



**ADDIS ABABA UNIVERSITY**  
**SCHOOL OF LAW**

**Legal Problems in Realizing Non-Performing Loans of Banks  
in Ethiopia**

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## **Acronyms**

**NBE** - National Bank of Ethiopia

**CBE** - Commercial Bank of Ethiopia

**DBE** - Development Bank of Ethiopia

**NPL** - Non- Performing Loan

**AMC** - Asset Management Company

**NIB** - NIB International Bank

## **Abstract**

A sound financial system presupposes legislations relating to banking and its supervisions. These legislations should cover different activities of banks including the amount of non-performing loans. Non-performing loans are one of the determinant factors for the soundness of the banking sector. That is why integral legal and institutional framework needs to be in place. Accordingly, this study was conducted to evaluate the problems faced by banks in resolution of non-performing loans. The paper aimed to provide a general idea on the legal framework for recovering non-performing loans in Ethiopia and the practical problems. The study employed secondary data from books, reports, journals and internet sources as well as primary data from interviews. Interviews were conducted in private and government banks. Cases were also collected and analyzed to show the problems in resolution of non-performing loans. Different Ethiopian legislations which have direct relation with the matters were assessed especially with respect to priority rights and procedures in realizing the securities for non-performing loans. The finding of the study indicated that legal gaps that exist in procedural laws and also institutional problems affect the resolution process. Lack of laws to protect financial securities such as Financial Guarantee Bonds and Negotiable Instruments mostly confined the credit system to collateral based credit system. Accordingly, the study recommends that amendments in procedural laws should be made. Furthermore, issuing appropriate laws covering financial securities, establishing a comprehensive institutional framework including Asset Management Companies (AMCs) with clear accountability and transparency are found to be very important.

# CHAPTER ONE: Introduction

## 1.1 Background

Banks play a very important role in the economic development of every nation. They have control over a large part of the supply of money circulation. Banks are the main stimulus of the economic progress of a country. The financial sectors contribution to growth lies in the central role it plays in mobilizing savings and allocating these resources efficiently to the most productive uses and investments in the real sector. On the other hand, restructuring of the financial sector is often a mirror reflection of reforms in the real sector, including trade and parastatal reform. Restoration of bank's financial health requires decisions about what to do with non- performing loans. The solidity of bank's portfolio depends on the health of its borrowers. In many countries, failed business enterprises bring down the banking system<sup>1</sup>. A sound financial system, among other things, requires minimum level of non- performing loans which in turn facilitates the economic development of a country.

The Ethiopian financial institutions have a far reaching history. The use of money and coins in Ethiopia has a long history, and the introduction of modern banking is nearly a century old. The original bank of Abyssinia started operation in February 1905 and its activities included keeping government accounts and financing exports. Despite the long history, which precedes the advent of modern banking throughout most of Africa, the Ethiopian financial system has not progressed much. The development of the financial sector was constrained by the government takeover of the existing private banks in 1975.

In the period of a shift from a mixed to a state managed economy, the development of the

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<sup>1</sup> Lakew Alemu (Dr), Financial Sector Reforms in Ethiopia and the Challenges Ahead, Awash International Bank, May, 2001 at [www.eaecon.org/econ-focus/vol14%20no4/lakew.html](http://www.eaecon.org/econ-focus/vol14%20no4/lakew.html), accessed June, 2009.

financial sector was stunted. Although the financial sector of Ethiopia has grown in the 1990's, compared to its state during the preceding decades, it is still in its infancy<sup>2</sup>.

At present, there are three government owned banks, nine private banks, and nine insurance firms. Over the years the percentage of non- performing loans has been reduced from its significant rate of over 50 percent.

To reduce the existence of non-performing loans, the relationship between borrowers and lenders should be good. The question remains “How worse could the consequence of not paying back one’s loans be?” The consequence of loan default is covered by different resolution mechanisms. At present, Ethiopian banks have been empowered to dispose of the property signed out by the borrowers as collateral and redeem their losses but the problem of default still exists<sup>3</sup>.

Appropriate legal protection and regulation plays important role in minimizing the existence of non- performing loans within banks. The method of regulating non performing loans differs from country to country. Ethiopia, as a developing country, has adopted different legal protections to control non performing loans.

Ethiopia issued a new 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.

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<sup>2</sup> Befekadu B. Kereta, Outreach and Financial Performance Analysis of Microfinance Institutions in Ethiopia, National Bank of Ethiopia, Economic Research and Monetary Policy Directorate, African economic Conference, Addis Ababa, Ethiopia, 2007.

<sup>3</sup> Martin Mayer, The Bankers,( Webright and Tally: New York).

## 1.2 Literature Review

An efficient and well-functioning financial sector is essential for the development of any economy, and the achievement of high and sustainable growth. Most unsound financial sectors show high level of non- performing loans within a country.

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

Many countries are suffering from non-performing loans (NPLs) which creates a big influence on the overall economy. There are different ways to secure NPLs, such as allowing banks to handle themselves, or for banks to auction them in public Asset Management Companies (AMCs), whose purpose is to dispose of the assets as profitable as possible.<sup>4</sup>There are also countries that use judiciary as recovery mechanism.

With enormous amount of NPLs on banks' balance sheet, countries established different regulatory mechanisms to manage the disposal of defaulted loans. But the process is not without struggle; still various legal as well as institutional problems arise in realizing the defaulted loans. The review of the study included the legal and theoretical frameworks relating to realization of non- performing loans. It included literatures and reviews with respect to the Ethiopian situation.

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<sup>4</sup> Jessica Patersson and Isac Wadman, "Non- Performing Loans-The markets of Italy and Sweden", Uppsala University thesis, Department of Business Studies Fall 2004.

### 1.3 Statement of the problem

During booms, markets are often full of expectations. More liquid assets are in business which affects the behavior of different actors as well as the general politics of society. Banks may wish to increase their lending in order to expand their market share. This could in worst case lead to a more easy going lending policy, which in turn can result in many loans be given to customers who are far from credit worthy. Commonly in times of recession, liquid assets decline, collaterals may lose value and suddenly banks might find themselves with large amount of non- performing loans.

To secure these loans, banks in Ethiopia are now given the power to enforce their claims without the intervention of the judicial authorities. Thus the banks can sell the mortgaged or pledged property if the debtor fails to discharge his obligation within 30 days after notice. The banks that sell the property are deemed to have sold it under the authorization of the debtor.<sup>5</sup>On the other hand, the bank is duty bound to follow the rules of the Civil Procedure Code (rules on sale by public auction) in this process.

*From this perspective, the paper addressed the legal problems that Ethiopian banks are facing in exercising their right of realizing non-performing loans. It assessed different legal and practical problems (issues) that arise from banks, debtors and third party creditors. It showed the legal problems with respect to different parties involved in realizing non-performing loans.*

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<sup>5</sup> Menberetesehai Tadesse (Vice President of the Federal Supreme Court of Ethiopia), The World Bank Global Judges Forum, "Commercial enforcement and Insolvency systems in Ethiopia", Pepperdine University School of Law Malibu, California, 2003.

## **1.4 Objectives of the Study**

Throughout the study, the paper aimed to provide a general idea on the legal framework for recovering non-performing loans in Ethiopia and the practical problems faced in the process.

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

- Assessing the legal frame work for controlling and recovering non- performing loans in Ethiopia.
- Identifying the legal problems Ethiopian banks are facing in realizing their non-performing loans and
- Describing the parties or institutions involved with respect to foreclosures and other related issues.

## **1.5 Significance and Scope of the study**

The knowledge generated by this study enables readers to grasp the necessary information with respect to the legal aspects of non- performing loans of banks in Ethiopia particularly, non- performing loans resolution process and legal frameworks. The research showed the practice with regard to non performing loans resolution. The research was adjusted to fit with the time and resources available. It addressed only the legal problems which relates with resolution of non-performing loans of banks in Ethiopia. It is confined to the legal aspects theoretically and practically.

## **1.6 Research hypothesis**

In previous days, many agrees that the main problem in realizing non- performing loans relates with going to courts to get judgment of foreclosure for securities. But with the issuance of the foreclosure law that problem was reduced. The problem relating to realization of non- performing loans still exists particularly in a situation where the rights of other creditors are involved and due to some procedural problems.

Generally, the issuance of a procedural law setting the bank's priority rights in auctioning the securities for non- performing loans as well as legally establishing Public Asset Management Companies to buy out the NPLs will reduce the existing problem which relates to realization of non- performing loans in Ethiopia.

## **1.7 Research Design and Methodology**

### **Choice of Method**

For this paper, different literatures were studied on the subject matter to give a fundamental introduction to the topic. In view of the fact that the secondary data on NPLs provided the general information, specific data were searched by different means.

### **Data Collection**

Secondary data that were collected from books, reports, literatures and internet were employed to come up with the necessary results. These secondary data was used to describe the conceptual frame work of non-performing loans including its causes and consequences. In order to identify the legal problems in realizing non- performing loans,

cases from courts are chosen and assessed. Cases were chosen according to their relevance to the specific subject on hand.

## **Interviews**

Interviews were conducted in different private and government owned banks to get direct information on the legal problems and challenges concerning non- performing loans. The interviews were sketched based on themes that were to be investigated. Under each theme, questions were formulated. Interviews as much as possible covered the concerned parties which are involved in the process of resolution of non- performing loans.

## **1.8 Analysis Method**

Data collected through interviews, court cases and secondary documents were analyzed with the legal framework of controlling non-performing loans in Ethiopia. Different Ethiopian legislations which have direct relation with the matters were assessed especially with respect to priority rights and procedures in realizing the securities for non performing loans. The laws were compared with different cases to see their practical applicability. In general, systematical work on the data was conducted in order to give the content as much substance as possible with regard to the aim. Finally, certain themes were identified and connected to each other.

## **1.9 Limitations of the study**

Finding out the legal problems faced by banks in resolving non- performing loans had a number of problems. Mainly, bank officers both in some private banks and the National Bank of Ethiopia were not willing to disclose information with regard to non- performing loans. This had created some inconvenience in getting full information on the designed

themes. Furthermore, during the interviews, there was limited time with most interviewees because interviews were held in offices that were not completely free from frequent interruptions.

### **1.10 Organization of the Study**

The thesis is organized as follows. Chapter two provides the legal aspect of the concept of non-performing loans including its causes and debt recovery processes. The third chapter is organized to give full information on the legal framework of NPL in Ethiopia. It describes different laws on controlling and recovery of NPL. Chapter four shows the practical legal problems faced by banks in resolution of NPLs. Conclusion and recommendations on the findings are provided under the last chapter.

## CHAPTER TWO: Legal Aspect of Conceptual Framework of Non- Performing Loans

### 2.1 Theoretical Review of Non- Performing Loans

Economic development needs to be a dynamic process. Most nation states seek to enhance the welfare of their people by following a development process that is designed to achieve specific goals that accelerate the economic growth of their countries<sup>6</sup>.

Investment on a productive sector is the precondition for achieving the economic growth from a country perspective. Capital formation positively supports this investment function. Once a satisfactory level of capital is formed, the option of sound investment comes, that ultimately leads to flow of capital in the future. Financial institutions, mainly banks do these functions through different mechanisms such as loans<sup>7</sup>.

Loans and advances are defined in the respective laws of different countries. In Ethiopia, under Article 13 of Banking Business Proclamation No. 592/2008 and Directive No. SBB/43/2008 Article 4 (4.5) loans and advances are defined as:

*“Loans” and “Advances” means any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdrafts, participation in a loan syndication, the purchase of loan from another lender etc.) or commitment to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or on demand, usually with interest. The term includes a contractual obligation of a bank to advance funds to or on behalf of a person, claim evidenced by a lease of financing transaction in which the bank is a lessor, and an over draft facility to be funded*

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<sup>6</sup> A. Gutterman and R. Brown, (Eds.) Commercial Laws of East Asia, Sweet and Maxwell, Hong Kong, 1997, pp. 11-14

<sup>7</sup> Mohammed Shofiqul Islam, Nikhil Shil and Mannan Abdul, Non-performing Loans: Its causes, consequence and some learning, American International University, Bangladesh, East West University, Stamford university at <http://www.mpra.ub.muenched.de/7708>, accessed June, 2009

*by the bank on behalf of a person. The term does not include accrued but uncollected interest or discounted interest*<sup>8</sup>.

Loans and advances are the most profitable of all the assets of a bank. These assets constitute the primary source of income by banks. As a business institution, a bank aims at making a huge profit. Since loans and advances are more profitable than any other assets, it is willing to lend as much of its funds as possible. But banks have to be careful about the safety of such advances<sup>9</sup>. In the words of Dr. Leaf, the banker “has to tamper liberty with caution. If he is too liberal, he may easily impair his profits by bad debts, and if he is too timid, he may fail to obtain an adequate return on the funds which are confided to him for use. It is by his capacity in lending that a bank manager is judged<sup>10</sup>.” A bank needs to be careful in giving loans as there is a greater risk which follows it in a situation where the loan defaults.

Beyond the parochial question of a bank profitability decisions to lend or not to lend are the way a bank influences the economic development of its community. As the lending process affects not only the banking activity but also the development process, risks should be avoided as much as possible. Fredric Solomon expressed the risk attached to loans as follows:

*Competition works best when competitors are reasonably clear as to their costs and bank costs are inescapably tied to a cost that is extraordinary unclear, uncertain, and difficult to appraise. This cost is the risk of loss on assets, especially if they have to be converted into cash...*<sup>11</sup>

Loan loss or defaulted loans puts a bank in a difficult situation especially when they are in greatest amount. Banks give loans with uncertainty whether they are returned or not

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<sup>8</sup> Article 4 (4.5), Asset classification and Provisioning Directive No. SBB/43/2008.

<sup>9</sup> M. Radha, and SV. Vasudevan, , A Text Book of Banking: Law, Practice and Theory of banking, (S,Chand &Co. Ltd :New Delhi), 1980)

<sup>10</sup> Ibid

<sup>11</sup> Fredric Solomon as cited in Martin Mayer, The Bankers, (Weybright and Talley: New York), p.296

though they may hold some security. In assessing any proposal for an advance or a loan, the banker has to satisfy himself/herself regarding the period for which the advance is required and the prospects of its repayment at the end of the period. He/she should not be carried away by the soundness of the security offered to him/her or the rate of interest. Profitability should be given only a sound consideration. He/she should also satisfy himself/herself about the purpose for which the advance is required. He/she is expected to discriminate against and discourage speculative advances<sup>12</sup>.

As a matter of fact most bank failures may be traced to faulty policies in respect of loans and advances. From the point of safety and liquidity, loan and advances are poor assets. The risk mostly ensues when loans become non- performing.

Allocating loans has always been one of the central pillars of the banking business. Traditionally this marked the start of a long term relationship with the client, which would continue at least until the maturity of the loan<sup>13</sup>. With the growth of deposits, banks are supposed to increase the lending. However, when Non-performing Loans (NPLs) are high, the willingness to expand loan reduces. This relationship will be distorted under high NPL condition<sup>14</sup>. In any lending process, there is inherent risk of loans being defaulted which leads to the concept of non- performing loans.

The concept of non-performing loans has been defined in different literatures. According to Jessica Patersson and Isac Wadman, non- performing loans are defined as defaulted

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<sup>12</sup> Shofiquil Islam, Supra Note 7

<sup>13</sup> Non-Performing Loans- an established asset class, at <http://www.dbresearch.com/PROD/DBR-INTERNET-DE-PROD/PROD000000000210818.PDF> accessed September, 2009.

<sup>14</sup> David Dickinson and Yixin Hou, The effect of non- performing loans: A threshold Method at <http://www.asialink.Philipines.googlepages.com/dickinson.hou.ppt> accessed September, 2009.

loans which banks are unable to profit from<sup>15</sup>. They are loans which cannot be recovered within stipulated time that is governed by the laws of a country.

According to the International Monetary Fund, 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<sup>16</sup>.

HR Machiraju expresses non- performing loans as a leading indicator of credit quality. 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<sup>17</sup>.

NPLs or bad loans arise in respect of the loans and advances which are given by banks to the whole range of different projects including but not exclusively retail or wholesale, personal or corporate or short, medium or long term projects. NPLs are a very sensitive element of a bank's operations.

According to C. Brown, D.J. Mallett and M.G. Taylor, the losses bad loans (NPLs) cause, by reducing the capital resource of the bank, affects its ability to grow and develop its business<sup>18</sup>. The classification of a loan as bad or doubtful may result from a specific act by the borrower, for example, petitioning for bankruptcy, or from circumstances that have the potential to place the loan at risk. For example, the borrower may have defaulted on one or more of the terms of the loan, or a substantial part of its assets may be in an

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<sup>15</sup> Paterson, supra note 4

<sup>16</sup> International Monetary Fund, at <http://www.imf.org>, accessed at September, 2009.

<sup>17</sup> HR Machiraju, *Modern Commercial Banking*, VIKAS Publishing House Pvt. Ltd. Co

<sup>18</sup> C. Brown, D.J. Mallett and M.G. Taylor( 1993 ), *Banks: an Industrial Accounting and Auditing Guide*, (Page Bros Ltd: Great Britain),

industrial sector or country that is suffering from an economic recession<sup>19</sup>. Non-performing loans could be recognized early from the violation of the terms of agreement by the borrower.

Disclosure of the extent of losses in its financial statements may lead to a loss of confidence in the bank's management and a reduction in its credit ratings. This will in turn increase the bank's cost of borrowing in the wholesale market and make it more expensive or more difficult to raise capital. In extreme cases, it can lead to a loss of deposits, the withdrawal of the bank's authorization and ultimately insolvency<sup>20</sup>.

Non-Performing Loan (NPL) is one of the concrete embodiments of credit risk which banks take. They have greater implication on the function of the banks as well as the overall financial sector development. This is why most countries provide their own rules regarding NPLs.

Historically, the occurrence of banking crises has often been associated with a massive accumulation of non-performing loans which can account for a sizable share of total assets of insolvent banks and financial institutions, especially during episodes of systemic crises. 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<sup>21</sup>.

The criterion for identifying non performing loans also varies in Africa. Some countries use quantitative criteria to distinguish between "good" and "bad" loans (e.g., number of days of overdue schedule payments), while others rely on qualitative norms (such as the

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<sup>19</sup> Ibid

<sup>20</sup> Ibid

<sup>21</sup> Hippolyte Fofack, Non- Performing Loans in Sub- Sharan Africa: Casual Analysis and Macroeconomic Indication at [http:// www-wds.worldbank.org/servlet/.../IW3P/IB/.../wps3769.pdf](http://www-wds.worldbank.org/servlet/.../IW3P/IB/.../wps3769.pdf) accessed July 2009.

availability of information about the client’s financial status, and perspectives about future payments). However, the Basel II Commission emphasizes the need to evolve toward a standardized and internal rating-based approach<sup>22</sup>. Accordingly, the Basel committee puts non performing loans as loans left unpaid for a period of 90 days.

Under the Ethiopian banking business directive, non-performing loans are defined as “loans or advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advances in question<sup>23</sup>.” It further provides that:

*..., loans or advances with pre established repayment programs are non-performing when principal and/ or interest is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity<sup>24</sup>.*

In addition to the above mentioned category of non- performing loans, the following are also considered as non- performing.

Overdrafts and loans or advances that do not have re-established repayment program shall be non-performing when:

- The debt remains outstanding for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity;
- The debt exceeds the borrower’s approved limit for 90 (ninety) consecutive days or more;
- Interest is due and uncollected for 90 (ninety) consecutive days and more; or
- For the overdrafts<sup>25</sup>,
  - (i) the account has been inactive for 90 (ninety) consecutive days or

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<sup>22</sup> Ibid

<sup>23</sup> Article 4(4.9), Supra note 8

<sup>24</sup> Ibid

<sup>25</sup> “Overdraft” means a deposit account on the books of the bank with a debit balance

- (ii) deposits are insufficient to cover the interest capitalized during 90 (ninety) consecutive days or
- (iii) the account fails to show the following debit balance at least once over 360 days preceding the date of loan review:
  - 1. 20% of approved limit or less latest by June 30, 2008;
  - 2. 5 % or less effective from June 30, 2009<sup>26</sup>.

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

The economic and financial costs of these impaired loans are significant<sup>27</sup>. Potentially, these loans may negatively affect the level of private investment, increase deposit liabilities and constrain the scope of bank credit to the private sector through a reduction of banks' capital, following falling saving rates as a result of runs on banks, accumulation of losses and correlative increased provisions to compensate for these losses. These loans also have potential for reducing private consumption, and in the absence of deposit guarantee mechanisms to protect small depositors, can be a source of economic contraction, especially when coupled with declining gross capital formation in the context of a credit crunch caused by erosion of banks' equity and assets<sup>28</sup>.

The insolvency of banks is costly to the macroeconomy *per se*, but this cost can be increased or decreased by the regulators and the policies they use in resolving the insolvencies. The faster banks can be resolved before their economic capital turns

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<sup>26</sup> Article 4(4.9), Supra note 8

<sup>27</sup> "Impaired Loans" are the accounting term for "non-Performing Loans"

<sup>28</sup> Fofack, Supra note 21

negative, the smaller are both losses to depositors and costs to the macroeconomy<sup>29</sup>. Banks should use various mechanisms to recognize early warning signs regarding their loans. The regulation and monitoring process will be successful when there is strong legal as well as institutional framework of the banking business. This is why most countries need to provide strict regulation regarding non- performing loans.

As discussed above, efficient banks and financial markets promote macro development. This development leads to growth in overall economy and most countries work towards ensuring that development. Accordingly, ensuring sound financial system and creating efficient banks by reducing non- performing loans becomes important. Usually giving solutions to non- performing loans arises from identifying the probable causes for its creation.

## **2.2 Causes of Non-Performing Loans**

Default culture is not a new dimension in the arena of investment. Rather in the present economic structure, it is an established culture. The redundancy of unusual happening becomes so frequent that it seems people prefer to be declared as defaulters<sup>30</sup>.

Basically, the non- performing loans are a result of the compromise of the objectivity of credit appraisal and assessment. The problem is aggravated by the weakness in the accounting, disclosure and grant of additional loans. In the assessment of the status of current loans, the borrower's credit worthiness and the market value of collateral are not taken into account thereby rendering it difficult to spot bad loans<sup>31</sup>.

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<sup>29</sup> George G. Kaufman, "Macroeconomic stability, Bank soundness, and Design Optimum Regulatory Structures," *Multinational Finance Journal*, 1/30/04.

<sup>30</sup> Sonali Abeyratne, *Banking and Debt Recovery in Emerging Markets: The law reform Context*, Dartmouth publishing Company, (England: 2001)

<sup>31</sup> Pateresson, Supra note 4

The causes for loan default vary in different countries. It extends from borrower's specific act to bank's weak regulatory mechanism in advancing loans and monitoring procedures.

Generally, in developing and underdeveloped countries, the reasons for default have a multidimensional aspect. Various researchers have concluded various reasons for loan default.

### **2.2.1 Reduced Attention to Borrowers**

Few of the loan defaults that make trouble for banks can be blamed on reduced attention to borrowers. Borrowers give better attention to the loans that they borrowed when they have the perception that better attention is given to them. Lending officers of institutions should try to keep up with their loans, visiting the borrower's premises at least once a year or up to a half a dozen times a year on larger loans<sup>32</sup>. Banks rarely lose money solely because the initial decision to lend was wrong. Even where there are greater risks that the banks recognize, they only cause a loss after giving a warning sign<sup>33</sup>. More banks lose money because they do not monitor their borrower's property, and fail to recognize warning signs early enough. When banks fail to give due attention to the borrowers and what they are doing with the money, then they will fail to see the risk of loss. The objective of supervising a loan is to verify, first, whether the basis on which the lending decision was taken continues to hold good<sup>34</sup>. And second whether the loan funds are being properly utilized for the purpose they were granted<sup>35</sup>. To satisfy these objectives banks need to see whether the character of the borrower, its capacity to repay the loan,

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<sup>32</sup> Mayers, *Supra* note 3, p.296

<sup>33</sup> Machiraju, *Supra* note 17

<sup>34</sup> See the recommendation of the Tandon Committee reproduced in Tannan's *Banking Law and Practice in India*, 19<sup>th</sup> Ed, India Law House, (New Delhi: 1998), P. 1034.

<sup>35</sup> Report of the Banking Commission, Government of India (Delhi: 1972), p. 50

capital contribution, prevailing market conditions and the value of the collateral that was taken continues to remain the same<sup>36</sup>.

A bank can use different ways to monitor the borrower. First, it can follow up the financial stability of a borrower by periodically scrutinizing the operations of the accounts, verifying the value of security and examining the stock statements. Second, bank officials can personally visit the borrower periodically to determine the progress of the borrower company's business activity and where necessary giving advice to resolve any problems. A bank official may be appointed to the board of directors of a company that has been granted a loan. Banks, however, eschew this practice, either because they do not have adequate officials who are capable of undertaking the task, or because they may be held legally responsible in the event of a borrower becoming insolvent<sup>37</sup>. It is clear that effective credit monitoring involves looking into various operations of the company including operations of the loan, checking whether the company is properly managed, and the environment in which the company is carrying out its business is satisfactory<sup>38</sup>.

A bank should have clearly defined continuous procedures for identifying potential bad and doubtful loans. Although the primary responsibility for this will rest with the loan officers or branch managers, the procedures should include regular independent reviews of the loan portfolio, which could be performed by the internal audit department, by area managers or by other senior management<sup>39</sup>.

Within this system, there should be formal procedures for the continuous review of all large loans and all areas of lending concentration. These reviews should place particular

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<sup>36</sup> George G., Supra note 29, p. 93

<sup>37</sup> P. Wood, Lender Liability Under English Law, In Cranston, R,(Ed) Banks, Liability and Risk, 2<sup>nd</sup> Ed, Lloyds of London, pp. 86-89, 199

<sup>38</sup> George G., Supra note 29

<sup>39</sup> Machiraju, Supra note 17, p.274

emphasis upon the borrower's continuing ability to service the loan<sup>40</sup>. Failure to do these continuous reviews and monitoring will lead to loss to banks or increases the risk of such losses.

From the regulatory point of view, Ethiopian banks are required to make continuous review of their loan and submit reports to the central bank. This function of banks has a legal as well as contractual base. But the detail as to the frequency of visiting the borrower's premises, verifying the use of the loan and other related circumstances is left to the discretion of individual banks. The legal base for banks to do the review is provided under Article 5 of Directive No. SBB/43/2008.

### **2.2.2 Macroeconomic Instability**

Macroeconomic stability and banking soundness are inexorably linked. Both economic theory and empirical evidence strongly indicate that instability in the macroeconomy is associated with instability in banking and financial markets and instability in these sectors is associated with instability in the macroeconomy<sup>41</sup>.

Most problems of poor loan quality faced by banks were compounded by macroeconomic instability. Macroeconomic instability which is mostly manifested by high inflation rate also makes loan appraisal more difficult for the bank, because the viability of potential borrowers depends upon unpredictable development in the overall rate of inflation, its individual components, exchange rates and interest rates. Moreover, asset prices are also likely to be highly volatile under such conditions. Hence, the future real value of loan security is also very uncertain<sup>42</sup>. Banks do poorly both when product and asset price

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<sup>40</sup> Ibid

<sup>41</sup> George G., Supra note 29

<sup>42</sup> Martin Brownbrigde, The Causes of financial distress in local banks in Africa and implication for prudential policy, UNCTAD/OSG/DP/132, March 1998.

inflation accelerate unexpectedly and when inflation decelerates unexpectedly, unemployment increases, and/or aggregate output and income decline unexpectedly. Unexpected accelerations in inflation adversely affect banks that, on average, lend longer-term at fixed-rates than they borrow because nominal interest rates will rise more than expected. This will increase their cost of deposits more than their revenues from loans. Decelerations in inflation and, in particular, bursting of asset prices harm banks because the value of their asset collateral is likely to decline below the value of the associated loans and fuel defaults and losses<sup>43</sup>.

Indeed, probably the greatest threat to banking stability in almost all countries is increasing asset price. Although banks do not initially ignite the increase in price of asset, they finance the increased demand for these assets, so that loans collateralized by these assets account for an important proportion of the earning assets if and when the price burst are likely to be both large and abrupt. Likewise, increases in unemployment and declines in aggregate output and income lead to loan defaults and losses<sup>44</sup>.

Macroeconomic instability would have consequences for the loan quality of banks in any country. High inflation increases the volatility of business profits because of its unpredictability, and because it normally entails a high degree of variability in the rates of increase of price of the particular goods and services which make up the overall price index. The probability that firms will make losses rise; as does the probability that they will earn windfall profits<sup>45</sup>.

Macro and banking stability are closely linked, so that what happens in one affects the other. The evidence for most countries suggests that, except where the banks are state

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<sup>43</sup> Tandon Committee, Supra note 34

<sup>44</sup> Ibid

<sup>45</sup> Supra note 35

owned or heavily state controlled, instability generally starts in the macro economy and spills over into the banking sector. The resulting banking instability, in turn, feeds back and amplifies the macro instability. Thus, to enhance overall stability in the economy, it is necessary both to pursue successful contra cyclical macroeconomic policy and to reduce the fragility of banking relative to the magnitude of macro shocks that may be expected in the particular economy<sup>46</sup>.

Generally looking, the effect of macroeconomic instability on the financial sector and banking in particular makes it a cause for non- performing loans. Because financial institutions basically deal in forward contracts, whose profitability hinges greatly on the ability to predict future prices, they do not do well in volatile environments that increase uncertainty and make forecasting more difficult. To reduce their risk exposure, the banks collateralize their loans with either the borrowers' estimated future income and/or the estimated future value of specified assets. If either the realized income or realized asset prices fall sufficiently short of the projected values, the borrower may default and generate losses for the bank<sup>47</sup>.

Recognizing the relation of lending activity and its relation with macroeconomy, the Ethiopian National Bank sometimes issue credit cape for banks i.e. it provides the maximum amount banks could lend to the public for specific period of time. The objective for such credit cape is to reduce the inflation rate. These credit capes are introduced by way of circular letters<sup>48</sup>.

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<sup>46</sup> Tandon Committee, Supra note 34.

<sup>47</sup> Machiraju, Supra note 17, p. 8

<sup>48</sup> Interview with Ato Kurunde Tesgge, Senior Bank Inspector, National Bank of Ethiopia

### 2.2.3 Unsound Assessment Mechanism and Weak Risk Consciousness

Risk, and the ways, in which it can be identified, quantified and minimized, is key concerns for a bank's management and its auditors when they are considering the need to provide for bad and doubtful loans. No loan is entirely without risk. Every loan, no matter how well it is secured, and no matter who is the borrower, has the potential to generate loss for the lender. It is the degree of risk to which a loan is susceptible and the probability of loss that vary; these should normally be reflected in the interest margin and other terms set at the inception of the loan<sup>49</sup>.

There are situations under which setting performance indicators ignored risk adjusted revenues. Most of the time, little emphasis is given on risk control and exit management. Heavily relying on the materials provided by managers and only reviewing the written reports and financial reports don't make risk review mechanism conscious. A bank should conduct due diligence by making every possible examination available<sup>50</sup>.

A bank, in considering whether to lend or not, takes into account the quality of a borrower which is reflected in, *inter alia*, its past and projected profit performance, the strength of its balance sheet (for example, capital and liquidity) the nature of and market for its product, economic and political conditions in the country in which it is based, the quality and stability of its management and its general reputation and standing<sup>51</sup>.

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

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<sup>49</sup> C. Brown, *Supra* note 18

<sup>50</sup> *Ibid*

<sup>51</sup> *Ibid*

The borrower's ability to repay a loan is of paramount importance. Ideally, the loan will be self-financing in that it will be repaid from the cash flow that the borrower is able to generate from employing the proceeds of the loan. A bank will often require security for a loan in the form, say, of a guarantee or mortgage, in which case it will be concerned about the value and title of that security. The decision to grant loan, however, should be based on the prospects and solvency of the borrower and a careful analysis of how the funds to repay the loan will be generated<sup>52</sup>.

Constant monitoring increases the chance that the company will respond to a bank's concern and provide information more willingly. A bank which always closely follows a company's standing can often point out danger or opportunities to the company, as well as quick agreement to request for credit. It thus establishes that monitoring is basically constructive, and not a panic reaction, and carries more weight when it expresses concern<sup>53</sup>. In general, banks lack effective measures to identify, quantify and control the regional and industrial risk, constrained by obtaining historical data, decentralized information systems and immature portfolio management skills. So they have to make judgment mainly based on personal experience and consequently have weak management measures on concentrated and systemic risk<sup>54</sup>.

In Ethiopia, the National Bank of Ethiopia under Proclamation No. 592/2008, as a regulatory organ determines and approves the management of a bank who makes decision on the activities of a particular bank including credit assessments. The bank further gives guidelines with regard to loan concentration by providing lending restrictions on specific

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<sup>52</sup> Ibid

<sup>53</sup> Donaldson, T.H., How to Handle problem Loans: A Guide for bankers, (St. Martin Press: New York), pp 55-57.

<sup>54</sup> Ning ning Guo, Causes and Solutions of non-performing Loans in Chinese Commercial Banks, Chinese Business Review, ISSN1537-1506, Vol. 6, No, 6, 2007.

persons. These restrictions are limitation on loans to related parties (Directive No. 30/2002) and single borrower loan limit (Directive No. SBB/29/2002) making it easy and possible for banks to conduct risk assessments.

#### **2.2.4 Lack of Strict Admittance policies and no active exit**

Under the influence of idea of pursuing market share excessively, banks do not establish detailed and strict market admittance policies, which undermine the first risk to prevent gate and weaken the orientation effect of admittance policies to market<sup>55</sup>.

During pre-loan investigation, some relationship managers put little emphasis on authenticity and integrality review on related materials. They haven't clarified the true intended usage of the loan (especially when extending short-termed credit) and the review is too optimistic, which does not analyze the potential influence of changes in related factors. There is also no deep review on the market, no enough understanding on enterprises' operation management situation, no thorough risk revaluation; inaccurate assessment, the risk of loans is not fully covered and the risk on group customers and affiliated enterprises are not identified effectively. The factors above damage the loans at the early stage<sup>56</sup>.

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

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<sup>55</sup> Shofiqul Islam, Supra note 7

<sup>56</sup> Brownbrige, Supra note 42

loans, splitting one big number into several small pieces to avoid the authority constraint, issuing bank acceptance to fund enterprises on a rolling basis, or discount without actual trade background<sup>57</sup>.

Most problems in this case relates with accepting guaranty from unqualified institutions such as governments and agencies, high loan-to-value ratio, providing loans without property registration and transfer of collateral, guaranty for each other between enterprises and legally flawed credit procedures etc<sup>58</sup>. And there are also problems in which that the conditions of the loans are not satisfied and the contracts of loans are not completed.

Though the primary role lies on banks to evaluate their admittance and exit policies, they are subjected to the general laws of a country on banking business. They further are required to submit reports to NBE on their loan disbursement as well as their outstanding and collected loans showing whether their lending procedure is according to the regulatory guidelines and laws. The credit manual of banks needs to provide for strict admittance and exit policies providing for accountability.

### **2.3 Debt Recovery Processes**

Capital and interest receivables are amongst a bank's primary assets. Of these, interest comprises a bank's principal source of revenue, and therefore, of profit. Accordingly, from a bank's perspective it is essential that its borrowers keep their contractual commitments and repay interest and capital as scheduled. Defaults are inevitable, but

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<sup>57</sup> Ibid

<sup>58</sup> Ibid

when they occur a bank should take appropriate remedial action, or failing that, recover the outstanding interest and capital promptly<sup>59</sup>.

An essential element of the desired commercial infrastructure is a legal and judicial framework that provides for an efficient and prompt debt recovery process. Unsatisfactory debt recovery is one of the main reasons for financial distress to many lenders across the world. In most developing countries, a significant proportion of loans made by banks and other financial institutions are in default. Consequently, many such lending institutions may be technically insolvent<sup>60</sup>.

Debt recovery or realization process is one of the important things in a bank lending activity. This is because if the bank neglects to do so or the recovery process is unduly protracted, the impact may be severe. The bank may end up with large loan portfolio arrears, which in turn would affect the bank's capital ratios. As a bank's capital diminishes, the incentives, which its owners have to preserve solvency, are reduced because with limited liability, they would have to bear only a proportion of the losses incurred to creditors. If the problem grows out of hand and regulators begin to question a bank's ability to lend, it will threaten its existence<sup>61</sup>.

The effect of non- performing loans goes beyond its impact on lending institutions. Severe financial distress to lenders has a widespread negative impact on economic growth and development. It is particularly costly for developing countries.

The consequence of inordinate delays in recovering debts can be severe. Borrowers may be encouraged to disregard their payment obligations, and take advantage of the weakness in the debt recovery process. Willing defaulters may obtain loans with deliberate intention

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<sup>59</sup> Ibid

<sup>60</sup> Abeyratne, Supra note 30

<sup>61</sup> Ibid

of avoiding payment, and may dispose of their assets beyond the reach of lenders because of the tedious pace of debt recovery suits<sup>62</sup>. In short, delays breed a credit culture of deliberate non- payment by defaulters.

Bad management in lending institutions also affects debt recovery. If internal controls are not in force, it will be difficult to hold individual officers responsible for either authorizing or collecting loans. Bank officers would then lack the incentive to pursue debt recovery actively. As one lawyer commented, bank officers at times waste almost six years before a decision is taken to initiate legal proceeding to recover a debt, and then expect judges and lawyers to recover the money within a year. Credit review procedures adopted by banks may not be of high standards<sup>63</sup>.

Speedy recovery of problem loans not only facilitates recycle of funds but also reduces the impact of non- performing assets. Banks have to incur substantial costs in terms of man power, legal and other administrative expenses to service and realize the problem loans. Though it is often difficult to quantify these costs, a bank with large portfolio of problem loans could be experiencing a decline in profitability arising from loss of interest, income and rising costs in terms of legal and other expenses<sup>64</sup>.

The recovery process is often legal and long drawn and in the mean time, the bank is continuously deprived of the opportunity to earn from such funds. Added to this, is the question of the bank's status and reputations which could be altered with an excessive portfolio of problem loans. Excessive problem loans have been compared to a problem bank which is dying slowly from several small wounds.

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<sup>62</sup> Ibid

<sup>63</sup> A. De Juan, From Good Bankers to Bad Bankers: Ineffective Supervision and Management as Major Elements in Banking Crisis(Unpublished), Washington D.C., 1987, PP. 4-10

<sup>64</sup> A.B. Chakravarty, Recovery of problem loans through Compromise, Dy. General Manager, Small industry and Small business Banking Department, State Bank of India, Central office, pp 554-555.

It has been said that:

*One is reminded of a form of torture and death known as “death of a thousand cuts” seen in American South- West among the Native Americans. The captive dies by slowly bleeding to death from many small nicks inflicted upon him by the women and children. No one cut is enough by itself to kill him, but the cumulative effect of all the small cuts eventually does. In many ways, it is that for a bank with enough problem loans so that it is perceived as a problem bank. The bank bleeds from all these small cuts and has a very hard, slow time recovering from the problems<sup>65</sup>.*

The very essential thing is to create a good environment for debt recovery process. Debt recovery process requires different mechanisms to be employed.

Ethiopian Banks adopt different ways of recovering non- performing loans. These methods are one or the combination of the following:

1. Settlement - This engages both the lender and the borrower in negotiation to settle through collection of cash.
2. Reschedule/Renewal - this method is used whenever a bank believes that the NPLs can be regularized in favorable terms and conditions through negotiation (term loans) and renewals (overdrafts). This is not without limitation. National Bank Directive No. SBB/43/2008 states a bank shall not reschedule restructure or negotiate short or medium term loan to a borrower for more than three periods. Before rescheduling, restructuring or renegotiating a short or a medium term loan, a bank shall collect in cash full amount of interest thereof and the following principal amounts:
  - a. A minimum of 25% of outstanding principal balance in case of rescheduling, restructuring or renegotiating for the second time.
  - b. A minimum of 50% of outstanding principal balance in case of rescheduling restructuring or renegotiating for the third time.

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<sup>65</sup> Ibid

3. Foreclosure - if the borrower doesn't pay his/her/its debt as per the contractual agreement through negotiation, the bank will be forced to foreclose the properties held as collateral (mortgaged and pledged) in line with Proclamation No. 97/98 and Amendment Proclamation No. 216/2000.
4. Write- off - cleaning from the bank's balance sheet non- collateral NPLs whose chance of recovery is remote.
5. Litigation- for loan with no collateral or have documentation issues or other related problems, the loan can be recovered by court order.

There are two general ways to secure NPLs. One is for banks to handle them themselves or auction them in Asset Management Companies (AMCs)<sup>66</sup>, which is common in countries where

NPL is not widespread. The other alternative is to use courts to enforce their rights.

### **2.3.1 Debt recovery through Courts**

Developing countries require efficient debt recovery procedures in order to fuel their ambitious development program and economic growth. In most developing countries, however, debt recovery process is not efficient enough<sup>67</sup>. The number of defaults is high and long delays are experienced by lenders seeking crucial remedies. Poor debt recovery has become one of the most important problems facing lenders in developing countries, which has had a wide spread negative impact on economic growth. Investment has been impeded as a consequence of increased lending costs and the denial of credit to many

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<sup>66</sup> The rationale for establishing AMCs is to set the environment right for banks to recommence lending. The AMC is tasked with the transfer of sub quality assets and its management. Though they help banks in recovery process, AMCs use the courts as a means of debt recovery.

<sup>67</sup> Machiraju, Supra note 17

borrowers<sup>68</sup>. One of the organs which plays important role in debt recovery process is the court. Though courts are a good means for debt recovery, there are different problems involved in the process. If a lender has to go to court to enforce its security<sup>69</sup>, it will benefit the lender only at the stage of execution.

In a case of debt recovery through courts, a lender seeking to recover money it has lent together with unpaid interest thereon has the right to institute a suit in any civil court that has jurisdiction against a defaulting borrower and to seek recovery from court<sup>70</sup>. The suits are handled according to the respective laws of a country.

In most cases, procedures involving the courts take excessively long time. When the legal process for the recovery of over- due debts becomes excessively long, it may further encourage dishonest borrowers to exploit deficiencies in the system. These borrowers may obtain loans with the deliberate intention of avoiding payment or, where loans have already been obtained, discontinue repaying the loan because of the well known delays experienced in the courts. These defaulters also take an unfair share of the new credit in the form of unpaid interest and capital, depriving more deserving borrowers of this credit<sup>71</sup>.

Timely repayment of loan is important to endure the financial soundness of lenders. Where borrowers are in default, lenders may reschedule loans, but ultimately they rely on recovery procedures and the courts to compel debtors to pay up. If the courts and the judicial system in a country fail the lenders, bad debts will begin to mount in number<sup>72</sup>.

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<sup>68</sup> Symposium on "Legal Issues in Debt Recovery, Credit and Quality", World Bank and Asian Development Bank, 1993

<sup>69</sup> It is known that lenders favor real property security though this creates inequalities within the society.

<sup>70</sup> Abyertane, Supra note 30

<sup>71</sup> Ibid, p. 159

<sup>72</sup> Ibid

Generally, debt recovery through courts requires speedy way of handling the cases. But because in most developing countries the court procedures take long times, there has been wide accumulation of non- performing loans in banks resulting in crisis. Most countries, tried to use different procedures to avoid this problems. For example Ethiopia can be mentioned as a country that employed different method to avoid this problem (this will be discussed more in the coming chapters).

### **2.3.2 Debt Recovery through Banks**

All business transactions involve risk- from the non- payment of a trade debtor, to a crop failure, to the inability to sell a costly new product. The position of banks differs in degree because they are subject also to the business risks of their commercial borrowers, to systemic failures in the financial markets and the consequences of the economic failure of countries<sup>73</sup>.

Banks make money by providing services that their customers want and by granting them credit. There are risks associated with these services and banks earn profits if they can charge a price for them that exceed the cost of providing them together with any losses that may crystallize from the risks they have incurred. When these risks occur, banks resort to debt recovery mechanisms<sup>74</sup>.

Debt recovery through courts has been the usual practice in different countries but due to the complex procedure and to minimize judicial process, most countries gave banks the right to recover loans by themselves. This process looks easier when the loan is securitized. The recovery of loans by banks provides for the management or sale of mortgaged property by banks without a court order.

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<sup>73</sup> Brown, Supra note 18, p.5

<sup>74</sup> Ibid

The rationale behind giving this power to banks relates with reduction of non- performing loans through effective means of recovering the loans. This is regarded as effective because of it takes minimum time compared to court procedures.

The procedures that banks follow for recovering the debt depend on the respective law of the country. In most countries, when a resolution is passed by the board of directors of a bank authorizing the sale of property, the lender has a statutory obligation to send a notice to the borrower informing him of the resolution so that the borrower is given an opportunity to take steps to settle the debt even at that stage. This statutory obligations placed upon lenders has adversely affected the debt recovery process because dishonest borrowers use it as a delaying tactic.<sup>75</sup> This is because, when notice is sent to borrowers they make one or two payments in order to have the sale stopped, and then default again. After giving notice, the banks are given a right to claim their loans with whatever means necessary<sup>76</sup>.

In a country where litigation costs are high and excessive delays are experienced in the courts, it was anticipated that lenders would consider this right a step forward in forcing security. In practice, banks have not used this power and continue to resort to the courts<sup>77</sup>.

There is a general observation that banks usually fail to exercise their right of recovery due to so many reasons such as suits instituted to courts by interested parties and court blocking orders. But considering how effective and fast this procedure is, it is regarded as very crucial by banks.

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<sup>75</sup> Abyertene, Supra note 30, P. 150

<sup>76</sup> Ibid

<sup>77</sup> Ibid, P. 217

## **CHAPTER THREE: The Legal Regime of Non- Performing Loans in Ethiopia**

### **3.1 Banking and Non- Performing Loans in Ethiopia**

The history of banking in Ethiopia starts with the establishment of the first bank, Bank of Abyssinia, in 1905. It was owned and managed by the British- owned National Bank of Egypt and it was given a banking monopoly for fifty years, including the right to issue notes and coins. However in 1931, the Bank of Abyssinia was replaced by the Bank of Ethiopia which was wholly owned by the government and members of the Ethiopian aristocracy, becoming the first 100% African- owned bank on the continent. It was also authorized to issue notes and coins and to act as the government's bank<sup>78</sup>. It operated for only a few years, being closed after the Italian invasion. During the Italian occupation, several Italian banks opened branches in Ethiopia.

After the liberation in 1942, the State Bank of Ethiopia was established. It became operational in 1943, with 43 employees and two branches, and acted as the country's central bank. The bank also acted as the country's main commercial bank, while a few much smaller foreign banks continued to operate. The country's first development bank was founded in 1951. The World Bank provided \$2 million towards the founding Development Bank of Ethiopia (DBE), and invested a further \$2 million in 1960<sup>79</sup>.

In 1963, a new banking law split the functions of the State Bank of Ethiopia in to central and commercial banking as the National Bank of Ethiopia and the Commercial Bank of Ethiopia respectively. Both were government- owned. The 1963 law allowed for other

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<sup>78</sup>Martin Brownbride and Charles Harvey, Banking in Africa: The Impact of Financial Sector Reform since Independence, Fountain Publishers, 1998, p.36

<sup>79</sup> Ibid

commercial banks to operate, including foreign banks provided that they were 51% owned by Ethiopians. The biggest of these was the Addis Ababa Bank<sup>80</sup>.

The fall of the imperial government in 1974 led to a major change in economic policy. During the era of state socialism (1974-1991), Ethiopia's financial institutions were charged with executing the national economic plan; state enterprises received bank finance in accordance with the plan's priorities. This system based on the template of the Soviet Union, saw little need to develop the tools and techniques of financial systems. With the overthrow of the Derg Regime in 1991, Ethiopia began its transition to a market economy. This transition has had profound implications for financial system. New financial system has been expanded, and the role of central bank is being formulated<sup>81</sup>.

During the socialist period, the government nationalized the small commercial banks and concentrated them into the Commercial Bank of Ethiopia (CBE). Commercial Bank of Ethiopia (CBE) and the other government banks were obliged to lend to public enterprises according to government instructions, which were in turn based on central planning. The CBE could not refuse credit in these circumstances, regardless of whether its credit assessment was positive or negative. The CBE made no provisions against lending to public enterprises during the relatively short period when debt service was in arrears (with the exception of lending to the construction sector, for which provisions were made after 1990). In practice, the CBE clearly expected the government to carry any unrecovered losses eventually. The losses incurred from lending to the construction sector have been 'presented' to government, which is expected to issue bonds in their place. There was therefore a second line of defense in the CBE's lending to parastatals, namely,

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<sup>80</sup> Ibid

<sup>81</sup> Tony Addison and Alemayehu Geda, Ethiopia's New Financial Sector and Its Regulation, Discussion Paper number 2001/55 at [http://www.wider.unu.edu/publications/working-papers/discussion-papers/2001/en\\_GB/dp2001-55/files/78091788041848685/default/dp2001-55.pdf](http://www.wider.unu.edu/publications/working-papers/discussion-papers/2001/en_GB/dp2001-55/files/78091788041848685/default/dp2001-55.pdf), accessed October, 2009

that it expected to be compensated for the cost of any bad debts resulting from the lending it had been instructed to undertake<sup>82</sup>. Considering the extent of loan advances given by CBE, it would have been possible for bad debts to have rendered the CBE insolvent. On the published evidence, this did not happen. Cumulative provisions were much greater than bad debts<sup>83</sup>.

After the fall of the Derg regime, financial liberalization started to take place. The CBE remained in 100% government ownership, but it was given greater autonomy in lending activity, especially from September 1994.

Financial reform began in earnest in 1994. Ethiopian National Bank's (NBE) role in overseeing the commercial banks was codified. Sector-specific interest rates administered by NBE were also ended, and replaced with a minimum deposit rate (10 per cent) and a maximum lending rate (15 per cent). The domestic private sector was permitted to enter the banking and insurance business (foreign financial institutions are not yet permitted to invest). The response to these reforms has been promising<sup>84</sup>. This is because there are now many private banks being established and already working in the banking sector.

During the series of financial sector reforms, private banks were allowed to be re-established. But during that time, the three large state-owned banks continued to dominate the market in terms of capital, deposits and assets<sup>85</sup>.

It can be seen that the share of assets of private banks grew from 6.4 percent in 1998 to 30.4 percent in 2006. This in turn implies that the share of state-owned banks significantly declined. Note, however, that the values of total assets increased from 1998

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<sup>82</sup> Supra note 78, p.38-41

<sup>83</sup> Ibid

<sup>84</sup> Ibid

<sup>85</sup> Koso Kiyota, , Barbara peitsch and Robert M. Stern, The Case for Financial Liberalization in Ethiopia, August 17, 2007 at <http://www.fordschool.umich.edu/rsie/workingpapers/wp.html>, accessed , October, 2009.

to 2006 for both state-owned and private banks. This suggests that the Ethiopian banking sector has grown rapidly. The growth of private banks has been much faster than state-owned banks, although more than two-thirds of assets are still held by state-owned banks. It is also evident that private banks show generally better performance than state-owned banks. Throughout the years, private banks had higher return of asset than state-owned bank<sup>86</sup>. The lending process also grows overtime creating a wider competition between different banks. But the undertakings of loan advancement by these banks are regulated.

All the banks are now regulated by the central bank which is the National Bank of Ethiopia. A central bank plays the most influential role in a country's economic and financial development. Generally, the primary role of a central bank is the same in all countries. It acts as a banker and financial advisor to the government as the nation's monetary authority, and is responsible to the government for promoting monetary stability in the country. To improve the stability of the financial system further, a central bank will act as a banker to the banking and other financial institutions in the country<sup>87</sup>. Consequently, a central bank can influence the lending policy of commercial banks and thus debt recovery.

The National Bank of Ethiopia was reestablished by Proclamation No. 591/2008. The NBE under article 5(7) has the power to license and supervise banks. Furthermore, it has the right to exercise such other powers and functions to execute its purposes as central bank customarily perform. NBE also acts as a banker to other banks and the government.

As discussed in the previous chapter, one of the main important functions of a bank is giving a loan. And these loans have a capacity of affecting the whole financial sector.

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<sup>86</sup> Ibid

<sup>87</sup> Cranston, R., Principles of Banking Law, Clarendon Press, Oxford, 1997, pp. 117-133

Accordingly, NBE issues different laws to control the activities of the banks regarding loans.

### **3.2 Laws relating to Control of Non- Performing Loans in Ethiopia**

In order to create a climate of confidence conducive to private sector business activities, appropriate laws that provide the necessary environment are necessary. Current theories on which economic development policies are based, as well as the guidelines of international financial institutions that provide technical assistance to developing countries are pursuing free market economic policies, emphasize the critical importance of having a modern commercial law infrastructure. The legal infrastructure should enable the developing or transitioning economy to have in place properly functioning credit and other financial systems that stimulate domestic and foreign investment<sup>88</sup>.

As discussed above, the need to control non- performing loans emanates from its harsh consequence on the financial system of a country and ultimately its economic development. Most countries design regulatory legal frame work for controlling non-performing loans of banks. The legal framework addresses issues extending from how loans could be given to realization of loans which are defaulted.

The legal frame work for controlling non-performing loan mostly addresses the following issues:

- Lending guidelines
- Defining loans which are considered as non- performing
- Determining loan provision requirements
- Classifying loans and advances

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<sup>88</sup> Abyertne, Supra note 30

- Examination and monitoring duties of banks etc

Under this part, we will discuss how these issues are treated under Ethiopian Banking Business Proclamation and respective Directives.

The banking sector in Ethiopia has undergone a lot of reforms over the years to reach the status it has today. The financial sector reform in Ethiopia was initiated back in 1992 as one of the important components of the economic reform program under the Structural Adjustment Program (SAP). The main objective of the economic sector reform included:

- To deregulate financial sector activities with a view to improve mobilization of domestic resource for investment.
- To improve the efficiency of financial intermediation through greater reliance on domestic resources for investment.
- To create conditions for the use of market oriented instruments in the implementation of monetary policies<sup>89</sup>.

Having this in mind, the government has introduced a number of measures including adopting regulatory and supervisory legal frameworks for banks and financial institutions in different areas and introducing foreclosure laws to facilitate quick recovery of non-performing loans in Ethiopia.

Financial markets are inherently imperfect, characterized as they are asymmetric information in relationship of borrowers to lenders. In Ethiopia, this imperfection is aggravated by the institutional frameworks under the Derg era. Public and private banks are only now developing the capacity to evaluate loan risk in the context of a market

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<sup>89</sup> Lakew Alemu (Dr.), Supra note 1

economy and are yet to offer the full range of financial instruments required by potential clients<sup>90</sup>. To support the new development, prudential regulation needs to be in place.

NBE must learn the skills of prudential regulation and supervision appropriate to market-based financial system. This requires the monitoring of capital adequacy and restrictions on bank portfolio choices (to avoid large loans exposures and “insider lending”)<sup>91</sup>.

NBE’s surveillance mechanisms require banks to submit key financial data such as the composition of lending and the scale of non- performing loans on a regular basis, in order to identify all the risks to which each bank is exposed. Commercial banks are legally required to make 100 percent provision against “bad” loans ( those with no collateral) and 50 percent provision of “doubtful”(those for which repayment is more than one year late, and for which there is no adequate security)<sup>92</sup>.

### **3.2.1 Asset Classification and Legal Provisioning requirements**

Most banks make both specific and general provisions against bad and doubtful loans. However, although these provisions may be computed separately, they are no more than elements of the same provision. In total the specific and general element of a bank’s provision for bad and doubtful loans should represent the aggregate amount by which management consider it necessary to write down its loan portfolio in order to state it at its estimated net realizable value in the ordinary course of business<sup>93</sup>.

The specific element refers to particular loans that have been identified as bad or doubtful. Its aim is to write down the value of those loans to their estimated realizable

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<sup>90</sup> Befekadu B. Kereta, Supra note 2

<sup>91</sup> Ibid

<sup>92</sup> Ibid

<sup>93</sup> Brown, Supra note 8

value at the balance sheet date. The general element relates primarily to the risk associated with loans that may prove to be wholly or partly irrecoverable, have not been separately identified, but are believed nevertheless to exist<sup>94</sup>.

In determining the extent of the specific element of the provision for bad and doubtful loans, a bank needs to consider the following factors:

- The amount of the loan and the bank's other commitments to that borrower;
- The borrower's business prospects;
- The security for the loan (if any) and how it could be realized;
- The costs that would be incurred in obtaining repayment if security or other rights had to be enforced, and
- The income from the loan.

The bank needs to consider the future prospects for the borrower's business in determining the need for and the size of any provision.

Ethiopian Banking Business Proclamation No. 592/2008 was issued with a view to ensure safety, soundness and stability of the banking system. It provides the basic guidelines with respect to banking activity. Based on the objective, the proclamation provides some rules on loans.

Banking Business Proclamation No. 592/2008 under Article 21(a) requires banks to make provisions for loans, advances and bad or doubtful receivables. The NBE will ensure whether the banks are holding the appropriate amount of provisioning<sup>95</sup>. It further

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<sup>94</sup> Ibid

<sup>95</sup> Article 21(a), Banking Business Proclamation, Proclamation No. 592/2008, Federal Negarit Gazeta, 14<sup>th</sup> year, No.52, 5<sup>th</sup>, August, 2008.

requires the amount of provisioning to be decided by directive to be issued by the National Bank of Ethiopia.

The National Bank of Ethiopia also is given a power under Article 22 of the proclamation to issue directives concerning the conditions and limitations on investments of banks and a loan, advance or other credit facility, financial guarantee or any other commitments or contracts given by a bank, directly and indirectly to a person.

The NBE issued directives on loan provision requirements and the responsibility of the banks to maintain their capital adequacy. This helps the banks not to make any decision which results in financial distress.

Directive No. SBB/43/2008 is issued to provide uniform guidelines to assure:

- Loans or advances are regularly reviewed and classified in a manner consistent with regulatory standards
- Loans and advances which are not performing in accordance with contractual repayment terms are recognized and reported as past due in a manner consistent with regulatory standards.
- Accrued but uncollected interest on loans or advances is accounted for in accordance with international accounting and regulatory standards.
- Timely and adequate provisions are made to the Provisions for Loan Losses Account in order to accurately reflect the risk inherent in lending activities and to ensure that disclosed capital and earning performance are accurately reflected.

The directive provides for provision requirement of all banks. Article 8 states that:

*All banks shall maintain a provision for loan losses account which shall be created by charges to provision expense in the income statement and shall be*

*maintained at a level adequate to absorb potential loss in the loans or advanced portfolio. In determining the adequacy of the provisions for loan loss account, provisions may be attributed to individual loans or advances or groups of loans and advances*<sup>96</sup>.

A bank with a large portfolio of loans will always find it difficult to identify all the bad and doubtful loans that exist at a balance sheet date and to estimate the extent of the losses that they will produce. Nor will it necessarily, at any given date, have information about its borrowers that is completely current. There may be factors relevant to the identification and evaluation of bad and doubtful loans which the bank has not yet become aware of<sup>97</sup>.

Furthermore, it is rare for a loan to become bad suddenly. More realistically, each loan should be regarded as lying on a continuum of quality, at one end of which it is entirely good and at the other end entirely bad. Each loan's position on this continuum will change with the condition of the borrower and of the economies in which it operates. Because it will not always be possible (or practicable, where there are many small loans) to determine with certainty whether or when a loan has become bad or what level of specific provision would be 'correct', a general element should normally be added to the specific element of the provision to ensure that the loan portfolio is included in the balance sheet at its net realizable value over all<sup>98</sup>.

To help identify loans which are non- performing and to calculate and determine the amount of provision, loans are classified into pass, special mention, substandard, doubtful and loss. For minimizing the risk of non- performing loans, the following provision requirement is provided under articles 7 and 8 of Directive No.SBB/43/2008 on asset classification and provision:

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<sup>96</sup> Article 8, Supra note 8

<sup>97</sup> Brown, Supra note 18

<sup>98</sup> Ibid

## 1. Pass

Loans or advances in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism. In general, any loan or advance, or portion thereof, which is fully secured, both as to principal and interest, by cash or cash-substitutes, shall be classified under this category regardless of past due status or other adverse credit factors.

For this kind of loans, 1% of provision requirement is specified in the directive.

## 2. Special mention

This category includes:

- (a) Loans or advances with pre established repayment programs past due 30 (thirty) days or more, but less than 90 (ninety) days;
- (b) over drafts and loans or advances that do not have a pre established repayment program, if:
  - (i) the debt remains outstanding for, but less than 90 (ninety) days; or
  - (ii) the debt exceeds the borrower's approved limit for 30 (thirty) consecutive days or more, but less than 90 (ninety) days; or
  - (iii) interest is due and uncollected for 30 (thirty) consecutive days or more; but less than 90 (ninety) days ; or
  - (iv) For overdrafts, the account has been inactive for 30 ( thirty) consecutive days or more, but less than 90 (ninety) days or the account fails to show the following debit balance at least once over 360 days preceding the date of loan review:
    - 1. Ten to nineteen percent of the approved limit latest by June 30, 2008;

2. One to four percent of the approved limit effective from June 30, 2009.

For this classification of loans, 3% provision requirement is placed.

3. Substandard

For loans placed under this category, the amount of provision is 20%. The following non-performing loans and advances at a minimum are classified as substandard:

- a. loans or advances with pre-established repayment programs past due 90 (ninety) days or more, but less than 180 (one hundred-eighty) days;
- b. overdrafts and loans or advances that do not have a pre established repayment program, if:
  - I. The debt remains outstanding for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity, but less than 180 (one hundred-eighty) days; or
  - II. The debt exceeds the borrower's approved limit for 90 (ninety) consecutive days or more, but less than 180 (one-hundred-eighty) days; or
  - III. Interest is due and uncollected for 90 (ninety) days or more, but less than 180 (one-hundred-eighty) days; or
  - IV. For overdrafts, the account has been inactive for 90 (ninety) consecutive days or more, but less than 180 (one-hundred-eighty) days; or the account fails to show the following debit balance at least once over 360 days preceding the date of loan review:
    - 1) twenty to thirty-nine percent of the approved limit latest by June 30, 2008;
    - 2) five to nineteen percent of the approved limit effective from June 30, 2009.

#### 4. Doubtful

The following non-performing loans and advances at a minimum are classified as doubtful with provision requirement of 50%:

- a. loans or advances with pre-established repayment programs: past due 180 (one-hundred-eighty) days or more, but less than 360 (three hundred-sixty) days;
- b. overdrafts and loans or advances that do not have a pre-established repayment program, if :
  - i. the debt remains outstanding for 180 (one-hundred-eighty) consecutive days or more beyond the scheduled payment date or maturity, but less than 360 (three-hundred-sixty) days; or
  - ii. The debt exceeds the borrower's approved limit for 180 (one hundred-eighty) consecutive days or more, but less than 360 (three-hundred-sixty) days; or
  - iii. Interest is due and uncollected for 180 (one-hundred-eighty) days or more, but less than 360 (three-hundred-sixty) days; or
  - iv. for overdrafts, the account has been inactive for 180 (one hundred-eighty) consecutive days or more, but less than 360 (three-hundred-sixty) days; or the account fails to show the following debit balance at least once over 360 days preceding the date of loan review:
    - 1) forty to sixty-nine percent of the approved limit latest by June 30, 2008;
    - 2) twenty to forty-nine percent of the approved limit effective from June 30, 2009.

#### 5. Loss

The following non-performing loans and advances at a minimum shall be classified as loss:

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

b) Overdrafts and loans or advances that do not have a pre established repayment program, if:

i. The debt remains outstanding for 360 (three hundred-sixty) consecutive days or more beyond the scheduled payment date or maturity;

ii. The debt exceeds the borrower's approved limit for 360 (three-hundred-sixty) days or more; or

iii. Interest is due and uncollected for 360 (three hundred-sixty) days or more; or

iv. For overdrafts, the account has been inactive for 360 (three-hundred-sixty) consecutive days or more, or the account fails to show the following debit balance at least once over 360 days preceding the date of loan review:

1) seventy percent and above of the approved limit latest by June 30, 2008;

2) fifty percent and above of the approved limit effective from June 30,

2009.

For non performing loans which are under this category, there is 100% provision requirement.

### **3.2.2 Loan Review**

A reliable system for the early identification and efficient control of doubtful loans will provide a bank's management with assurance that the financial statements are accurate and may also serve to reduce the losses eventually suffered. Accordingly, Directive No. SBB/43/2008 under Article 5 states that the board of directors of each bank is responsible for establishing a loan review system which:

- Recognizes accurately and timely problem of deteriorating loans or advances
- Assure the adequacy of the provisions for loan loss account
- Ensures that overdraft facilities are properly used by borrowers only for the purpose specified in the loan contract they entered with the bank, and in case such loans are diverted from the intended purpose enables to take timely, prompt and appropriate correction actions.

The loan review control mechanisms will enable the concerned officials to identify certain loans that do not require extended consideration because they have an extremely low inherent risk. Under the directive, the loan review function is entrusted to be formed by the board of directors of each bank or a group of individuals to be designated by the board of directors who are knowledgeable in credit analysis methodologies and who are not involved in the lending activities of a bank.

The boards of directors of each bank are required to maintain adequate records supporting its evaluation of potential losses in the loans and advances portfolio and the entries made to reflect earnings and the adequacy of the Provisions for Loan Loss Account<sup>99</sup>; such records shall be made available to examining personnel of the National Bank of Ethiopia upon request.

The loan review function shall assure on an on-going basis, at a minimum, that lending activities are in compliance with prudent written lending standards as approved and adopted by the board of directors; the borrowers are using overdraft facilities for the purpose they negotiated with the bank; and in case of diversion from the intended purpose that timely measures are taken to correct the problem<sup>100</sup>.

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<sup>99</sup> Article 5, Supra note 8

<sup>100</sup> Ibid

The board of directors should be adequately informed of the risks and potential loss exposure in outstanding loans or advances. The loan review mechanism should see whether problem or deteriorating loans or advances are properly and timely identified, classified, and placed on ‘non-accrual statuses’<sup>101</sup> in accordance with the requirements laid out in the directives. The review must see appropriate provisions are made to the Provisions for Loan Losses Account for loans or advances classified in accordance with the requirements laid out in the directives; and uncollectible non-performing loans or advances are written off as appropriate.

The loan review function shall regularly and on an ongoing basis review all loans or advances which exceed 5% (five percent) of a bank’s total capital to a single borrower, calculated in accordance with the single Borrower Loan Limit, all loans and advances required to be placed on non- accrual status in accordance with the directive and sampling of the remaining loan and advances portfolio<sup>102</sup>.

### **3.2.3 Monitoring and Reporting Mechanisms**

One mechanism under which National Bank of Ethiopia conducts its monitoring is through bank examination. Bank examinations are supervisory measures that aim at collecting information on bank’s financial information and their compliance with regulatory standards. Prudent regulation of bank’s operation focuses on six main areas. These are Capital Adequacy, Asset quality, Management and administrative ability, Earning level and Quality, Liquidity and Sensitivity to market risks, in short CAMELS.

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<sup>101</sup> All non- performing loans are placed on non- accrual status unless they are (i) well-secured and (ii) in process of collection

<sup>102</sup> Ibid

Loans and advances carry greater risk for solvency of the banks. The fact that the failure of financial system has great implication to the economy in general necessitates for prudent regulation based on the CAMELS rule.

The NBE monitors the conditions of banks so as to check whether the flows of activities are in accordance with the rules and regulations of the country. Bank evaluation or examination is a supervisory action carried to determine systematically and objectively the efficiency and effectiveness of activities at the completion (end) of the plan period. It is an organizational process for improving activities that are in progress and assessing management in future planning, programming and decision making. Hence, performance measurement can be considered as a process of monitoring and evaluation.

By carrying out these performance measurements (examinations), NBE ascertains capital adequacy, asset quality checks, the credit quality, checks the board management and management soundness and whether there is satisfactory or unsatisfactory earning performance. NBE also evaluates whether there is liquidity problems or not, checks the overall financial conditions, under provisioning, credit administration, risk management, violation of NBE's and internal policies, regulations and directives and develop a plan for soundness and health of a bank<sup>103</sup>.

Prudential supervision is best carried out through a combination of offsite monitoring and onsite inspection (examination). The power of NBE in controlling banks through off site inspection could be exercised by issuing directives and by demanding reports while on-site inspection is done by physical presence of the NBE inspections. Articles 28 and 29 of Proclamation No. 592/2008 gives the National Bank of Ethiopia the power to collect

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<sup>103</sup> Report by Research and Business Development Division, DBE performance measurement, p.9

financial information and to make an on- site inspection of any bank without prior notice respectively.

The offsite examination is based on reporting mechanisms. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on solo or consolidated basis. These should include basic financial statements as well as supporting schedules that provide greater detail on exposure to different types of risk and various other financial aspects of the bank, including provisions and off-balance sheet activities.

In Ethiopia, Directive No. SBB/21/96 provides different reporting formats and number of days within which banks are required to make financial reports. Accordingly, banks are required to submit to the Banking Supervision Department of the National Bank of Ethiopia a quarterly report on loan classification and provisioning<sup>104</sup>. The NBE will analyze the data provided by each bank and determine the soundness of it. The reporting mechanism is conducted based on standard reporting format.

The other method is onsite examination. Supervisors must have a means of validating supervisory information either through on- site examination or use of external auditors. On- site work, whether done by examination staff of the banking supervisory agency or commissioned by supervisors to be undertaken by external auditors, should be structured to provide independent verification that adequate corporate governance exists at individual banks and that information provided by banks is reliable<sup>105</sup>. The NBE makes at least once a year on site examination by sending its experts.

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<sup>104</sup> Article 13, Supra note 8.

<sup>105</sup> Basic Documents of the Basel Committee on Banking Supervision,p.34

The third method that NBE uses is special examination. Special examination is target area examination. NBE investigates specific area of the banking activity for instance, credit or capital adequacy of a bank. The source for this kind of examination may arise from the government, customer petition or from the banks themselves. The law on banking business is silent about this kind of examination. But according to NBE, this kind of examination is regarded as part of on- site examination<sup>106</sup>.

### **3.3 Laws relating to Recovery of Non- Performing Loans in Ethiopia**

Lenders may extend credit to borrowers with or without security. If the reputation or record of a borrower reassures a lender sufficiently that the money will be repaid, it may be prepared to extend credit without security. In all other cases a lender will demand some sort of security as a safeguard against a risk that the borrower may not be able to repay the loan, be forced in to insolvent liquidation proceedings. By taking security, the immediate benefit to a lender is the reduction of risk against default, but it will also have a greater economic benefit in the long term<sup>107</sup>. Where security is provided, a lender may be willing to authorize a loan more easily. It may also be prepared to offer lower interest rates, extend longer periods for which the loan is granted and if necessary, increase the amount of the loan<sup>108</sup>. Favorable lending terms will inevitably result in better flow of credits to the economy, leading to increased investment and growth rates.

A lender's objective of taking security is to recover a debt granted to a borrower if it defaults under a loan agreement. A borrower granting security to a lender must therefore diligently keep to his repayment schedule, or run the risk of the lender enforcing its rights

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<sup>106</sup> Interview with Ato Kurunde tesgge, Senior Bank Inspector, National Bank of Ethiopia.

<sup>107</sup>H. Flesig, , The Power of Collateral in The World Bank: View Point, No 43, World Bank, 1995

<sup>108</sup> Simpson, J, and Rover, J., General Principles of a Modern Secured Transactions Law, In Norton,, J., and Andenans, M.(Eds), Emerging Financial Markets and Secured Transactions, Kluwer Law International, London, 1997, p. 143

if it defaults. In the event of insolvency of a borrower, a lender with security will be considered a secured creditor, and stand outside the insolvency proceedings. For this reason, secured creditors are often called super-priority creditors. By contrast, creditors who are unsecured would receive little or nothing through the ratable distribution process employed in such proceedings<sup>109</sup>.

If lenders find it difficult to enforce security and recover their debts, the objective of taking security will prove to be useless. If on the other hand, the security enables the lenders to recover debts quickly without following cumbersome process, the security will be more valuable.

In Ethiopia, the relation between the lender and borrower emanates from the lending agreement which is subject to the general provisions of contract. In order for the agreement to be valid, the element of capacity, consent, object and the necessary form requirement should be fulfilled. But there are some requirements which are amended by a new proclamation. Under Article 1723 of the Ethiopian Civil Code, a contract creating or assigning rights in ownership or bare ownership on an immovable shall be in writing and registered with a court or notary. But this requirement has been amended by Civil Code Amendment Proclamation No. 639/2009. According to the preamble, the amendment is necessitated by the fact that the formality provided under the Civil Code for the conclusion of mortgage contracts is exerting negative impact on the efficiency of loan supervision service which is a day to day activity of banks and micro- financing institutions. It further states that, the invalidation of existing contracts of mortgage concluded under the prevailing practices of banks and micro-financing institutions for not being notarized, as provided by the Civil Code, leave most of the existing loans unsecured

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<sup>109</sup> R. Goode, Principles of Corporate Insolvency Law, 2<sup>nd</sup> Ed., Sweet and Maxwell, London, 1997, pp. 143-144, 151- 161

with a serious threat to the existence of the banks and the micro- financing institutions and to the country's overall economy.

Article 2 of Proclamation No. 639/2009 added the following under Article 1723 of the Ethiopian Civil Code as Sub- article (3).

*Notwithstanding the provisions of sub- article (1) of this article, a contract of mortgage concluded to provide security to a loan extended by a bank or micro- financing institution may not require to be registered by a court or a notary<sup>110</sup>.*

The Amharic version of this article states that:

**የዚህ ንዑስ ቁጥር /፩/ ድንጋጌ ቢኖርም ለባንክ ወይም ለአነስተኛ ፋይናንስ ተቋም ብድር መያዣነት የተሰጠ የማይንቀሳቀስ ንብረት የሚመለከት ውል በፍርድ ቤት መዝገብ ወይም ሥልጣን በተሰጠው አዋዋይ ፊት መፈረም አያስፈልገውም፡፡**

Basically, the law relieves the banks from the obligation of making the contract in front of a court or a notary<sup>111</sup> but that doesn't mean registration in the appropriate office is unnecessary. Looking the English version directly, one may say that banks don't need to register the contract in the appropriate office. The Amharic version clears this ambiguity.

Generally, In most developing countries, the court system are insufficient, slow and follow protracted procedures that result in unreasonable delays in issuing judgment and their enforcement<sup>112</sup>. Taking this in consideration, the above mentioned laws are making it easy for banks to recover their loans

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<sup>110</sup> Article 2, Civil Code as Amended Proclamation No. 639/2009, Federal Negarit Gazeta, No. 46, 30<sup>th</sup> June, 2009.

<sup>111</sup> In practice, Document Authentication and Registration offices are responsible to conduct the function. They evaluate the consent of the parties, their capacity and other related elements

<sup>112</sup> Shihata, I., The World Bank in a Changing World: Selected Essays and Lectures, Vol.II, Martinus Nijhoff Publishers, Dordrecht, 1995, Chapter 4

### 3.3.1 Foreclosure Law

In previous years before the issuance of the Foreclosure Law, banks in Ethiopia used to resort to courts as a recovery mechanism. This mechanism proved to be inefficient. Recognizing this inefficiency, Ethiopia has issued a law which deals with property mortgaged or pledged with banks. Proclamation No. 97/1998 is issued aiming to achieve different objectives. The objectives include avoiding long time it takes to obtain judgment, from the court of law, for sale of property mortgaged or pledged with banks, avoiding problem in execution of judgments and avoiding its adverse effect on public money received by banks by way of saving deposits or acquired from other sources<sup>113</sup>. Furthermore, the law is expected to create conducive environment to economic development by enabling banks to collect their debts from debtors efficiently and there by promoting a good business culture.

The power of banks to sell the mortgaged or pledged property emanates from lending agreements. A loan agreement must be just and equitable to lenders as well as borrowers. Bankers must feel confident that the provisions in the loan agreement will afford them adequate credit protection and give them power to exert influence over borrowers, or control over a loan if necessary. For example, if the bank was in an unsecured position it would insist on including restrictive covenants into the loan agreement to protect itself. If a bank was aware that a corporate borrower has had a doubtful past record or there are material doubt related to the loan, it may want the right to control the loan tightly. On the other hand, a borrower company may consider this unwanted intrusion into management's freedom to run the company. Nevertheless, it is the price to pay to obtain a

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<sup>113</sup> Preamble, Property Mortgaged or Pledged with Banks, Proclamation No. 97/1998, Federal Negarit Gazeta, No 16, 19<sup>th</sup> February, 1998.

loan<sup>114</sup>. Borrowers must not also feel vulnerable because of their inability to stop lenders from doing what they want. In developed systems of law, there are a number of ways in which transactions that are unreasonable may be nullified.

When a loan agreement is being drafted, the covenant must be designed to achieve at least three objectives of lenders. First, in addition to repaying the loan, a bank must commit the borrower to obligation such as providing financial information regularly to the bank, undertake not to dispose of its assets, or change its business activities. Second, the covenants must put the lender in a strong position in the event of default. The bank must have the right to terminate the agreement, and where relevant, be released from providing further loans that were agreed. Third, they must enable lenders to recover the money when defaults occur without difficulty, preferably without recourse to court<sup>115</sup>.

Under Article 3 of the Proclamation No. 97/1998, an agreement authorizing a creditor bank with which a property has been mortgaged or pledged and whose claim is not paid within the time stipulated in the contract, to sell the said property by auction upon giving a prior notice of at least 30 days to the debtor and to transfer the ownership of the property to the buyer, shall be valid<sup>116</sup>. This is an exception to the general rule provided under Article 2851 which prohibits an agreement authorizing creditor, in the event of non- payment on the due date, to take possession of the pledge or to sell it without complying with the formalities required by law<sup>117</sup>.

The sale made by the bank is considered as a sale made on behalf of the debtor creating an agent- principal rights. Ethiopia's debt recovery law requires banks to be subject to

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<sup>114</sup> George G., Supra Note 29, p. 82

<sup>115</sup> J. Day, , and P. Taylor, , Bankers' Perspectives on the Role of Covenants in Debt Contracts(1996), 11 Journal of International Banking Law 203

<sup>116</sup> Article 3, Supra note 113.

<sup>117</sup> Article 2851, Civil Code of the Empire of Ethiopia, Proclamation No. 165 of 1960, Negarit Gazeta, 19<sup>th</sup> Year, No. 2, 5<sup>th</sup>, May, 1960.

procedural laws to execute their right of debt recovery. Banks follow different modes of execution provided under Articles 394- 449 of the Civil Procedure Code in exercising their power of selling the mortgaged or pledged property by auction. The bank is liable for any damage it causes to a debtor in the process of selling by auction without following the procedural laws<sup>118</sup>.

In general, when a loan goes bad, it is too late to think about the causes of default, and lenders are then faced with the task of recovering the loan and the interest. The debt recovery laws needs to provide lenders with effective mechanisms to recover debts.

### **3.3.2 Write- off**

In Ethiopia, banks could write- off their NPLs from their balance sheet. This method is employed when the likelihood of recovery becomes remote. As a result, National Bank of Ethiopia issued a guideline for banks to help settle outstanding loans in time following a specified set of rules and improve the financial management of a bank. The guideline will be used as a last resort after reasonable efforts are made to collect receivables.

Under part 8 of the guideline, banks should make reversal entries when a physical asset once written off is reinstated. It further states that departments should initiate and take the necessary actions if there exists a possibility of recovering a written off item. The departments are those departments which issue the proposal for write off. But in any time, if they see an opportunity for recovery, they are required to take the necessary actions. The decision to write off a debt is made by the governors or the board of directors of a bank. In order to do so, there should be different evidential support. The evidential requirements provided under the guideline include:

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<sup>118</sup> Article 7, Supra note 113.

- A court decision for insolvent or bankrupt organizations.
- Government decision or court ruling for liquidated or closed down organization.
- Letters produced from Kebele, Municipality and transport offices for absence of any attachable or other property.

After the decision to write off is taken, if there is recovery, then reinstatement is required to be made in the balance sheets of banks. Accordingly reinstated written off amounts will be used to credit the uncollectable account.

During debt recovery, there is a chance, that due to different reasons such as the existence of the interest of third parties, the case will be held in court procedures. In such cases, the parties are obliged to follow substantive as well as procedural laws of the country. The same is true in Ethiopia.

### **3.3.3 Court Auction**

Court auction is another debt recovery method undertaken by courts. Banks use this kind of asset disposal method for non- loan cases (i.e. credit extended on clean bases and credit extended on personal guarantees or when the security held is not enough)<sup>119</sup>. In this process, the court orders the attachment of the property of the judgment debtor from transferring or charging the property with any right in rem.

According to Article 422 (2) (a) of Ethiopian Civil Procedure Code, execution of a decree for the sale of immovable property will be conducted by the officer of the court. The court may sometimes appoint an auctioneer. The court is also not prevented from

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<sup>119</sup> Samson Assefa, Non- performing Loan Resolution: Prospects and Possibilities in Ethiopian Institutional and Legal framework, Unpublished, P. 16

authorizing the sale by private contract at the request and with the consent of judgment debtor.

There are certain procedures the court follows in making the sale, the first procedure is that the court will cause publication (“proclamation” as written under the Code) of the intended sale be made (Art. 423(1)). The law further under Art. 423 (2) states that such publication shall be drawn up after notice to the decree-holder and the judgment-debtor and shall state the time and place of sale, and specify as fairly and accurately as possible:

- (a) the property to be sold and the estimated value thereof;
- (b) any encumbrance to which the property is liable;
- (c) the amount for the recovery of which the sale is ordered;
- (d) the terms and conditions of the sale and manner in which and time within which the purchase price shall be paid; and
- (e) every other thing which the court considers material for a purchaser to know in order to judge the nature and value of the property<sup>120</sup>.

The court has the power to auction properties in conducting execution for its own judgments. Banks use this procedure in situations where there is no security or when they have clean base loans or when the security they hold is not enough to cover all the debt plus interests.

In general, the legal frameworks discussed above are designed to make the control as well as the recovery of NPLs easy. The next part of the paper will discuss the practical problems faced in recovery.

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<sup>120</sup> Article 423(2), Civil Procedure Code of the Empire of Ethiopia, Decree No. 52 of 1965, Negarit Gazeta, No. 3, 28<sup>th</sup> October, 1965.

## **CHAPTER FOUR: Legal Problems Faced in Resolution of Non- Performing Loans in Ethiopia**

### **4.1 Analysis of the Problem**

As they are in the business of risk management, at times, banks in their operation are bound to confront a period of financial instability due to the derivative risk of their borrowers. The ever- present economic cycle of boom and recession makes the NPL problem perennial to the industry. But, admittedly, sometimes this problem may go out of hand unless due care is exercised before it is too late<sup>121</sup>.

Loan transaction may be secured or unsecured. Lenders will be prepared to grant unsecured loans if the creditworthiness of borrowers sufficiently assures that the loan will be repaid. Most lenders in developing countries however, do not lend without security. Lending institutions demand security as a pre- condition to the granting of credit irrespective of the risk involved<sup>122</sup>.

The resolution of NPL in any country requires both strong legal and financial frame work. Appropriate legislation alone would not create an environment conducive to business activities. Laws are only as good as the institutions that enforce them. It is vital therefore; the courts and other organs are responsible for enforcing the laws and resolving disputes expeditiously<sup>123</sup>. Judges should take an active part in interpreting the law when obvious deficiencies in the laws are seen. It is also vital that disputes can be resolved with the minimum delay and at a reasonable cost, and that enforcing judgments are smooth and

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<sup>121</sup> Flesig, H, Supra note 104, p. 1

<sup>122</sup> Supra note 24, p.211

<sup>123</sup> Blaz, M., and Schiffman, H., *Insolvency Law Reform for Economies in Transition: A Comparative Law perspective*, Butterworth Journal of International Banking and Financial Law, 1996, pp.19-26, 65-72

effective. Equally important are those institutions that are involved in the process of NPL resolution.

If the business laws of a country are not market friendly and the law enforcement agencies are inefficient, business costs such as transaction costs to arrange, monitor and enforce contracts would be high<sup>124</sup>. Litigation costs would inevitably rise. Where inefficiency exists, uncertainty prevails, and in such an environment prudent decision making, which is vital to business activities would be difficult.

De Soto observes,

*Basically, what property rights, contracts and extra contractual liability do is reduce uncertainty for people who want to invest their labour or capital in the development of existing resources... In any country, uncertainty or legal instability reduces the volume of long –term investment and investment in plant and equipment. People save less and invest the little they do save in such socially unproductive goods as jewellery, gold, or luxury property...The less costly the transaction and the more secure the right to enjoy the fruits of the investment, the greater the real value of an economic activity. A law that is efficient in dealing with these elements will encourage people to identify and seize existing opportunities and will systematically increase the value of economic activity<sup>125</sup>.*

It is therefore important, not only to increase equity in the society and raise productivity, but also to ensure that the legal system is efficient and legal costs are moderate.

In Ethiopia, as discussed before, different legal frameworks are in place to facilitate the debt recovery process. To study the legal problems in resolution of non- performing loans, different private and public banks were visited and interviews were conducted. The results found are discussed under this part.

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<sup>124</sup> Coase, R., *The Firm, The market and The Law*, University of Chicago Press, Chicago, 1988, 114-119

<sup>125</sup> De Soto, H., *The other Path*, Harper and Row Publishers, New York, 1989, 181- 183

## 4.2 Foreclosure Blocking Order by Courts

Despite the fact that under the Civil Code Article 3059(1)<sup>126</sup>, banks have a priority of claims, courts at times issue a blocking order to the registrar on the mortgaged and pledged properties based on the petition of third party creditors<sup>127</sup>. These third party creditors may have contractual or extra contractual claims against the borrower.

The problem starts when a bank begins foreclosure procedure. Third parties without confirming their priority right or without any priority sue the banks as well as the borrower in a court of law. The court then orders blocking order without evaluating the circumstances. Such situations lead to long and unnecessary litigation process resulting in depreciation of the value of the property. Though most decisions in such circumstances are made in favor of the banks, the litigation process takes time and involves banks in costly procedure<sup>128</sup>.

The effects of court blocking/injunction involve the following

1. Due to the fact that the foreclosure is blocked, the asset value of the security reduces from time to time.
2. As the interest over the debt increases, it will reach very high amount rendering it difficult to get full recovery.
3. It will jeopardize the interest of other third party creditors who will get the return amount from the foreclosure.
4. If the blocking order is given without any warranty, the borrower makes the property disappear or diminish parts of it.

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<sup>126</sup> Article 3059(1) states that "Where the immovable mortgaged is attached by the creditors of the mortgagor, the mortgagee may demand to be paid, out of the proceeds of the sale of immovable, in priority to any other creditor."

<sup>127</sup> Interview with Ato. Desta Denka, Manager, Debt Recovery and Foreclosure Division, Awash International Bank

<sup>128</sup> See reports by Ethiopian Banks Association, Hawassa, 2009.

5. Unnecessary cost and time of the lender as well as the court will be spent.
6. The capacity of the banks to lend will be weak due to high NPL.

Due to court blocking orders the execution of Proclamation No. 97/98 will be delayed giving borrowers a reason to default. If borrowers don't feel that the laws are being implemented, they will use it as a method of getting away. It is clear that the problem encountered by lenders cannot be resolved only by enacting effective laws. There is a vital need to provide suitable training to judges who deal with commercial cases<sup>129</sup>. In addition, the administrative staff in the courts and offices must be aware of the new procedure, and made to comply with the procedures set out in the new debt recovery laws. It is equally important to encourage the members of the legal profession to act in the spirit of the enacted reforms.

### **4.3 Problem between banks and courts regarding power to auction**

Courts handle public auctions based on Articles 394 - 449 Civil Procedure Code. In a situation where the judgment debtor cannot satisfy the claim of judgment creditor, the next process is attachment of properties by the order of the court. In such circumstances, the court tries to sell the property using public auction. During this process, the banks raise their objection claiming that the property is held as a security and that the court should allow them to handle the auction based on Property Mortgaged or Pledged with Banks Proclamation No. 97 of 1998.

The Ethiopian Civil Procedure Code states that without prejudice to the provisions of the following articles every decree for the payment of money including a decree for the

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<sup>129</sup> Third Interim Report of the Committee on Debt Recovery Legislation, Government printing Department, Colombo, 1992, xi

payment of money as the alternative to some other relief may be executed by the attachment and sale of the judgment debtor's property<sup>130</sup>. Where any claim is preferred to, or any objection is made to the attachment of, any property attached in execution of a decree on the ground that such property is not liable to such attachment, the court shall proceed to investigate the claim or objection with the like power as regards the examination of the claimant or objector, and in all other respects, as if he was a party to the suit: provided that no such investigation shall be made where the court considers that the claim or objection was unnecessarily delayed<sup>131</sup>.

Article 420 of Civil Procedure Code gives the court the right to sell the attached property taking into consideration such mortgage right or right *in rem*. It states that where the court is satisfied that the property is subject to a mortgage or right *in rem* in favour of some person not in possession, and thinks fit to continue the attachment, it may do so, subject to such mortgage or right *in rem*.

Though banks want to foreclose the properties which are held as security usually courts foreclose the property by registering the bank as a secured creditor with first priority rights<sup>132</sup>. The problem with regard to court foreclosure relates with:

1. The estimated asset values of the property by the courts are usually less in amount because they only evaluate the construction cost. They don't give regard to location value of the property<sup>133</sup>.
2. When courts hold the auction by setting minimum value of the asset, they don't usually allow banks to participate.

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<sup>130</sup> Article 394, Supra note 120.

<sup>131</sup> Article 418(1), Supra note 120.

<sup>132</sup> Shihata, Supra Note 112

<sup>133</sup> Interview with Ato. Desta Denka, Manager, Debt Recovery and Foreclosure Division, Awash International Bank

In a case where Awash International Bank is involved the judgment debtor is Ato Gutu Ejeta and the judgment creditor is MISROY International P.L.C. The Federal First Instance Court observed that:

*Courts recognize the power of banks to foreclose properties they held as securities. But in a situation where the Judgment Creditor started execution process and the foreclosure order is already given by a court, there is no law that prohibits courts not to handle foreclosures. The only effect of deciding otherwise will be delay. The fact is that the procedural law both banks and courts use in foreclosing the property are the same. This court does not see any reason to stop the foreclosure process and give it to the bank. The court doesn't believe that the outcome will be any different whether it is auctioned by the bank or the court<sup>134</sup>.*

Based on the stated reasons the court did not accept the appeal by Awash International Bank. The decision of the First Instance Court has been confirmed by all upper courts including the Federal Cassation Court. Though the bank is registered as the first creditor, the estimated asset value of the property by the bank and the court is different (It is important to note here the estimated value of the asset by the bank is much higher than the court). If so, can the bank participate in the auction?

In such situations, the First Instance Court observed that:

*... Basically, the fact is that if the auction was going to be undertaken by the bank, the bank could not participate in it. The court doesn't have any reason to think that the involvement of the bank in the auction will be important neither to the interest of the debtor nor to the public in general. It seems that the question of the bank to take part in the auction emanated from profit making intentions rather than debt recovery. Courts auction the property based on the current market value of the property...<sup>135</sup>*

The court decided that banks cannot participate in the auction regardless of its claim.

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<sup>134</sup> Awash International Bank v. MISROY International P.L.C, case no 89612, 2001

<sup>135</sup> Ibid

The effectiveness of security can be measured by the extent to which it can be enforced expeditiously, and the cost involved. These circumstances, which are discussed above, affect banks that are unable to cover their debt in full. Though in different laws auctioning power is given both to banks and courts, the purpose for governing financial institution in different procedure is aimed at serving their vulnerable status to overall economy.

As Mather observes:

*Security is taken as an insurance in case of need and it must always be remembered that the test of any sound insurance is that it should be available readily realizable and sufficient when required. Nothing is more disconcerting than to find that the security taken as an insurance against the unexpected is inadequate or cannot be realized when it is most needed<sup>136</sup>.*

In Ethiopia, banks need to feel that the securities they hold are readily available to recover their loans. Debt recovery helps banks in many directions especially as banks are required to make provisioning for unreturned amounts. To this effect, the power given to them in Proclamation 97/1998 has a vital role. In a situation where the debtor sells the property, banks have the right to follow the property based on their right in rem but what are their fates when the property is sold by court? This question is not answered by any of our laws. Though most of the time they take the money as first creditors, this is the question that remains unanswered.

The law also does not regulate the criteria to be followed in fixing the minimum amount of the asset to be auctioned. Because of that the estimation between the banks and the courts differ.

#### **4.4 Lack of Criteria regarding fixing the Minimum Asset Value**

Security takes many forms, but can usually be categorized in one of two ways. First, it may be either direct (provided by the borrower) or indirect (provided by a third party).

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<sup>136</sup> L. Mather, Securities Acceptable to the Lending Banker, Waterlow and Sons Ltd, London, 1960, p.1

Second, it may give either a legal or an equitable title. Both forms of title provide the bank with an interest in the property subject to the beneficial owner's right to redeem (that is, recover) the security by, for example, repaying the loan. Where it has legal title, the bank has the right to sell the security if the customer defaults. Where it has equitable title the bank obtains such a right by applying to the court<sup>137</sup>.

A charge by deed by way of legal mortgage creates a direct, and either legal or equitable, claim over the asset or class of assets referred to in the deed, subject to the mortgager's right to the equity of redemption (that is, to redeem the mortgage by repayment)<sup>138</sup>.

In realizing the mortgage property, one of the main things to be handled by the bank is fixing the value of the asset to be sold by auction. In Ethiopia, the substantive law as well as the procedural law is silent about the criteria to be followed by banks in fixing the price of the asset to be auctioned. It is possible that banks may fix a nominal amount so that the bank is assured of recovering its dues. Under European Asset Valuation Guide, some criteria to be used are provided<sup>139</sup>. These include:

- Market value: Market value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.
- Sustainable net asset value which is the value that an asset may be expected to achieve or maintain over the long term and

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<sup>137</sup> Supra note 13, p.p.227,228

<sup>138</sup> Ibid

<sup>139</sup> European Mortgage Securitisation: A Valuer's Guide, *TEGoVA, November 2002*.

- Mortgage Lending Value: Mortgage lending value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property.

In addition to the above mentioned basic criteria's, the type of property, the location of the property, the building structure and equipment and the condition of the property should be taken in consideration. Issuing this kind of valuation guideline will help the existing problems.

Where immovable property is to be sold, banks have the right to sell the property. The sale procedure involves different actions. The law is silent first, with regard to the fact that whether eviction should be made before or after the auction is handled. Second, as to the procedures a bank should follow in taking the property.

In practice, different banks use different procedures. Some evict the owners before the auction is made and some banks after the auction is made. In some cases, debtors provide objection saying that the bank's nominal value for the property is not fair. Due to the lack of these procedures and lack of a law which provides for guidelines to fix the value, most borrowers feel vulnerable. It also opens a gate for corruption.

#### **4.5 Issue of Successive Auction**

Under the foreclosure law, banks are given the power to auction properties. Per the Property Mortgaged or Pledged with Banks (Amendment) Proclamation No. 216/2000 and as per the Civil Procedure Code Arts 394-449, the practice is that property will be

posted only two times and if there is no bidder in these auctions, the bank would receive the property at the estimated value.

The Amendment Proclamation provides that: "... or if no buyer appears at the second auction, to acquire the property at the floor price set for the first auction and have the ownership of the property transferred to it<sup>140</sup>."

The rationale for limiting Public Auction is to protect the interest of debtor who would suffer from first, defraying expenses for successive auction. Second, from further accumulation of interest in their defaulted loan (i.e. normal and penalty) third, from economic opportunity loss of the detained property without any service and mostly without maintenance<sup>141</sup>.

With regard to the law, there are two gaps that can be seen:

1. The law does not govern or does not give any direction what should be done if banks are not interested to receive the property by estimated value.
2. There is no specific time that is provided under the foreclosure law regarding how much time banks can spend without issuing the second auction. Lack of this time limitation resulted in accumulation of interests on the debtor or the heirs in case of death of the debtor.

In *Ethiopian Commercial Bank V. Wro Tesfalem Agegne and others*, the Federal Cassation Court provided interpretation with regard to issues involving the lack of time limit in auctioning and also on the issue of whether banks are obliged to take the property after they issue the second auction.

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<sup>140</sup> Article 2, Property Mortgaged or Pledged with banks (Amendment) Proclamation No. 216/2000, Federal Negarit Gazeta, 6<sup>th</sup> year, No. 46, 6<sup>th</sup> July, 2000.

<sup>141</sup> Flesig, H, *Supra* note 107

The Federal Cassation Court has given decision on two core points. The first issue is that can third party guarantor or a person who give his property guarantying the debt of another require banks to foreclose the property? And the second issue is that, is there any legal base for debtor to claim the reduction of interest by banks for their lateness in realizing their debts?

The court has given the following interpretation regarding the two issues:

*Based on the legal provisions on contracts, one of the cases where a debtor is relieved from his/her duties is in the circumstance where he/she fully discharged their obligations under the contract. If the debtor did not discharge his/her obligation, any claim regarding a security should be made by the creditor not the debtor. The creditor has the right to claim or make sale of the securitized property, but not the debtor for his/her own obligation. As the heirs of the debtor also succeed his debts as well as his assets, they only have a right to the extent of the right of the debtor. Because of that there is no legal base neither for the debtor nor the heirs to require the sale of the property held as security by the bank to be relieved from their obligation. The other relates with the relation between the guarantor and the bank. The relation between the bank and the guarantor emanates from suretyship contract. The question is can the guarantor require the creditor to sell the property and be relived from his/her obligation? The court investigating the appropriate laws applicable in this kind of situation as well as the proclamations on Property mortgaged and pledged with banks, could not find any legal base for the guarantor to pursue banks to realize the securities<sup>142</sup>.*

The court further gave decision on the issue that whether the banks are obliged to take the property if no buyer appeared after the second auction. The court decides that the proclamations on foreclosure only gave the courts the right to issue two auctions but do not limit them only to the two auctions and that they are not obliged to take the property even after the second auction. So basically the choice is left for the banks under the law.

When we see the decision of the court, it has more implication in practice and raises many questions. First, if all power to decide on how many foreclosures should be

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<sup>142</sup> Ethiopian Commercial Bank V. Wro Tesfalem Agegne, Federal Cassation Court no.15711, 1999

conducted is left to banks wouldn't that delay the debt recovery procedure as banks may prefer only that method? Second, if banks are not obliged to take after the second auction, what alternative methods does the law provide for banks to realize their securities thus enabling quick recovery?

When one sees it from the debtor and other creditors' point of view, giving this much flexible right to the creditor bank will jeopardize their interest. This is because both the debtor and other creditors' have to wait until the bank realizes its debt to be relieved from obligation and to satisfy their claim respectively. From debtor point of view, the interest is increases as time goes by. This results more obligation to the debtor. Banks should not be reluctant to realize their NPL. To make sure that they realized their security timely and appropriately, auctions should be restricted.

The above raised questions are not governed in a strict manner under Ethiopian debt recovery laws for banks. The Civil Procedure Code under Article 428(2) implies that the court will stop on the second auction. It states that where no bidder presents himself at the second auction, the court *may*, notwithstanding any provision to the contrary, authorize the decree-holder to take possession of the property ordered to be sold at its estimated value in full or partial satisfaction of the decree, as the case may be<sup>143</sup>. Though this is not obligatory, the practice in most cases is two auctions taking in to consideration the above mentioned importance of limiting public auctions.

In relation to foreclosure, the law does not authorize the bank to fix an "upset price" below which the property cannot be sold to any other person other than the bank to which the property is mortgaged. Rather based on the Civil Procedure Code, the second auction is going to start at zero and is going to be sold at any amount.

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<sup>143</sup> Article 428(2), Supra note 120.

According to Article 428 (1) of the Civil Procedure Code:

*Where the highest bid at a sale by auction does not reach a sum equal to the value specified in the proclamation in accordance with Article 413 (2) (a), a second sale by auction shall be held after the issue of a fresh proclamation in the manner and within the time specified above and the sale shall thereafter be effected to the highest bid, whatever its amount<sup>144</sup>.*

If banks apply this provision, both the interest of the banks and the borrower will be in jeopardy because the sale may not cover the debt of the borrower. As a result, some banks even without authorization from a court, participate in the auction<sup>145</sup>.

There needs to be a procedural law which covers the gaps regarding the auction procedures. Though, customarily banks do not sell the property as a fresh at the second auction, there is no legal base for them to do so.

#### **4.6 Problem in relation with Executive Bodies**

The existence of different laws or amending the existing legislations on their own could not provide long lasting solution to debt recovery. Rather supporting the laws with effective institutions are important. Changes to improve the administration of the courts and fiscal offices, government registries for immovable properties and motor vehicles and the registrar of companies are essential. Problems in debt recovery can be attributable to deficiencies within executive institutions<sup>146</sup>.

Under Property Mortgaged or Pledged with Banks Proclamation No. 97/1998, registrars are given the power to take the necessary measures. Article 8 of the proclamation provides that:

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<sup>144</sup> Article 428 (1), Supra note 120.

<sup>145</sup> Interview with Ato Merawy Tadesse, Senior Attorney, Abyssinia Bank.

<sup>146</sup> De Juan, A., from Good Bankers to Bad Bankers: Ineffective Supervision and Management Deterioration as Major Elements in Banking Crisis (Unpublished) Washington DC, 1987.

1. *The registrar shall have the powers and duties to take the necessary measures for carrying out the sale by auction.*
2. *If the registrar, while taking action in accordance with sub- article (1) of this article, finds it necessary to use police force, he may order police.*

The necessary measures in relation with auction to be handled by the registrar include:

- To seize motor vehicles which are subject to auction
- To avoid any chaos in relation with order to auction, and
- To give order for valuation of the asset.

But in practice, the executive bodies that are responsible to handle such cases, are usually falling short of action. This fact is creating a big problem to realization of non-performing loans. According to report by Ethiopian Banks Association, registrars, especially in regions, do not understand and accept their responsibilities under the proclamation<sup>147</sup>. Furthermore, registrars are mostly reluctant to provide information for a bank which is the first registered creditor when a property is attached by courts.

In Ethiopian Development Bank v. Wro Jemila Yesuf and Adama town municipality registrar<sup>148</sup>, due to the failure of the registrar to execute its duties, the bank has to file a suit in a court of law. The Federal Supreme Court ordered the registrar to execute its duties accordingly specifying their duty under Proclamation No. 97/1998. The failure of the registrars, according to the report by Ethiopian Banks Association, usually emanates from not understanding their power which is provided under the law or their interpretation in different way.

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<sup>147</sup> See reports by Ethiopian Banks Association, Hawassa, 2009.

<sup>148</sup> Ethiopian Development Bank v. Wro Jemila Yesuf and Adama town municipality registrar, Federal Supreme Court, File No. 391999, 2001E.C.

Because of that, banks usually spent more time trying to get the registrar execute its duties. The registrars require court orders to act and do not accept the request of banks. This is usually aggravated in regional cases<sup>149</sup>. It is, therefore, important to create legal awareness not only within the bank staff but also to other institutions involved in debt recovery process such as the registrar and the police.

#### **4.7 Financial Guarantee Bond**

Customarily, Ethiopian banks give loans by holding financial guarantee bonds as security. Though there was no law which authorizes insurance companies to guarantee using this kind of bonds in Ethiopia, it has been customarily conducted. The National Bank of Ethiopia after 2004 prohibited insurance companies from issuing such bonds.

There are still cases pending in the Federal Cassation Court regarding the issues of financial guarantee bond provided by insurance companies before 2004. Banks have been giving loans to borrowers by holding financial guarantee bonds as security for repayment. The bank and insurance companies have agreed in writing as to insurance of a debt.

The National Bank of Ethiopia issued a directive regarding the issuance of financial guarantee bond. According to Article 1(1.3) of Directive No. SIB/24/2004 financial guarantee bond mean a bond payable on demand issued by an insurance company obliging such insurance company to pay to a lending bank or another creditor or supplier all outstanding claims arising from non- payment by principal debtor or debtors<sup>150</sup>.

The issuance of financial guarantee bond by the insurance companies has left both the banks and the insurance companies in jeopardy. This is because there is no law which

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<sup>149</sup> Interview with legal officers in NIB International Bank, Awash International Bank, Abyssinia Bank, Commercial Bank of Ethiopia, Development Bank of Ethiopia and Wegagen Bank.

<sup>150</sup> According to article 1(1.3) of Directive No. SIB/24/2004

governs such kind of securities. Though the insurance companies in Ethiopia used to offer Financial Guarantee Bonds as one of their products to cover losses that may arise as a result of failure of an obligor to settle its financial obligations, it has found to be difficult to implement.

Unless and until comprehensive law regarding financial guarantee bond is issued, the issuance of the directive is appropriate. But the question remains what is the fate of already signed Financial Guarantee Bonds?

There are different amount of NPL in banks guaranteed by this kind of bond and they are involved in litigation with the insurance company. The cases are yet to be decided by the Federal Cassation Court.

In general, investment in any sector requires the availability of credit system to investors and greater protection to banks with regard to the past practices which left them in lengthy court procedures. As most cases are pending decision in Federal Cassation Court, the author could not say much on the cases at hand. But one thing is clear, our credit system is mostly based on the availability of physical collateral and the practice with regard to Financial Guarantee Bond will benefit many capable borrowers if and only if legal protection is given to both the banks and insurers.

#### **4.8 The issue of Subrogation**

Subrogation refers to a situation where one person is substituted in the place of another with reference to lawful claim, demand or right, so that he who is substituted succeeds to the right of the other in relation to debt or claim, its rights, remedies, or securities. Under Ethiopian civil code subrogation is governed in Articles 1968 – 1974 and Article 3083.

The discussion above is raised to see the practice and the decision taken by Federal Cassation Court regarding subrogation. In United bank v. Abyssinia bank, the Federal Cassation Court investigated different issues with regard to subrogation. The fact of the case shows that Ethiopian commercial bank and Abyssinia bank have lent to Demise investment P.L.C as a first and second creditor by securing the debt with property of the borrower respectively. United bank has lent money to Demise Investment P.L.C which is used by the latter to pay the debt of Commercial Bank of Ethiopia. The lending agreement between United Bank and Demise Investment P.L.C did not show the money is borrowed for the purpose of paying the debt. Regardless of that, United Bank has received the title deed of the property from Commercial Bank of Ethiopia. The claim by United Bank is that, they are subrogated in the place of CBE by paying the debt. Whereas Abyssinia bank claims that United Bank cannot be subrogated because the contract did not fulfill the requirement of the law with regard to subrogation.

Based on these facts, the Federal Cassation Court investigated different issues. The issues are:

1. What are the provisions of the law regarding subrogation and the interpretation thereof?
2. What requirements should be fulfilled for a third party to be subrogated in the place of a creditor?
3. Can Article 3083(1) of the Civil Code be interpreted to prohibit subrogation under Article 1968(1)?
4. What is the effect of such subrogation on other successive creditors?

The court has investigated Article 1968- 1974 in rendering decision in the case. The law provides three ways in which subrogation could be effected. These are:

1. Subrogation by creditor- this is a case where a creditor who is paid by a third party subrogates him to his rights. Subrogation by the creditor should be express and effected at the time of payment.
2. Subrogation by debtor – Subrogation by the debtor implies that the instrument evidencing the loan bears an authenticated date and that the use of the sum lent is expressly specified therein. The receipt for the loan shall bear an authenticated date and include an express statement that the payment was made by means of the borrowed money.
3. Legal Subrogation – Subrogation to the rights of the creditor shall take place by virtue of the law to the extent of the amount paid.
  - a) for the benefit of any person who, being bound with the others or on behalf of the others for the payment of a debt, discharged the debt and is there by entitled to indemnity or contribution from his co-debtors; and
  - b) for the benefit of any person who, being owner of a property or enjoying over it a right of lien, mortgage or pledge, paid a creditor who enjoyed over the same property right of lien, mortgage or pledge; and
  - c) whenever the law so provides.

The court observed that:

*United Bank claimed its subrogation with the consent of the first creditor. Accordingly the relevant provision is Article 1968 of the Ethiopian Civil Code. The law states that where a creditor who is paid by a third party may subrogate him to his rights. Subrogation by the creditor should be express and effected at*

*the time of payment. Here the question to be raised is how could a person show that there is express consent of subrogation by creditor? The intention of this provision is that the way the creditor express his consent should be in such a way that the debtor and also other creditors could understand and see the subrogation. It does not require it to be in writing. In this case, CBE has given the title deed to United Bank which shows its express consent to subrogation.*

*With regard to Article 3083(1), it states that any mortgagee may pay a creditor having the priority with the consent of the creditor, or where the immovable attached on the latter's request, without such consent. This shows that any successive creditor can be subrogated in the place of a creditor in priority only when the consent of the first creditor is secured. In our case the choice is left to CBE (whether to use Article 3083(1) or 1968) even if Abyssinia Bank requests so. But the fact shows that Abyssinia Bank did not provide any request to CBE to pay the debt. So we don't see any reason why other third party could not be subrogated. In addition, as Abyssinia bank is a second creditor even before such subrogation, there is no damage it incurs as a result because if CBE satisfies its claim against the debtor by foreclosure, they still only have a right as a second creditor on the property...<sup>151</sup>*

When we see the articles written by Associate professor Tilahun Teshome on subrogation by the creditor, it shows that subrogation by creditor can be made when two circumstances are fulfilled. First, when there is express intention by creditor. According to the article, this doesn't mean there should be different contract to be concluded as regards to subrogation or that it should be in writing in a strict manner. But as any contract made with no written agreement, it will be difficult to prove subrogation when not expressed in writing. Second, Subrogation should be effected at the time of payment. Subrogation cannot be made after payment. Unless otherwise provided, subrogation is presumed to be made at the time of payment when the payment and subrogation is concluded in the same document. The rule that subrogation cannot be made after payment emanates from the principle of payment itself. Payment refers to discharge of obligation.

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<sup>151</sup> United Bank V. Abyssinia Bank, Federal Cassation Court, File No, 39778 (interpretation by the researcher) Unpublished.

Making subrogation after payment is validating (giving life) to a contract extinguished by payment<sup>152</sup>.

From the above decision we can see that the court did not see when the title deed is transferred to United bank. It did not give any decision whether the payment and subrogation is concluded at the same time. Rather the court concentrated on interpreting the term “expressed” and did not address the second requirement.

Generally, banks will lose a lot of money on this kind of decisions. If the debtor borrows the money, the bank could not get the appropriate information on time in credit information sharing. Rather banks will lose confidence to give credit as a second or third creditor, even though, they believe it is possible to do so.

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<sup>152</sup> See የኢትዮጵያ የውል ሕግ መሠረተ ሀሳቦች, ተባባሪ ንግድና ጥላውን ተሾመ, 2ኛ ዕቅድ አዲስ አበባ 1995 ዓ.ም.

## **CHAPTER FIVE: Conclusion and Recommendations**

### **5.1 Conclusion**

Economic development needs to be a dynamic process. Most nation states seek to enhance the welfare of their people by following development process that is designed to achieve specific goals that accelerate the economic growth of their countries. Countries chose different legal and judicial infrastructure mechanism to achieve their goals to economic development. This legal and judicial infrastructure should place an effective financial structure in a country.

Financial system of a country should concentrate on banking lending activity, which is the main stimulus of money circulation. Banks ability to lend to potential borrowers is very important to strengthen investment. But this lending activity is not without risk. There is always a risk in which loans become non- performing. Non- performing loans have been defined by different scholars as defaulted loans which banks are unable from. They are 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.

The criterion for identifying non- performing loans varies in different countries as they are determined in respective laws of a country. Some countries use quantitative criteria to distinguish non- performing loans such as the number of days elapsed from scheduled payment, while others relay on qualitative norms including the availability of information about the client's financial status. In Ethiopia, according to NBE's directive No. SBB/43/2008 article 4(4.9) states that loans or advances with pre established repayment

programs are non- performing when principal and/ or interest is due and uncollected for 90 (ninety) consecutive days or more beyond the scheduled payment date or maturity.

Basically, non- performing loans are the result of the compromise of the objectivity of credit appraisal and assessment. The problem is aggravated by the weakness of the accounting disclosure and legal frame works. Identifying the causes of NPL plays important role in designing credit advancing process and also legal frame works. Most causes of NPL includes reduced attention to borrowers which could be explained as failure of banks to give due attention to borrower's activity with respect to the loan, macroeconomic instability which could be expressed as failure of the overall economy with high inflation rate, unsound assessment of the borrower credit worthiness by lenders and weak risk consciousness and lack of strict admittance polices which is consistent with the lending policies and no active exit procedures designed by banks. These and other causes create high NPL in banking business putting the bank as well as the economy in jeopardy. This is why strong legal support is needed in controlling NPL and ultimately the recovery process. Recoveries are the amounts banks receive from loans employing different method of NPL resolution mechanisms including negotiation, rescheduling, foreclosure, litigation and reinstatement of written off loans.

An essential element of commercial infrastructure is a legal and judicial framework that provides for efficient and prompt debt recovery process. Debt recovery process could be handled by banks themselves or by using the court as a debt recovery mechanism.

In Ethiopia, banks are entrusted with the power to recover their NPLs. But before the recovery process, there are different laws issued by NBE regarding control of NPL. Directive No. SBB 43/2008 provides that banks should have minimum legal provision with regard to different classes of loans. Accordingly, banks are required to have 1%

provision for pass, 3% provision for Special mention, 20% for Substandard, 50% for Doubtful and 100% for Loss.

The directive further requires the board of directors of each bank to establish the loan review control mechanism which will enable the concerned officials to identify certain loans that require extended consideration and others who do.

To make sure that banks are complying according to the laws, regulation and directives of the banking sector, the NBE conducts on site and off site examination and employs different monitoring mechanisms based on the powers given to it by Proclamation No. 592/2008. The onsite examination refers to a situation where the bank sends its officials and auditors to see the activity of the banks. The offsite examination is made based on different annual and quarterly reports provided by the banks to the NBE. Accordingly, banks are duty bound to give report with respect to their amount of dispersed loans, the collected amount, outstanding loans and sector disbursement of the loans.

In addition to the above mentioned NPL controlling legal provisions, there are also different laws with regard to debt recovery. These laws are Property Mortgaged or Pledged with Banks Proclamation No. 97/1998; Court Auction procedural laws, and write off guidelines. Banks are given the power to foreclose any property they held as a security. In doing so, banks follow the auctioning procedure provided under Civil Procedure Code of Ethiopia.

The bank debt recovery process based on the proclamation No. 97/1998 is not without any problem. There are legal as well as institutional problems banks face in trying to foreclose a property. From legal point of view, there are different gaps in procedural laws that banks are finding difficult to comply with. Lack of limitation on the number of public

auction, lack of alternative means banks could use in situation where they are not interested to acquire the property, the procedural law (article 428 of Civil Procedure Code) which orders the second auction to start from zero and lack of criteria in estimation of asset value etc are found to be the major challenges in debt recovery. From institutional point of view, the main problem comes from registrars who failed to exercise their power and duties under Article 8 of Proclamation No. 97/1998. Due to the institutional web of problems, the recovery process is delaying unnecessarily.

Based on this study, it is vital and very important to include and employ the following recommendations with regard to NPL resolution.

## **5.2 Recommendations**

A key driving point that is addressed in the issue of NPL is whether the institutional and legal framework environment gives a way for portfolio resilience and recovery in the banking sector<sup>153</sup>. From the above analytical description, we can see that when the loan becomes NPL, there is a little room for workout because of that bank must always be careful and strengthen risk sensitive credit analysis and appraisal function.

Banks operate in the prevailing macroeconomic environment which includes institution and systems. These institutions and systems more often are influenced by exogenous factors that are in turn influenced by factors that are completely out of the control span of diligent credit risk assessment.

The Ethiopian loan workout mechanism and resolution methods are mostly handled by banks. Though there are different laws with regard to control as well as recovery of NPLs, it is difficult to say they are comprehensive enough.

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<sup>153</sup> Flesig , Supra note 108

As a general recommendation, the establishment of Asset Management Companies (AMCs) to handle distressed assets is found to be important. According to the international practice, Asset Management Companies are established with the sole purpose of managing non marketable collateralized assets. These companies takeover the distressed assets from banks and administer or improve the property until such time the market is improved. Transferring NPLs to an AMC improves the balance sheet of the financial institutions and allows banks to concentrate on its core activities without worrying about managing and recovering NPLs. AMCs can be private when established by banks themselves as a separate entity or public entity when established by government.

In Ethiopia it is possible to establish AMCs. Banks may establish private AMCs for managing their defaulted loans. On the other hand, they can be established by government pursuant to Public Enterprises Proclamation No. 25/1992. They should be accountable for the NBE. AMCs should purchase NPLs from banks based on transparent portfolio rating.

This method of asset disposal has been used in different countries such as Thailand, South Korea and Sweden. Establishing AMCs in Ethiopia will help banks, that have high influence from share holders to attach their property or that acquired dismantled properties, be free of such burden. In addition, time, cost and also conflict of estimation of asset value between borrowers and banks will be resolved as there will be standardized rating.

The practice in Ethiopia shows that there are legal gaps in recovering NPLs. What should be done? is the main question that arise when we see the problems. Especially, the Property Mortgaged or Pledged with Banks Proclamation No. 97/98 does not have its own procedural remedies. It refers them to Civil Procedure Code articles which are issued in 1965. Basically, this creates a problem in present day especially the part with regard to

the second auction procedures. Amendment of the procedural codes should be made with regards to the issue of how and when second auction could be held.

Furthermore, time limit should be provided with regard to when first as well as second auction should be made for the interest of banks, debtors, third party creditors, guarantors and to the overall economy. Lack of legal limitation on the number of public auctions defeats the initial objectives of limiting it. These objectives include protecting the debtor who would suffer from further accumulation of interest in their defaulted loan and from the economic opportunity loss of the detained property. Taking these facts into consideration, the law should provide the number of auctions banks should undertake in strict manner. The law should also establish alternative methods for banks to dispose the assets in a situation where they are not interested to acquire the security. One method for this will be establishing public AMCs.

As discussed in the previous part, lack of criteria for estimating the asset value within the existing market is creating a big problem as objection is raised by the debtor. In addition, in case of court auction in which banks are the first secured creditors, difference could clearly be seen in estimation by court and by officers of the bank. That is why most banks claim to foreclose the property by themselves. To avoid this problem, there should be a clear criteria set in our procedural laws giving due regard to location value, construction cost, and the space of the land of the mortgaged property. Experiences should be taken from European countries in valuation of assets. Furthermore, uniform guidelines as to when and how eviction should be made needs to be governed by procedural laws to be issued or amended.

From institutional point of view, bank staff should have proper training in loan administration and dealing with the problems of borrowers. If the innovative credit

disbursement programs are to be successful, it is essential that bank officers take a leading role. It is therefore important for the bank staff to be aware of the new credit culture that is being promoted in their country. Judges have to be more committed to expanding the judicial process by striking out spurious defenses and ordering trials to be conducted without unnecessary delays. This way the problem Ethiopian banks face in court blocking order will be avoided. As the general counsel of the European Bank for Reconstruction and Development observed:

*[t]here is little point in having well drafted laws...unless such laws are properly enforced by trained lawyers and judiciary...*<sup>154</sup>

It is crucial that the laws and institutions are developed to high standard, so that they are considered as a serious threat by defaulters. In this regard, the role of the concerned registrars in Ethiopia should be given emphasis. The municipality registrar, the motor vehicle registrars (Ministry of Communication and Transportation) and Company registrars (Ministry of Trade and Industry) plays important role in realizing non-performing loans in Ethiopia. Legal awareness training should be given to these organs with regard to their powers and duties under the laws. Police also should involve in these trainings. Independent law regulating the power and duties of the respective institutions and defining their relation with banks should be established to increase accountability and transparency in debt recovery process.

The Federal Cassation Court should in giving decision or in interpreting laws provide a detailed rule on specific issues on hand to avoid future disputes. Decision taken by courts in litigations of debt recovery process or in interpreting any law which is important to the process should involve decision and interpretation of all the elements of the concerned

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<sup>154</sup> J. Taylor, *New Laws, New Lawyers and The EBRD* (1996), *International Business Lawyer* as cited by Sonali Abeyratne, *Banking and Debt Recovery in Emerging Market: The Law reform Context*, 2001.

provision. Especially, as the decision of the Federal Cassation Court is taken as a law in Ethiopia, they should try to cover all the elements rather than a single element. Otherwise, the laws will have a damaging implication to the banking industry. If the decision give analysis of the legal bases in detail including each and every element of a provision, it will help for further use by other courts.

Banks in Ethiopia give loans mostly based on the availability of collaterals i.e. the ability of the borrower to provide adequate collaterals (though sometimes there are clean base loans)<sup>155</sup>. This is a problem by itself; because many capable borrowers will lose the opportunity to realize their aims due to lack of collaterals. This implies that, there should be appropriate legal protection to banks with regard to other forms of securities. Laws on negotiable instrument, investment securities and financial guarantee bonds should be developed to give a chance to banks the opportunity to revitalize their delinquent portfolio in existing environment.

Ethiopia needs to utilize the existing legal professionals with respect to creating legal awareness. There needs to be an institution or law firm which will give consultation on the existing legal frameworks of banking business and lending to investors, traders and the public at large. The government should allow the establishment of private law firms working on this area side by side with the government training sectors. In general, there needs to be comprehensive and developed legal and institutional framework to give solution to the problems in banking sector with regard to NPL resolution.

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<sup>155</sup> Interview with Ato Beyene Alemu, Head, Debt recovery and foreclosure Division, Nib International Bank S.C.

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## **Interviews**

Interview with Ato Beyene Alemu, Head, Debt recovery and foreclosure Division, Nib International Bank S.C.

Interview with Ato. Desta Denka, Manager, Debt Recovery and Foreclosure Division, Awash International Bank S.C.

Interview with Ato Merawy Tadesse, Senior Attorney, Bank of Abyssinia S.C.

Interview with Ato Kurunde Tesgge, Senior Bank Inspector, National Bank of Ethiopia.