELATED LITERATURE**

There primary objective of commercial banks like any other business institution is to grow and survive. This can mainly be achieved by making profit. In the case of banks, profit is a function of both the volume and the quality of loan, among others; good quality of credit can only be considered as a good source of profit. The effect of poor quality loans is not limited to that of affecting the profit of one particular bank but has a ripple effect that extends it self in to the economy at large. Hence, prudent banks are concerned about the quality of their loans.

#### **2.1. What is Loan?**

According to Macdonald and Koch,(2006:86) "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."

A certain amount of money that is given by one party to the other party with the expectation of it being fully repaid is called a loan. The nature of this transaction is financial.

All the specific terms and conditions that are apart of the transaction from either side are formally laid out in a promissory note.

A lender granting temporary use of a sum of money to borrower, who must repay the money that, was borrowed over a fixed term, in addition to the interest on the loan or debt, that was incurred, defines loan.

There is a stetted due date to the borrower by the lender to repay the money back to the borrower, but if the borrower failed to repay the stetted money back, the lender charges late fee from those person's who do not return the money on the due date.

Generally, according to Kandasami and Parameswaran,(2003:196) loan is sanctioning of specified lump sum amount by the transferred to the customer. once a loan is sanctioned and transferred to the customer current account, the customer is required to pay interest on the full amount irrespective of the fact that the amount is used or not a loan once repaid in full or in part cannot be withdrawn again by the borrower unless the banker sanction a fresh loan this is the aspect which differentiated it from the cash credit.

## **2.2. Types of loan**

According to their maturity times Dashen Bank (2007:7) Loans are divided in to three types:

**2.2.1. Short - term loans** - these are loans that is a special commitment lone of a single - purpose with a maturity of less than one year. Its purpose is to cover cash shortage, such as special inventory purchase, an unexpected increase in account receivable or a need for interim financing.

**2.2.2. Intermediate or medium term loans** - this are term loans to finance the purchase of furniture, fixtures, vehicles, and plant & office equipment. Maturity generally runs more than one year but less than five. Consumer loans for automobiles, boats home repair ad remodeling are also intermediate loans.

**2.2.3. Long term loans** - mortgage loans are used to purchase real estate and are secured by the asset it self. They usually run between ten - forty years.

Generally, types of loans include mortgage, credit card debts, car loans lines of credit, promissory notes and bonds. Loans are usually provided with terms out lined written contracts but also are acknowledged by an oral promise to repay presently, banks and finance & companies are the most providers of loan; historically merchants have provided this service.

### 2.3. Characteristics of Loan

According to Impendey, (1984:256) the characteristics loans are as the following:

- A. Time to Maturity** - the length of the loan contract. Loans are classified according to their maturity into short term, intermediate - term debt and long-term debt. Revolving credit & perpetual debt have no fixed debt for retirement banks provide revolving credit through extension of a line of credit brokerage firms supply margin credit for qualified customer on certain securities. In this case the borrower constantly turns over the line of credit by paying it down and re-borrowing the funds when needed a perpetual loan requires only regular interest payment. The borrower who usually issued such debt through a registered offering determines the timing of the debt retirement.
- B. Repayment schedule** - this schedule is a schedule that shows two parts that is apportion of the out standing principal and the interest costs with the interest cost with the passage of time the principal amount of loan is reduced, or repaid little by little until it is completely retired. It is required at the end of the contract or on asserted interval, usually on a monthly or semi - annual basis.
- C. Interest** - it is a cost of borrowing. The interest rate charged by lending institution must be sufficient to cover operation & administrative costs on acceptable rate of return. It may be fixed for the term of loan or adjusted to reflect the changing market condition; floating rates are tied to some market index and are adjusted regularly.
- D. Security** - assets pledged as security against loan are known mortgages. Unsecured debt relies on the earning as collaterals credit backed by collateral is secured. In many cases the asset purchased by the loan often serves as the only collateral in other cases the borrower puts other assets including cash, aside as collateral. Real estate or land collateralized power of borrower.

## 2.4. The Major Source of Loanable Fund - Deposit

According to Kent,(2008:76) a bank as an organization whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to other investment.

Deposits are the major source of loanable fund in commercial banks, deposits provide most raw materials for bank loans and advances, thus it represent the ultimate source of bank profit and growth. As other profit making organization commercial banks are aiming at maximizing their profit by increasing the quality and quantity of the disbarring loans.

Banks mobilize deposit from depositors by offering interest and other features of benefits that meet customer's needs better than alternatives uses of funds.

According to Indian Institute of Banking and Finance, (1928:98) deposits normally classified into 'Demand Deposits' and 'Time Deposits'. Demand deposits are those which can be withdrawn or transferred by the customer at anytime without previous notice to the bank. Theses deposits are maintained to meet liquidity and transaction needs. Demand deposits are a gain of three types:

**A. Demand or current deposit:** are funds such as checking account balances, which may be withdrawn in whole or in part at a time.

**B. Saving deposit:** are funds accumulated for special purpose or as cash resaves for the future, which earn compound interest. it is common practice to permit the depositor to withdraw these funds without advance notice of intention to do so.

**C. Time Deposit:** relatively high interests earning bank deposit for a specified period. Withdrawal before the end of the specified period results in partial or total forest of accrued interest.

## **2.5. Lending Activity - Credit**

### **2.5.1. Definition of Credit**

The word "CREDIT" is derived from Latin word creditum, which means to believe or trust. In economics, the term credit refers to a promise by one party to pay another for money borrowed or goods or services received. It is a medium of exchange to receive money or good on demand at some future date. (Jhingan, 2002:165)

Kent, (2008:66) defines credit as the right to receive payments or the obligation to make payment on demand at some future time on account of the immediate transfer of goods.

Another definition of credit is that it has originated from the Latin word "credo" which means 'I believe'. Credit is a matter of faith in the person and less than in security offered. Credit is purchasing power not derived from income, but by financial institution either as an offset to idle incomes held by depositors in the banks, or as a net addition to the total amount of purchasing power. In fact, no economy functions without credit; all economic transactions are settled by means of credit instruments today. It is the very life blood of modern business and commercial system. (Cole, 2000:198)

The principal reason commercial banks are operating in their environment is to maximize their profit by extending credit facilities to their customers. Banks are expected to support their local business communities with an adequate supply of credit for all legitimate business and consumer financial needs and to price that credit reasonably in line with competitively determined interest rates. In deed, it is the principal economic role of banks-to provide loans to the business entities and individuals who are engaged in various economic activities (Agriculture, manufacturing and industry, import/ export, trade and services, housing etc...)The bank's role in finding involves assisting prospective borrowers by availing working or investment capital from which it generates profit.

How well a bank performs its lending function has a great deal to do with the economic development of the country, because bank loans support the growth of new businesses and creates jobs with in the banks' environment and promote economic growth, More over, bank loans often seem to convey positive information to the marketplace about a browser's credit quality, penalty, enabling a browser to obtain more and perhaps some what cheaper funds from other sources.

For most commercial banks, loan accounts are half or more of their total assets and about half to two-third of their revenue, moreover, risk in banking tends to be concentrated in the loan portfolio when a bank gets serous finical trouble, its problems usually come from loans that have become uncorrectable due to mismanagement, illegal manipulation of loan, misguided lending policies, or unexpected economic downturn. (Yonas, 2004:28)

#### 2.5.2. Type of Credit in Banks

The great variety of credit line results from the widely varying needs and activities of borrowers and lenders. Credit can be classified in different ways, but usually in banking sector it can be classified based on two criteria:

##### I. Based on the needs of customers and nature of their business

- ^ Overdraft Facility: This is credit facility by which customer is allowed to draw cash in excess of his deposit, but to the extent of an approved limit by the bank.
- ^ Term Loan: it is a type of credit facility giving for specific time. The duration may be short up on one year or medium up to five years and long about five years. These loans are paid by equal monthly, Quarterly or semi-annually repayments. Short-term loans are usually used for working capital needs; medium term loan may be extended to purchasing or public transport vehicles, equipment, trucks and trailers ... etc. Long- term loan extended for building and constructions purpose.

- ^ **Merchandise Loan** - When a loan is granted against the pledge of merchandise goods for a short period it is called merchandise loan.
- ^ **Letter of credit Facility** - When importers are not in apposition to cover fully the value of the letter of credit to be opened for goods intended to be imported, the bank provide them advance to cover some part of the cost and deal with the exporters' bank on behalf of the importer.

## **II. Based on Economic Sectors**

Loans can be classified based on the purpose they involved in the economic sector. These economic sectors are Agricultural production, manufacturing production, Domestic trade and Service, Building and Construction and import - Export loan categories (Aklilu, 2002:22).

Three fundamental functions to be fulfilled by the banks in order to lend:

- ^ Loan should be granted on a sound and collateral basis.
- ^ Funds should be profitable for the benefit of shareholders and the protection of depositors
- ^ The legitimate credit need of economic agents and/or households should be satisfied.

### **2.6. What is Non-Performing Loan?**

The concept of non-performing loans has been defined in different literatures. According to Paterisson and Wadman,(2004:16), non-performing loans are defined as defaulted loans which banks are unable to profit from the loans which cannot be recovered within stipulated time that is governed by the laws of a country.

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).

Countries that are using standard classification system often (but not always) define non-performing loans as loans in the three lowest categories (substandard, doubtful loss). (CBE, 2002:3)

According to the International Monetary Fund (IMF,2009:150), a non-performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days worth of interest has been refinanced.

Non-performing loans generally refer to loans which for a relatively long period of time do not generate income; that is the principal and/or interest on these loans has been left unpaid for at least 90 days (Fofac, 2009:211).

Non-performing loans are further defined as loans whose cash flows stream is so uncertain that the bank does not recognize income until cash is received, and loans those whose interest rate has been lowered on the maturity increase because of problem with the borrower (Machiraju, 1998:196).

According to World Bank, (2010:5253) asset classification is important for repayment of loan. Asset classification is the process where by an asset is assigned a credit risk grade, which is determined by the likelihood threat debt obligations, will be serviced and debt liquidated according to contract terms. In general all assets for which a bank is taking a risk should be classified.

Asset classification is key risk management tool. Assets are classified at the time of origination and then reviewed and re-classified as needs any (according to the degree of credit risk) a few times per year. The review should consider loan service performance and the borrower's financial condition.

Also according to NBEs directive under articles 7 and 8 of Directive No.SBB/43/2008 loans & advances are classified in to five categories for better understanding of non - performing loans.

- A. **Epecially Mentioned Loans** - Loans in this category are performing but have a potential weakness, which if not corrected may weaken the loan and the banks asset quality. Examples are, credit that the lending officer is unable to properly supervise, an inadequate loan agreement, uncertainty of the condition of collateral, or other deviation from prudent lending. Loans and advances with arrears form 1 - months are classified here.
- B. **Substandard Loans** - Loans in this category have a well - defined weakness, where the current sound worth and paying capacity of the borrower is not assured; orderly repayment of debt is in jeopardy. Non-performing loans and advances with arrears ranging from 4 - 6 months are known as substandard.
- C. **Doubtful loans** - This exhibit all the characteristics of substandard loans, with the added characteristics that collection in full is highly questionable and improvable classification of loss is differed because of specific pending factors, which may strengthen the asset. Such factors include merger. Acquisition, liquidation, procedure, and capital injection, perfecting lines on additional collateral and refinancing plans. Non - performing loans and advances with arrears ranging from 7 - 12 months.
- D. **Loss loans** - are considered UN - collectable and of such little value that their continuance as bankable asset is not warranted. This classification does not mean that the assets has absolutely no recovery or salvage value, but that it is no practical or desirable to differ full provision or writing off this basically worthless loan. Partial recovery may be affected in the future. Non - performing loans & advances having arrears exceeding 12 months over due loans and advances are also kept here.

## **2.7. Signals for Non-Performing Loans**

When we are taking about reducing the magnitude of sick loans or NPLs we have to come first with its signals. Signals can be classification in to two groups that is signals from financial statement and other signals. (Haregewoin, 1999:47)

### **A. Signals from financial statements**

The past operating statements and balance sheets of a sick loan would reveal the following signals.

- ^ Improper accounting treatment
- ^ It may suffer cash losses, which will result into a reduction in its net Working capital.
- ^ Continuous cash losses would erode its net worth and.
- ^ Ultimately net worth becomes negative.

### **B. Other signals**

Other signals which can be observed out of the financial statements are summed up as follows (Haregewoin, 1999:50)

- ^ Non - submission of stock list
- ^ Involuntary accumulation of finished goods
- ^ Drop in demand and reduction in sales
- ^ Request for rescheduling term - loan repayment
- ^ Frequent request for enhancing the limit
- ^ Dishonor of bills or request for extending due dates
- ^ Bouncing of checks
- ^ Increased withdrawals not justified by normal expenses and wage bills.
- ^ Removal of sign board from the go dawn and generally non - cooperative
- ^ Bad market report
- ^ Non-payment of takes resulting in to attachment notice
- ^ Legal suits and notice by the creditors

All these signals and failures considered in financial terms would show that there has been a continued excess of out flows over inflows, resulting ultimately in eroding of working capital. Consequently the performance of the loan becomes sick. So when these signals are shown the lending officer/management of the bank should take appropriate measures before the banks as well as the borrower fail in undesirable situation.

## **2.8. Provision**

According to oxford dictionary of business (Peter, 2002:6) provision is an amount set aside out of profits in the account of an organization for a known liability even though the specific amount might not be known or for the diminution in value of an asset.

The provision for loan losses on the bank's income statement is determined a regulatory requirement that the bank maintains loan loss reserve (on the balance sheet) if at least 1 percent of total loans.

The accounting rules of the bank do not permit negative provision for the loan losses. If loans are decreasing and charge off are small, the reserve for loan losses may be zero, and the reserve for loan losses may be greater than 1 percent of the total loans. (Haley, 2000:30)

Adequate loan classification and provisioning practice are essential parts of a sound and effective credit risk level and provide general of specific provision. General provision is held for possible losses not yet identified where a certain percentage is provided for total loans and advances in lump sum. On the other hand, specific provision is provided for identified losses, pending on the magnitude of risk associated to each loans or advances. Mean while, the NBE has issued a new provision directive no. SBB/28/02, which enter in to force in the first day of April 2002, in replacement of directive number SBB/18/96. This directive requires deflation the initial estimated value of collateral, using a coefficient of 0.67, provided that the estimated value of collateral does not exceed 100% of the outstanding

balance, instead of deducting the realizable market value of the security held as collateral.

Soon after that, however, the NBE revises its provision directive no.SBB/32/02, which interred in to force since September 01, 2002. Accordingly, loans such as pass, special mention, substandard, doubtful and loss require minimum provision.

According to the NBE'S directive No.SBB/18/96 effective June 1997, the following techniques were followed by the CBE in calculating provisions.

Classification of all non-performing loans whose repayment have been discontinued for 90-180 as "substandard", 181 - 365 days as "Doubtful" and over 365 days as "loss loans".

Deduction of the respective realizable market value of pledged security from the outstanding balance of each loan classified as non performing if the value obtained is greater than zero, then 25%, 50% and 100% provision shall be calculated for each classified loan as substandard, doubtful and loss loan, respectively.

## **2.9. Causes for Non-Performing Loans**

Causes for non - performing loans are merely varied from bank to bank as well as countries to countries. Even the classification of this causes differ one to the others. Some classified them based on the level of the responsibility for the occurrence of NPLs.

Akililu, (2002:19) on his paper, financial risk of Ethiopia financial sector, classified the causes for NPLs as follows:

- ^ The cause of NPLs at borrower level
- ^ The cause of NPLs at the banks level
- ^ The cause of NPLs at economic level

Corporate planning and development department of Dashen bank on its October 2005 issue classified the causes in two broad groups.

**A. Internal factors**

- ^ Lack of continuous follow up of repayment due to manpower shortage
- ^ Lack of consultation and communication with defaulter
- ^ Overstating the collateral value at the time of estimation
- ^ Lack credit information to be gathered from other commercial banks
- ^ Agency problem (i.e. branch managers focus merely on increasing their loan portfolio by accepting loaners with out making due analysis)

**B. External factors**

- ^ Diversion of the borrowed fund to other purposes
- ^ Unavailability of demand and price fluctuation on both local and international market.
- ^ Country's economic and political condition
- ^ Impact of change fiscal and monetary policy
- ^ Insufficient credit awareness
- ^ Unwilling customer to disclose the information required
- ^ Unethical computation made between banks
- ^ Willful default

There are large macroeconomics reasons for wide spread of NPLs and the causes for it have multi faced dimensions such as structural systematic policy and managerial. Though different banks encounter different causes for NPLs general consensus of common causes, are also there. Some of these common causes are; bankruptcy of the borrower business, absence of risk assessment, poor follow - up. Lack of credit information and moral hazard (Haregewoin, 1999:43)

Although the causes of NPLs different from bank to bank, the following are the bank and self - explanatory reasons for the occurrence of NPLs in the commercial banking sector of Ethiopia. (Yonas, 2004:15)

- ^ Providing loan over the total capital of the forms or business entities
- ^ Providing loan with out sufficient back up /adequate safety of collateral or security
- ^ Providing loan without sound credit principal and appraisals
- ^ Providing loan to unfamiliar borrowers and without adequate information about the borrower.
- ^ Providing loan without the quality and dependability of personal guarantee
- ^ Providing loan (large sum) with out audited financial statement of borrower firm /company
- ^ Providing additional loan without additional collateral
- ^ Providing loan without the expertise of engineering appraisal and without consideration of depreciation and current fair value of the property of the borrower
- ^ Providing loan without sufficient credit history or information of the borrower
- ^ Providing loan with a collateral, which has no legal document, or registration with the municipality
- ^ Providing loans without viable project/business proposals

The damages of NPLs on commercial banks occurred due to the above causes aggravated because of the way that the banks try to recover sick loans.

## **CHAPTER THREE**

### **DATA PRESENTATION, ANALYSIS AND INTERPRETATION**

In this Chapter, the researcher group used both primary & secondary data sources. The primary data was collected through questionnaire, interview and researcher group observations. The secondary data collected from different literatures, manuals and reports of the bank.

From a target population of 15 staffs, questionnaires were distributed to 15 staffs of the bank who are working in credit department of the three branches. All of them had completed and returned the questionnaire. So the following analysis and discussions done on the collected data from the questionnaires. The purpose of this section is to assess the impact of nonperforming loan on profitability of the bank. The major findings from the responded questionnaire are compared and presented here under by respective questions.

As shown on table 3.1 of item 1 regarding sex 6(40%) of the respondents were male while the remaining 9(60%) are female. This clearly depicts that female respondents are dominant in number compared with males.

As can be seen on the table 3.1 of item 2, concerning age 11 (73%) were 25 to 35 years and the rest 4(27%) of the respondents are below 25 years. The researcher group observed that most of the respondents are young employee of the Bank.

In terms of experience, table 3.1 of item 3, 7(47%) of the survey respondents indicates that they had 5 - 10 years of banking experience. The second larger number of respondents, 5(33%) had banking experience of 2-5 years. The third large number of respondents 3(20%) had above 10 years. The remaining 2(13%) respondents had banking experience of below 2 years

only. This clearly depicts that respondents had rich experience in providing response that naturally contributed to the data quality of the survey.

**Table 3.1. Respondents Background Information**

No.	Items	Options	No.	%
1	Sex	Male	6	40
		Female	9	60
		Total	15	100
2	Age	Below 25 years	4	27
		Between 25 & 35 years	11	73
		Between 35 & 45 years	0	0
		Above 45 years	0	0
		Total	15	100
3	Work experience	Below 2 years	2	13
		Between 2 & 5 years	5	33
		Between 5 & 10 years	7	47
		Above 10 years	3	20
		Total	15	100
4	Educational background	Certificate	0	0
		Diploma	0	0
		First degree	14	93
		Above first degree	1	7
		Total	15	100
5	Position	Manager	1	7
		Loan officer	2	13
		Credit analyst	12	80
		Accountant/Teller/Cashier	0	0
		Total	15	100

As shown on table 3.1 of item 4, regarding to the educational level of respondents 14(93%) are first degree and the remaining 1 (7%) are above first

degree. This shows that the banks employees are well trained and they contribute a quality survey to our study.

Looking at the positions of survey respondents revealed that on table 3.1 item 5, 12(80%) were bank Credit analyst while 2(13%) were loan officers and 1 (7%) were credit Manager of the Bank. As it can be seen from the table during the primary data collection the credit analyst plays a big role for our study and they are many in number which is very important for credit follow up for the Bank.

**Table 3.2. Effects of Nonperforming Loan on Bank Profitability**

Item	Options	Respondents	
		No.	%
To what extent Nonperforming loan affects the Banks profitability?	High	4	27
	Medium	8	53
	Low	3	20
	Total	15	100

As can be seen on table 3.2 about 8(53%), 4(27%) and 3(20%) of respondents said that there are some observed problem in nonperforming loan affects the banks profitability at medium, high and low level respectively. From this analysis the effect of nonperforming loan on banks profitability shown at medium level, which means it leads to less profit.

As the student researcher observed from the interview question the interviewer stated that the effect of NPL as follows:

- Deteriorating asset quality,
- Potential loss of profit/capital as the case may be,
- Reduction in lending power,
- Failure in investor confidence and popularity,
- Decline in the banks rating among computing institutions
- Loss of public confidence.

**Table 3.3. Presence of Follow-up Technique for Nonperforming Loan**

Item	Options	Respondents	
		N°.	%
Is there any credit follow up techniques and procedure designed and implemented by the bank?	Yes definitely	9	60
	Yes to some extent	5	33
	Not at all	0	0
	I am not quite aware of it	1	7
	Total	15	100

As shown on table 3.3, the respondents 9(60%) and 5(33%) confirm that the bank has instituted a formal credit follow-up technique and procedures that is vital for enhancement of 'asset quality management' also, a formal organ is executing the tasks outlined in the procedure. while the remaining 1(7%) of the respondents said that not quite aware of it.

According to the respondent's response, the student researcher observed that the bank has designed and implemented credit follow-up techniques and procedure to minimize its nonperforming loans.

**Table 3.4. Mechanisms Implemented by the Bank to Protect Loan from being NPL**

Item	Options	Rank			Score	%
		1	2	3		
What Mechanism do you apply in order to Collect the loan?	Extension of the life of the loan	7	5	3	34	38
	Injection of additional loans	3	5	7	26	29
	Rearrangement of loan repayment	5	5	5	30	33
	Total	15	15	15	90	100

**Note:** For 1<sup>st</sup> Rank Given 3 Points 2<sup>nd</sup> Rank Given 2 Points & 3<sup>rd</sup> Rank Given 1 point

Table 3.5, indicates that 26(29%) of the respondents, replied that the bank used injection of additional loan mechanisms in order to collect the loan, where as 34(38%) of the respondents said that extension of the life of the loan as a major mechanism. The remaining 30(33%) of respondents mention that rearrangement of loan repayment was other mechanism to collect the loan. In general, anyone can understand from the table that extension of the life of the loan is the major remedial for the bank to reduce non performing loans at the lowest level.

In addition, from the interview question regarding to prevent the happening of sick loan the interviewer states the following points:

Continuous consultation and advisory services and assessment of how the business is performing.

Timely processing of requests especially when the economic factors are worsening.

Renegotiation of existing loans aimed at reduced periodic commitments that in turn reduce the stress of higher payments and injection of additional capital by way of fresh loans and advances if it is assumed that the business could perform well with additional capital.

**Table 3.5. Timing, Purpose and Estimation of Collateral for the Bank**

No.	Items	Options	Respondents	
			No.	%
1.	Does the loan spent on the intended purpose?	Yes	12	80
		No	3	20
		Total	15	100
2.	Do you think that the collateral estimated properly by the responsible body?	Yes	15	100
		No	0	0
		Total	15	100

Concerning the purpose of the loan as shown on table 3.5 of item 1, 12(80%) of the respondents have viewed that loans granted was spent for the intended purpose while the remaining 3(20%) of the respondents said that sometimes there are loans which use for other purpose. Even though item 1 shown that the loan granted has spent for the intended purpose the researcher group observes that the granted loan for other purpose is a major cause of nonperforming loan. In addition during the primary data collection through interview question the interviewer certified that diversion of funds approved for one purpose is used to another was one of the major causes of nonperforming loan.

As the table 3.5 of item 2, shown 15(100%) assure that the collateral offered by the borrower for the loan purpose is estimated properly by responsible body of the bank. since the collateral offered by the borrower properly estimated by the responsible body of the Bank, this item have no contribution for nonperforming loan of the Bank.

The major causes for Nonperforming loans are merely varied from bank to bank. This paper compiles and presents here the various causes of nonperforming loans in summarized form. As has mentioned in chapter two the causes for Nonperforming loan are very wide and differ from one country to another country. The causes could be classified in to the following three basic levels.

- I. At borrower level
- II. At bank level
- III. At economic level

Then, based on the above classification questionnaire were prepared and distributed to Dashen bank staffs that have more than three years work experience on loan activities (loan officers, accountants, tellers, credit analysts assistant managers and managers). The significance of causes is ranked from one up to six. One give to causes which have least contribution on occurrence of sick loans and six give for causes which have a high significance on nonperforming loans. The selected bank branch staffs have

played a great role in the finalization of this paper by answering the asked questions in the form of questionnaire. Out of the total 15 questioners 15 were filled out and returned their responses for the respective questions are analyzed as follows:

Table 3.6. The Major Causes for NPL at Borrower Level

The major causes of NPL at borrower Level	N° of Respondents by Rank						Total	%
	1	2	3	4	5	6		
Lack of proper business plan	3	4	2	1	2	3	56	18
Contingencies at borrower e.g. death, sick	2	3	4	2	1	3	54	17
Diversion of the borrower fund to other purpose	4	1	3	3	2	2	56	18
Insufficient credit awareness	2	2	5	2	1	3	53	17
Unwilling customer to disclose the information required	1	3	0	4	4	3	41	13
Willful default/unwillingness to pay	3	2	1	3	5	1	52	17
Total	15	15	15	15	15	15	312	100

Note: For 1<sup>st</sup> Rank Given 6 Points 2<sup>nd</sup> Rank Given 5 Points, 3<sup>rd</sup> Rank Given 4 points, 4<sup>th</sup> Given 3 points, the 5<sup>th</sup> Given 2 points and the 6<sup>th</sup> Given 1 point.

Table 3.6 shows the cause of Nonperforming loan at borrower level. The highest percentage of the cause is due to lack of proper business plan of the borrower, diversion of the borrower fund to other purpose was 56(18%) each. The next highest percentage contingencies at borrower, insufficient credit awareness and willful default/unwillingness to pay was 54(17%) each. This suggests that lack of proper business plan, insufficient credit awareness to disclose the information diversion of the borrowers fund to

other purpose and willful default/unwillingness are difficulties for the bank to perform credit risk assessment in borrowers' level.

Table 3.7. The Major causes for NPL at Bank Level

The Major Causes of NPL at Bank Level	N° of Respondents by Rank						Total	%
	1	2	3	4	5	6		
Lack of continuous follow up and proper risk assessment	2	4	2	1	3	3	52	16
Lack of consultation and communication with defaulters	1	2	1	4	3	4	47	15
Lack of sufficient credit information from other commercial banks	5	4	1	2	2	1	65	21
Mistake on estimation of collateral and evaluating the Borrowers financial report	3	2	6	2	2	0	62	19
Problem associated with loan eligibility criteria	2	2	2	3	4	2	49	15
Willful default/unwillingness to pay	2	1	3	3	2	3	45	14
Total	15	15	15	15	15	15	320	100

Note: For 1<sup>st</sup> Rank Given 6 Points, 2<sup>nd</sup> Rank Given 5 Points, 3<sup>rd</sup> Rank Given 4 point, 4<sup>th</sup> Rank Given 3 Points, 5<sup>th</sup> Rank Given 2 Points and 6<sup>th</sup> Rank Given 1 Points.

The table 3.7 Summarizes, the causes of Nonperforming loan at bank level. The main causes with the highest percentage 65(21%), which was Lack of sufficient credit information from other commercial banks, and Mistake on estimation of collateral and evaluating the Borrowers financial report was 62(19%), even if Dashen bank has its own engineering department for this purpose, Lack of continuous follow up and proper risk assessment shows 52(16%) holds for Problem associated with loan eligibility criteria and Lack

of consultation and communication with defaulters was the third position shows 47(15%) of the analysis and finally Willful default/unwillingness to pay was 45(14%). This is because of the implemented system of sharing credit information among banks by National bank of Ethiopia. As per the analysis from the table shown the researcher group found that failure of collection credit information from other commercial banks and mistake on estimation of collateral & evaluating financial reports of the borrowers are the major causes of nonperforming loan at Bank side.

**Table 3.8. The Major Causes for NPL at Economic Level**

The major causes of NPL at Economic Level	N°-of Respondents by Rank					Total	%
	1	2	3	4	5		
Unstable political situation	4	4	2	4	1	40	19
Excessive government intervention	2	3	4	3	2	42	20
Political power of the borrower	4	2	3	2	4	45	21
Weak economic plan and strategy implementation	3	4	2	4	2	47	22
Change in fiscal and monetary policies	2	2	4	2	5	39	18
Total	15	15	15	15	15	213	100

Note: For 1<sup>st</sup> Rank Given 5 Points, 2<sup>nd</sup> Rank Given 4 Points, 3<sup>rd</sup> Rank Given 3 point, 4<sup>th</sup> Rank Given 2 Points and 5<sup>th</sup> Rank Given 1 Points.

Table 3.8, shows that the major causes for NPLs at economic level, 47(22%) of the respondents, replied that due to Weak economic plan and strategy implementation and Political power of the borrower 45(21%), while 42(20%) of the respondents said that excessive government intervention. On the other hand, 40(19%) of the respondents reason out that unstable political situation. Finally 39(18%) of the respondents believe that Change in fiscal and monetary policies. The researchers observe from the above table, that

the given options are almost similar effect on nonperforming loan at economic level. However, weak economic plan & strategy implementation and political power of the borrower are the major causes of nonperforming loan at economic level. It means the failure of considering economic situation in its strategic plan and the political power of the borrower creates to reduce the performance of repayment loan and it leads to nonperforming loan.

**Table 3.9 Distribution of Loan**

<b>Item</b>	<b>No</b>	<b>%</b>
Agricultural Sector	4	27
Manufacturing	2	13
Domestic Trade & Service	6	40
Export	1	7
Import	0	0
Building & Construction	0	0
Transport Loan	2	13
<b>Total</b>	<b>15</b>	<b>100</b>

**Chart 1: Distribution of Loan**

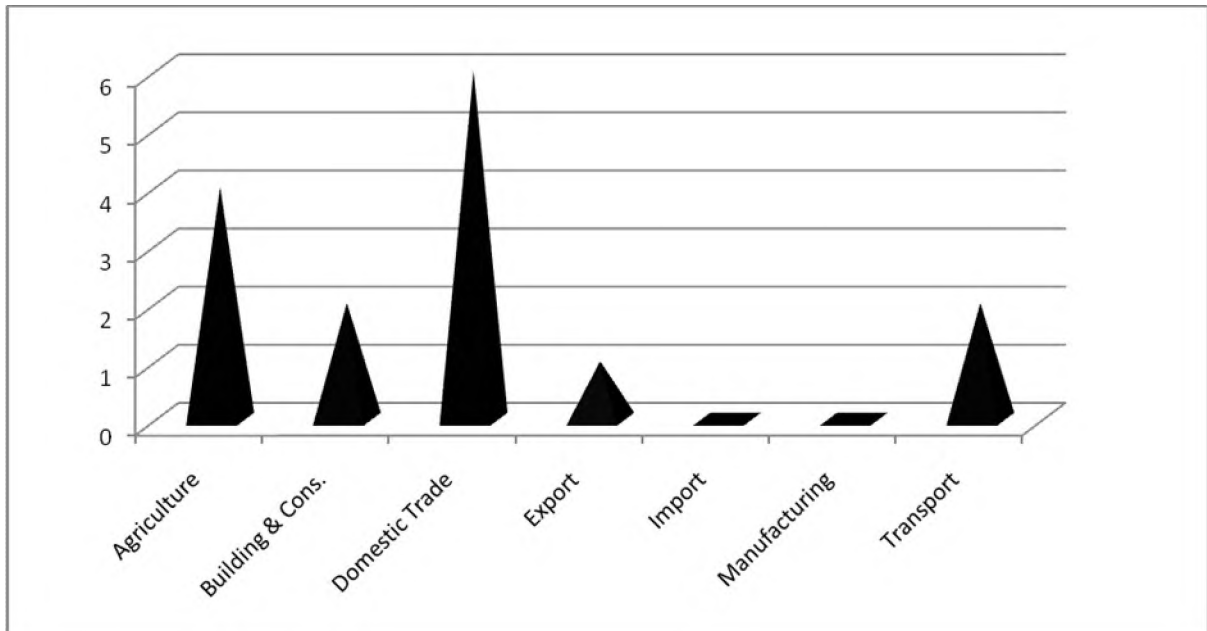


Chart 1 Indicates 6(40%) of the respondents, replied that the bank usually emphasized on Domestic Trade and Services (DTS) loan, whereas the 2<sup>nd</sup> major area of focus is agriculture which holds 4(27%) of loan share, the third manufacturing and transport holds 2(13%) each. The rest 1(7%) of the respondents, also pointed out that export loan.

From Table 3.9 or Chart 1, analysis Domestic Trade and Services account the highest portion of outstanding loan during the period under review and agriculture sectors take the second position most of the years under the study.

From this observation, one can conclude that the bank emphasized on Domestic Trade and Service due to business viability and high demand on the sector.

As seen from table 3.10, about 12(80%) of respondents say there are some observed that borrowers past financial history and credit worthiness as per the Banks policy and procedure, while others 3(20%) respondent conclude

that yes to some extent the banks review the borrowers financial history and credit worthiness as shown on the study.

**Table 3.10. Assessment of Borrower's Financial History**

Item	Options	Respondents	
		No.	%
To assess the borrower's financial history, credit worthiness and detailed financial analysis?	Yes definitely	12	80
	Yes to some extent	3	20
	Not at all	0	0
	I am not quite aware of it	0	0
	Total	15	100

Regarding the assessments of borrowers financial history the researcher group observe that the Bank has proper procedure and evaluate the financial history and credit worthiness, this implies that the strengthen side of the Bank to reduce its nonperforming loan to the minimum.

Based on the interview conducted for interview question the respondents replied the following opinion: The interviewees forward their opinion on "what are the loan disbursement procedures in Dashen Bank?"

- > Once a loan is approved, disbursement will be made after fulfilment of the following procedure:
  - S Signing of appropriate loan contract ; and mortgage agreements
  - S Registration of collateral properties
  - S Insuring properties secured as collateral
- > "What are the main causes for loans to become nonperforming loan in the Bank?"

As per the interviewees respond the main causes are indicated below:

- S Mismanagement of funds
- S Diversion of funds approved for one purpose in to another purpose

S Acquisition of fixed assets using funds approved for enhancing working capital

S Sudden events in the market(economic factors)

S Improper planning and evaluation of businesses

S Loss incurred(sustained)

In general, The percentage of NPL indicates so many factors including asset quality, competitiveness and transparency of the credit evaluation and appraisal system, competence of the workforce, behavioural issues regarding those involved in the credit appraisal and evaluation process, the efficiency of management to implement and control, and etc...thus, it is highly recommended that financial institutions need to adept a system where there exists transparency, accountability, fair and professional credit appraisal and evaluation, disciplined and trustworthy staff, turned to the needs credit operating and processing policies and procedures, timely and critical evaluation of performance of loans and advances, and effective NPL handling(whether procedural or legal) mechanisms. The issue of NPL has too many implications and therefore needs to be contained to the minimum possible at all times.

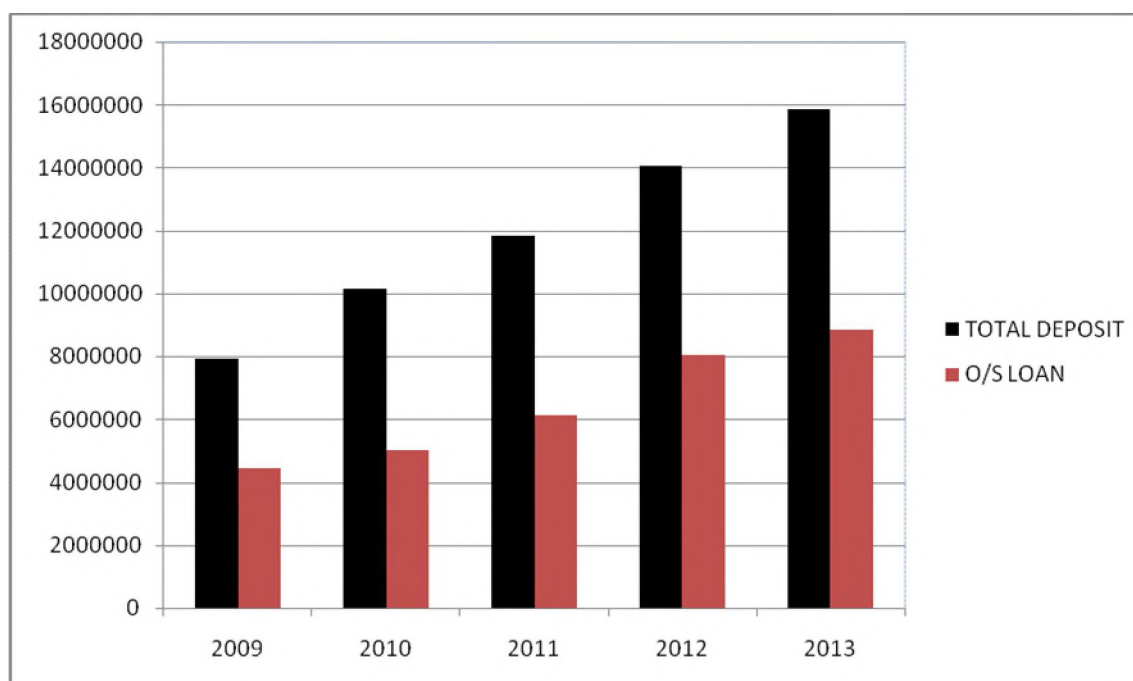
According to secondary data collected the position of Non-performing loans in Dashen Bank can be analyzed in the following manner.

**Table 3.11. Ratio of Outstanding Loan and Advance to Deposit In Birr ('000)**

Deposits	2009	2010	2011	2012	2013
Saving Deposit	5,033,506	6,730,372	7,797,453	8,888,844	10,577,451
Demand Deposit	2,189,749	2,715,397	3,408,063	4,392,717	4,265,723
Time Deposit	702,000	699,000	636,000	784,038	1,008,089
Total Deposit	7,925,255	10,144,769	11,841,516	14,065,599	15,851,265
Outstanding Loan	4,447,024	5,033,073	6,141,666	8,041,997	8,836,627
Percentage Proportionate	56.11	49.61	51.87	57.17	55.75

Source: Dashen Bank Annual Reports 2009 - 2013

**Chart 2: Growth rate of Outstanding Loan and Deposit**



**Table 3.12 Growth rate of Outstanding Loan and Deposit In (birr"000")**

Years	O/S Loans	Growth Rate (%)	Total Deposit	Growth Rate (%)
2009	4,447,024	-	7925,255	-
2010	5,033,073	13.18	10,144,769	28.01
2011	6,141,666	22.03	11,841,516	16.73
2012	8,041,997	30.94	14,065,599	8.78
2013	8,836,627	9.88	15,851,263	12.7

Source: Dashen Bank Annual Reports 2009 - 2013

As can be seen from table 3.11 and chart 2 can simply explain the growth trend and proportion of loan and deposits of Dashen Bank through five years data.

Table 3.12 Shows that the proportion of the Loans and advances growth as total deposit increased. More or less the proportion has shown an increasing trend from year to year. Especially for the year ended June 2012 it was 57.17% which was the highest among the covered period.

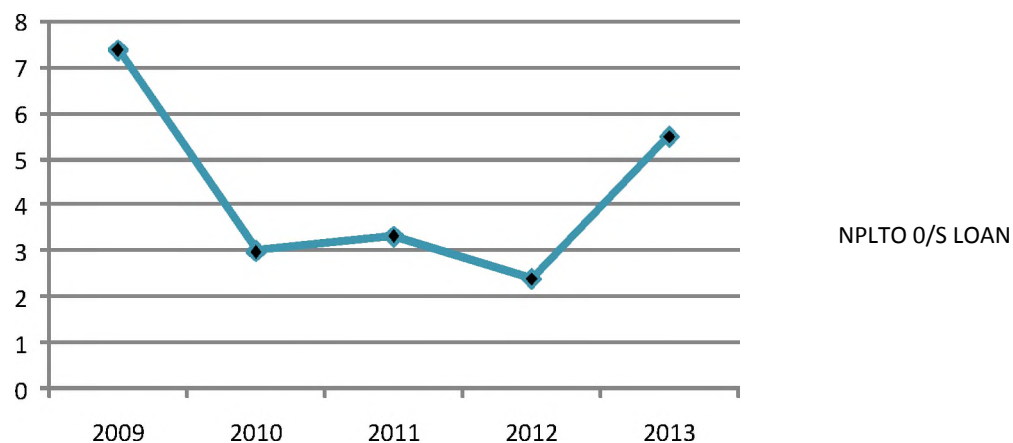
Anyone can see from chart 2 how the trend of both outstanding loan and total deposit were growing for the period starting from June 2009 to June 2013. These growth trends can also be seen on table 3.12. And it presents on what percentage that both outstanding loan and total deposit have been growing from year to year. When we compare the year 2010 to its consequent year 2013 the growth of outstanding loan and total deposit were substantial i.e. 13.18%, 22.03%, 30.94%, 9.88% and 28.01%, 16.73%, 18.78%, and 12.70% respectively. The outstanding loan of the last two years went up from 8,041 million in year 2012 to 8,836 million in years 2013 depicting a growth of 109.89%. Similarly the total deposit increased from 14,065 million in 2012 to 15,851 million in 2013 i.e. a growth of 112.70%. Since branches are the principal interface between banks and their clients, the increase in the number of branches creates more opportunity for the bank to increase its loans disbursed and deposit. The other reason for the above mentioned improvement is the goodwill of the bank that is developed through the five years. (Annual report, 2012/2013).

**Table 3.13. Ratio of NPL to Outstanding loans *In Birr "000"***

<b>Years</b>	<b>O/s Loans</b>	<b>Total NPL</b>	<b>Percentage Proportion</b>
2009	4,447,024	328,472	7.39
2010	5,033,073	150,890	3.00
2011	6,141,666	204,393	3.33
2012	8,041,997	193,379	2.4
2013	8,836,627	484,194	5.5

Source: Internal reports

**Chart 3: NPL to O/S Loan Ratio**



It could be noted from chart 3 that the ratio of the total balance of NPL to outstanding loans has shown increment in 2009; however it shows remarkable improvement through the covered years.

From table three anyone can see that the trend of the ratio in percentage from year 2010 to 2013 it increase from 3% to 5.5%.

**Table 3.14. Growth rate of NPL**

Years	Total NPL	Growth in Amount	Growth Rate (%)
2009	328,472	-	-
2010	150,890	(177,582)	(118)
2011	204,393	53,503	26
2012	193,379	(11,014)	(6)
2013	484,194	290,815	60

Source: Internal report

From table 3.1 4. Anyone can understand that the amount of NPL as of June 2010 and 2012, has exhibited an excessive decrease by 118% and 6% respectively, which was about birr 177,582 and 11,014 million. But when we see in the year 2011 and 2013 increase to 53,503 and 290,815 million respectively, In general from year 2009 to 2013 its growth rate has decrease with increase rate as shown on the table above.

Dashen Bank registered an operating profit of Birr 813 million in the year 201 2/201 3 fiscal year which is less than that of the preceding year; it shows 8.8% decrease from last fiscal year's profit.

According to their audit report conducted by foreign audit firm A.W. Thomas and Co. There is a 813 million Birr profit before tax.

The net profit after tax also less than that of the preceding year. It has decline from 652 million Birr to 607 million Birr the succeeding year is less than that of the preceding year.

**Table 3.15 Composition of Income**

Items	2009	2010	2011	2012	2013	Total	%
<b>Interest income from loan &amp; advances</b>	431,238,109	477,299,822	592,641,091	876,597,744	1,004,928,293	3,382,705,059	52
<b>Interest income from Deposits with Foreign Banks</b>	3,539,010.00	5,356,033	11,036,475	21,132,629	15,807,916	56,872,063	1
<b>Other Income</b>	320793006	481,674,059	678,512,220	827,626,835	796,053,367	3,104,659,487	47
<b>Total</b>	<b>755,572,134</b>	<b>964,331,924</b>	<b>1,282,191,797</b>	<b>1,725,359,220</b>	<b>1,816,791,589</b>	<b>6,544,236,609</b>	<b>100</b>

Source: Internal report

As we can see from the table interest income from loan and advances accounted for 3,382,705 million of the total revenue, which shows a slightly higher as compared to the other composition of the banks source of revenue.

**Table 3.16 Breakdown of Expenses (In 000 Birr)**

<b>Items</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>Total</b>	<b>%</b>
Interest expense	199,448	248,187	325,272	410,231	489,877	1,673,016	47.85
Salaries & Benefit	154,046	190,793	243,072	307,439	381,407	1,276,757	36.52
General Expense	47,414	54,734	66,906	194,971	114,804	478,829	13.69
Provision from NPL	2,175	11,361	17,061	19,452	17,768	67,817	1.94
<b>Total</b>	<b>403,082</b>	<b>505,076</b>	<b>652,311</b>	<b>932,094</b>	<b>1,003,855</b>	<b>3,496,419</b>	<b>100</b>

As table shows that interest expense during the year 2012/2013 fiscal period increased by 47.85% or by Birr 489,876 million, which is a reflection of the increase in the amount of interest bearing deposits. Salary and benefit also grow by 36.52% by Birr 381,406 million mainly as a result of increase in staff salaries, benefits and recruitment of new employees.

**Table 3.17 Growth Rate of Profit**

<b>Year</b>	<b>Total Profit</b>	<b>Growth in amount</b>	<b>Growth rate (%)</b>
2009	352,488,395	-	-
2010	458,253,987	105,765,592	23.08
2011	629,878,382	171,624,395	27.25
2012	893,262,960	263,384,578	29.49
2013	812,934,208	(80,328,752)	(9.89)

**Table 3.18 Growth rate of profit as compared with growth of NPL**

<b>Year</b>	<b>Growth of NPL (%)</b>	<b>Growth of Profit (%)</b>
2009	-	-
2010	28	23.08
2011	26	27.25
2012	(6)	29.49
2013	60	(9.89)

**Chart 4. Growth Rate of Profit Compared With NPL**

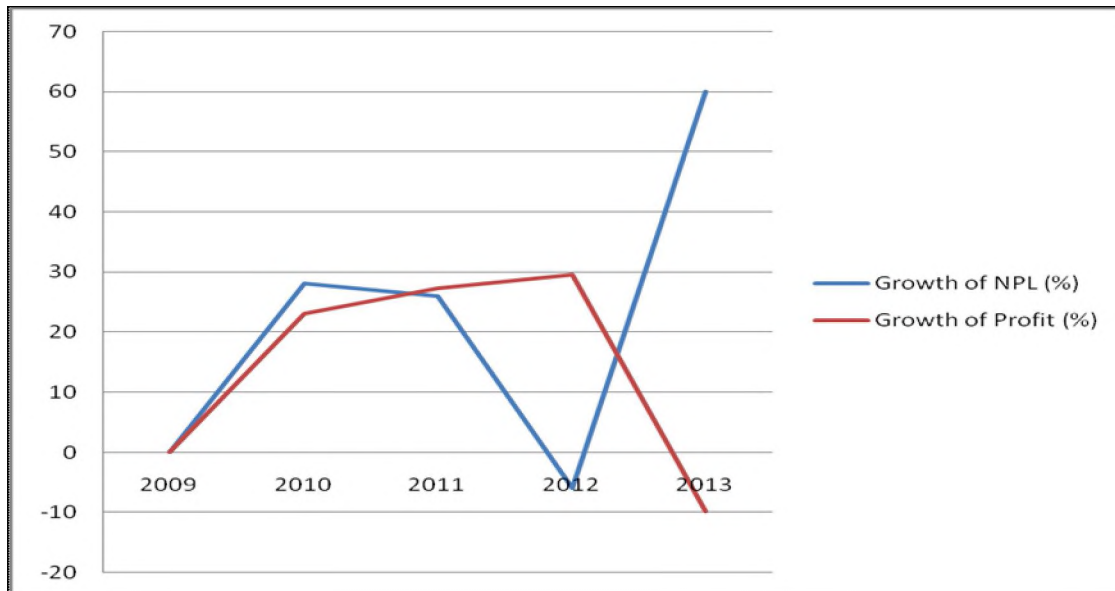


Chart 4 shows that the relationship between Non Performing Loan and Profitability i.e. as we can see from the table in the year 2010. The growth rate of Non Performing Loans was 28% with that of same period. The growth rate of profitability shows 23.08% increase and in the year 2011 the growth rate in Non Performing Loan depicts 26% decrease of the same year also the profitability growth increase to 27.25%. In 2012 the growth rate of Nonperforming Loan shows decrease full% and the profitability increases by 29.49%. Finally, in the year 2013 the growth in Non Performing Loan increases by 60% and the profitability decrease by -9.89%. It shows a direct relationship between them.

### **3.19 Outstanding Loans by Economic Sectors**

Dashen Bank provides various loan facilities to the business community operating within the country. It entertains requests of business organizations for loans regardless of size, economic sector, ownership and location. However, the disbursement requires primarily the soundness and

viability of project proposals. The loans disbursed for various economic sectors need deep and multi - dimensional analysis on the purpose they requested before disbursement.

The major economic sectors identified in the banking environment are Agriculture, Manufacturing, Domestic trade and services, Export, Import, Building and construction, and transportation. Dashen Bank categorizes loans by their "end-use". Based on these classifications the balance of the outstanding loans and its growth rate during the period under the study are presented in the following tables.

**Table 3.20 Growth Rate of Outstanding Loans by Economic Sectors**

**In birr"000"**

Sector	2009		2010		2011		2012		2013	
	O/S	Growth Rate (%)	O/S	Growth Rate (%)	O/S	Growth Rate (%)	O/S	Growth Rate (%)	O/S	Growth Rate (%)
Agriculture	164,577		154,180	-6.74	137,659	-12.00	182,767	24.68	182,805	0.02
Building & Cons.	941,434		405,655	-132.08	410,923	1.28	781,569	47.42	910,824	14.19
Domestic Trade	1,293,617		1,633,920	20.83	2,001,946	18.38	2,636,702	24.07	3,204,226	17.71
Export	355,929	-	402,048	11.47	383,007	-4.97	548,841	30.22	588,420	6.73
Import	389,851	-	501,232	22.22	686,087	26.94	860,547	20.27	730,134	17.86
Manufacturing	1,048,343		1,113,729	5.87	1,435,641	22.42	1,724,143	16.73	1,896,982	9.11
Transport	253,273	-	347,421	27.10	432,507	19.67	507,484	14.77	435,326	16.58
Real Estate	-	-	474,888	-	653,896	27.38	799,484	18.21	887,910	9.96
Total	4,447,024		5,033,073		6,141,666		8,041,537		8,836,627	

**Table 3.21 Share of Outstanding Loan by Economic Sector**

Sector	2009	2010	2011	2012	2013	Total o/s by sector	%
	O/S	O/S	O/S	O/S	O/S		
Agriculture	164,577	154,180	137,659	182,767	182,805	821,988	3
Building & Cons.	941,434	405,655	410,923	781,569	910,824	3,450,405	11
Domestic Trade	1,293,617	1,633,920	2,001,946	2,636,702	3,204,226	10,770,411	33
Export	355,929	402,048	383,007	548,841	588,420	2,278,245	7
Import	389,851	501,232	686,087	860,547	730,134	3,167,851	10
Manufacturing	1,048,343	1,113,729	1,435,641	1,724,143	1,896,982	7,218,838	22
Transport	253,273	347,421	432,507	507,484	435,326	1,976,011	6
Real Estate	-	474,888	653,896	799,484	887,910	2,816,178	9
<b>Total</b>	<b>4,447,024</b>	<b>5,033,073</b>	<b>6,141,666</b>	<b>8,041,537</b>	<b>8,836,627</b>	<b>32,499,927</b>	<b>100</b>

*Source: Dashen Bank report on the status of NPL*

The performance of Agricultural sector has been a major determinant of how the country's has performed in the course transforming the overall economy of the country from agriculture to industrialization. In other word, it is the key element for Ethiopia's economic development strategy, AGRICULTURAL DEVELOPMENT LEADS TO INDUSTRIALIZATION (ADLI). However the share of agricultural sector of outstanding loan or loan disbursed for this sector is 3% in the covered years under the study. This is happen just because of the nature of the sector in Ethiopia. In developing countries like Ethiopia agriculture is characterized by a subsistence level of farming. Farmers have no valuable capital assets that can be used for collateral purpose to request loan from formal financial institutes like banks. Most of the time banks do not grant loan without collateral. In recent time there has been introduction of commercial farming like horticultural, floricultural etc... in Ethiopia. (Dashen Bank, Corporate-planning Department)

The primary activity in economic development is construction for most of developing countries. i.e. construction of road, buildings, dam, etc. Due to this and other reasons loan disbursed to this sector has shown 11% share from the economic sector under the study. From table ten we can see that

the share of outstanding loans disbursed to building and construction sector.

Because of the nature of product market and the structure of Ethiopian economy the loan disbursed to domestic trade and services take the major share from the total outstanding loan balance. As shown on table ten the outstanding share of domestic trade and services sector is 33% under the covered years of the study.

In recent time the development of international trade in any country has a direct relation with globalization. As we can see from the table, the share of outstanding loan in export sector was 7% in the given periods. According to National Bank of Ethiopia report this tremendous turn of export sector was mainly on account of increases in both the volume and price of coffee, hide and skins, pulses, meat and meat products. In other hand Import sector shows increasing by 3% when compare with export sector. The total outstanding share of import sector was 10% from the given economic sector over the period under the study.

According to various reports the manufacturing sector of Ethiopia economy has also shows a remarkable improvement for the past five years. We can also see from table ten this sector shows 22% share of outstanding loan balance from the given economic sector under the study.

Transportation sector has a forward and back ward linkage with all other economic sectors. Any improvement or deterioration of other economic sectors can directly affect the performance of this sector. Even if the development of most of the economic sectors in Ethiopia shows a continuous improvement in the past five years, loan disbursed to transport sector was a 6% share. This decrease in loan disbursed to the transport sector is a deliberate policy of the bank to reduce its heavy risk, which has been a cause of some of the problems that the bank was facing during these years.

Real-estate sector has one of the developing projects in a given country. This sector was a recent project and loan disbursed to this sector by the bank on the beginning of year 2010 under the study its share shown 9% of the economic sector under the given period.

In general Domestic trade and services account the highest portion of outstanding loan during the period under review and manufacturing and building and construction sector take the second position. Real-estate sectors take the third position most of the years under the study. And agriculture sector take the least position next to Transportation sector.

### **Non-Performing Loans by Economic Sectors**

Reports on credit performance reveal that lending activity of Dashen Bank towards different economic sectors was at fast pace and most of the time above the budget level of the bank. As the balance of outstanding loan become more and more overtime the credit risk of the bank become more and more. The occurrence of Non-Performing loans has a direct correlation with the outstanding loan and the nature of the business that the loan granted. In other word the risk ness of any business activity differs from one economic sector to another.

The riskiness of disbursed loans due to the economic sector arises due to three major reasons:

- I. That economic sector may not be well developed in that country.
- II. That economic sector may have weak forward or back ward linkage with other economic sector.
- III. That economic sector can be highly affected by worldwide activities or international trade or globalization.

**Table 3.22 Growth Rate of NPL by Economic Sectors**

sector	2009		2010		2011		2012		2013	
	NPL	%age NPL	NPL	%age NPL	NPL	%age NPL	NPL	%age NPL	NPL	%age NPL
Agriculture	44,538	13.56	18,754	12.43	40,653	19.89	22,792	11.79	29,023	6.02
Bui ldi ng & Cons.	51,237	15.6	9,373	6.21	5,570	2.73	2,337	1.21	101,836	21.12
Domesti c T rade	114,074	34.73	56,744	37.61	71,290	34.88	57,853	29.92	156,191	32.39
Export	19,396	5.9	6,205	4.11	31,810	15.56	28,169	14.57	54,778	11.36
I m port	16,253	4.95	4,865	3.22	5,679	2.78	45,511	23.53	14,447	3
Manufacturi ng	77,596	23.62	19,366	12.83	28,361	13.88	25,021	12.94	95,223	19.75
Rl st	-	0	29,987	19.87	14,120	6.91	2,173	1.12	18,612	3.86
Transport	5,378	1.64	5,596	3.71	6,910	3.38	9,523	4.92	12,084	2.5
Total	328,472	100	150,890	100	204,393	100	193,379	100	482,194	100

*Source: Dashen Bank report on the status of NPL*

Table 3.22 shows the balance of non-performing loans across different economic sectors and their share out of the total non-performing loans balance. This table also shows that the balance of non-performing loans was increasing and decreasing with in the period under the study. As can be seen from the table it had increased from Birr 328 million in 2009 and Birr 482 million in 2013 which about 147%, but the remaining year 2010 to 2012 the total NPL balance was increasing with decreasing rate Birr 151 million, Birr 204 million and Birr 193 million respectively.

As its share is highest from total outstanding loans, Domestic trade and services here again take the highest share from total non-performing loans balance. It takes 34.73%, 37.61%, 34.88%, 29.92 and 32.34%, share from the total NPL balance in year 2009, 2010, 2011 and 2013. The main reason for this is the nature of the business activities hold in this sector. Most of the time they have been highly affected by unstable market nature and government policies and regulations. (Dashen bank, corporate planning Department).

Manufacturing and building & construction sector take the second position interchangeable over the covered years. Both sectors has shown continuous increasing trend. For international trade the reasons were the drastic fall of the price for the imported goods and a fall of demand for primary good, which are the highest share of Ethiopian export, in the world market. For manufacturing sector the reason was a fall of demand for domestic goods

because of cheap-imported goods. (National Bank of Ethiopia Annual report, 2004).

In general the cause for the growth of Non-Performing Loan from time to time is that due to internal and external factors but the main reasons (causes) from all sectors is that:

- Lack of sectoral analysis
- Agency problem
- Diversion of funds, economic and political conditions
- Impact of new regulation information asymmetry

On this part the data collected from different sources will go to be discussed (analyzed), also from the data collected by distributing questionnaires.

- ^ Is based on comparison between what literature says and what actually done in Dashen Bank.
- ^ Like other banks Dashen Bank S.C. extends loan for domestic trade and services, import, building and construction, manufacturing, transportation, hotel and tourism, agriculture and export.
- ^ By having their own standard procedure, all banks require a legally binding contract which is a written document with specified terms and should be supported by acceptable collateral.
- ^ Dashen Bank requires collateral for all types of loans except staff loan.
- ^ Interest rates that are changed on loan compensate the lender for lending risks, many banks use industrial analysis for granting loan including Dashen Bank.

## CHAPTER FOUR

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This study deals with in identifying the impact of Nonperforming loan on the Banks profitability. Further, the following basic questions are used to gather the necessary data.

- ^ To what extent that non-performing loan affects the bank's profitability?
- ^ How does Dashen Bank follow-up the customers or the borrowers?
- ^ What are the major causes of Non Performing Loans?
- ^ To what extent the Bank manage its credit distribution?

The student researcher used primary and secondary data to gather the required information and distributed questionnaires for 15 samples selected and gathered from all respondents.

#### 4.1 Summary

Based on data presentation, analysis and interpretation made in chapter three, the following are summary of the major finding.

- About 9(60%) of the respondents are female, while the remaining 6(40%) were male.
- The majority of the respondents age was 25-35 years which means 11(73%), whereas the rest 4(27%) of the respondents age was below 25 years. Which means the majority employee the Bank are female youngsters.
- 7(47%) of the respondents had below 10 years bank experience, 5(33%) had banking experience of 2-5 and the remaining 3(20%) of the respondents are above 10 years.
- About the respondents educational status the majority 14(93%) was first degree and the remaining 1(7%) are above first degree. Almost all of the respondents had first degree and above so that they are professional.

- 12(80%) of the respondents position was bank credit analyst, while 2(13%) and 1(7%) are loan officers and manager of the bank respectively.
- About 8(53%) of the respondents have viewed that nonperforming loans affects Bank profitability at medium level, while 4(27%) of the respondents agree with affects at high level. and the rest 3(20%) are at low level.
- About 9(60%) of the respondents confirmed that the Bank has instituted a formal credit follow-up technique and procedure, while 5(33%) of the respondents replied that the credit follow-up technique is at minimum level. the remaining 1(7%) of respondents are not quite aware of it.
- 26(29%) of the respondents replied that the Bank used injection of additional loan in order to collect the loan, whereas 34(38%) of the respondent said that extension of the life of the loan is a major mechanism. the remaining 30(33%) of the respondents mention that rearrangement of loan repayment was other mechanism to collect the loan.
- All of the respondents which are 15(100%) replied that the bank has reminded its customer for effecting repayment.
- 12(80%) of the respondents have viewed that loans granted spent for the intended purpose, while the reaming 3(20%) agreed that loans used for other purpose.
- 15(100%) of the respondents assure that the collateral offered by the borrower for the loan purpose is properly estimated by the responsible body of the bank.
- Among different causes for NPL at borrowed level lack of proper business plan and diversion of the borrowed fund to other purpose are given priority by the respondents.
- From different major causes for NPL at Bank level lack of sufficient credit information from other commercial Banks, mistake on estimation of collateral evaluating the borrowers financial report and

lack of continues follow-up and proper risk assessment are the priority given by the respondents.

- Regarding causes of NPL at economic level, weak economic plan and strategy implementation, political power of the borrowers and excessive government intervention are the major causes according to the respondents.
- On distribution of loans by economic sectors 6(40%) of the respondents agree that domestic trade and service takes the first priority by the bank on the other hand 4(27%) of the respondents replied that the bank gives priority to agricultural sector, while the remaining 2(13%), 2(13%) and 1(7%) respondents agreed that manufacturing, transport and export takes the banks priority respectively.
- Majority of the respondents which is 12(80%) replied that the bank assess borrowers past financial history, credit worthiness and perform detailed analysis before extending the loan.

## **4.2 Conclusions**

Based on the summary of major findings of the study the following conclusions are drawn.

Even if the overall Credit Management of Dashen Bank is good, it needs some improvements in order to stay in a leading position in the dynamic business environment and to minimize the banks NPLs as desired.

As NPL has a devastation effect on survival of banks they have to address this issue effectively and efficiently. Here the study categorizes the cause of NPL in three areas, which is problem at borrower, bank and economy system at large.

- a) Regarding to the borrower after they take loan they spent the money for the purpose which is not stated in the contract and they take the loan without having proper business plan.

- b) On the bank side, lack of sufficient credit information from other Commercial Banks, mistake on estimation of collateral and evaluating the borrowers' financial report and lack of continuous follow up proper risk assessment are the major causes of NPL at the Bank side.
- c) At economic level because of effect of weak economic plan and strategy implementation, political power of the borrower and excessive government intervention are causes of NPL at economic level.

In order to develop a given countries economy financial institution like banks is one of the major role in raising funds to different sectors. Hence, in order to finance the fund to the sectors the banks profit should be stable and the disbursed loans should be collected on the scheduled time. Whereas once the do not collect the fund on repayment period its profit were affected by the non-performing loans. From the study we conclude that the banks profit were affected by the NPLs at medium level.

In the current competitive markets any financial institutions like banks should design and implemented policies and strategies to survive in the future. From the study we conclude that Dashen Bank has designed credit follow-up techniques and procedures and implemented through telephone conversation, by written reminding letters in order to collect the disbursed loans at the contract periods before being NPL.

Dashen Bank provides various credit lines to different economic sectors. These economic sectors also defined as loan categories in banking industry. Loan disbursed by banks to different economic sectors are classified to different loan categories based on their end use. The Domestic Trade and Service take the largest share of outstanding loans during the period under the study. Even if for any business activity is characterized by transport the loans disbursed to this sector takes the least share out of the total outstanding loan balance.

#### **4. 3 Recommendations**

Thus, from the summary of major findings and conclusions the following recommendations are forwarded.

1. The bank should frequently follow up by visiting borrowers businesses to create long lasting relationship and assure future repayment.
2. Over estimation of collateral or fall in its value upon sale would result in increasing NPLs. Therefore, when collateral is offered the bank should make a proper valuation and check whether it can be converted to cash easily or not.
3. Short-term training and workshops on credit risk management for personnel engaged in the credit analysis and/or borrowers should be organized on a regular basis and also make available pertinent reading material and publications. Since, competent personnel in the loan processing results in quality loan approval, which will minimize the amount of NPL.
4. Awareness should be created among borrowers that they should be close to the bank and consult the bank when they observe any symptom that they will be facing difficulties on meeting obligation.
5. Granting loan without taking collateral will expose the bank to NPLs, thus appropriate precaution on borrowers' financial capacity to repay the loan on the scheduled time periods from previous loan repayment history should be exercised from the bank's side.
6. Precaution should be exercised by all credit processing and approving personnel for the collateral types and values, business continuities, balance sheet and income statements and the borrowers credit information in dealing with financial analysis.

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# **APPENDICES**



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