



ADDIS ABABA UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS

ASSESSMENT OF LOAN COLLECTION CHALLENGES IN
THE CASE OF DEVELOPMENT BANK OF ETHIOPIA

BY
YOSEF TESFAYE

NOVEMBER, 2020
ADDIS ABABA, ETHIOPIA

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THE CASE OF DEVELOPMENT BANK OF ETHIOPIA**

**A THESIS SUBMITTED TO ADDIS ABABA UNIVERSITY COLLEGE OF BUSINESS
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AWARD OF THE DEGREE OF MASTERS IN BUSINESS ADMINISTRATION WITH
SPECIALIZATION IN FINANCIAL SERVICES**

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ACRONYMS

CIC.....	Credit Information Centre
CRMD.....	Customer Relationship Management Directorate
CSR.....	Corporate Social Responsibility
DBE.....	Development Bank of Ethiopia
FY.....	Fiscal Year
KYC.....	Knowing Your Customer
LAT.....	Loan Approval Team
NBE.....	National Bank of Ethiopia
NPL.....	Non-Performing Loan
PRLRD.....	Project Rehabilitation and Loan Recovery Directorate
SME.....	Small and Medium Enterprise

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STATEMENT OF DECLARATION

I, the undersigned, declare that this thesis is my original work, prepared under the guidance of Temesgen Worku (PhD). All sources of materials used for the thesis have been duly acknowledged. I further confirm that this research has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

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ENDORSEMENT

This thesis has been submitted to Addis Ababa University, College of Business and Economics for examination with my approval as a university advisor.

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ABSTRACT

Development bank of Ethiopia is state owned and specialized financial institution with the mandate of providing long, medium and short term loans to feasible and viable projects of commercial agriculture, agro processing and manufacturing sectors following government priority area. To address the main objective of the study, Development Bank of Ethiopia, Head office is selected for the study purpose. The study was aimed to assess the challenges of loan collection & suggest sound strategy for decision makers on how to increase the loan collection of the bank. The study used primary and secondary data obtained from working units of the credit process. Primary data collection instruments were Survey through structured questioner, Key informant Interview and focus group discussion. Secondary data on financed projects and the banks credit operation were obtained from Human Resource Management Directorate, Project Evaluation and Loan portfolio Management Directorate and Strategic planning, change and communication Directorate. The study was basically conducted from three different perspectives, borrowers related factors, bank related factors, and factors related to external environment were analyzed through descriptive statistics such as mean, percentages, tables and figures to show the relationship between selected factors such as strategic objective and mandate clarity; organizational structure and leadership effectiveness, due diligence assessment strength, existence of strong feasibility analysis, reliable loan approval process, clear and well-structured loan/project follow up process, and existence of effective and efficient loan collection strategy or scheme. Based on the descriptive results/analysis, the researcher has recommended to the bank to undertake proper screening, disbursing loan at the right time, conduct proper follow-up, provide sufficient amount of loan as per the feasibility study of the project, solve other difficulties as identified in this study and work on all other factors affecting loan repayment performances.

Key words: Bank, borrower, Loan Repayment.

CHAPTER ONE

1 INTRODUCTION

1.1 Background of the Study

Development banks are seen as an important tool to solve market imperfections that would leave either profitable projects or projects that generate positive externalities without financing (Bruck 1998, Yeyati, Micco and Panizza 2004). In economies with significant capital constraints, these banks serve to alleviate capital scarcity and promote entrepreneurial action to boost new or existing industries (Armendáriz de Aghion 1999, Cameron 1961). They also lend to companies that would not undertake projects if not for the availability of long-term, subsidized funding from a development bank (Rodrik 2004, Yeyati, Micco and Panizza 2004). These positive effects notwithstanding, development banks—and state-owned banks more generally—are often criticized for supporting politically connected industrialists (Ades and Di Tella 1997, Faccio 2006, Hainz and Hakenes 2008, La Porta, Lopez de Silanes and Shleifer 2002) or crowding out private sources of capital that would otherwise help promote new investment (Antunes, Cavalcanti and Villamil 2012, Lazzarini, Musacchio, Bandeira-de-Mello and Marcon 2015).

According to Armendáriz de Aghion (1999, p. 83), “development banks are government-sponsored financial institutions concerned primarily with the provision of long-term capital to industry.” This definition highlights two key aspects of development banks: their state-owned status, and their emphasis on solving failures in credit markets, especially in the case of projects with long-term maturity. Indeed, various authors highlight the importance of development banks in promoting industrial “catch-up” (e.g. Amsden, 2001; Aronovich and Fernandes, 2006; Cameron, 1961; Rodrik, 2004). In his study of state intervention in the banking system, Gerschenkron (1962) argues that, without public participation, lack of trust among creditor and debtors would inhibit deepening credit markets. Within this perspective, private banks will be reluctant to give credit to risky investments, thereby leaving value-enhancing projects unfunded. Thus, following this logic, development banks will be “lenders of last resort,” in the sense that they will solve failures in credit markets inhibiting industrial growth (Bruck, 1998).

State banking defendants see development banks as an important tool for solving market failure which leads to suboptimal productive investment. Development banks can thus solve market imperfections that would either leave profitable projects or projects that generate positive externalities without financing (Bruck, 1998; Yeyati, Micco, and Panizza, 2004). Moreover, those banks can alleviate capital scarcity in economies with significant capital constraints, and promote entrepreneurial action to boost new or existing industries (Armendáriz de Aghion, 1999; Cameron, 1961; Gerschenkron, 1962). Development banks are doing more than just lending to build large infrastructure projects, according to such an industrial policy view. They also lend to companies that would not undertake projects unless it were for a development bank's long-term, subsidized funding to be available (Rodrik, 2004; Yeyati et al., 2004). Development banks may also provide capital to firms conditional on operational improvements and performance targets (Amsden, 2001). In such circumstances, after obtaining a loan, we would expect to see firms borrowing from development banks increasing capital investments and overall profitability.

Related to the critical role of development banks in economies where the market is imperfect, experiences have shown that there are several challenges to such banks. Many literatures show that the failure of development banks has led to a number of factors such as financial, political, and management problems. (Yirga-Hall, 1998; De Aghion, 1999; Siraj, 2004) Their critical challenges were the interference of governments or corrupt officials in their activities, weak institutional environment, limits of critical skills in management, finance and operations. Development banks should be well managed, and well regulated. It should operate on the principles of commerce. It should be managed well to reconcile conflicting objectives of maintaining financial sustainability while pursuing socially desirable outcomes.

Development Bank of Ethiopia (DBE) is a specialized public financial institution which plays a critical role for the growth and development of a country starting from 1909. The Bank has passed through various policy changes over its life with the changing policy environments of regimes existed during these times. Currently, the Bank provides loaning services to its customers at its Head Office, 12 district offices, and 88 branches strategically located all over the country.

The Bank's focal point is the provision of customer focused lending and technical advice to viable projects in line with government priority areas such as commercial agriculture, agro-

processing, manufacturing and extractive industries preferably export focused as well as lease financing for small & medium enterprises by mobilizing fund from domestic and foreign sources while ensuring its organizational sustainability. As a result, through providing credit to viable project, the Bank contributes to the growth of the economy, thereby ensuring that the money available in the economy is used for viable and socially desirable project financing which can stimulate the economy as well.

The major source of revenue for DBE comprises interests, fees and commissions. The purpose of loan collection endeavour of DBE, like other banking industries, is to ensure its generations of revenue, so as to ensure its sustainability as banking institution Hence, proper credit management affects not only the performance of the banks, but also the borrowers and a country as a whole. DBE's ability to collect mature client loans is crucial to the Bank's long-term sustainability in project finance. Since loan portfolio is the largest asset and predominant source of revenue, effective credit function management is fundamental to bank safety and soundness. Providing loans to borrowers, however, is not an easy task; this is due to the Bank's high financial risk as a result of failing to collect mature loans from the customers. If bank loans are not properly assessed, there is a risk that the borrower will not be able to pay or willing to honour their obligation.

If the loan is not collected on time it will have a major impact on the Bank's overall performance and increase the NPL thereby reducing the Bank's portfolio quality. The Bank's loan collection may be mainly affected by factors related to external, borrower, and banks. Thus, the purpose of this study is to identify the challenges of loan collection and suggest sound strategy for decision makers on how to increase the loan collection of the Bank.

1.2 Statement of the problems

Credit has long been recognized as one of the key tools that support development project success that contributes to economic development. Similarly, DBE provides sustainable credit facilities for customers who invest in commercial farming projects, agro-processing industries, manufacturing and extractive industries and lease financing services for small and medium-sized enterprises which can result in development of the country. (www.dbe.com.et)

So, in order to achieve this objective the bank needs to strengthen its liquidity position by enhancing its loan recovery. However, credit provision alone does not support the country's

economic development unless it is accompanied by the presence of factors necessary for the fund's efficient use to repay the loan in accordance with the agreement.

This has an impact on continuing sustainable credit facility for those who want for a productive purpose. (Adamu, 2013)

Based on strategic objective of the Government, projects financed by the bank have long loan repayment periods which may extend up to twenty years including maximum of five years of grace periods. Moreover, low interest rates than commercial banks, which is 11.5% for priority area projects and 12% is for non-priority area projects, and suitable rehabilitation mechanism makes the bank different from other lending institutions.

The bank's sustainability depends not only on the source of funds domestic and foreign but also on its loan recovery rate. The loan repayment performance of its clients should be effective so that the bank is sustainable and the asset quality improved. The non-performing loan ratio (NPLs) is one of the instruments by which the bank's asset quality can be measured is the non-performing loan ratio (NPLs ratio). Hence, in order to obtain soft loans from its lenders, the asset quality of DBE must be regularly monitored and assessed whether or not it is within the acceptable standard that is 15 percent of the total outstanding loan set by the African Development Finance Institutions Association (Arega et al 2016)

Accordingly, when looking at the asset quality of DBE, the average NPLs ratio for the last five years has increased from 12.54% in 2014/15 up to 33.92% in 2018/19. This clearly indicates that there is a problem in loan collection as it is highly deviated from the accepted standard 15% of the total outstanding loan (DBE, central data Annual Report, 2014/15 up to 2018/19).

The increasing level of NPLs could have very serious implications. For example, it discourages the financial institution from refinancing the defaulting client, which once again puts the defaulters in a vicious low-productivity circle. Therefore, brief investigation of the various aspects of the loan defaults, the source of the loan, the purpose of the loan, the loan form and the condition of the loan provision are of utmost importance both for policy makers and the lending institutions. Even if default is random and influenced by unpredictable behaviour, or it is influenced by certain factors in a specific situation, an empirical investigation is needed so that any financial institution can use the findings to streamline its

credit program for the better. Most of the default arose from poor management procedures, diversion of loans and an unwillingness to repay loans, etc. The lenders therefore have to provide various institutional methods aimed at reducing the risk of defaulting loans (Ahmmed et al., 2012).

Consequently, to reduce the default rate and enhance the bank's sustainability, it is imperative that both borrowers and lenders identify the various factors that significantly affect the performance of loan repayments. Hence, this study is to investigate the challenges of loan collection and put the way forward to concerned bodies.

The reason for this study is that it appears to the best of the researchers' knowledge that adequate research has not been carried out to fully assess the challenges of loan collection in the banking industry in general and the Ethiopian Development Bank in particular, with the exception of a single study by Wondimagegnehu (2012) on the determinants of NPLs in the banking industry in Ethiopia. In addition, most of the prior studies in other countries focused on NPL's specific bank and macroeconomic determinations. However, no study on borrower-specific factors influencing nonperforming loans was conducted in the previous empirical analysis. Moreover, there have been many changes in the country in the recent past which has greatly influenced the economic environment as well as the business climate. In addition to the country's economic growth and environmental changes in recent years, the Bank has also undergone changes in its lending procedures, lending limits, credit policies and organizational structure. Therefore, the current study will try to narrow the research gaps through focusing on challenges of Loan collection financed by the Development Bank of Ethiopia.

1.3 Research questions

1. What are the major challenges of loans collection in DBE?
2. What measures the bank should undertake to improve its loan collection and reduce its NPL?
3. What strategies the bank should follow in the future to minimize loan default?
4. What mechanisms of effective debt collection the bank should use to minimize its NPLs?
5. What are the main reasons for the swelling of NPL and loan collection challenges?

1.4 Objective of the Study

1.4.1 General Objective of the Study

The general objective of the study is to assess the challenges of loan collection & suggest sound strategy for decision makers on how to increase the loan collection of the bank.

1.4.2 Specific Objectives of the study

The specific objectives of the study are:

- To show the existing loans collection trend of the Bank.
- To assess challenges on the loan collections.
- To forward possible suggestions or recommendation on loan collection increment.

1.5 Scope of the study

The study will be limited to Bank specific factors, customer specific factors even though macroeconomics factors have a huge impact on loan repayment performance. Thus the study will explore Bank specific challenges of loan collection in project financing. Hence the study will cover the repayment aspect of DBE and will focus on the explanatory variable and the dependent variable like loan possessing time, number of project follow-up, project implementation period, amount of loan, education level, type of management, type of market for the commodity financed, managerial experience of project manager, equity to debt ratio, availability of raw material, distance from project location to input raw material, market accessibility, and distance from project location to output product market were associated with loan repayment. Borrower data will be considered only for the projects in which the Bank has financed between 2014/15 and 2018/19 fiscal year. This is because the credit terms of the financed projects were either medium or long term; as a result, to determine the success or fail factors of the projects it is mandatory to go back to the loan rendered period of the project to review the current status. The scope of the study will be delimited only to Head office borrowers' of DBE, due to the portfolio of the Head office loan takes a lion share which is 72.39 % of the total loan portfolio of the Bank as of June 30, 2019. (DBE, 2019)

1.6 Significance of the study

According to the data obtained from central database of DBE, the loan recovery performance report of the Bank shows 50.09 % as at June 30, 2019. This has an impact on the sustainable provision of credit to the potential investors and existence of the Bank as a financial institution. It is therefore, important for the financial institutions to devise a means of enhancing loan collection performance of the Bank. This can be achieved if the Bank identifies the challenges of loan collection performance in project financing. Thus this study is for:

- Policy makers to formulate successful credit policies and programs that would in turn help in allocating financial resources effectively and efficiently.
- Managers clearly understand the extent to which the impact of loan possessing time, number of project follow-up, project implementation period, amount of loan, education level, type of management, type of market for the commodity financed, managerial experience of project manager, equity to debt ratio, availability of raw material, distance from project location to input raw material, market accessibility, and distance from project location to output product market for the loan repayment performance.
- The management of the Bank can understand the determinants of successful loan repayment performance and evaluate the loan repayment performance.
- Helps other researchers to identify the factors behind successful loan repayment and to make research on related issues.

1.7 Organization of the study

This research will be organized into five chapters. The first chapter contains the background, statement of the problem, research questions, objectives, significance, scope and organization of the study; chapter two deal with overview DBE's loan collection challenges, review of theoretical & empirical literatures that are relevant to loan collection and its challenges; chapter three describes research design and methods, sample and sampling techniques, source and tools of data collection & methods of data analysis applied; chapter four deals with data analysis, presentation, interpretation & discussion of the result/findings of the study. And the last chapter (chapter five) includes summary of the research findings, conclusions &

recommendations. In addition to the above chapters, list of reference materials & annexes would be added at the end of the paper.

CHAPTER TWO

2 REVIEW OF RELATED LITERATURE

This chapter presents the theoretical foundation of the study critically with issues pertaining to assess the challenges of loan collection & suggest sound strategy for decision makers on how to increase the loan collection of the bank.

A critical review of the existing literatures concerning the repayment performances of borrowers and factors which influences the repayment capacity, and Various literatures focusing both on non-performing loans and successfully performing loans are thoroughly reviewed and presented in this part of the study. Accordingly, first there are the theoretical reviews on well performing and non-performing loans which include nature and definition of NPLs, Classifications of Loans and advances, theories on bank loan and cause for loan default and performing loans. The other important part is reviewing different empirical results regarding the impact of various banks specific, borrowers' specific and macro level factors on the growth of nonperforming loan.

2.1 Theoretical Review

2.1.1 Banks and Its Importance

The term bank refers to an institution that deals with money and provides other financial services. According to Heffernan (1996), banks are defined as intermediaries between depositors and borrowers in an economy that are distinguished from other types of financial firms by deposit collection and offering loan products. The role of banks in any country's economy is very significant. They play intermediation function by collecting money from those who have excess, and lending it to those who need it to invest.

The Bank mobilizes deposit and effectively allocates the mobilized money to the most productive uses of real-sector investment. Delivering borrower credit is one way banks contribute to the growth of economies. The contribution of banks to growth lies in their role in mobilizing deposit and efficiently allocating the resource to the most efficient uses of real-sector investment. So making credit available to borrower is one means by which banks are contributing to economic growth. Banks pool together resources for projects too large for individual shareholders to undertake (Bagehot, 1873). They are also considered the most

important enabler of financial transactions in any country's economy and are the principal source of credit (Rose, 2002). Bank finance is the primary source of debt funding. Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Saunders & Cornett, 2003). In addition, banks are also the custodians of the nation's money, which is accepted as deposits and paid out on the instructions of the client (Sinkey, 2002; Harris, 2003). Banks accept deposits, make loans, and derive a profit from the difference in interest rates between paid and charged. Some banks have also the power to make money (Fasil and Merhatbeb, 2009).

Despite all other activities, the banking industry considers lending as their most important function for utilization funds. Because the industry's biggest portion of gross profit is earned from loans, the administration of loan portfolios has a serious impact on bank profitability.

The most important financial institutions are commercial banks, mutual funds, security firms, insurance companies, and pension funds.

2.1.2 Development Banks

A development bank is a 'bank' set up for the purpose of 'development financing.' A traditional definition of a development bank is one which is a national or district financial institution designed to provide medium- and long-term capital for productive investment in less developed areas, often accompanied by technical assistance (British Encyclopaedia, 2003). Development Banks are financial intermediation providing financing in a developing economy to high priority investment projects. This definition implies that development banking has the purpose of bringing the country to a higher level of development. Development banks fill a gap left by undeveloped capital markets, and commercial banks' reluctance to provide long-term finance.

2.1.3 The Difference between a Development Bank and Commercial Banks

There are several differentiating factors between a development bank and a commercial bank. Some extreme observations below are made in order to emphasize "traditional" differences between the two in order to emphasize the point. Actual practice, of course, differs from commercial bank to commercial bank and from development bank to development bank. As the capital markets of the country develop, the difference between these specialized

institutions will be smaller and the similarities will become more apparent. The traditional differences between development and commercial banks are in the following areas, with this as a premise (compiled by the Asian Development Bank, ADFIAP, 2007)

- a. Impetus for the Creation of the Institution:** A development bank is created as an instrument of economic development, while commercial bank is created by business opportunities.
- b. Posture Relative to Business Opportunities:** A development bank should be proactive, because it should play an active role in promoting projects and developing institutions (entrepreneurs). The projects selected are those which are consistent with the priorities for economic development. A commercial bank is known to be reactive to opportunities for business. It requires bank ability only after the decision has been made by the entrepreneur; it waits for the idea to culminate into a funding requirement.
- c. Types of Projects Supported:** There is an explicit effort, for a development bank, to support economic development projects. The following 'impact' project is the basis for scanning opportunities: import substitution (at competitive prices); exports; increased local demand; district development (e.g. tourism); and increased industrial efficiency through improved technology. For a commercial bank, the above goals are not the starting point for project identification. They would most likely be side-benefits, instead. A commercial bank has little concern for those objectives, except for bank transaction viability. In short, the activities of a development bank are project-based while the commercial banks are transaction-based.
- d. Search Process for Projects Financed:** A development bank goes into a planning cycle, identifying which are the likely areas to go into. For example, if it determines that an export is an area to be promoted, then it conducts a marketing study and seeks entrepreneurs to implement related projects. The search process is different for commercial bank. "Are you an exporter?" it asks. "And then look at the cash balance of that entrepreneur to determine if the transaction has a marketing opportunity.
- e. Project Promotion Activities:** A development bank offers counselling and advisory services for enterprise development and promotion as part of its development lending process. A commercial bank offers legal and business advice, appraisal services and

credit investigation, usually for a fee. It undertakes very little project promotion and institutional development. Its emphasis is on client development and marketing.

- f. Strategic Goals:** A development bank has a more difficult strategic objective because it is involved with the concerns of the country, specifically economic development. Aside from this, after providing financing, it is also concerned with developing the enterprise. Explicit development of these would entail additional costs for the bank. Development of enterprises dramatically limits the number of accounts that a development bank can handle, because it takes time. The principal concern of a commercial bank is to generate profits. Other benefits are nothing more than incidental. Economic development would be its last priority, with the cost-consciousness of a commercial bank.
- g. Criteria for Financing:** A development bank takes risks from the project and does not insist on too much collateral. It will provide financing as long as the other criteria are met. In relation to the collateral criteria a commercial bank pays less attention to the project. The more progressive banks, however, lend against project cash flow and with no collateral
- h. Assessment of the Loan Proposal:** A development bank employs project appraisal as a means to determine the viability of the project submitted for financing. Project appraisal looks at the technical, financial, marketing, management, environmental and economic aspects of the project. Loan repayment is based on the cash flow to be generated by the project. A commercial bank uses risk asset management as tool to assess the borrower. It looks at the credit of the so-called 5 C's, i.e. character, capacity, capital, collateral and condition. It bases the loan repayment on the borrower's ability to pay (even from other sources) rather than the 'project' itself. Thus, development bank financing can be said to be project-oriented while a commercial bank's is borrower-oriented.
- i. Term of Loans Extended:** A development bank mainly provides term loans (more than one year of maturity). In contrast, a commercial bank mainly provides short-term loans (less than one year maturity).
- j. Sources of Loan Funds:** A development bank depends on long-term concessionary funds, such as pension funds, multilateral financial institution funds such as the World Bank, Asian Development Bank, etc. Access to domestic or commercial funds is typically restricted. A commercial bank has a strong deposit base and is also depositor

of its corporate borrower. They can match its commercial borrowing against its own short-term loans.

- k. Lending Policies for Cyclical Industries:** A development bank supports its clients through short-term cycles while a commercial bank does not like cyclical industries
- l. Resource Mobilization:** A development bank undertakes project promotion work to match long-term concessional financing while a commercial bank mobilizes deposit funds from small depositors that are lent to large companies
- m. Client Relationship:** A development bank is more related to clients as borrowers. There is less business-to-day relationship there. A commercial bank's trade transactions allow for frequent monitoring and close client relationship.
- n. Scope of Institutional Mandate:** A development bank is essentially a specialized institution. It holds limited branching and product range. The commercial bank has a Charter that is generalized. It can offer a wide range of products (especially in the case of universal banks) and more branches can open.

2.1.4 Basic Requirements to Access Credit

In order to at least minimize the inevitable credit risks, according to (Ghatak and Guinnane, 1999) a thorough credit assessment should be conducted by the lenders especially concerning the borrowers' character, collateral, capacity, capital and condition (what is normally referred to in the banking circles as the 5C's) should be conducted if they are to minimize credit risk. Such gathering of information is possible primarily from your credit application and a credit bureau report, to determine whether borrowers are able and willing to repay the debt. Every credit grantor, in the end, attempts to answer the question: how risky is it to lend or extend credit to this applicant? For most, this decision is relatively easy because the applicants will fall on either end of the continuum or on the other end of the Five "C"s of Credit.

Capacity: is a determining factor in the creditworthiness. It is assessed by weighing a borrower's earning ability and the likelihood of continuing income against the amount of debt that the borrower carries at the time the credit application is made.

Capital: Factor in determining creditworthiness which is the tangible assets and resources of a borrower. The presence of sufficient capital in a borrower's profile is an assurance that if the need arose a debt could be paid out of the borrower's assets.

Character:-Character is determined by analysing how past obligations have been handled by a borrower.

Collateral:-is a real or personal property pledged by a borrower for the term of a loan. The creditor may take ownership of the property by following legally mandated procedures if the borrower fails to pay back.

Conditions:-A factor often considered with the factors of capacity, capital, and character when creditors are analysing an applicant's creditworthiness. This factor consists of economic conditions that could affect a borrower's ability to repay, such as unemployment, seasonal work.

2.1.5 Performing Loans

The principal profit- making activities of banks are loans. In allocating funds, the primary objective of bank management is to earn income while serving the credit needs of its community. Therefore, Lending represents the heart of the industry. Loans are the dominant asset and represent 50-75 percent to total amount of assets at most banks, that generate the largest share of operating income and represent the banks greater risk exposure (Mac Donald and Koch, 2006).

Loans and advances are defined in the respective laws of different countries. In Ethiopia, under NBE, Directives, No. SBB/69/2018 Article (2.8) loans and advances are defined as:

“... Any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdrafts, participation in a loan syndication, the purchase of loan from another lender etc.), or commitment to advance funds by a bank to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or on demand, usually with interest. The term includes a contractual obligation of a bank to advance funds of or person, claim, evidenced by the lease financing transaction in which the bank is the lessor, and an overdraft facility to be funded by the bank by on behalf of a person. The term does not include accrued but uncollected interest or discounted interest.”

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. However, banks have to be careful about the safety of such advances.

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

So, loan may be considered as performing if payments of both principal and interest charges are up to date as agreed between the creditor and debtor. Therefore, managing loan in a proper way not only has positive effect on the banks performance but also on the borrower firms and a country as a whole. Failure to manage loans, which make up the largest share of banks assets, would likely lead to the episode of high level of non -performing loans.

2.1.6 Nonperforming Loans: Meaning and Nature

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

The lending function is considered by the banking industry as one of the most important function for the utilization of funds. Loans and advances are the most profitable of all assets of banks and constitute the primary source of income by banks. Banks are business institution; hence, want to make as much profit as possible through extending loans and advances. But due concern has to be given and banks have to be careful about the safety of such advances, according to (M. Radha, and SV. Vasudevan. 1980).

Banks provide loans and advances in the existences of asymmetric information, certain level of risks are inevitable. Accordingly, due to controllable and uncontrollable factors, it is

unlikely to have 100% of collection of loan and advances in reality. Loan defaults are inevitable given the uncertainty of the future economic conditions and the existences of other controllable and uncontrollable factors. The main issue is how to minimize the rate of this risk? How to increase asset quality of financial institutions, or minimize the rate of non-performing loans by identifying factors that causes it?

Non-performing loans are closely associated with banking crises. Many authors argue that the magnitude of non-performing loans is a key element in the initiation and progression of financial and banking crises. Unless properly managed and kept at reasonable standard non-performing loans (NPLs) often associated with bank failures and financial crises in both developing and developed countries (Gebru Meshesha, 2015). The issue of non-performing loans (NPLs) has gained increasing attentions in the last few decades across the globe because the immediate consequence of large amount of NPLs in the banking system is bank failure. The issue of loan default is related with none recovery/repayment of loans. When a borrower cannot repay interest and/or instalment of the loan after it has become due, then it is qualified as default loan or non-performing loan. It is known as non-performing, because the loan ceases to “perform” or generate income for the bank.

Our world has experienced banking crises in different times. Banking crises in turn cause very bad economic conditions. 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 a period of systemic crises. Nonperforming loans generally refers 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. The economic and financial costs of bad loan are significant. 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. Impaired 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 asset (Fofack, 2005).

The definition of NPL varies across countries; there is no global standard to define nonperforming loans at practical level. The concept has been defined in different literatures and by different scholars using different parameters. Criterion for identifying non-performing loans varies throughout the world even between countries. Some countries use quantitative criteria to distinguish between “good” and “bad” loans like the number of days overdue, schedule payments while others rely on qualitative standards like the availability of information about the client’s financial status, and management judgment about future payments as used by (Teshome, 2010).

According to the International Monetary Fund, a non- performing loan (NPL) is any loan in which interest and principal payments are overdue for 90 days or more. A number of other literatures have also tried to define NPLs in their own ways. Even though, attempts are made to define NPL by different institutions and scholars in different ways, still all of them indicate NPLs are Loans that are outstanding in both principal and interest for a long period of time contrary to the terms and conditions contained in the loan contract. Different endeavours are also made by a number of writers and authors to define what is meant by bad or Nonperforming loans as per their understanding of the subject matter. Machiraju (2001) for instance, expresses NPLs as a leading indicator of credit quality. NPLs or bad loans arise in respect of the loans and advances which are given by banks to the whole range of different projects including but not exclusively retail or wholesale, personal or corporate or short, medium or long term projects. NPLs are very sensitive elements of a bank’s operations.

Another writer that attempted to define nonperforming loans are Caprio and Klingebiel (1996), cited in Fofack (2005). They defined non-performing loans as those loans which for a relatively long period of time do not generate income that is, the principal and /or interest on these loans have been left unpaid for at least ninety days. The authors further supported that non-performing loans are the loans which are not generating income. According to (Guy, 2011), Nonperforming loans are also commonly described as loans in arrears for at least ninety days and nonperforming loans have been widely used as a measure of asset quality among lending institutions and often associated with failures and financial crises in both developed and developing world.

Non -performing loans can also be defined as defaulted loans, which banks are unable to profit from it (Tihitina, 2009). 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.

From all these definition, it's very clear that nonperforming loans occurs when a debtor has not met his or her legal obligations according to the debt contract like where debtor has not made a scheduled payment, or has violated a loan covenant of the debt contract.

Likewise, Ethiopia has also defined what is meant by nonperforming loans under National Bank of Ethiopia's (NBE's) Directive no, SSB//52/2012, Article, 4.5)

“Loans” means any financial assets of a development finance institution arising from a direct or indirect advance of funds (i.e. unplanned over drawings, participation in loan syndication, the purchase of loans from another lender, etc.) or commitment to advance funds by a development finance institution to a person that are conditioned on the obligation of the person to repay the funds, either on a specified date or dates or on demand, usually with interest. The term includes a contractual obligation of a development finance institution to advance funds to or on behalf of a person, claim evidenced by a lease financing transaction in which the development finance institution is the lessor, and line of credit to be funded by the development finance institutions on behalf of a person. (NBE, Directive, No. SBB/52/2012, Article, 4.5)

2.1.7 Loan classifications in Ethiopia

Loan classification and assessment of provision requirement is to be undertaken in compliance with Asset Classification and Provisioning Directives of the NBE for Development Finance Institutions (NBE Directives No SBB/48/2010 which was in use since August 5, 2010 and the amended NBE Directives No 52/2012 which came into force starting on January 19, 2012);

In accordance with the NBE Directives cited above, the DBE shall classify all its loans into five categories of pass, special mention, substandard, doubtful and loss based on the following criteria:

1. **Pass:** Loans in pass category are fully protected by the current financial and paying capacity of the borrower and are not subject to any criticism. Accordingly, given the

nature of the Bank and based on the directives of NBE, the following loans shall be classified as pass loans:

- 1) Short term loans past due for less than 30 (thirty) days;
 - 2) Medium and long term loans past due for less than 180 (one hundred eighty) days;
and
 - 3) Any loan, or portion thereof, which is fully secured, both as regards to principal and interest, by cash or cash-substitutes, regardless of past due status or other adverse credit factors.
2. **Special Mention:** The following loans at a minimum shall be classified as special mention:
- 1) Short term loans past due for 30 (thirty) days or more, but less than 90 (ninety) days;
 - 2) Medium and long term loans past due six months or more, but less than 12 (twelve) months.
3. **Substandard:** The following non-performing loans at a minimum shall be classified substandard:
- 1) Short term loans past due 90 (ninety) days or more, but less than 180 (one-hundred-eighty) days;
 - 2) Medium and long term loans past due 12 (twelve) months or more, but less than 18 (eighteen) months.
4. **Doubtful Loans:** The following non-performing loans at a minimum shall be classified doubtful:
- 1) Short term loans past due 180 (one-hundred-eighty) days or more, but less than 360 (three-hundred-sixty) days;
 - 2) Medium and long term loans past due 18 (eighteen) months or more, but less than 3 (three) years.
5. **Loss:** The following non-performing loans at a minimum shall be classified loss:
- 1) Short term loans past due 360 (three-hundred-sixty) days or more;

- 2) Medium and long term loans past due three years or more. Based on the above classification the loan of the banks considered as performing and nonperforming. If the loan fall under pass and special mention category they are classified as performing loan otherwise it is considered as non-performing loan (DBE, 2016).

The DBE shall maintain the following minimum provision percentages against the outstanding principal amount of each loan classified in accordance with the criteria set for the classification of loans:

Classification Category	Minimum Provision Rate for Short, Medium and Long Term Loans
Pass	1%
Special Mention	3%
Substandard	20%
Doubtful	65%
Loss	100%

Source: NBE's Directive, No SBB/52/2012

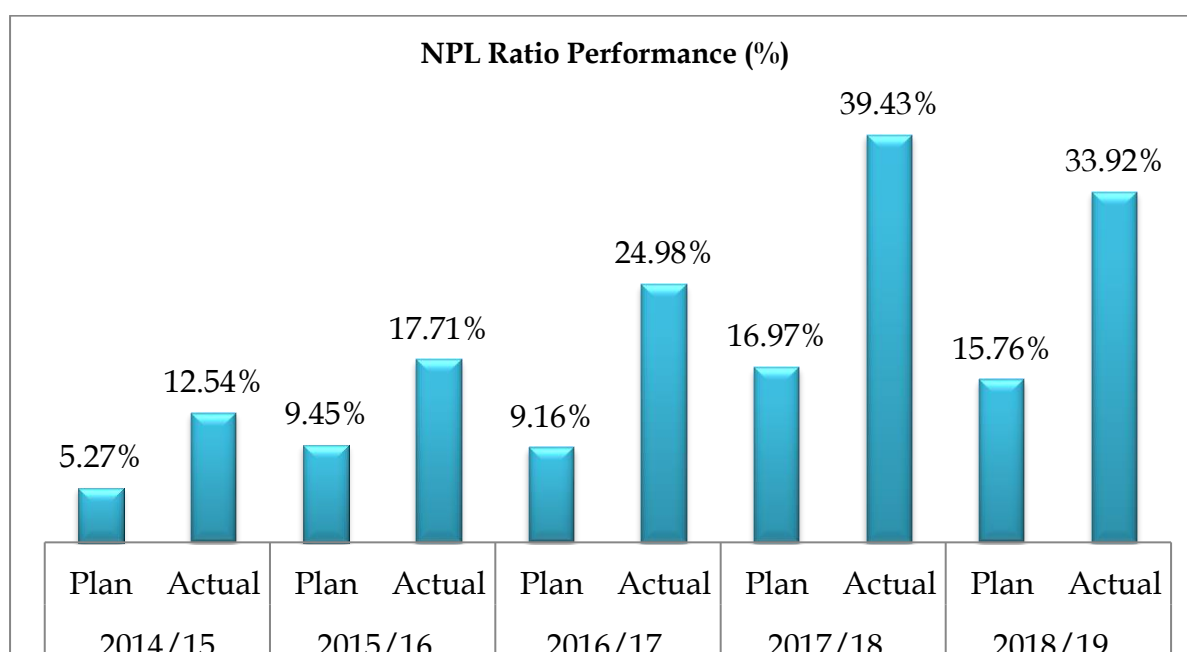
2.1.7.1 Trend of Non-Performing Loan Performance

A non-performing loan (NPL) shall mean bad debts as defined by NBE for development financial institutions as per in the Directives No SBB/52/2012 of January 19, 2012. In line with the non-performing loans, the performance of the Bank is very low and the actual non-performing loan ratios of the Bank during the last five years have been stated on the below figure 2.1. Accordingly;

- During 2014/15 fiscal year, the targeted NPL ratio of the Bank was 5.27% but the actual NPL ratio of the Bank was 12.54% which was 42% higher than the targeted plan.
- In 2015/16 fiscal year, the Bank planned to have 9.45% NPL ratio, however, the actual NPL ratio of the Bank reached 17.71% (5.6 billion birr) which was 53% higher than the targeted plan. This implies that the performance of the Bank in minimizing the NPL Ratio during the fiscal year was poor in relation to the target.
- The Planned NPL ratio of the Bank during 2016/17 was 9.16% while the actual NPL ratio of the Bank reached 24.98% (8.45 billion birr) that is 46% higher than the targeted plan.

- During the fiscal year of 2017/18, the actual NPL ratio of the Bank reached 39.43% (15.44 billion birr) which was 43% higher than the planned target.
- In 2018/19 fiscal year, the Bank targeted 15.76% NPL ratio at the end of the year but the actual NPL ratio of the Bank was 33.92% (16.14 billion birr) which was 46% higher than the targeted plan.

Figure 2. 1 Trends of DBE’s NPL Ratio Performance



Source: DBE Annual Report of 2014/15 - 2018/19

2.2 Assessment of the structural & functional arrangement of the credit process

2.2.1 Assessment by Loan processing units

Loan Processes According to DBE loan procedure and manual (2016), the Loan Process of the Bank is designed to serve the customer with a shortest possible time, minimum cost and high quality. This process starts its function by attracting and persuading customers to apply for investment loans and ends at loan collection. This loan process encompasses the following four independent loan-processing teams at corporate and District level to handle loan-processing activities at various stages and responsibility levels.

2.2.2 Customer Relationships Management Directorate /CRMD/

The Bank accepts applications from both recruited and walk-in customers if they fulfil the Bank’s loan requirements. The recruiting customers are done by attracting and persuading potential applicants using appropriate means of communication. On the other hand, due

diligence or KYC assessment undertaken by the Bank to identify the integrity of the borrower. This is done to protect the Bank from entering into relationships with inappropriate borrowers and to check the borrower's creditworthiness.

2.2.3 Corporate Project Appraisal/CPA/ Directorate

The project appraisal document focuses on assessments and evaluations of the technical, market, financial, and managerial viabilities as well as socio-economic benefits of the specific projects. The various aspects of the project are assessed in the Project Appraisal Report. The market aspect of the project such as demand and supply analysis, market prospects and major marketing areas of the proposed product or service, marketing strategy and arrangements for the products or Services, price analysis for the products/services of the project and strengths, weaknesses, opportunities and threats (SWOT Analysis) of the project.

Technical assessment includes location and site, project engineering, availability of utilities, availability of inputs, production process and system of production, project implementation plan and environmental impact assessment of the project. Project management aspect includes organization, management and labour issues. Financial analysis (investment cost, working capital requirements, pre-operating costs, financing scheme, equity requirement of the customer, revenue estimates and operating costs, projected financial statements, viability and measures of project worthiness, working capital determination). Economic and social benefits and costs, conclusion and recommendation, loan repayment schedule, etc. are also included as a part of appraisal document.

2.2.4 Corporate Project Loan Review Directorate

Once loan applications for financing of development projects are received, screened and prepared due diligence (Knowing Your Customer) forwarded to Appraisal units by the CRMDs/branches, the CPA Directorates/District Appraisal Teams appraise the project. The loan amount proposed by the project appraisal work units needs to be decided by the Corporate/District Loan Approval Committee. In this process, the Loan Review organs deliberate and decide on the loan approval document to accept or reject the loan proposal. Once the loaning decision is made the case goes back to CRMD/branch for subsequent actions. Then after, facilitation and follow-up of loan contract signing between the Bank and the borrower will be done. After signing and registering of the loan contract, compliance

check is performed before disbursement/equity is released to ensure that the borrower has fulfilled all the requirements as per the agreement stipulated in the loan contract. In checking loan disbursement/equity utilization, the CRMD or the branch uses the Equity Release or Loan Disbursement Request Approval Formats of the Bank

2.2.5 Project Rehabilitation and Loan Recovery (PRLR)

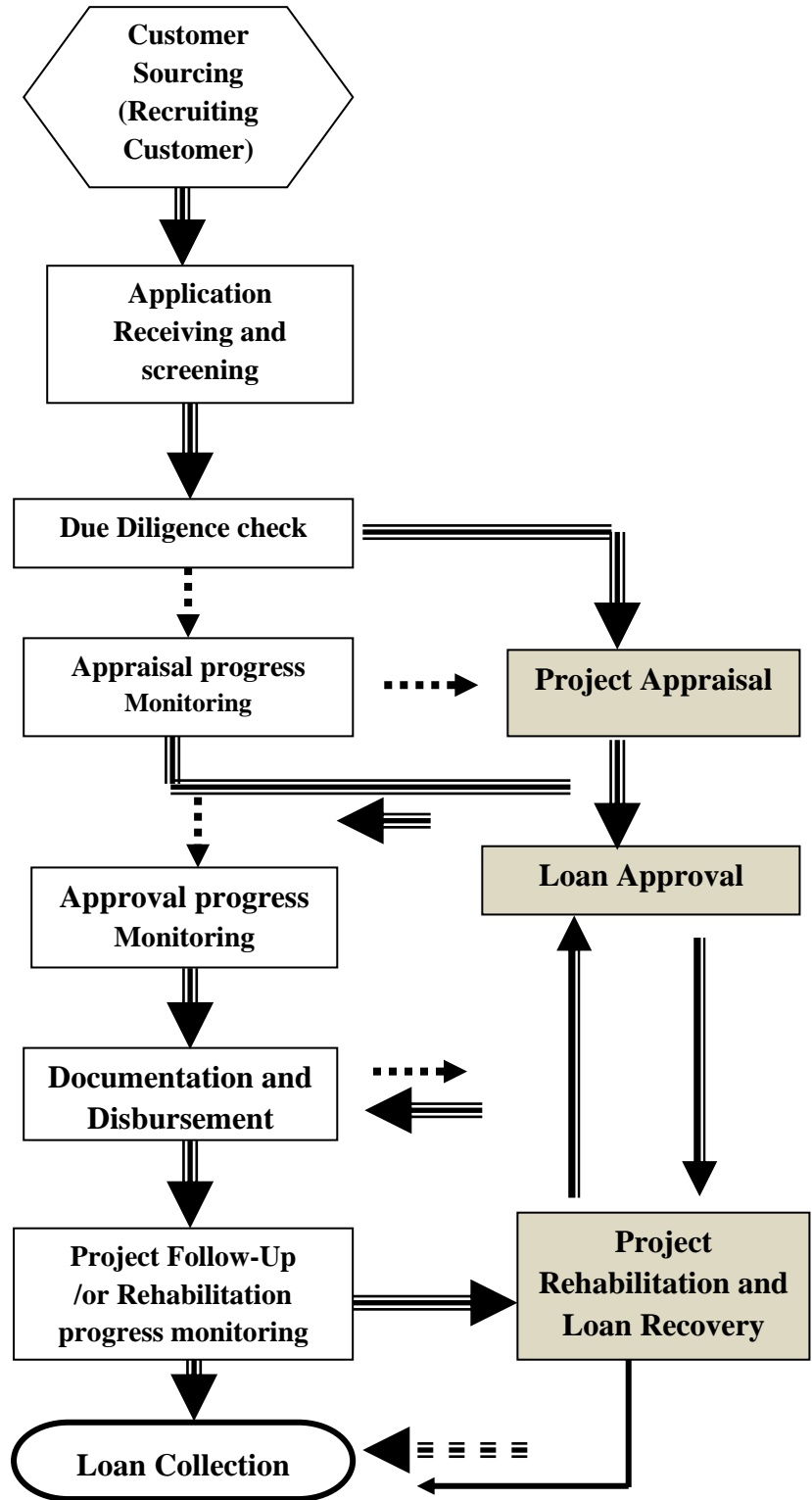
A project is basically defined as sick when its loan turns out to be non-performing as per NBE definition. However, projects that meet the following conditions should be immediately transferred to CPRLRD/DPRLR together with a complete and up to date project follow-up report: First, if the loan is classified as doubtful or loss. Second, if it exhibits continuous loss for more than two financial years unless expected in the initial study.

Once a project is identified as sick in accordance with the above definitions and its problems could not be resolved by CRMD or branch , it will formally transferred to the CPRLR Directorate I or II or DPRLR team, where a thorough analysis will be conducted in order to decide whether the project can be rehabilitated. Such projects can be given relief and concessions, as and when necessary depending on their specific nature. The following are some of the relief and concessions that may be extended by the Bank to sick projects for rehabilitation.

- **Management Intervention:** the Bank may intervene into the management role of a given project by overtaking its day-to-day management tasks fully or partially.
- **Provision of Additional Working Capital Loans:** if provision of additional investment and/or working loans is deemed necessary for rehabilitation of projects, it should be entertained accordingly.
- **Loan Repayment Rescheduling:** whenever loan repayment rescheduling is found to be the best project rehabilitation mechanism, it should be implemented accordingly.
- **Loan Transfer to Third Party:** as an option for project rehabilitation task, upon agreement among the Bank, the customer and a person willing to take over the project, projects (loans) can be transferred to third party as a rehabilitation mechanism.
- **Different debt-equity ratio:** In some cases, the PRLR team may propose higher debt-equity ratio. The newly higher debt-equity ratio to be proposed based on the existing reality of sick projects and it must justify that the sick projects will be

rehabilitated. The PRLR team can also propose a different mode of loan repayments so that the sick projects may not face cash constraints for the rehabilitation tasks.

Figure 2. 2 High Level Loan Process of the Bank



Source: DBE Loan Manual

2.2.6 Assessment of DBE Loan Collection Process

2.2.6.1 An Introduction about Loan Collection Process

The process of collections is defined as the set of coordinated, appropriate and timely activities aimed at the full collection of client loans. The process is intended to convert the receivables of the Bank into liquid assets as quickly and efficiently as possible, while maintaining the client's goodwill in the case of future transactions.

The collection process requires significant interaction with the client, beginning with a careful analysis of the situation of the client and continuing through timely and frequent contact during the duration of the loan. Clients should be offered payment alternatives that are timely and appropriate to each situation, and all collections activities should be recorded to facilitate continuous monitoring and follow-up as well as control of client compliance with negotiated agreements. Loan Collections and recovery tasks requires excellence in the following aspect (Fair Isaac Corporation, 2019).

➤ **Division of action into phases, progressing according to clear rules:**

Collection activity calls for progressive pressure to be exerted on the delinquent customer. This collection activity has to be segmented as soft, pre-litigation, litigation, and recovery (written-off accounts).

During the early phases, the bank should work out a solution in cooperation with the customer, giving high priority to the protection of the customer relationship. The aim is to minimize the number of cases moving through to the later stages, where the focus shifts from protecting the customer relationship to protecting assets and minimizing losses. Conditions for moving from phase to phase must be predefined and clearly stated, though some ad hoc management is always required. The rules for advancing must not be dependent solely on the number of days of delinquency, but must also factor in product and customer risk information.

➤ **Combine the pool approach with assigned ownership:**

In the collection process, the bank should use both approaches. Pool approach means, projects at initial phase may be given randomly to collection teams. But in the ownership case of delinquent clients is identified and a specialized collection team will be assigned to be

responsible for the repayment from the beginning to the end. With the pool assignment approach, it is generally recommended for soft collection in retail environments, while ownership assignment is usually preferable for handling corporate accounts or hard collection and litigation management.

➤ **Put in place centrally defined collection tools:**

The object of collection is to obtain an agreement to repay the overdue amount, followed by fulfillment of this agreement. Repayment agreements can take several forms, depending on the delinquency stage that has been reached. For example, in the soft phase, agreement may take the form of a single Promise to Pay or a repayment plan under which the overdue amount is repaid by fractions, with no change to the credit contract. For the pre-litigation phase, a repayment plan may stipulate that the overdue amount is to be repaid by fractions with a discount – again with no change to the credit contract – or with a restructuring of the credit contract. Acceptable Promises to Pay have to be clearly defined in terms of the amount to be repaid and the delay in repaying, the rules on qualifying a Promise to Pay as kept, partially kept or broken, and the acceptable repayment plans for soft and pre-litigation, restructuring, and consolidation situations .

➤ **Provide effective and targeted communication scripts:**

Every agent contacting a customer is representing the bank and should be helped to convey the right message and handle customers' arguments effectively. Scripts should be created that take account of the customer's profile and level of delinquency and that promote the bank's code of ethics. Simple repetition of similar messages in successive phone calls or mails is counterproductive. Scripts should generally provide a detailed walkthrough of the communication and should include an introduction, a discovery phase and an involvement phase, incentives, and appropriate replies to arguments that may be put forward by the customer.

➤ **Select external agencies carefully and monitor them closely:**

Use of the external resource of a debt collection agency (DCA) typically results from cost/benefit analysis of this approach in comparison with carrying out the operation internally (unless local regulations direct otherwise). If the bank eventually decides to outsource accounts, a thorough selection process should take place. This should not be based solely on

price. It should involve research into the relevant market and the agency's organizational structure, systems, contingency plans, financial strength, and customer base. Its reputation and experience in the specific sector should be examined and due diligence should be carried out to establish whether the agency is capable of providing the collections service that is required. After selection, the drafting of appropriate contract terms is the most critical step toward successful cooperation. The contract should include a description of the services and the bank products to be assigned. It should also include a detailed description of the phone calls, covering the bank's expectations, the assignment/recall process, assignment files management, and the bank's notifications and controls. Fees, penalties, and conditions for audit should be agreed and binding. After setting up the arrangement, the bank needs to monitor the DCA's compliance with all the agreed terms, as well as its performance. If more than one DCA is used, this makes it possible to make comparisons and provide additional incentives. It also provides the option to adopt a rotation strategy, so that accounts are not assigned and retained by a single agency, which often proves to be an efficient and effective approach.

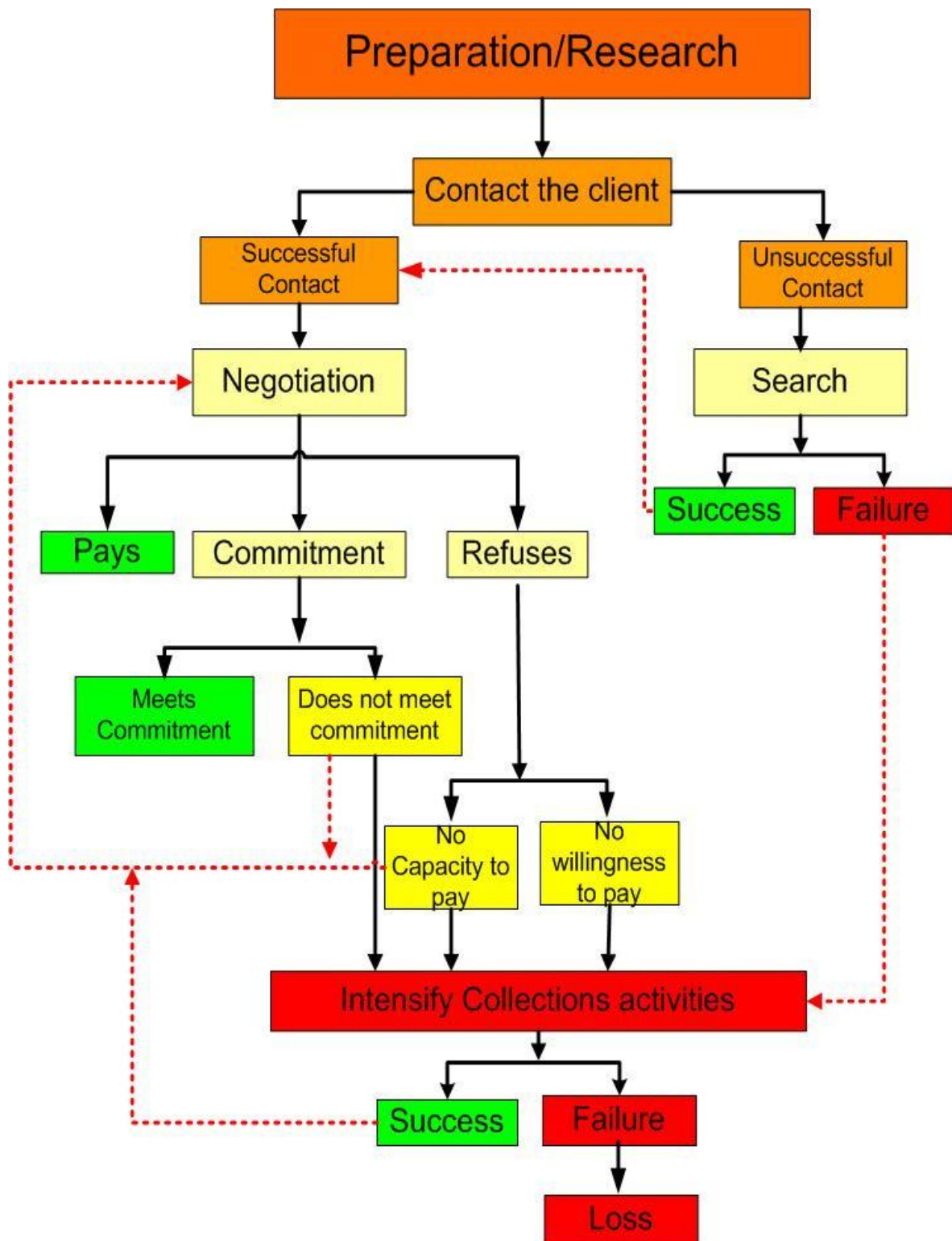
➤ **Measure performance and provide incentives for your collectors:**

Collection agents are the means through which a collection strategy is mainly applied, and their performance must be closely monitored. Through monitoring and measuring, the supervisor recognizes collectors' strengths and identifies opportunities for improvement. Normally these areas are related to understanding the technology, system applications, product knowledge and specific skills required to perform effectively in a collections call center. Collectors need feedback about day-to-day performance to know that they are doing their job effectively. Receiving supervisory feedback also demonstrates to them that others are interested in what they are doing. When performance is satisfactory, feedback improves self-esteem and personal competence. When opportunities for improvement are identified, a foundation is established for future development, training, and behavioral changes, so that the collector can be helped to succeed. In best practice operations, most collectors are eligible to receive monthly individual and team performance-based rewards, recognition, and incentives.

ACCION Insight (2008) on the other hand illustrated the following typical activities in the collections:

- i. **Analysis of the particular case:** this is the first step that a loan collection team does by identifying the client, his/her situation, description of the original loan conditions, and clarification of the reasons the loan fall in past-due. The team should consider internal and external sources of information.
- ii. **Contact with the client: After analyzing a default case the next step is make a contact with the client. Here we have to record** what information the client provides, and we have to witness the location of the client and identify actions taken previously.
- iii. **Assessment:** it is all about identifying the problem at the root of the current delinquency. It helps to know with what type of client we are dealing with.
- iv. **Suggesting an alternative:** The objective here is to sell the benefits of paying on time in order to foster a positive payment culture with the client.
- v. **Securing payment commitments:** Here, The Bank must clearly identify when, where, how, and how much the client will pay and must remember, for example, how a client in a situation of over-indebtedness or decreased income will prioritize the payment of his bills.
- vi. **Compliance with payment commitments:** Make sure whether the client pays on the agreed-upon date, or demonstrate a desire to repay the loan. The objective here is to demonstrate consistency throughout the collections process. It is not enough to reach an agreement and depend on the client's apparent goodwill and positive attitude; collections staff must follow up on payment commitments.
- vii. **Recording collections activities:** focus on to make sure collections activities are carried out in a coordinated manner.
- viii. **Follow-up on the case:** we should be aware of the client's situation and the collections activities the case has been subject to us.
- ix. **Intensification of collections activities:** here we have to choose the best action to secure collections of the loan in the most immediate manner. We have to identify the assets that the client possesses. We have to estimate accurately How much can be collected through legal action. The sole objective when a past-due loan reaches this point is collections, even if it means losing the client.

Figure 2. 3 Loan Collection Map



2.3 Empirical Review

2.3.1 Empirical Evidence from other countries

There's a lot of empirical literature on the study of non-performing loan determinants with macro-level and bank-specific analysis. Some of important studies related to this study are reviewed as follows:

Saba et al (2012) determines non-performing loans in the US banking sector between 1985 and 2010. They used correlation tests and regression tests. The study considers Real GDP as independent variables per Capita, Inflation, and Total Loans, and Non-Performing Loan Ratio as dependent variable. The regression tests indicate that all independent variables have a significant impact on the dependent variable however coefficient values are not very high.

On the other hand, Joseph et al (2012) examined the causes of non-performing loans in Zimbabwe. They used descriptive analysis of interpreting factors affecting NPL. The paper revealed that external factors are more prevalent in causing non-performing loans in CBZ Bank Limited. Their findings indicated that non-performing loans were caused by internal and external factors. In the context of CBZ Bank Limited, internal factors such as poor credit policy, weak credit analysis, poor credit monitoring, inadequate risk management and insider loans have a limited influence towards non-performing loans. However, external factors namely natural disaster, government policy and the integrity of the borrower as the major factors that caused non-performing loans in CBZ Bank Limited. In another study, Messai and Jouini (2013) tried to detect the determinants of non-performing loans for a sample of 85 banks in Italy, Greece and Spain for the period of 2004 to 2008. They used macroeconomic variables and specific variables to the bank as determinates of NPL. The macroeconomic variables are included the rate of growth of GDP, unemployment rate and real interest rate with respect to specific variables opted for the return on assets, the change in loans and the loan loss reserves to total loans ratio (LLR/TL). After the application of the method of panel data, they found that NPL is negatively with the growth rate of GDP, the return on assets and positively with the unemployment rate, the loan loss reserves to total loans and the real interest rate.

In the contrary, Farhan M. Et al, (2012) examine the economic factors that cause non-performing loans in Pakistan's banking sector. The study was conducted via a well-structured

questionnaire, and data was collected from 201 bankers involved in lending decisions or analysing credit risk or handling portfolio of non-performing loans. Analysis of correlation and regression was conducted to analyse the impact of selected independent variables (Interest Rate, Energy Crisis, Unemployment, Inflation, GDP Growth, and Exchange Rate) on Pakistani banking sector non-performing loans. It selected top 10 Pakistani banks as a sample. According to the results Pakistani bankers perceive that interest rate, energy crisis, unemployment, inflation, and exchange rate have a significant positive relationship with Pakistani banking sector's non-performing loans while GDP growth has a significant negative relationship with Pakistani banking sector's non-performing loans.

The nonperforming loans in the Albanian banking system were also analysed by Shingjergji and Shingjergji (2013). They used a model of simple regression. Some macroeconomic and banking factors which have contributed to increasing the level of non-performing loans are taken into consideration in the model. They found out that real effective exchange rate is positively related with the nonperforming loans according to which the international competition of the economy of a country is an important determinant of the credit risk. In other words any time there is a deterioration of the competition in a country's economy the nonperforming loans level that derives from the main export sectors is likely to increase.

In Kenya, Wanjiru (2013) looked over a period of 2008 to 2012 at the cause of non-performing loans using multiple regressions. The study revealed that non-performing commercial bank loans in Kenya relate positively to inflation rate. The study also found that non-performing loans are negatively correlated with real interest rates and loan growth.

Similarly, the reasons for non-performing loans (NPLs) in commercial banks in Tanzania and strategies used in dealing with NPLs were critically examined by Evelyn Richard (2011). A semi-structured questionnaire was administered from 14 commercial banks to 48 bank officers that provided corporate loans and had been in operations for at least five years. Findings suggest that a major factor that causes NPLs is the use of funds for purposes other than agreed ones. The creation of an environment to make banks seen as problem solvers and trusted borrowers advisor was cited as the main strategy for solving problems with NPLs.

Hippolyte Fofack's (2005) study investigated the leading causes of NPLs during the economic and banking crises that affected a large number of Sub-Saharan African countries in the 1990s using causality and pseudo-panel models. Empirical analysis shows a dramatic

increase in these loans and an extremely high credit risk, with significant differences between the CFA and non-CFA countries, and substantially higher financial costs for the latter sub-panel of countries. The results also highlight a strong causality between these loans and, in line with the causality and econometric analysis, economic growth, real exchange rate appreciation, real interest rate, net interest margins and interbank loans, which reveal the significance of macro and microeconomic factors.

Ali S. and Iva (2013) who conducted study on “the impact of bank specific factors on NPLs in Albanian banking system” considered Interest rate in total loan, credit growth, inflation rate, real exchange rate and GDP growth rate as determinant factors. They utilized OLS regression model for panel data from 2002 to 2012 period. The finding reveals a positive association of loan growth and real exchange rate, and negative association of GDP growth rate with NPLs. However, the association between interest rate and NPL is negative but weak. And also inflation rate has insignificant effect on NPLs.

Similarly, Shingjergji (2013) conducted study on the “impact of bank specific factors on NPLs in Albanian banking system”. In the study, capital adequacy ratio, loan to asset ratio, net interest margin, and return on equity were considered as a determinant factor of NPLs. The study utilized simple regression model for the panel data from 2002 to 2012 period and found as capital adequacy ratio has negative but insignificant whereas ROE and loan to asset ratio has negative significant effect on NPLs. Besides, total loan and net interest margin has positive significant relation with NPLs. The study justifies that an increase of the CAR will cause a reduction of the NPLs ratio. Besides, an increase of ROE will determine a reduction of NPLs ratio.

Besides, Mileris (2012) on the title of “macroeconomic determinants of loan portfolio credit risk in banks” was used multiple and polynomial regression model with cluster analysis, logistic regression, and factor analysis for the prediction. The finding indicates that NPLs are highly dependent of macroeconomic factors.

However, Swamy (2012) conduct study to examine the macroeconomic and indigenous determinants of NPLs in the Indian banking sector using panel data a period from 1997 to 2009. The variables included were GDP growth, inflation rate, per capital income, saving growth rate, bank size, loan to deposit ratio, bank lending rate, operating expense to total assets, ratio of priority sector`s loan to total loan and ROA. The study found that real GDP

growth rate, inflation, capital adequacy, bank lending rate and saving growth rate had insignificant effect; whereas loan to deposit ratio and ROA has strong positive effect but bank size has strong negative effect on the level of NPLs.

Chirwa (1997) used a probit model to estimate the probability of agriculture credit repayment in Malawi. The result indicated that crop sales, income transfers, degree of diversification and quality of information are positively related while size of club negatively related to the probability of repayment. Other factors like amount of loan, sex, household size and club experience were found to be insignificant.

Keeton and Morris (1987) investigated the causes of loan losses for a sample of nearly 2,500 US commercial banks for the period 1979–1985. Using simple linear regressions, they found out local economic conditions along with the poor performance of certain sectors like agriculture and energy explain the variation in loan losses recorded by the banks. The study also stated that commercial banks with greater risk desire tend to record higher losses.

Hu et al (2006) analysed the relationship of ownership structure, bank size and revenue diversification with commercial bank NPLs in Taiwan with a panel data set covering the 1996-1999 periods. The study shows that lower NPLs were recorded by banks with higher government ownership. Hu et al (2006) also show that bank size is negatively related with NPLs while diversification has not found a significant association with NPLs in the commercial banking sector in Taiwan.

A study by Rahman et al (2017) on the impact of financial ratios on Bangladesh commercial banks' non-performing loans applied an econometric model to identify correlations between financial ratios, and a sample of 96 observations from 20 banks out of 30 listed commercial banks was analysed during 2010-2015. The study mostly agrees with the existing literature that the credit-deposit ratio, net interest margin has a positive influence on the non-performing loans and capital adequacy ratio, the return on assets has a negative impact on the non-performing loans. It also reveals that loans from the sensitive sector, priority sector loans have a significant positive impact on unsecured loans and loans, profit per employee, investment deposit ratio have a significant negative impact on gross non-performing loans

Salas and Saurina (2002) analyse problem loans of the Spanish commercial and savings banks and find that credit risk is determined by microeconomic individual bank level

variables, such as bank size net interest margin, capital ratio and market power, in addition to real GDP growth.

Louzis et al. (2010) analysed the determinants of NPLs in the Greek financial sector using the dynamic data panel model and found that the growth rate of real GDP, ROA and ROE was negative while the lending, unemployment and inflation rate were positive whereas the loan-to - deposit ratio and capital adequacy ratio had negative effects on NPLs.

Vogiazas and Nikolaidou (2011) investigated the credit risk determinants of the Bulgarian banking sector by means of time series modelling approach covering the time period from January 2001 to December 2010. The results indicate that, the macroeconomic and financial markets' variables, specifically the unemployment rate, the construction index, the industrial production index and the real effective exchange rate jointly with the credit growth and the global financial crisis influence the NPLs of Bulgarian banks.

2.3.2 Empirical Studies in Ethiopia

2.3.2.1 Bank and Customer Specific Factors Affecting Loan Collection Performances of Development Banks

Empirically, literature on determinants affecting loan collection challenges performances of development banks is very limited. Much of the research output available on development finance are related to fund utilizations and factors affecting loan collection performances of small and medium sized enterprises financed by micro-finance institutions. Proxy literatures related to loan repayment performances of customers of micro finance institutions and that of commercial banks were used to provide some possible glimpses into the nature of factors affecting loan collection performances of development banks. Accordingly, Pasha and Negese (2014) studied the performance of loan repayment determinants in Ethiopian Microfinance and their study shows that there were significant association between the dependent variable loan repayment performance of micro enterprises and factors like education level, loan diversion, loan size, time laps between loan application and disbursement, repayment duration and all business types. And, there were significance difference between defaulters and factors like age, family size, business experience, repeatedly borrowing, and supervision. Similarly, Abafita (2003) indicated that loan diversion and loan amount are significant factors that undermine loan repayment

performance, while income, loan supervision, repayment period suitability, and literacy level are important and significant factors that increase the probability of repayment.

Some empirical studies on determinants of NPLs [the main consequences of poor loan repayment performances of banks] of commercial banks in Ethiopia portrays that factors like underdeveloped credit culture, poor credit assessment, aggressive lending, botched loan monitoring, lenient credit terms and conditions, compromised integrity, weak institutional capacity, unfair competition among banks, wilful defaults by borrowers and their knowledge limitation, fund diversion for unexpected purposes and overdue financing has significant effect on NPLs, Wondimagegnehu (2012) as cited by Arega, et al (2016).

2.3.2.2 Empirical Evidences on Factors Affecting Loan Collection Performances of DBE

Specific to the Development Bank of Ethiopia very few empirical findings are available which show factors affecting loan collection performances of the bank. Accordingly, Arega, et al (2016) have shown that bank specific factors like weak credit risk management, easily admitted borrowers [poor assessment of borrower's creditworthiness], poor credit monitoring-failure to properly monitor what the borrower is doing with the money, excessive risk appetite by the Bank, compromised integrity in approving credit, rapid credit growth, poorly negotiated and lenient credit terms; and borrower specific factors like credit culture of customers, lack of knowledge and related experience of borrower for the proposed business, wilful default, loan diversion, lack of commitment on the side of the promoter and project management problem were the factors which have impact on the prevalence of NPLs. Furthermore, according to Gebremedhin (2010), factors like educational level of borrowers, repayment period of the loan, availability of other sources of income, sector and purpose of the loan positively and significantly determine the successful loan repayment performance of DBE borrowers in the Northern Region, whereas other variables such as gender and household size have positive signs, but not statistically significant.

Moreover, another research thesis prepared by Shirega (2016) indicates that loan processing time is an important factor that affects the successful implementation of projects and it has a significant impact on production and revenue schedule of the project. This in turn affects the repayment performance of the project and it is the cause for a number of rescheduling of loan repayment period. Furthermore, with respect to some variables related to management of a

project like type of management (owner versus hired manager), experience of project manager and education level of project manager the study made by same person concluded that projects managed by employed managers are less successful in loan repayment performance than projects managed by owner managers; more years of managerial experience has an impact on the successful loan collection performance of the bank; projects managed by managers with educational level of BA/BSC degree or above have successful loan repayment performance than projects managed by managers with educational level of diploma or below. With respect to factors related to project implementation period, project follow-up, size of loan and proportion bank loan in relation to that of the owners' equity in financing the project, the same study also reveals that delayed project implementation period leads to decreased loan repayment performance; DBE financed projects that were repeatedly supervised or followed-up have successful loan repayment performances; most of the defaulted projects have no sufficient permanent working capital so that the amount of loan has an impact on successful loan repayment performance of the DBE-financed projects; as the debt-to-equity ratio of defaulted and successful projects in loan repayment performances is similar, the impact of this factor is insignificant on loan repayment performances of projects, (Shirega, 2016).

Again, the study has drawn some important conclusions with respect to factors related to availability and distance of raw materials from the project, market arrangements and distances for the output of projects financed by DBE. Accordingly, projects financed by DBE have not faced raw material problem for defaulter or the successful projects implying that input raw material availability has low influence on successful loan collection performance of the bank; the distance of the project from raw material site has insignificant influence on loan collection performance of the bank; export oriented projects are more successful in loan repayment than those projects which sell their products locally; market accessibility for products of projects has high influence on success of loan repayment performances of DBE-financed projects, that is, projects facing market accessibility for their products are defaulters while projects that were not facing market accessibility for their products are successful; and distance of the project from product market has insignificant effect on their success or failure of the projects in loan repayment performance.

2.4 Conclusions and Research gap

In general, the above empirical studies can be categorized as External factors, Bank specific factors and Borrower specific factors. External factors includes, government policy, interest rate, unemployment, inflation, GDP growth, exchange rate, sensitivity to change in stock market, sensitivity to change in inflation, economic cycle, asset and house price, currency depreciation are major external determinants of loan default.

Bank specific determinants of non-performing loans are also identified by various empirical studies as weak credit assessment, lack of proper skill by the loan officers, long loan processing/approval time, agency problem, poor credit policies, loan recovery procedures, lenient credit terms and conditions, credit growth, poor credit assessment, failed loan monitoring, aggressive lending, compromised integrity, ownership structure of the bank, bank size and weak institutional capacity ,unfair competition among banks, poor asset quality, poor corporate governance and risk management practice are the major Bank specific determinants of loan default.

And Borrower specific determinants of non-performing loan are identified by various studies as uncompromised integrity of the borrower, lack of technical training for loan beneficiaries, under-developed credit culture, and wilful default by the borrower, knowledge limitation of the borrower, fund diversion for unintended purpose and misuse of loan amounts states as a reason for loan default.

Varies determinants of NPL have been identified by various literature as stated earlier, these determinants have been categorized under External/macro-economic factors Bank specific factors and Borrower specific factors of loan default; However, there are still gaps identified in empirical literatures discussed above.

- ✚ The studies conducted were focused on some bank specific factors. But for non-performing loans this are not the only factors, there are also specific factors that will lead the loan to become NPL.
- ✚ Most of the studies are conducted in developed countries but very few studies are conducted in Ethiopia context. Even the studies conducted in Ethiopia are focused in all Banks regardless of Bank size and ownership structure and no special focus is given to Development bank of Ethiopia however it is the largest project and investment financing Bank in Ethiopia.

CHAPTER THREE

3 RESEARCH METHODOLOGIES

In the preceding chapter the review of related literature on factors affecting loan repayment performances, the empirical studies and their respective findings are presented. As loan repayment performances basically comprises of performing and non-performing loans, different studies related to both scenarios were thoroughly reviewed under the preceding chapter. This Chapter presents the methodology that provides a detailed direction about the methods that the researcher used in conducting the research. Hence, the research design, description of the study area, data type and source, methods of data collection, sampling techniques, methods of data analysis and definition variable, measurement and description of variables are discussed.

3.1 Research Design

Research design is a comprehensive plan. It is a blueprint for empirical research aimed at answering specific research questions or testing specific hypotheses (Anol Bhattacharjee, 2012). Research design is the program that guides the researchers in the process of collecting, analysing and interpreting the data.

Therefore, the nature of problem and objective of any study usually determine the type of research design adopted by researcher. A choice of research design reflects the priority of a researcher about the dimensions of the research process and methods. The objective of this research is to identify the challenges of loan collection in Development Bank of Ethiopia. The collected data mainly focused on description of borrower's characteristics, lending institution/bank related factors, business/project related factors and external factor that affects loan repayments and their relationship among the dependent and explanatory variables. Therefore, both qualitative and quantitative research method were used in the study.

3.2 Data Type and Source

Primary and secondary data obtained from working units of the credit process. Primary data collection instruments were Survey through structured questioner, Key informant Interview and focus group discussion. Secondary data collected from annual financial reports of the bank issued during the period covering 2014/15 up to 2018/19, credit policy, and procedure

manuals and also on financed projects and the banks credit operation were obtained from Human Resource Management Directorate, Project Evaluation and Loan portfolio Management Directorate and Strategic planning, change and communication Directorate.

3.3 Method of Data Collection

In order to achieve the objectives stated in the preceding section and considering the nature of the problem and the research perspective, the researcher used both quantitative and qualitative data. The Primary data were collected through primary data collection techniques mainly using structured and semi structured questionnaire and interviews with the officials and senior officers of the bank. Secondary Data were directly gathered from records and published documents of the bank.

3.4 Sampling and Sampling Techniques

This study has made use of both primary and secondary data. The secondary data of seven years has been taken from Project Evaluation and Loan Portfolio Directorate. It enables the study to make an assessment on the quality of loan for the bank in different sectors. Structured questioner was designed and a survey on representative sampled employees of the bank has been done. Primary data were also collected through key informant interview and focus group discussion from the selected team managers, officers, directors, and customers of the Bank. An interview was made to 10 customers, 20 officers, 18 team managers and 7 Directors. In addition, focus group discussion was conducted. Secondary data were collected by reviewing loan documents of selected projects. The documents of 20 projects whose loan status were substandard, doubtful & loss were reviewed. To broaden the scope of the study, all 12 districts were requested to send their loan collection challenges and the way forward via fax and email. Data analysis was conducted by identifying themes (thematic analysis) and make assertion accordingly. In addition to this structured questionnaires were prepared and distributed to a sample of 125 employees based on a stratified sampling technique. Representative sample from all levels of employees (Directors, Team managers, senior officers, officers and junior officers) was taken.

3.5 Method of Data Analysis

The collected data had entered into Statistical Package for Social Science Software (SPSS) version to run the descriptive data. It selected because of its simplicity and clarity to draw

inferences. Besides, it used mean, median, percentage, charts, and tables for the analysis of the collected data.

Data analysis techniques can be using both analyses tool, quantitative and qualitative. It involves collections of quantitative information that tabulated along a continuum in numerical form. Therefore, for this study, combinations of both qualitative and quantitative analysis had been employed to describe the existing scenarios regarding loan collection performance of the Bank in comparison against the given theoretical framework.

CHAPTER FOUR

4 RESULTS AND DISCUSSIONS

This chapter deals with the results of the study, which includes descriptive statistics; specifically, mean, and median result between selected factors used for loan collection challenge in the bank. The statistical package SPSS was used to compute these statistical tests.

4.1 Descriptive Analysis and Survey Result Analysis

Descriptive statistics are important tools to present research results clearly and concisely. They help one to have a clear picture of the characteristics of sample units by applying descriptive statistics such as mean, percentages, and graphs to show the relationship between selected factors such as strategic objective and mandate clarity; organizational structure and leadership effectiveness, due diligence assessment strength, existence of strong feasibility analysis, reliable loan approval process, clear and well-structured loan/project follow up process, and existence of effective and efficient loan collection strategy or scheme.

Likert scales are widely used in survey studies. In particular, the questionnaires propagated by the five grading approaches were based on Likert scales. A number of researchers have provided empirical evidence suggesting that using the median to approach Likert scale variable to generate new variable from a group of variables that are Likert scale type (Bhattacharjee, 2012).

A total of 125 questionnaires were distributed for sample respondents among employees of credit processing units of DBE (CRMD I, CRMD II, CRMD III, CRMD IV, PAD I, PAD II, PAD III, PRLRD I, PRLRD II, Loan Review I and Loan Review II) and 107 (86%) questionnaires were returned. The questionnaire included both close ended, which was Likert type question, and open ended questions. The collected data were analyzed through descriptive statistics, mainly using mean adequacy score in order to understand and differentiate the most serious issues that hampered loan processing activity in DBE among the listed variables of each parameter under the study. The scale was from 1-5, (1=Strongly Disagree, 2=Disagree, 3= Neutral, 4=Agree, 5=Strongly Agree).

4.1.1 Mandate Clarity and Strategic Objective in DBE

The existence of well-defined strategic objective is a tool to achieve organizational vision. Setting strategic objectives transforms the strategic vision into specific performance targets. Setting strategic objective is a key element of crafting strategy. It is a very important exercise to ensure that the organization's long term plans and goals are attained. It exhibits management's commitment to action and outcomes. To execute strategic objective, establishing clear mandate within the organization is mandatory. Mandate clarity means the degree to which required information is provided about how the employee is expected to perform his or her job (Rizzo et al. 1970). Different studies indicated that the existence of mandate clarity within the organization enables to improve employee performance. Gladstein (1984) asserted that if there are higher levels of clarity of role within teams, each team member presenting freely communicates behavior in team settings is more likely. Forsyth (1999) stated that clarity of role has both behavioral (e.g., performance) and psychological (e.g. job satisfaction, self-efficacy) implications not only for task-occupants but also for the rest of the team. Increased clarity of members' role within teams leads to better outcomes for individual jobs (Hartenian et al. (1994).

The respondents were asked to rate their degree of agreement on the following variables of mandate clarity and strategic objective in DBE case and the following statistical results were obtained.

Table 4.1 Mean adequacy score of the respondents on mandate clarity and strategic objective

Sr. No	Items	Observation	Mean, Adequacy Score
1	There is a system in DBE that effectively ranks projects against mission benchmarks	107	2.21
2	The bank is assessed effectively and factually against its given KPIs by independent experts	107	2.26
3	DBE strategic objectives are realistic	107	2.29
4	DBE strategic objectives are consulted with shareholders and communicated to staff and publicized externally.	107	2.34

5	DBE strategic objectives are clear and measurable	107	2.57
6	DBE has realistic actionable strategic objectives	107	2.59
7	DBE has clearly defined KPIs	107	2.74
8	DBE has precisely formulated missions	107	3.42

Source: own survey, 2019

As table 4-1 indicates that most of the mean adequacy scores of listed variable are below 3.0, which implies that the respondents were indifferent to agree on the idea. The existence of a system that effectively rank projects against mission benchmarks in DBE have least score (2.21). The mean adequacy score also tell us in DBE there are great problems on assessing its key performance indicators by independent experts, setting realistic, measurable and clear objective and consulting and communicating its strategic objective with the stakeholders.

4.1.2 Organizational Structure and leadership effectiveness

Organizational structures have substantial impact on the financial performance and ability to manage employees. According to Stephen and Thimoty (2009), an organizational structure is "how job tasks are formally divided, grouped, and coordinated." Stephen and Thimoty work specialization, departmentalization, chain of command, level of supervision, centralization and decentralization, and formalization are elements of organizational structure. The effectiveness of organizational structure is dependent on the effectiveness of organizational leadership. Effective leaders must be able to support the work of the group, encourage sustainable development, and empower group members, creating the confidence of group members to complete a given job, develop the group identity, manage conflict directly, and create change. Under taking these importance's the researcher attempted to assess employees' perception on the existing organizational structure and leadership effectiveness of DBE and following mean adequacy score were obtained in each variable.

Table 4.2 Mean adequacy score of organizational structure and leadership effectiveness

Sr. No	Items	Observation	Mean, Adequacy Score
1	DBE Senior managements are clear and transparent and designed to promote effective credit process of the bank	107	1.95
2	Senior management of DBE has the quality to implement business strategies, risk management systems, risk culture, processes and controls for managing the risks	107	2.17
3	Management staffs selected through an appropriate promotion or recruitment process	107	2.24
4	Senior management of the staff provide adequate oversight	107	2.24
5	Senior management of DBE has the quality to delegating duties	107	2.26
6	DBE management staffs have the necessary experience, competencies and integrity	107	2.36
7	In the bank, employee selection and promotion is on the basis of technical competency	107	2.45
8	There are clearly set Procedures for dealing with work situations in the working units	107	2.64
9	Rights and duties of positions are were articulated and in place for working units of DBE	107	2.71
10	There is recruitment of competent employees	107	2.76
11	DBE has internal organization with a clear separation of duties	107	2.83
12	Division of labor in DBE is based on functional specialization	107	2.85
13	Communication is characterized by Impersonality of interpersonal relations in DBE	107	3.02
14	There is Well-defined hierarchy of authority within the working unit and at bank level.	107	3.14
15	DBE has a good mix of staff and a Board of Directors with various origins and background	107	3.26

Source: Own Survey, 2019

Based on the mean adequacy score (1.95), in DBE there is acute problem among senior managements on making clear and transparent and designed to promote effective credit

process of the bank (see table 4-2). The following organizational structure and leadership effectiveness measurements score least and indicate how the problems are very serious in DBE:

- Quality of senior management to implement business strategies, risk management systems, risk culture, processes and controls for managing the risks (2.17)
- Selecting management staffs through an appropriate promotion or recruitment process (2.24)
- Senior management quality to provide adequate oversight (2.24)
- Senior management quality to delegating duties (2.26)
- DBE management staffs experience, competencies and integrity(2.36)

Therefore the bank has to reorganize its management staffs to improve and promote effective leadership in DBE.

4.1.3 Due Diligence Assessment in DBE

Among the key credit process due diligence is the one. Due Diligence is an examination about operations, financial condition, competitive position, performance, business objectives and plan, the labour force, supplier, its customers and the sector of its business of their customers (business firms). In accordance with regulatory requirements, all lending institution must develop and implement appropriate risk-based procedures for conducting on-going customer due diligence. The existence of a well-organized KYC assessment helps to obtain and analyse sufficient customer information to understand the nature and purpose of customer relationships in order to develop a customer risk profile and to identify and report suspicious transactions and to retain and update customer information on a risk-based basis, including information about beneficial owner(s) of legal entity customers. DBE has its own KYC assessment and under this study the researcher examined the existing practice. The result of mean adequacy score of the sample respondents indicated as follow, which help to understand the specific problems in the due diligence assessment of DBE.

Table 4.3 Mean adequacy score of the respondents on due diligence assessment in DBE

Sr. No	Items	Observation	Mean Adequacy score
1	DBE KYC assisted with advanced software	107	1.85
2	The team of experts making KYC are independent of other working units and management interference	107	2.11
3	The team of experts undertaking KYC are highly professional and a system is there to make them accountable	107	2.13
4	DBE has successful Customer Identification Program	107	2.23
5	DBE KYC assessment help to effectively manage risks and protect the bank against criminals, terrorists, and Politically Exposed Persons	107	2.31
6	There is independent audit testing of customer due diligence in DBE	107	2.42
7	DBE has effective On-going Due Diligence	107	2.44
8	DBE has a system in place to do effective corporate know your customer assessment too	107	2.57
9	DBE has clearly defined Customer Acceptance Policy	107	2.81
10	The KYC assessment provides effective tools of managing risks	107	2.91

Source: own data, 2019

The above table indicates that due diligence assessment measurements variables mean adequacy score is below 3, which tell us the respondents are arguing that there is problem in

the due diligence process in all the parameters indicated the questioner for the effectiveness of due diligence assessment. Among the listed variables of due diligence assessment the following has the least mean adequacy score and it indicates the presence of great gap in DBE KYC assessment:

- The existence of advanced software that assist KYC assessment in DBE (score 1.85)
- Expertise independence and free from top management interference to conduct KYC (score 2.11)
- The existence of professional expertise and their accountability to the KYC they under take (score 2.13)

The respondents were also asked to write the basic problems associated with the KYC assessment in DBE and their idea summarized in the following figure.

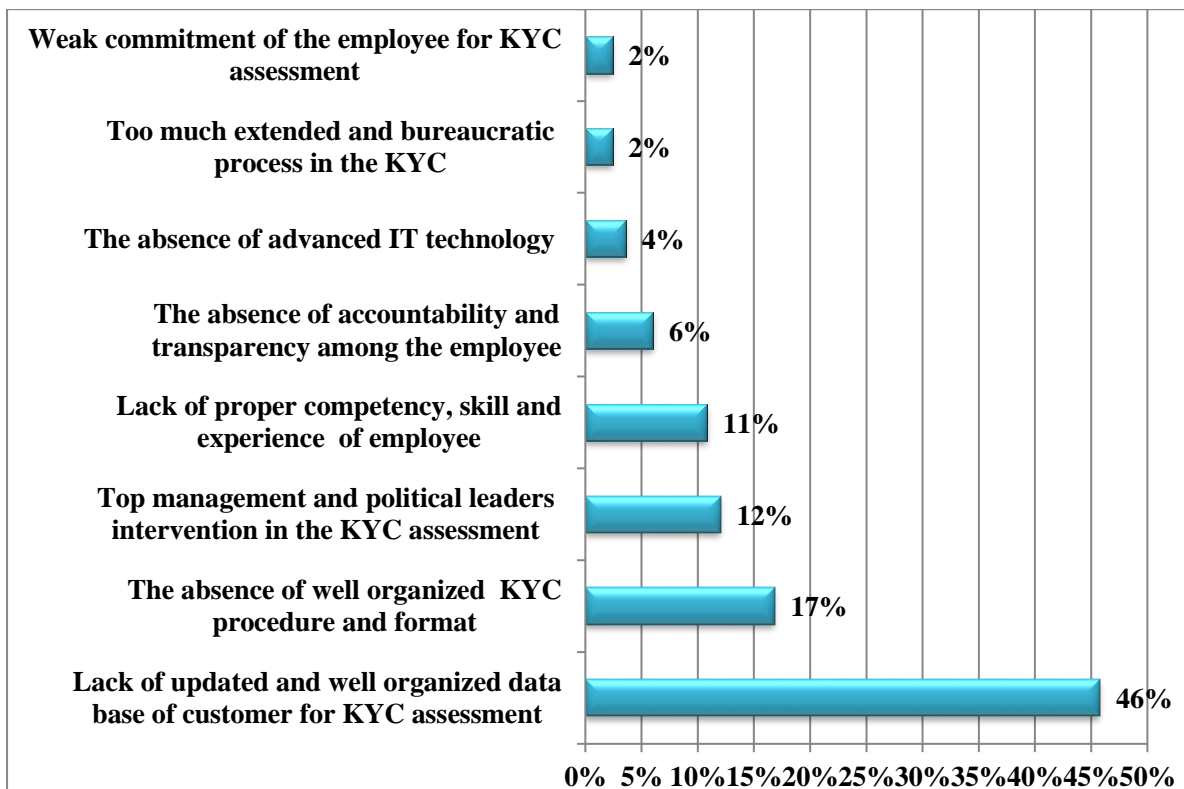


Figure 4. 1 Respondents’ opinion on the basic problems to conduct KYC assessment

As figure 4-1 shows, majority of the respondents (45.8%) mentioned that lack of updated and well organized customer data base is the basic problem during the KYC assessment in DBE.

This is also reflected in the above mean adequacy score in which the respondents disagree on the existence of well-organized data warehouse in DBE that help to easily access customer data during the due diligence assessment. The respondents also mentioned the following problems that challenge the quality of KYC in DBE (see fig. 4.1):

- The absence of well-organized KYC procedure and format (16.9%)
- Top management and political leaders’ intervention in the KYC assessment (12.0%)
- Lack of proper competency, skill and experience of employees (10.8%)
- The absence of accountability and transparency among the employee (6.0%)
- The absence of advanced IT technology (3.6%)
- Too much extended and bureaucratic process in the KYC (2.4%)
- Weak commitment of the employee for KYC assessment (2.4%)

The respondents were also asked to write the possible solution for the existing challenge for KYC assessment in DBE and their ideas summarized in the following figure.

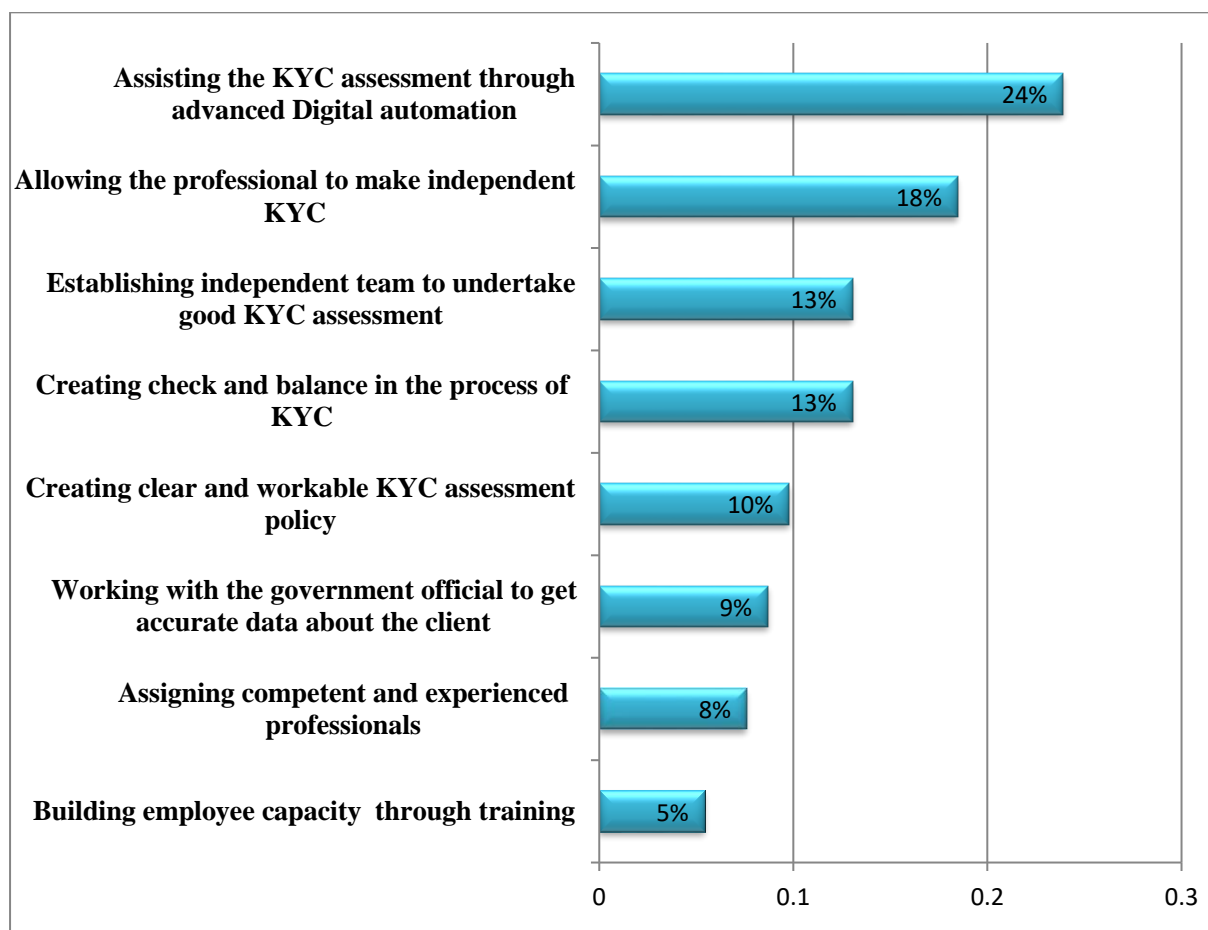


Figure 4. 2 possible solutions for the existing challenge of KYC assessment in DBE

As shown on figure 4-2 majority of the respondents expressed that assisting the KYC process through digital automation and making the professional independent during the KYC assessment are the possible solutions to conduct effective due diligence in DBE. KYC assessment conducted through manually is time consuming, the process is error-prone, humans can make mistakes, operational errors are caused when policies are applied inconsistently, and a firm not performing these tasks consistently is at risk of regulatory action. Therefore DBE has to implement digitally assisted KYC assessment to minimize these problems.

4.1.4 Appraisal Assessment in DBE

Credit appraisal is a comprehensive process that begins from the time a prospective borrower joins the bank and ends in credit delivery and monitoring with the objective of ensuring and maintaining the quality of lending and credit risk management within acceptable limits. The quality of credit appraisal processes depends on two factors: on the one hand, a transparent and comprehensive presentation of the risks when granting the loan, and on the other, an adequate assessment of those risks (Seyfried, 2001). Weak credit appraisal process is one of the factors that lead to high levels of nonperforming loans (Ka'nyiri, 2005). Therefore under this study sample respondents were asked to rate their level agreement on the existing appraisal practice in DBE and the following statistical data were obtained:

Table 4.4 Respondents mean adequacy score on credit appraisal assessment in DBE

Sr. No	Items	Observation	Mean, Adequacy score
1	DBE has reliable, up-to-date and verifiable data warehouse and information collection system used by the appraisal team.	107	2.09
2	There is a regular independent auditing to evaluate credit appraisal process, procedures and verification of information used in the appraisal process.	107	2.6
3	Strong Market Appraisal Team and verifiable demand-supply gap assessment exists	107	2.68
4	There exist strong “Socio economic appraisal” team	107	2.74

5	The team of experts in each appraisal team is highly professional and a system is there to make sure they are accountable.	107	2.84
6	There exist strong “Management appraisal” team	107	2.89
7	There exist strong “Technical appraisal” team	107	2.94
8	There exist strong “Financial appraisal” team	107	3.01
9	There is independence and autonomy of tasks to be done by different appraisal teams and working units in the credit process.	107	3.04
10	There are an adequate and professional mix of all experts in each appraisal teams	107	3.36

Source: Own data, 2019

The mean adequacy score obtained from the respondent on the practice of the above for seven of the listed variables of appraisal assessment in DBE is below the average level three indicates existence of a problem in this regard. Based the above statistical data, we can understand that there are acute problems to find reliable, up-to-date and verifiable data warehouse and information collection system used by the appraisal team and conducting regular independent auditing to evaluate credit appraisal process, procedures and verification of information used in the appraisal process since their mean adequacy score least which 2.09 and 2.60 respectively. The mean adequacy score also indicates the prevailing problems in the following areas of appraisal assessment process:

- Lack of qualified professionals that assess the market to identify demand supply gap
- Poor project appraisal team composition that effectively assess technical, socio-economic and financial aspect of the project

The respondents were also asked to narrate the major challenges that affect the success of appraisal process in DBE and their idea summarized in the following figure

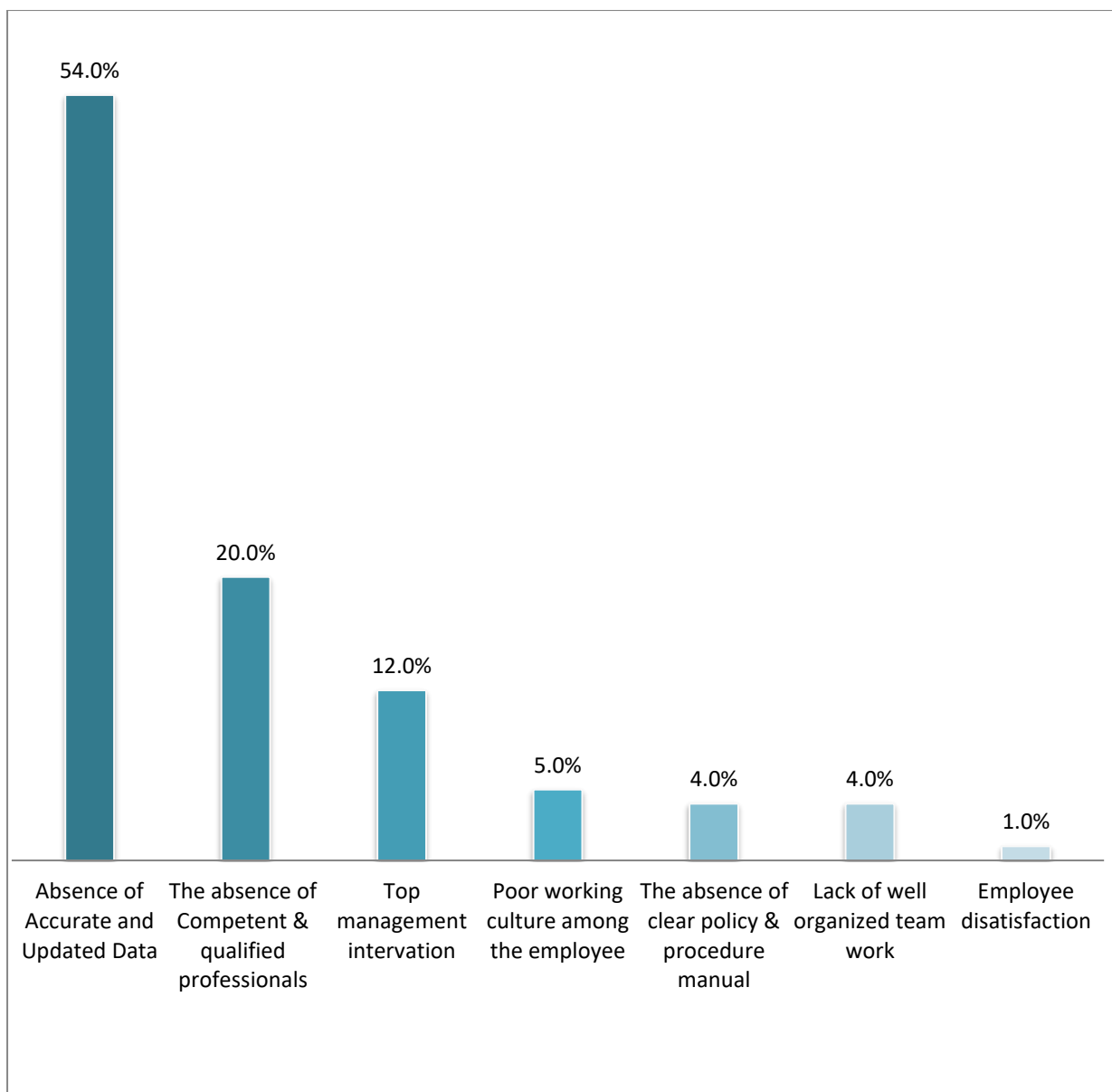


Figure 4. 3 Basic challenges that are encountered by the appraisal team

As shown from figure 4-3 majority of the respondents (54%) indicated that lack of accurate and updated data is the basic challenge for their credit appraisal process. Therefore the bank has to review its data collection strategy and mechanism mainly the working unit that provide the expected data for the credit appraisal process (commodity study). The absence of competent and qualified professional and top management intervention has also impact on the credit appraisal process in DBE.

The respondents were also asked to recommend the possible solution to improve the quality of project appraisal in DBE and their responds summarized as follows

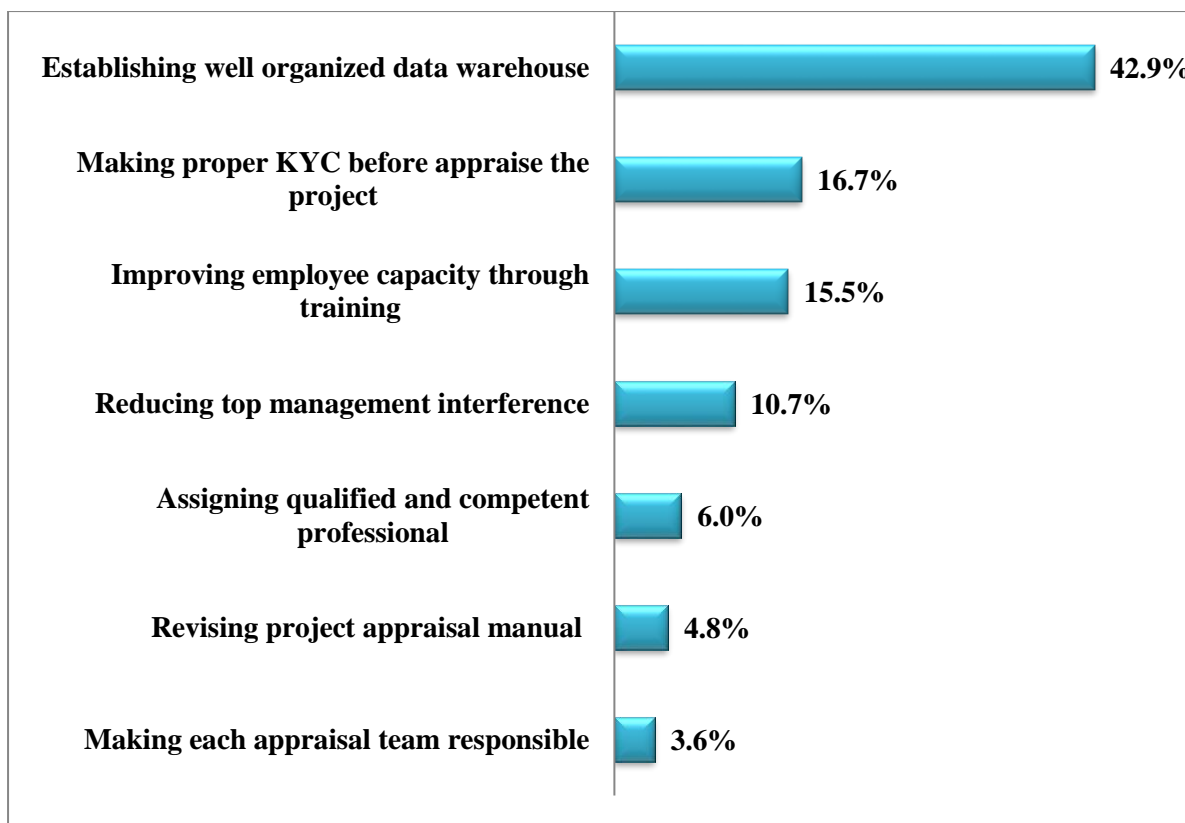


Figure 4. 4 Respondents recommendation on the possible solution for quality project appraisal

To solve the existing challenges of quality project appraisal majority (42.9%) of the respondents suggested the establishing well organized data warehouse. Currently, in DBE data predominantly collected manually through commodity study to appraise project which is highly exposed to error and the data are not updated regularly. Therefore, to minimize these problems of getting accurate data DBE has to establish advanced data warehouse that enable the appraisal team to easily access accurate and up to date data. In addition to this the respondents also suggested making proper KYC before appraise the project, improving employee capacity through training and Reducing top management interference.

4.1.5 Project approval assessment in DBE

In DBE credit process after the KYC assessment and final project appraisal report, the loan review team assesses the project in detail to approve or reject the project. Therefore credit approval process took preponderate role to make sound decision and to reduce the possible risks, which in turn has key role for NPLs reduction in the bank. Therefore the researcher assessed the existing practice of loan review team so as to identify major problems with in this credit processing unit.

Table 4. 5 Respondents mean adequacy score on project approval assessment in DBE

Sr. No	Items	Observation	Mean, Adequacy score
1	The Loan Review Team makes an objective assessment of portfolio Quality and provides regular feedback to management and directors	107	2.8
2	The loan review team in DBE has clear and objectively verifiable Credit Risk Grading system.	107	2.9
3	It regularly Identifies relevant trends that could affect collectability of the loan portfolio, and isolates certain potential problem	107	2.9
4	The Loan Review Team has strong capacity of Promptly identifying loans with well-defined weaknesses.	107	3
5	Loan review team make independent and objectively decisions	107	3.1
6	The Loan Review Team has a procedure to critically assess the adequacy of and adherence to loan policy and procedures, and ensures that the loan portfolio complies with NBE policies	107	3.1
7	The experts in the loan review team are from different disciplines and accountability is in place for the decisions the made.	107	3.1
8	Identifies loan documentation weaknesses and discrepancies in credit file reporting, while providing appropriate corrective recommendations.	107	3.02
9	Loan proposals sent to the loan review team is in proper Credit Line Proposal	107	3.5

Source: own survey, 2019

As indicated in the above table among project approval assessment variables, the following has least mean adequacy score and the respondents are the existence of problems related to:

- Loan review teams capacity to make an objective assessment of portfolio quality and provides regular feedback to management and directors.
- Identifying relevant trends that could affect collectability of the loan portfolio, and isolates certain potential problems.

- The presence of clear and objectively verifiable credit risk grading system within the loan review team.

Therefore DBE has to give due attention to transform these issues and to increase the quality of project approval process.

According to the respondents the major challenges that affect the activity of loan approval team in DBE indicated in the following chart

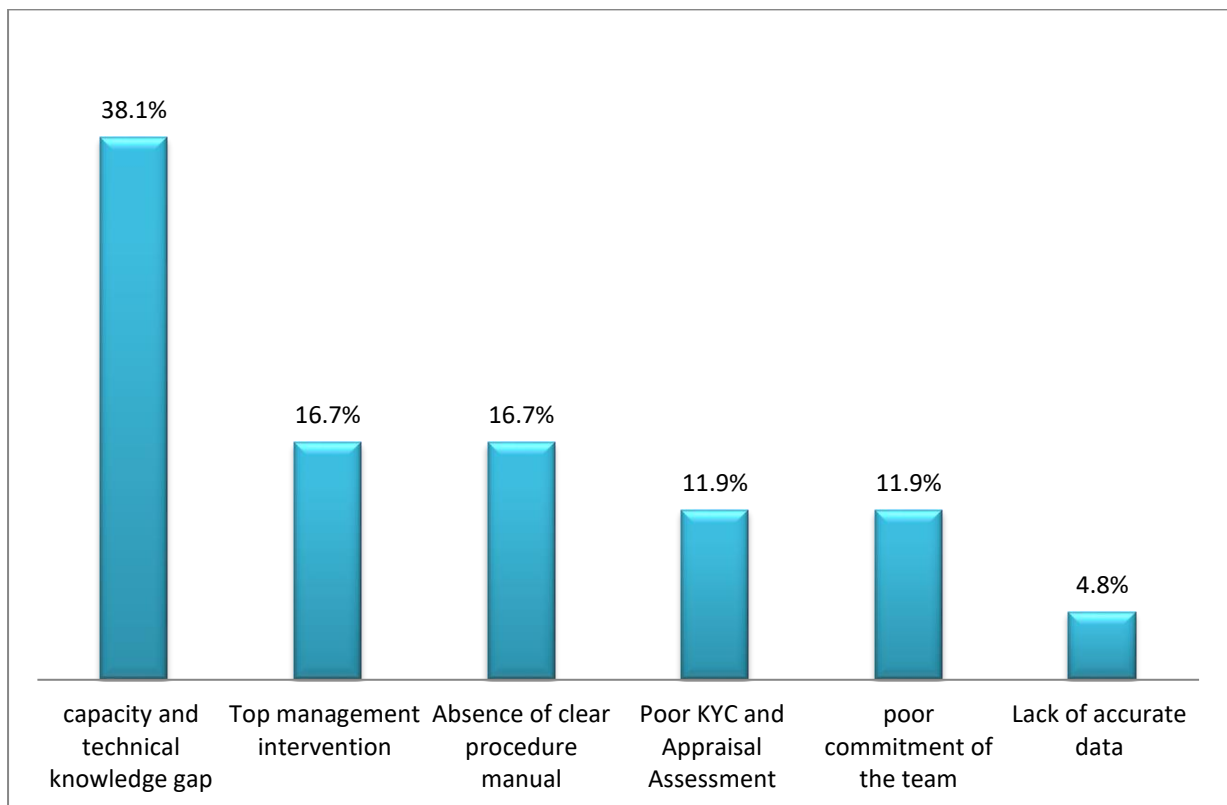


Figure 4. 5 The challenge of loan review team in DBE

As shown on Figure 4-5; 38.1% of the respondents mentioned that capacity and technical knowledge gap among the team members of loan review is the basic challenge that affects the quality and effectiveness of project approval in DBE. Significant number of respondents also mentioned top management intervention in the project approval process and the absence of clear procedure manual within the loan review team affect the success of loan review team.

Sample respondents forwarded their idea on the possible solution for the above mentioned problems as follow:

- Reorganizing loan review team with different professional mix
- Setting clear objective for the loan review activity
- Providing proper training for the employee
- Making the loan review team independent
- Taking appropriate measure on corrupt officials

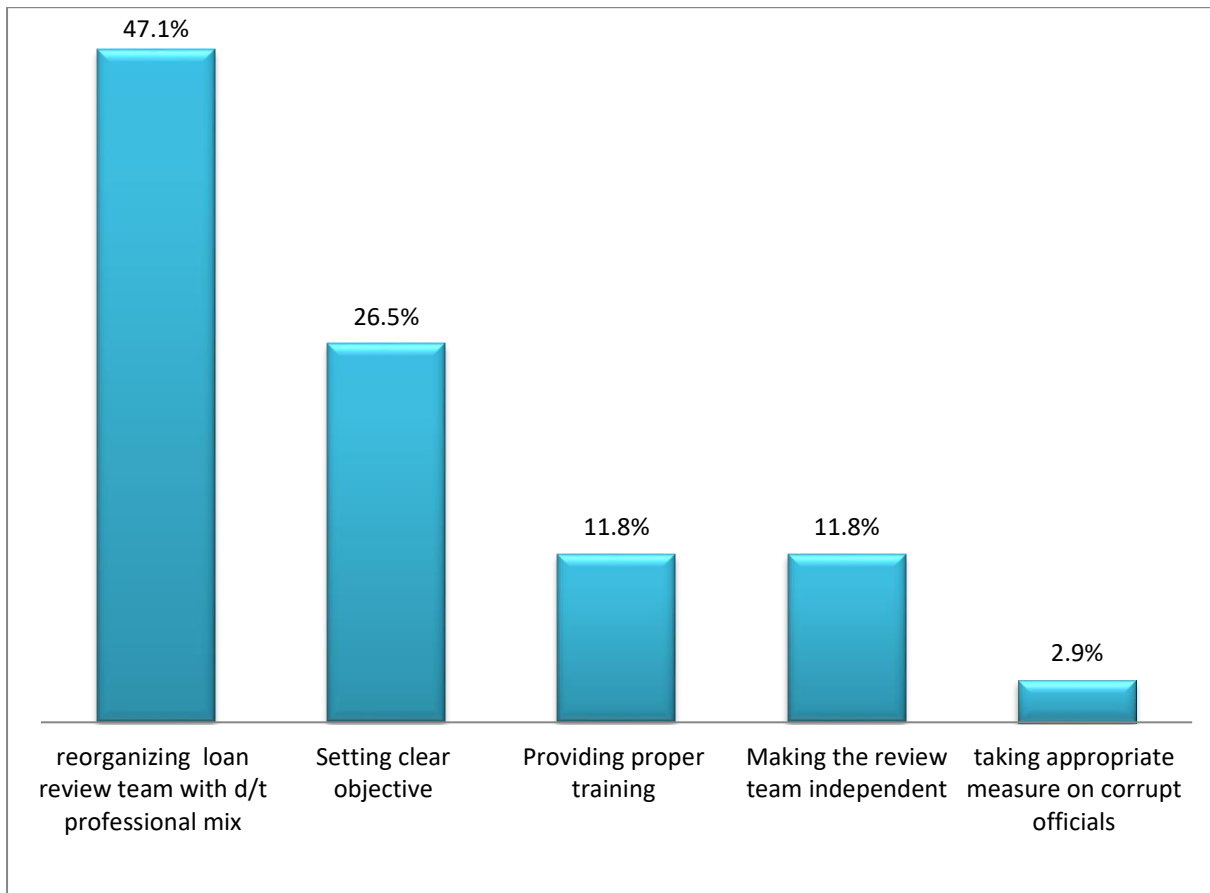


Figure 4. 6 Respondents recommendation on the possible solution for the existing problems within the loan review team

4.1.6 Follow up Assessment in DBE

Follow-up is one of the financial institution's key activities that engaged in lending projects like DBE. The decision to lend is made on sound credit risk analysis / appraisal and creditworthiness assessment of borrowers. But past records of satisfactory performance and integrity are no future guarantee, although they serve as useful performance trend project guide. Loan granted on the basis of sound analysis is might go bad because of the borrower

may not meet obligations per the terms and conditions of the loan contract. It is for this reason that proper follow up and monitoring is essential. A monitoring system provides the information needed to oversee loan portfolio quality at any given time, identifying potential problems at the earliest moment possible. Under this study the research team assessed the existing practice of project follow up in DBE and the following statistical data indicates on which area the problem is aggressive while under taking follow up activity.

Table 4.6 Respondents mean adequacy score on the existing practice of project follow up in DBE

Sr. No	Items	Observation	Mean, Adequacy score
1	The loan follow-up team used computerized loan monitoring systems	107	2.2
2	There is a system established to indirectly monitor client	107	2.2
3	The loan Follow-up team under take effective Periodic direct monitoring of clients	107	2.7
4	There is timely Monitoring of actual loan repayment performance of Clients and periodic reporting of Loan portfolio review report, Due payment report, Past-due payment report, Loan portfolio at risk report with their reasons.	107	2.7
5	There is open communication established between the follow-up team and the borrower	107	3
6	The loan follow-up team has always at hand up-to-date and complete Loan files containing all the documents with a complete historical and on-going record of the relationship between the Bank and the borrower.	107	3

Source: own survey, 2019

As indicated on table 4-6 relatively among the listed variables making the follow up assisted with computer system and the existence of established systems help to monitor the client has least mean adequacy score. Form this we can understand that in DBE project follow up activity has the problem of using advanced technology and system. An obvious advantage of computerized and system based loan monitoring is that reports can be generated automatically. As a speedy response to loan default is vital for maintaining a sound loan portfolio, automation can help to identify problem loans at a very early stage, allowing for

immediate corrective action. In addition to these problems the mean adequacy score of the respondents tell us, in DBE there exist problems of team under take effective Periodic direct monitoring of clients.

4.1.7 Loan collection strategy assessment in DBE

Effective credit collection techniques are one of the necessities for financial institutions in any economic climate. Knowing how to encourage customers to pay their outstanding debts to financial institutions like banks on time can increase the cash flow of banks and help to avert the risk of NPLs. Therefore, the process of loan collection requires significant interaction with the client, starting with a careful analysis of the situation of the client and continuing through timely and frequent contact during the duration of the loan. Clients should be offered payment alternatives that are timely and appropriate to each situation, and all collection activities should be recorded to facilitate continuous monitoring and follow-up as well as customer compliance control with negotiated agreements. As explained in the previous section of this study, the loan collection trend of DBE has deteriorated from year to year, which in turn increases the bank's non-performing loan. Therefore the researcher undergoes to assess problems related with loan collection in DBE and the following statistical data were obtained:

Table 4.7 Respondents mean adequacy score on Loan Collection Strategy of DBE

Sr. No	Items	Observation	Mean, Adequacy score
1	DBE has strong and systematic process of managing Defaults	107	2.3
2	DBE has Instilled the culture that making late payments by clients is unacceptable. It uses “carrots” and “sticks” to keep late payments to a minimum	107	2.4
3	There is a strict delinquency follow-up in DBE	107	2.5
4	A system for critical situation analysis is in place to investigate reasons for default by customers and to signal dangers when it occurs.	107	2.6

5	DBE has effectively debt collection mechanisms including the collection of pledged collaterals and guarantees legally and strategically.	107	2.6
6	Default loan in depth situational analysis is made with team of experts well awarded of the client business.	107	2.6
7	Rescheduling and restructuring strategies as a remedy for default loans are handled with the greatest care	107	2.7

Source: own survey, 2019

As indicated on Table 4-7, the mean adequacy score of all variable is below three (3) which indicate the majority of the respondents are disagreeing on the idea address under loan collection strategy in DBE. Relative to other measurement variables the score tell us the existence of acute problems on the following issues regarding to loan collection in DBE:

- Creating strong and systematic process of managing Defaults (score 2.3)
- Creating the culture that making late payments by clients is unacceptable(score 2.4)
- The existence of a strict delinquency follow-up in DBE to induce the client to pay (score 2.5)

Sr. No	Loan collection challenge Parameters	Observation	Mean Adequacy Score
1	Due Diligence	107	2.33
2	Loan collection strategy	107	2.38
3	Mandate Clarity and Strategic Objective	107	2.48
4	Project Follow up	107	2.52
5	Organizational Structure and leadership effectiveness	107	2.66
6	Project Appraisal	107	2.84
7	Project approval practice	107	2.93

On the above table loan collection challenge parameters ranked based on their mean adequacy score and the finding indicates that the top three (3) parameters that affect the performance of loan collection in DBE are the following:

- The ways due diligence assessment conducted in DBE (score 2.33)
- The strategy DBE follow to collect the loan (score 2.38)
- The way DBE set strategic objective and to clarify mandate for each stakeholders (score 2.48)

However, it doesn't mean that other mentioned parameters in the table have no effect on the loan collection activity of the bank. As it is indicates, their score is below three (3), which implies the prevailing problems with regard to project follow up, organizational structure and leadership effectiveness and appraising project.

4.1.8 Perception of respondents on main reason for NPLs, loan collection challenge and mechanism to reduce NPLs in DBE

Employees working under credit processing units in DBE were asked to mention major problems related with NPL and loan collection and the possible solution for the prevailing problems and their idea condensed in the following figure for the sake of clarity.

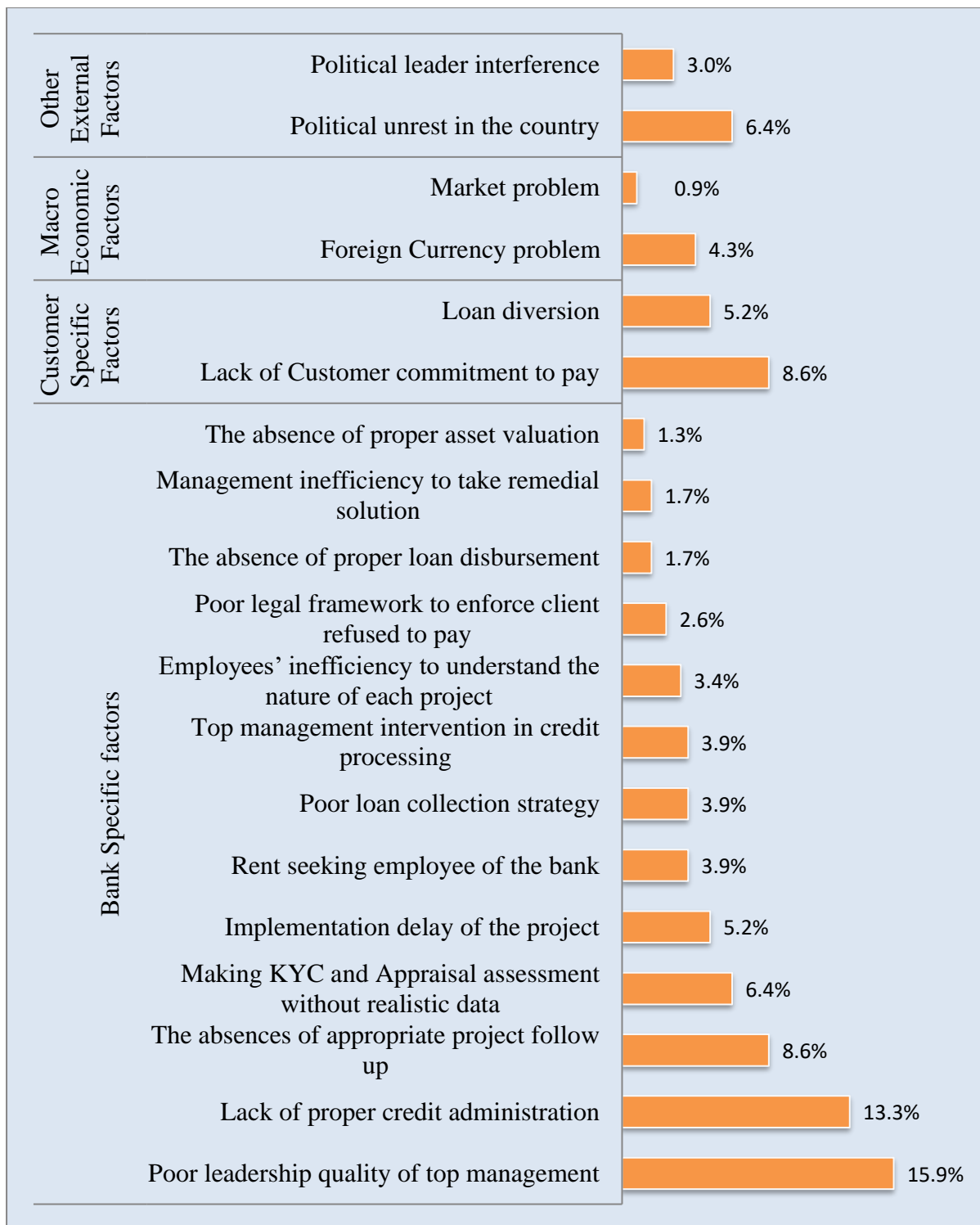


Figure 4. 7 Respondents' perception Problems related with NPLs increment in DBE

As shown on Figure 4-7 the respondents mentioned that most of the problems for the current NPLs increment in DBE are related with bank specific factors. Among bank specific factors majority of the respondents mentioned the following issues

- Poor leadership quality of top management (15.9%)
- Lack of proper credit administration (13.3%)
- The absences of appropriate project follow up (8.6%)
- Making KYC and Appraisal assessment without realistic data (6.4%)
- Implementation delay of the project (5.2%)
- Rent seeking behavior of employees of the bank (3.9%)
- Poor loan collection strategy (3.9%)
- Top management intervention in credit processing (3.9%)
- Employees' inefficiency to understand the nature of each project (3.4%)
- Poor legal framework to enforce clients who refused to pay (2.6%)

On the other hand among the customer specific factors that aggravate non-performing loan of DBE, respondents mentioned the following major factors

- Lack of commitment to pay (8.6%)
- Loan diversion (5.2%)

In addition to the above mentioned problems significant number of respondents also addressed foreign currency problem, political unrest in the country and political leader interference and enforcement in the credit process contributed for the existing swelling NPLs problem in DBE. Therefore designing and implementing strategy that help to minimize the above mentioned problems help DBE to reduce the swelling NPLs.

The respondents were forwarded the possible solutions to minimize NPL in DBE and their ideas summarized in the following figure



Figure 4. 8 possible solutions to reduce the excising problem of NPLs in DBE

Majority of the respondents indicated that making regular project follow up with appropriate measure and improving the quality of KYC and Project appraisal assessment help DBE to reduce problems related with the swelling NPLs. Along with these significant number of respondents also suggested the following possible solutions

- Establishing clear and advanced credit policy (11.7% of respondents)
- Making loan processing time shorter (9.6% of respondents)
- Assigning appropriate employee with d/t professional mix (9.6% of respondents)
- Reducing top management and political leaders interference (5.3% of respondents)
- Changing the business model of the bank (4.3% of respondents)
- Making the employee accountable for their task (4.3% of respondents)
- Improving the regal frame work of the bank (4.3% of respondents)
- Making proper asset valuation (3.2% of respondents)

4.2 Loan Quality Assessment by Sector & Loan Collection Performance

4.2.1 Portfolio Concentration by Loan Status/Classification

000'

Status	2015	2016	2017	2018	2019
Pass loans	19,440,791.26	19,223,605.96	20,086,999.55	12,754,884.40	25,994,737.25
Special mention loans	4,506,413.23	6,914,351.14	5,288,725.44	10,768,566.69	5,111,422.86
Substandard loans	2,104,504.41	1,524,083.01	3,693,892.19	9,018,360.99	6,765,293.33
Doubtful loans	749,523.27	3,466,609.72	1,472,218.54	5,035,348.21	4,065,857.92
Loss Loans	683,232.70	611,169.67	3,286,612.09	1,385,697.16	5,305,200.20
Total	27,484,464.87	31,739,819.51	33,828,447.81	38,962,857.46	47,242,511.55

Source: DBE Annual Report of 2014/15-2018/19

4.2.2 Trend of outstanding loan by number of clients and loan amount

Development bank of has been giving its project and lease financing service to customers in selected priority areas selected by the government to spur the economic development agenda of the country. These priority areas are Commercial Agriculture; Agro processing, manufacturing and Extractive Industries, preferably export focused. The bank has been providing its financial and technical support to all sectors of the economy. Figure 4-9 showed that majority of the clients for the Bank are from the agriculture, manufacturing and financial service (Lease financing and credit to Microfinance institutions). Following GTP II, the number of clients from these sectors has shown increment. The withdrawal of the Bank from financing service sector projects is the reason for the decline in the number of clients for the service sector.

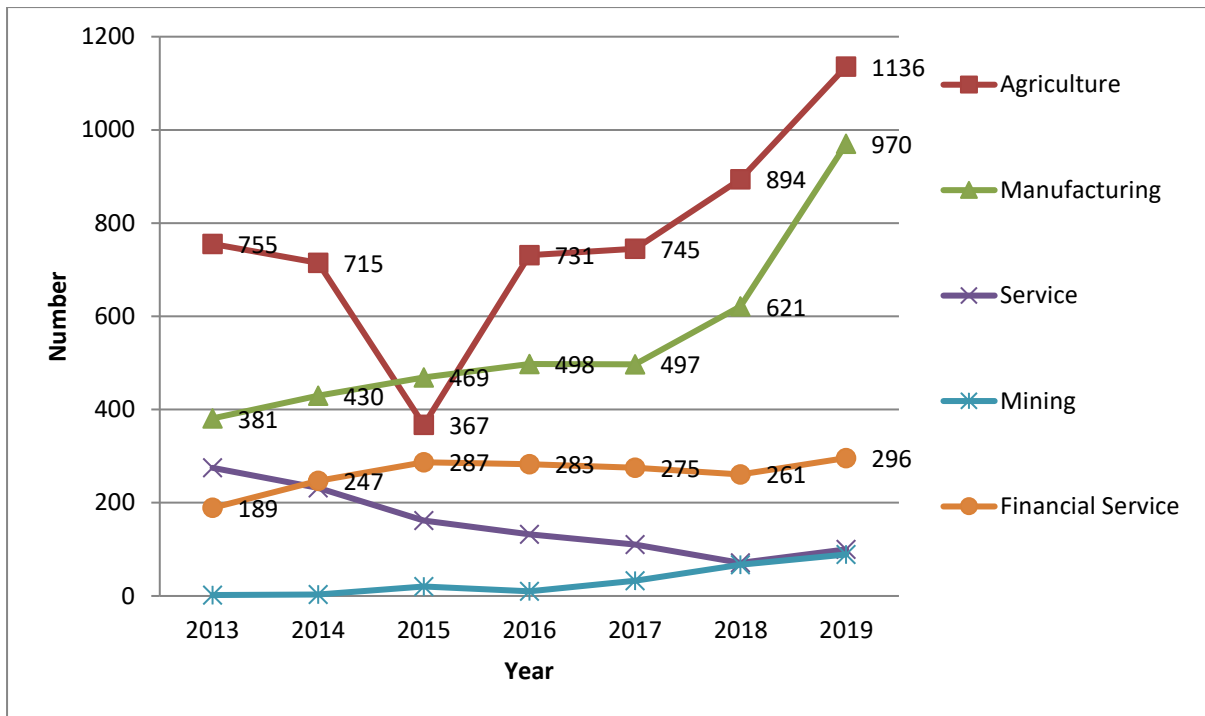


Figure 4. 9 The number of clients by economic sector

However in terms of amount, outstanding loan given to the Manufacturing sector is by far exceeds the other sectors which is followed by the agriculture sector and the financial services. The loan outstanding for DBE in recent years is highly concentrated to the manufacturing sector.

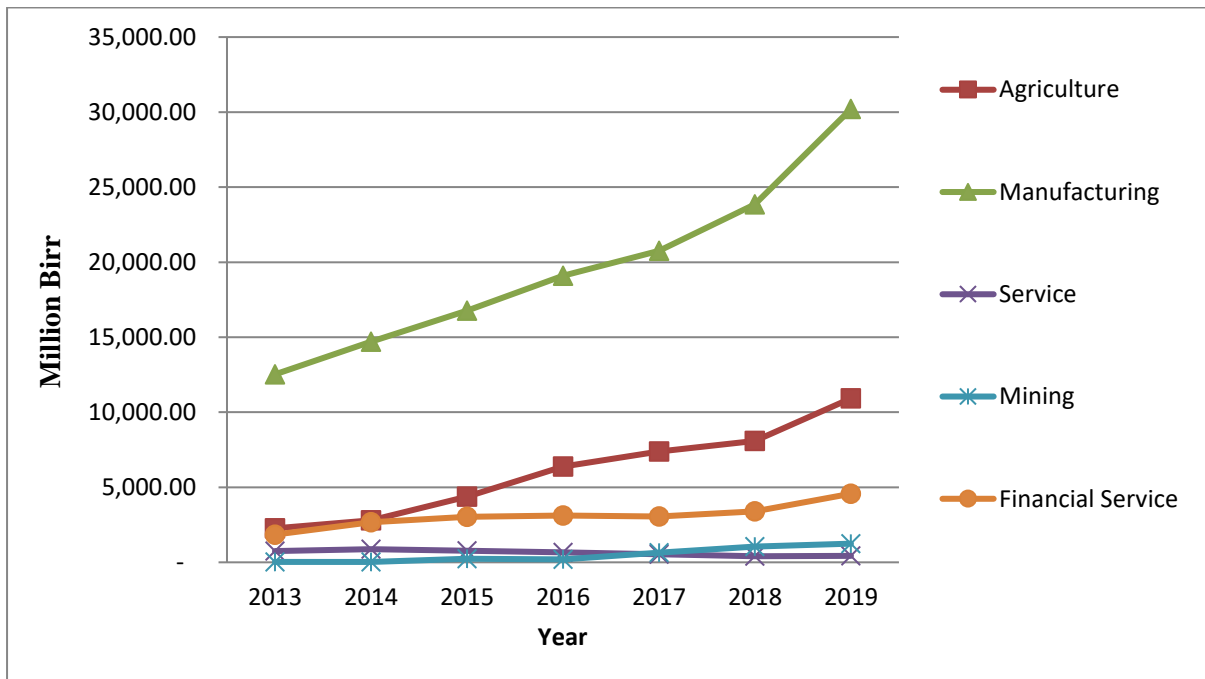


Figure 4. 10 Trend of amount of loan outstanding by sector

The concentration of loan per client is the highest in the manufacturing sector followed by the mining and extractive sector; the financial service sector and the agriculture sector (see Figure 4-11).

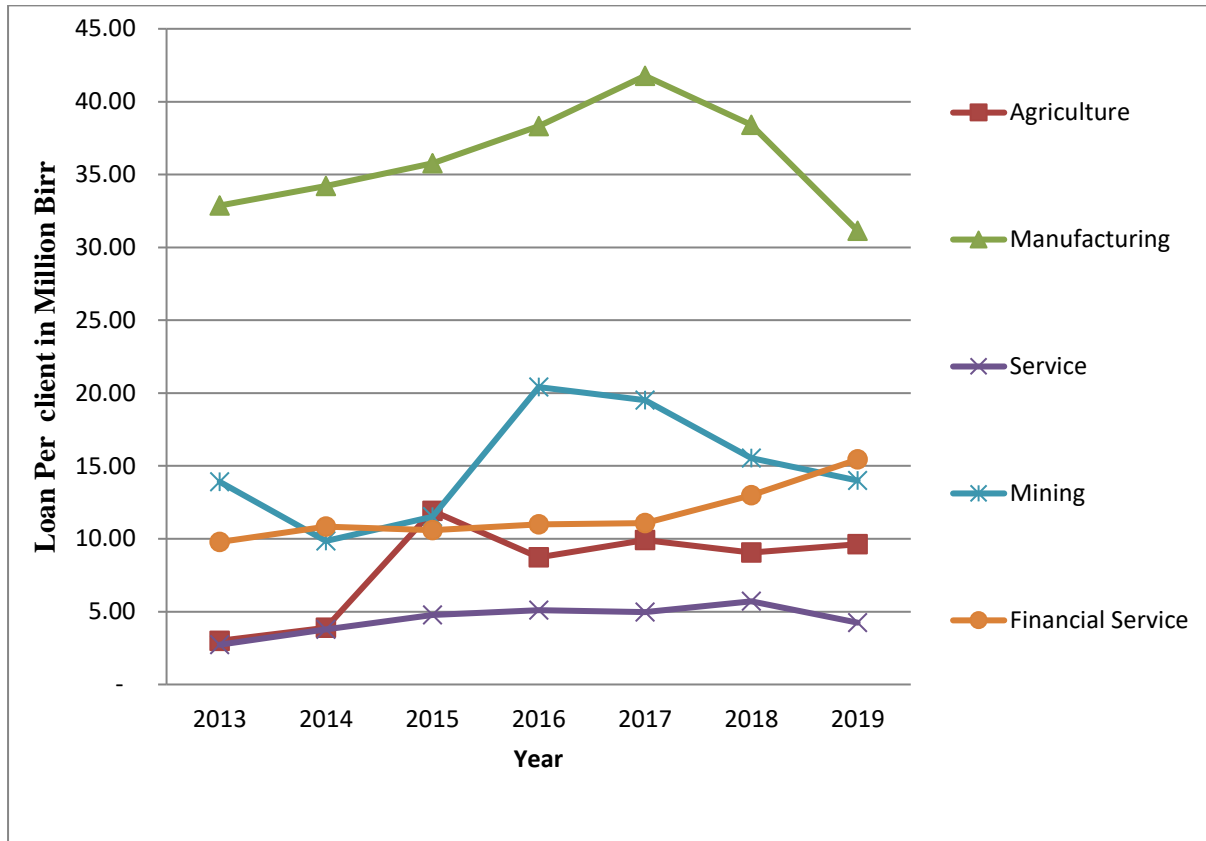


Figure 4. 11 Loan concentrations per client by sector

DBE gives loan to the agriculture sector for production of oil crops, fiber crops, Horticulture cereal & pulses coffee and others. It gives credit for Agro service purpose too. The numbers of clients for the bank are more concentrated in the oil crops production sub-sector followed by fiber crops and agro-service. The number of clients in the oil crops sub sector is increasing while clients in the coffee and other sub-sectors are declining (Figure 4-12).

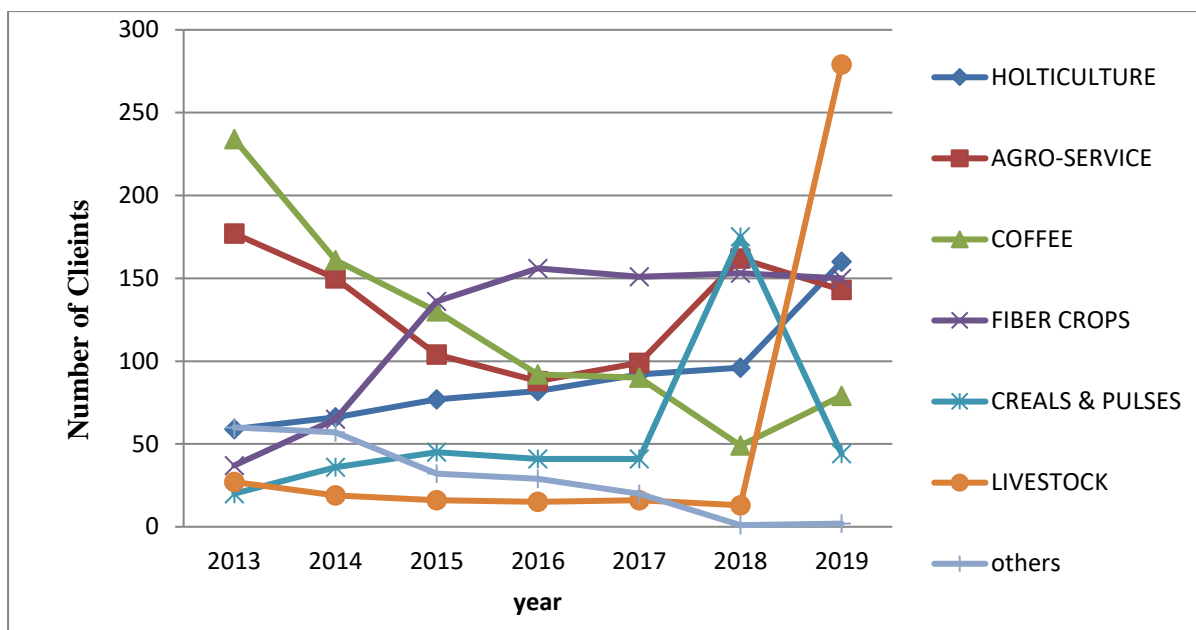


Figure 4. 12 Agriculture sector clients by category

However, in terms of loan amount the fiber crops production sector took the leading share followed by the oil crops, horticulture, cereal and pulses and other sub sectors respectively (Figure 4-13). The loan concentration per client is the highest in the fiber crops sub-sector too. It is followed by the horticulture, the livestock and oil crops sub-sectors respectively (Figure 4-14).

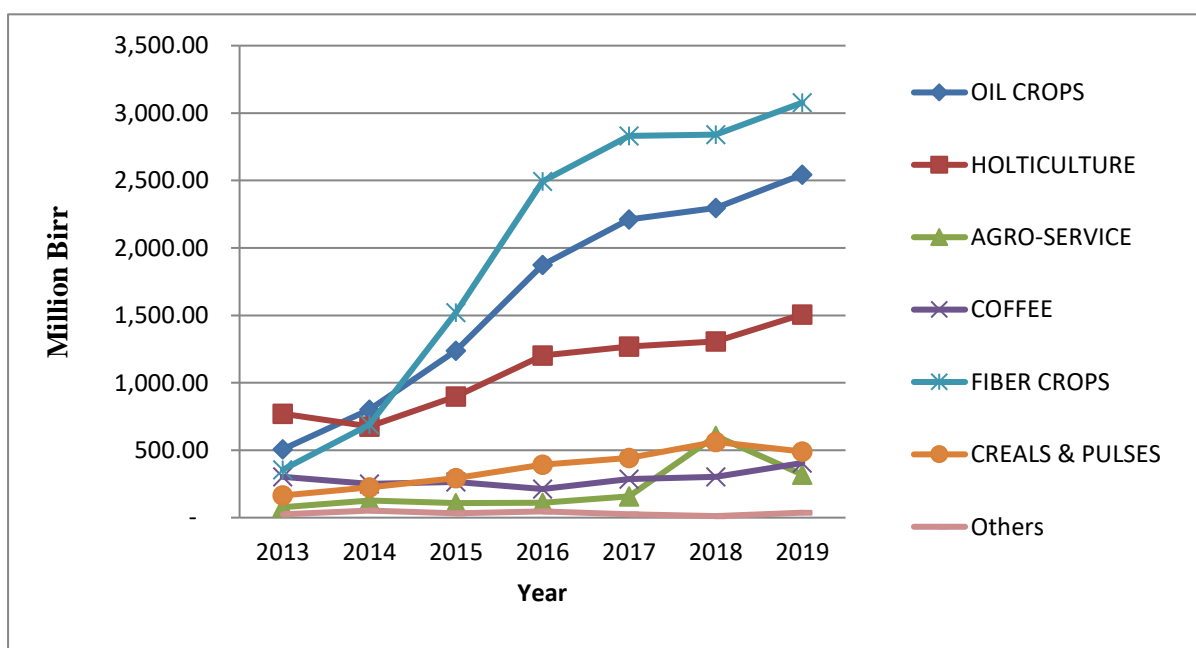


Figure 4. 13 Loan outstanding by Sub-sectors of Agriculture

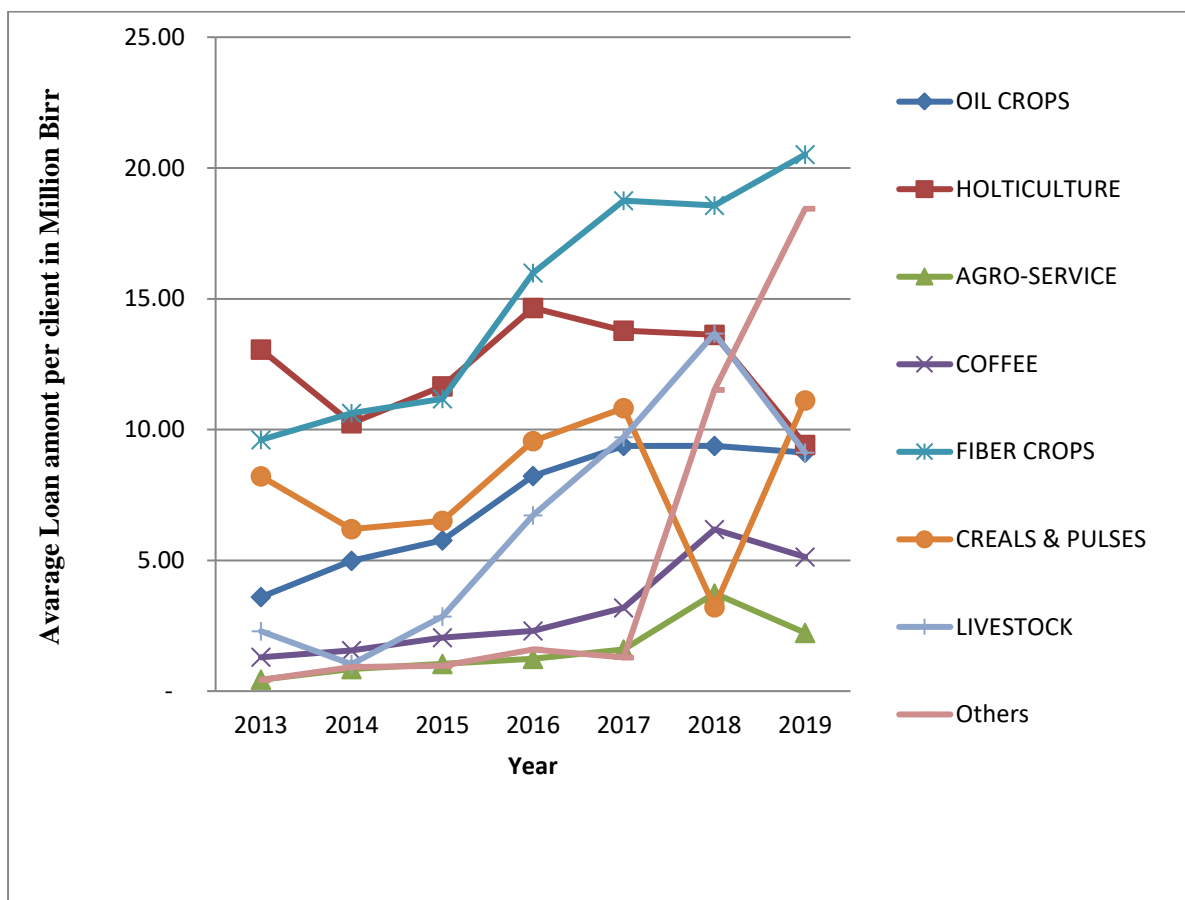


Figure 4. 14 Loan amount Concentration per client by sub-sectors

4.2.3 The Manufacturing sub Sector loan Assessment

To support the country’s economic development through the manufacturing sector growth following the Growth and transformation plan of the country, it gives loan to the cottage industry, food processing, agro processing, manufacturing of liquor and beverage, metallic and non-metallic products, textile and garments, chemical & plastic products, wood and paper products etc.

Manufacturing of Textile and garments takes the leading share of the Bank’s outstanding loan followed by integrated agro processing, manufacturing of non-metallic products production of household appliance, rubber and communication equipment and apparatus production , manufacturing of plastic and chemical products and the food processing sub-sectors respectively.

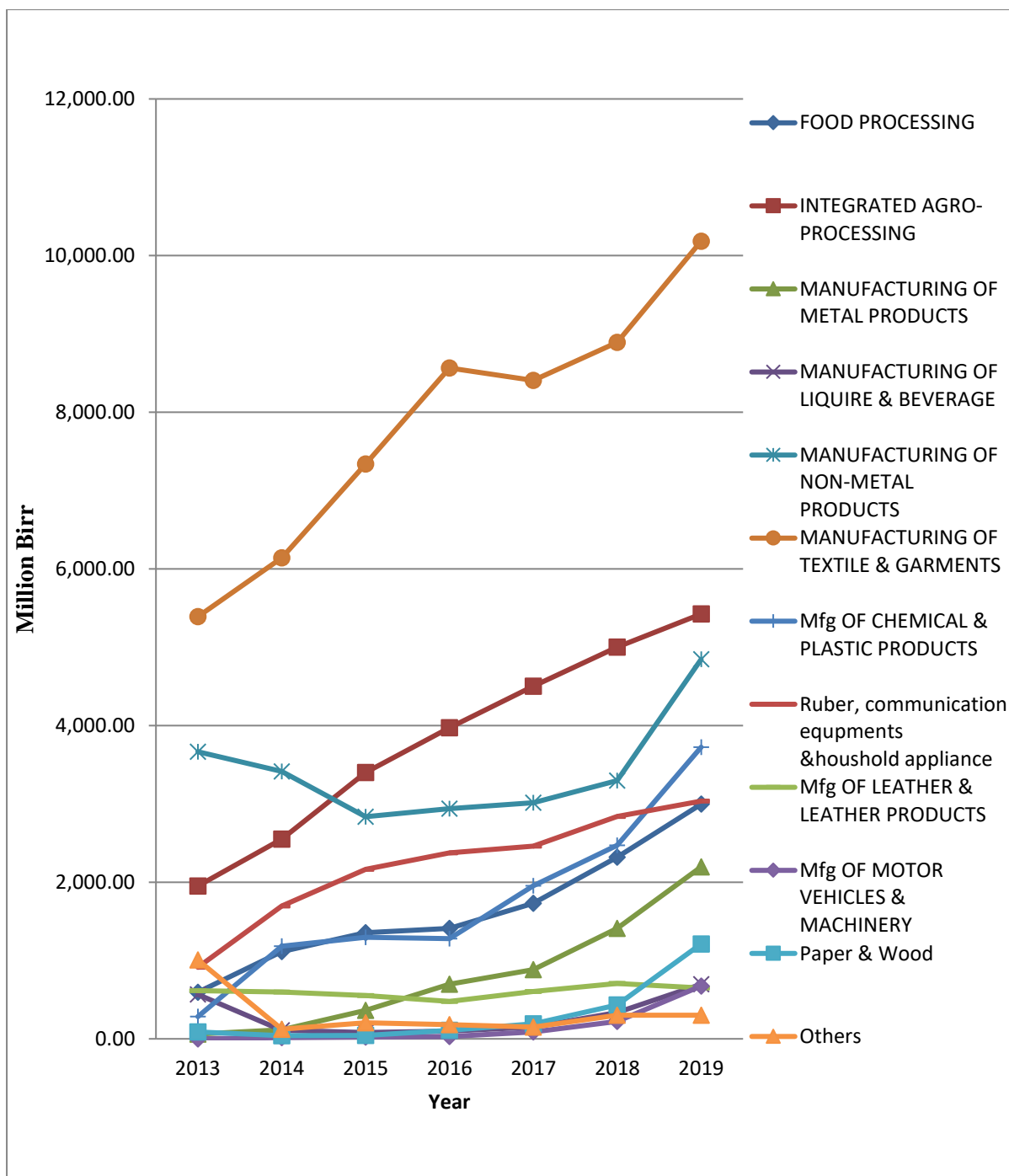


Figure 4. 15 outstanding loans by the Manufacturing sub-sector

Based on the number of clients having outstanding loan, the food processing and the integrated agro-processing, manufacturing of chemicals & plastics sector, and the manufacturing of textile and garments sub sectors are dominating respectively. The loan amount per client is higher in the agro processing sub sector followed by the manufacturing of textile and garments (see Figure 4-16 & Figure 4-17).

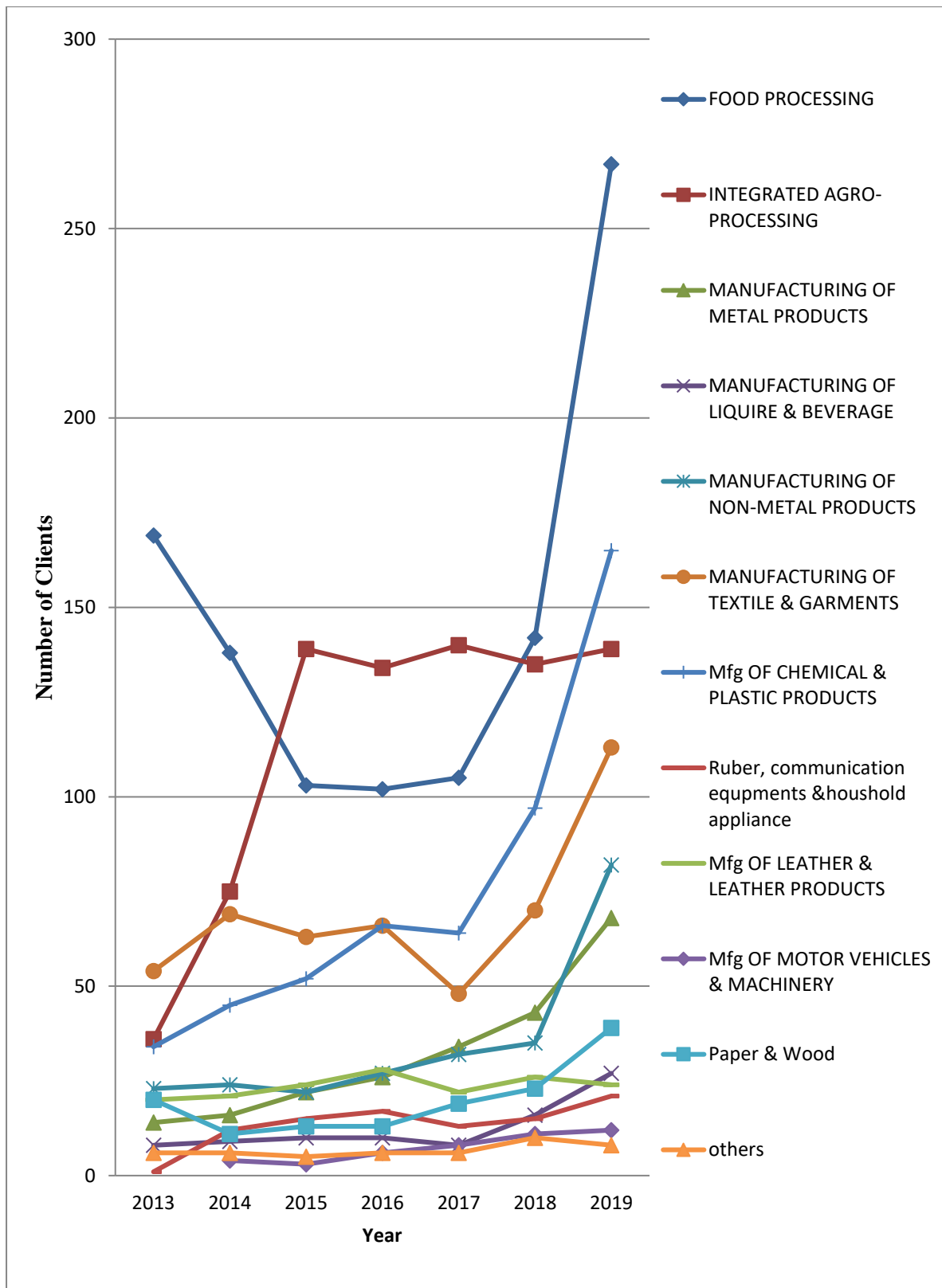


Figure 4. 16 Number of clients having outstanding loan in DBE by manufacturing sub-Sector

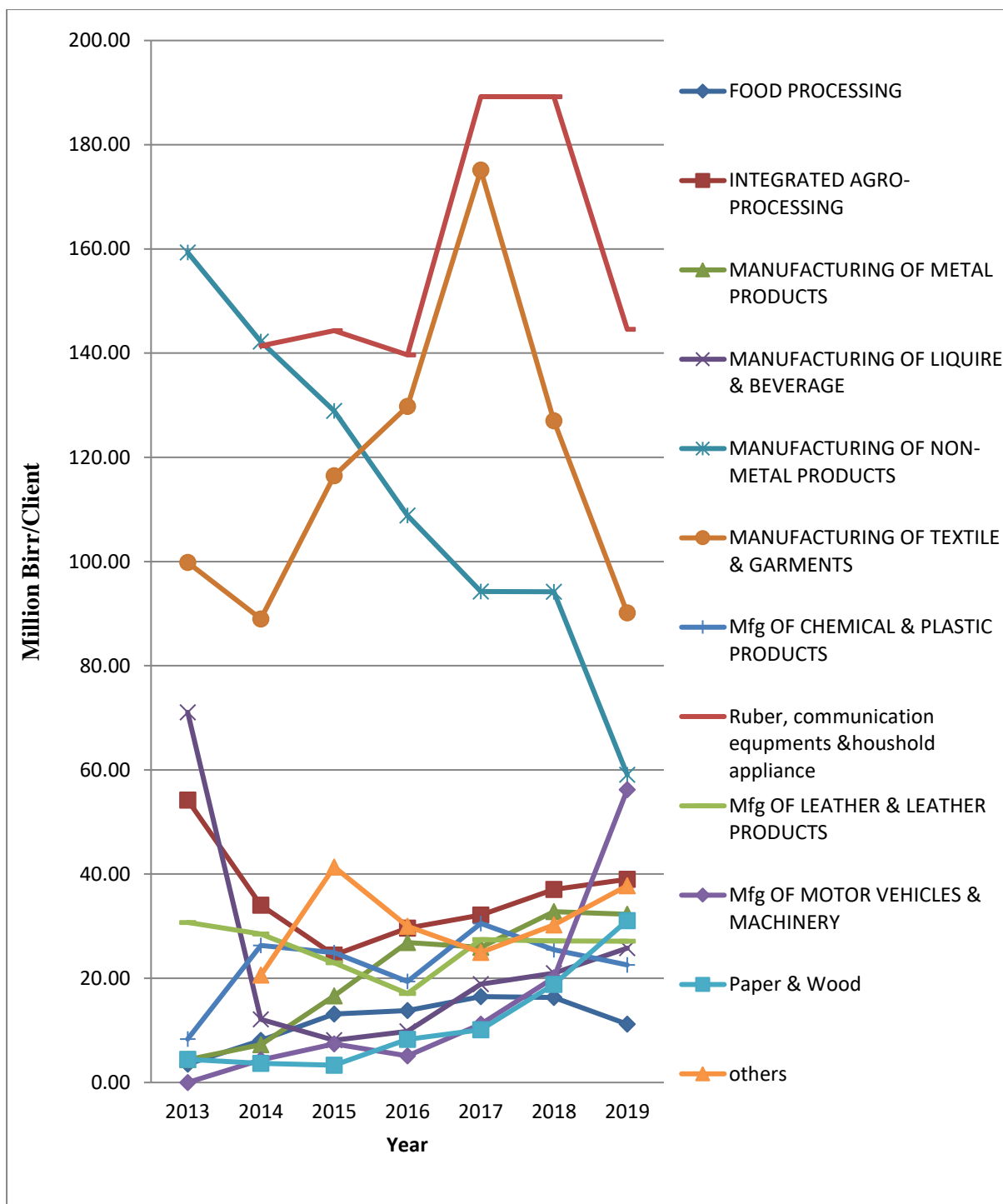


Figure 4. 17 Loan amount per client by sub-sectors

4.2.4 Trend of Nonperforming loan by number of clients and loan amount

The number of clients whose loan status is non-performing has been increasing for the agriculture sector and manufacturing sector loan. The trend of clients getting into the non-performing loan status has been increasing by far higher rate in the agriculture sector than the other sectors (see Figure 4-18).

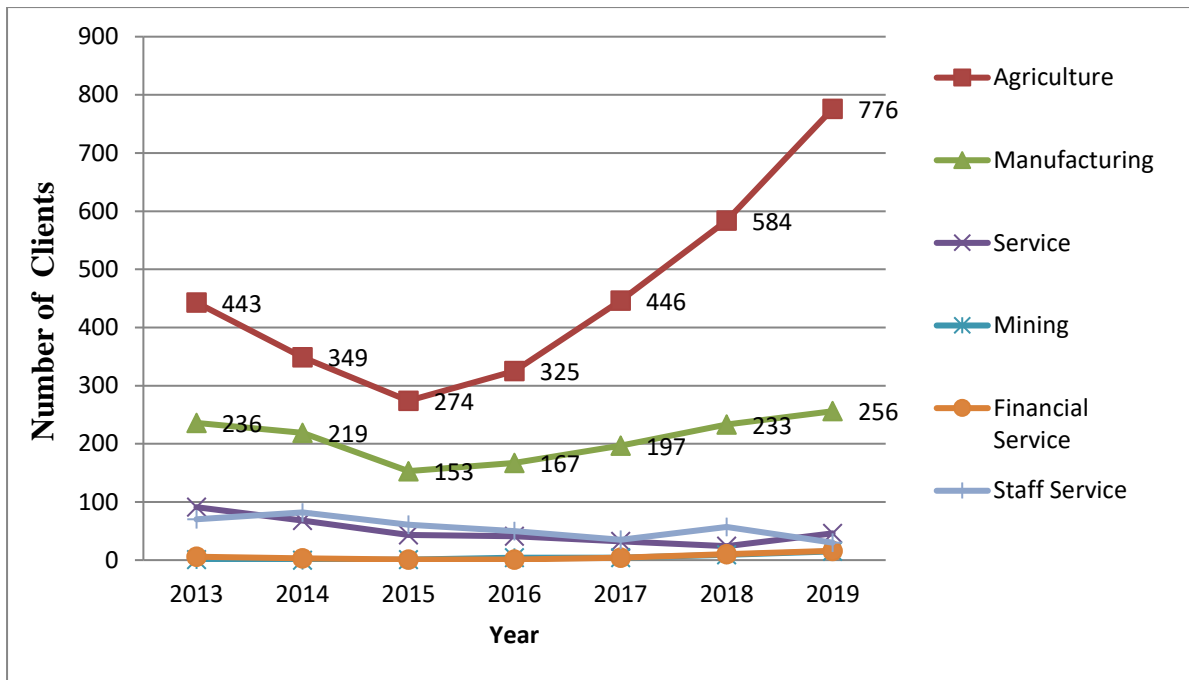


Figure 4. 18 Number of clients with non-performing loan by sector

However; the non-performing loan amount is dominated by the manufacturing sector and then followed by the agriculture sector. Both sectors have shown an increasing trend in NPLs since 2015 (See Figure 4-19).

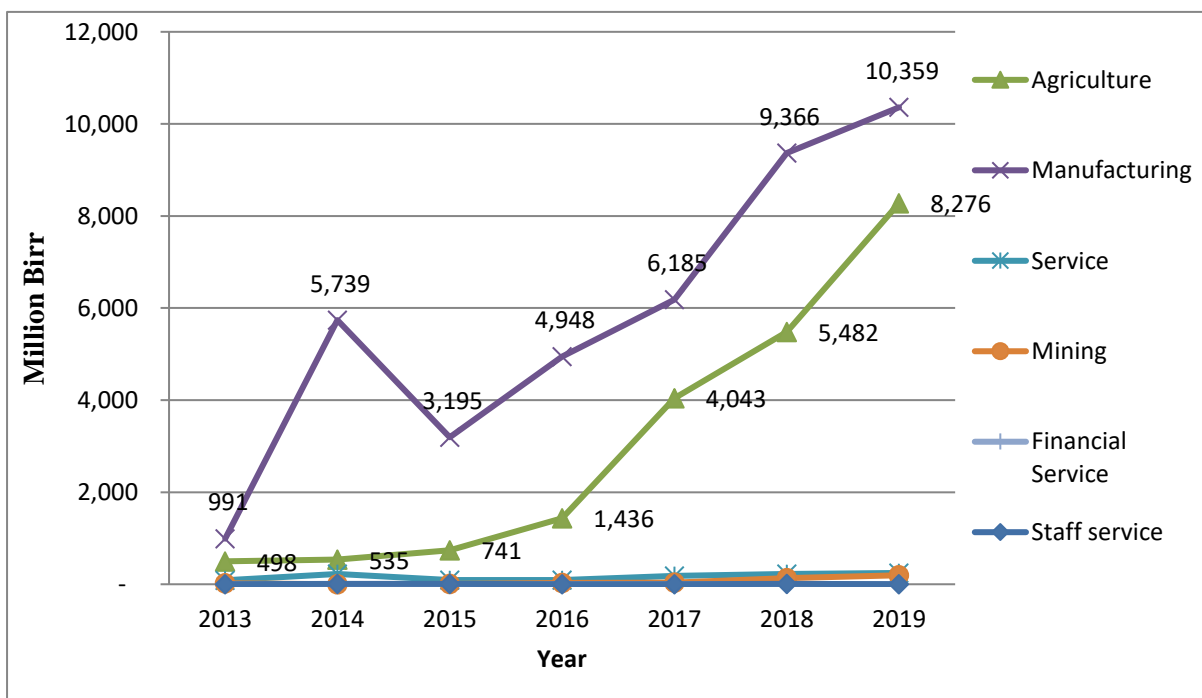


Figure 4. 19 Trend in amount of non-performing loan by sector

The NPL ratio calculated based on numbers of clients and loan amount showed that the agriculture sector is the most risky sector in terms of recoverability of loan through collections followed by the manufacturing, service and mining and extraction sector respectively (see Figure 4-20 and Figure 4-21).

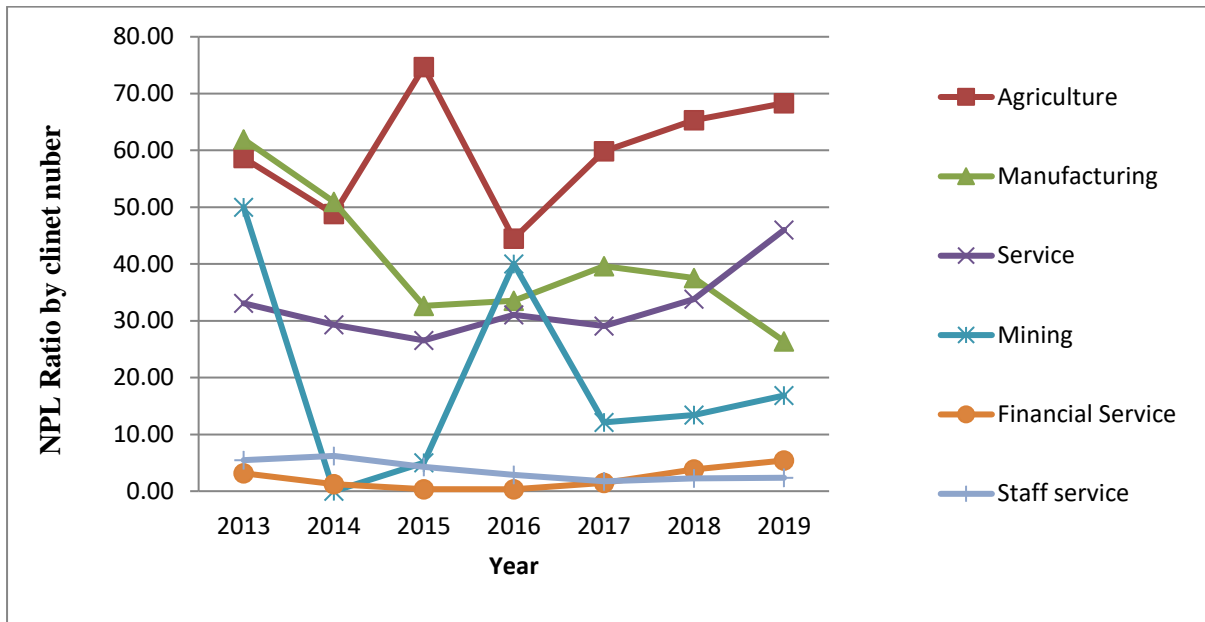


Figure 4. 20 NPL Ratio Calculated by clients Number

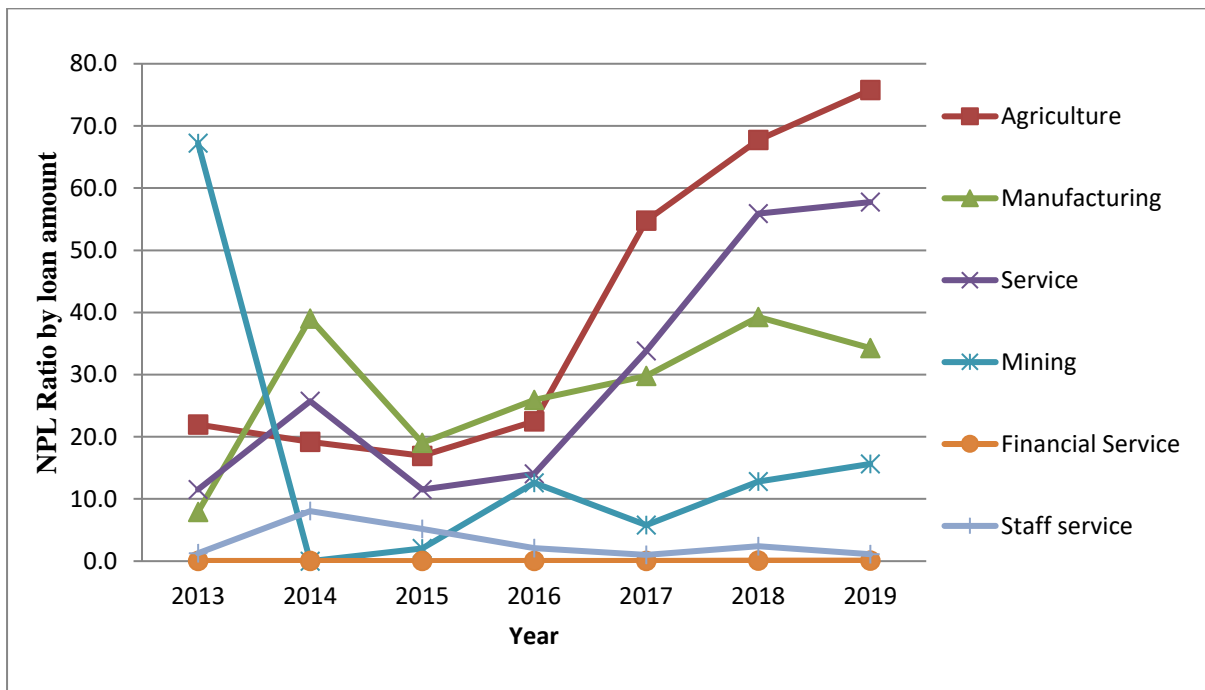


Figure 4. 21 NPL Ratio Calculated by loan amount by sector

4.2.5 The agriculture sub-sector loan Assessment

The non-performing loan in the agriculture sector is mainly attributed to fiber crops, oil crops production and the horticulture sub sectors. As described in Figure 4-22, the number of clients whose loan becomes NPL has been increasing for the Oil crops production sub sector, followed by the fiber crops and pulses and cereals production sub sectors of the agriculture. The bank should give due attention for these subsectors for the ease of loan collection problems.

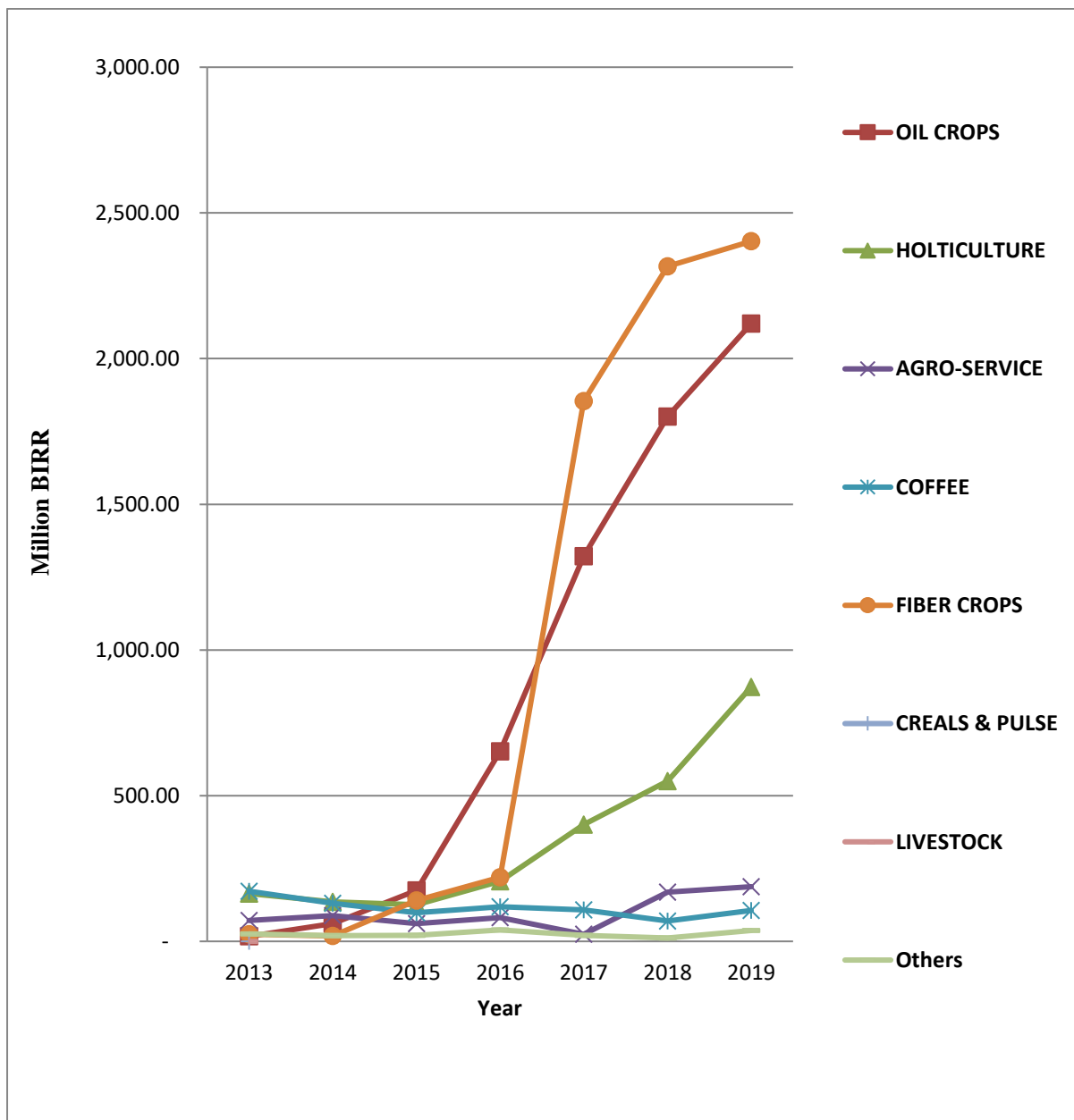


Figure 4. 22 NPL by the agriculture sector sub sectors

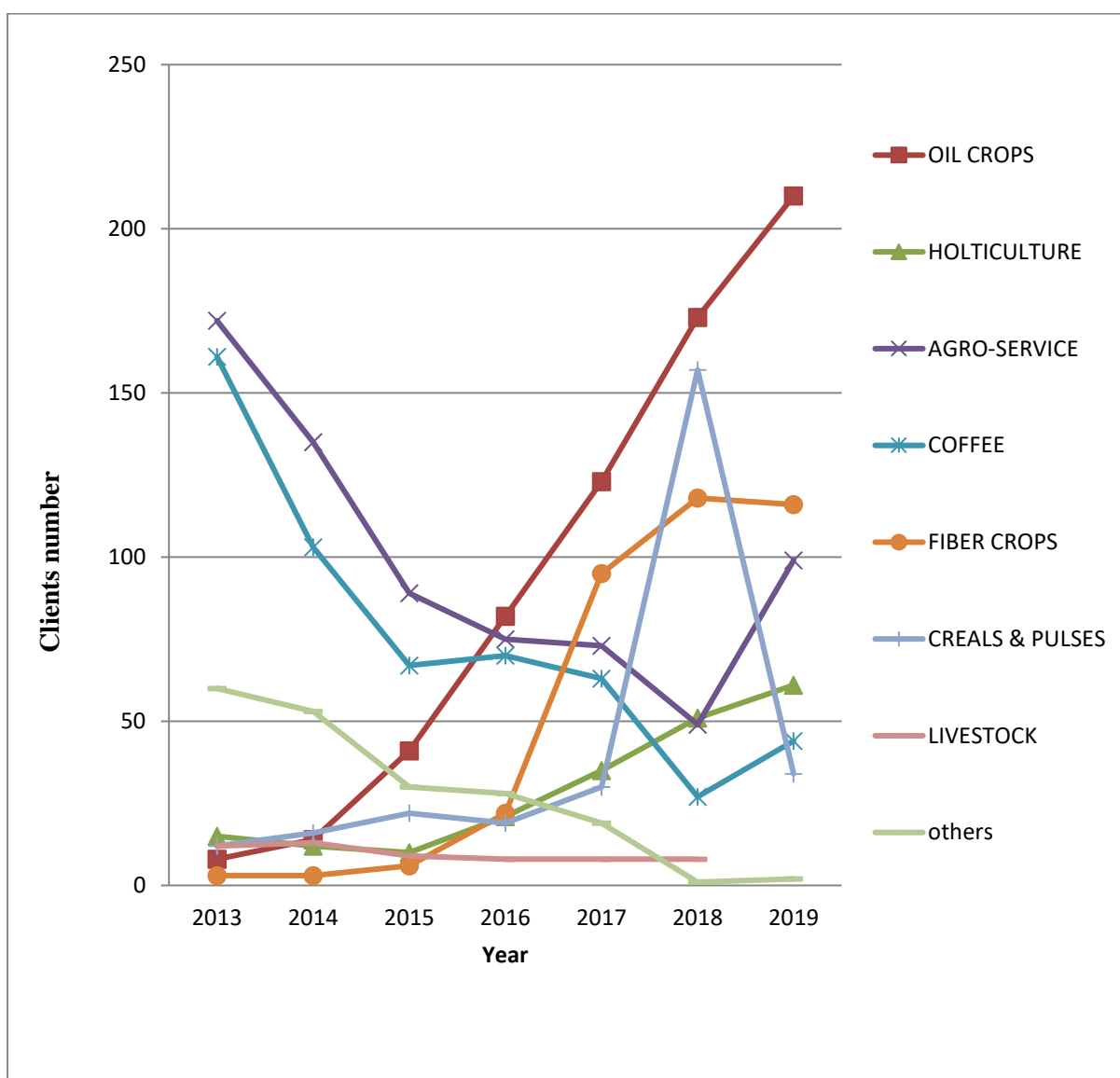


Figure 4. 23 Number of clients with non-performing loan by sub-sectors of Agriculture

4.2.6 The manufacturing sub Sector loan Assessment

The manufacturing sector NPL is mainly associated with the textile and garment sub-sector. The integrated agro processing subsector and the household appliance manufacturing sub sectors NPL has been increasing in recent years, As a result due attention should be given for such sub-sectors while making a monitoring and follow up and the processing of additional loan requests. Especially the number of clients whose loan enters in the category of NPLs is increasing in the integrated agro processing sub-sector (See Figure 4-24).

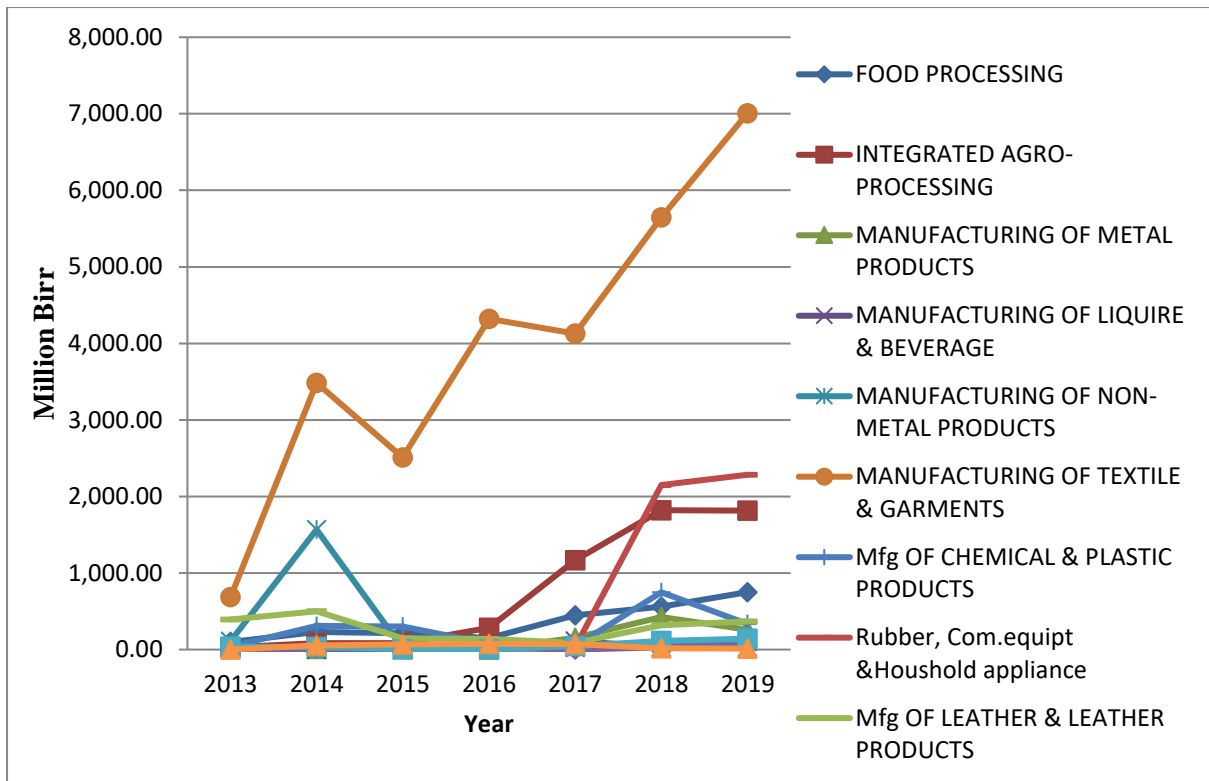


Figure 4. 24 Trends of NPL by the manufacturing sub sectors

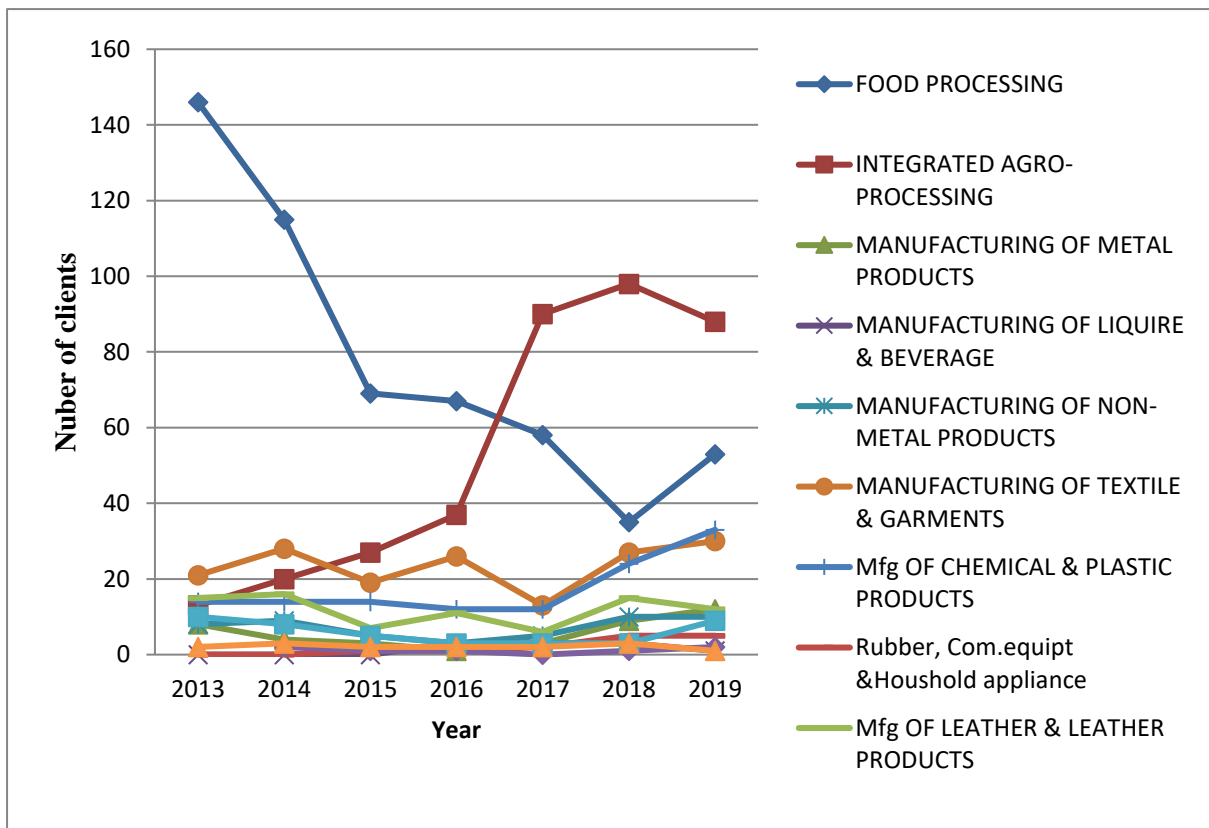


Figure 4. 25 Number of client with their loan under NPL by sector

4.3 Loan Collection Performance

4.3.1 The nexus of NPL and Collections in DBE

The NPL amount for the bank has showed a sharp increment which is not matched by the increment in our efforts to increase the level of our collection. Figure 4-26 clearly showed that we have no improvements in the level of our collections while the amount of NPL is increasing and surpassing the collections.

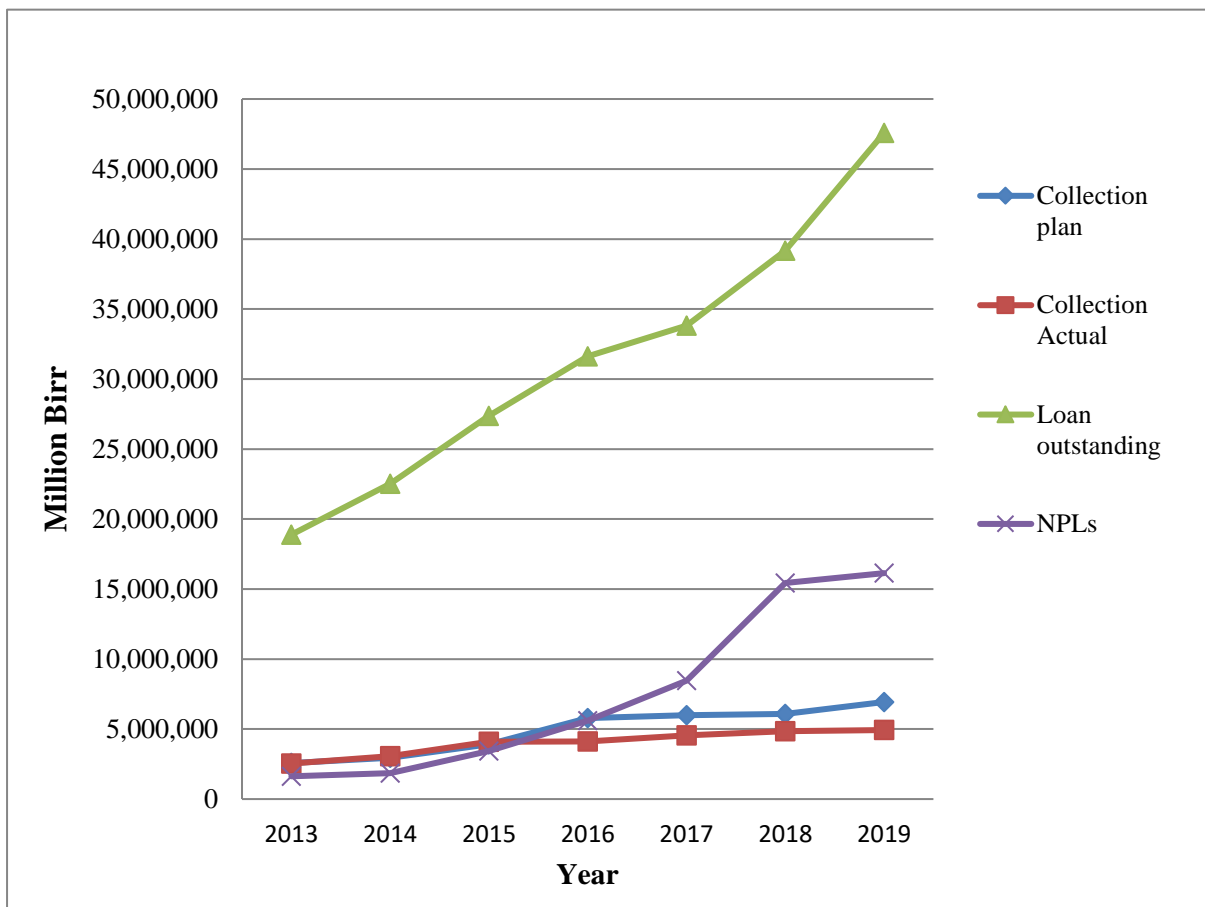


Figure 4. 26 Amount of loan collected and non-performing loan trend

It is obvious that the level of collection in terms of plan and actual should go with the amount of outstanding loan growth that the bank has shown. Loan outstanding has shown average growth rate of 17% while actual collection amount and planned collection amount registered average growth rate of 12% and 19% respectively.

Table 4.8 Loan collection plan & actual, outstanding loan and NPLs in Million Birr

Year	Collection plan	Collection Actual	Loan outstanding	NPLs
2013	2,573,852	2,539,950	18,886,582	1,627,124
2014	2,961,450	3,053,551	22,523,263	1,853,254
2015	3,900,155	4,087,324	27,362,467	3,431,034
2016	5,788,152	4,109,070	31,630,367	5,601,862
2017	6,000,000	4,560,094	33,822,000	8,449,943
2018	6,092,655	4,842,183	39,155,361	15,439,406
2019	6,934,214	4,930,606	47,577,140	16,136,351
Average Growth	19%	12%	17%	50%

The prevailing gap between actual and plan collection of loan on one hand and the increasing level of loan outstanding and Non-performing loan on the other hand is an indicator of the bank has also exerted less effort for collection of its loans. At least the Bank should increase the collection in terms of plan so that it can match with its loan outstanding (See Table 4.8 and Figure 4-26).

4.3.2 Collection Trend and Performance for the Last Five Years

Under this section, the last five years' DBE's loan collection trends and performances have been addressed. In order to see the past loan collection trends of the Bank, the researchers considered the total loan collection plan and actual total collect loans of the Bank for the last five fiscal years. Besides this, Loan Outstanding Position, Non-Performing Loan Ratio, and Loan Recovery Rate of the Bank have been considered. So as to see the performances of the Bank on these issues, five fiscal years periods have been taken into account commencing from 2014/15-2018/19. Accordingly, the plan and actual performances of the Bank on the loan collection, Loan Outstanding Position, NPL Ratio and loan Recovery Rate of the Bank for the last five years have been stated on the table below;

Table 4.9 Loan Collection, Loan Outstanding, NPL Ratio and Loan Recovery Rate Performance of the Bank for the Last Five Years “in Billion Birr”

Credit Operations	2014/15 F.Y Performance			2015/16 F.Y Performance			2016/17 F.Y Performance			2017/18 F.Y Performance			2018/19 F.Y Performance		
	Plan	Actual	%	Plan	Actual	%	Plan	Actual	%	Plan	Actual	%	Plan	Actual	%
Loan Collection	3.90	4.09	105%	5.78	4.11	71%	6.00	4.56	76%	6.09	4.84	79%	6.93	4.99	72%
Loan outstanding	32.15	27.36	85%	38.61	31.63	82%	42.46	33.82	80%	40.54	39.15	97%	41.78	47.58	114%
NPL ratio	5.27%	12.54%	42%	9.45%	17.71%	53%	9.16	24.98%	46%	16.97%	39.43%	43%	15.76%	33.92%	46%
Loan Recovery Rate	63%	47%	75%	57%	53%	93%	67%	50%	75%	58%	40%	69%	55%	50.09%	91%

Source: DBE Annual Report of 2014/15-2018/19

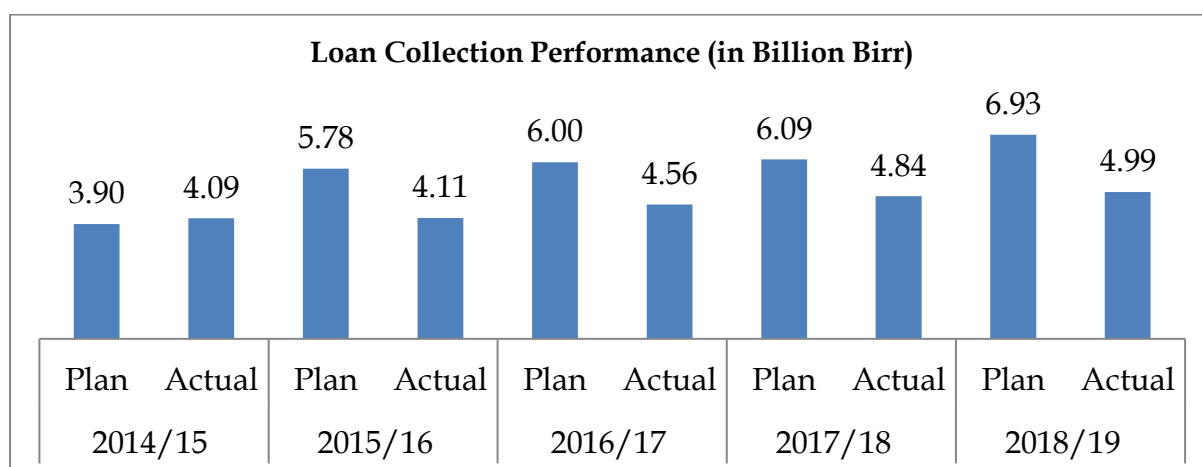
☞ Loan Collection Performance

As can be seen from the above table 4.8, in 2014/15 fiscal year, the Bank set plan to collect 3.90 billion birr; however, the Bank collected 4.09 billion birr which was more than 100% and appreciable. However, during the 2015/16 fiscal year, the Bank planned to collect 5.78 billion birr but the actual performance of the Bank was 4.11 billion birr which was 71% of the target. This year, the performance of the Bank towards loan collection was less compared to the preceding year which was more 100% of the targeted.

The loan collection status of the Bank during the fiscal year of 2016/17 was 76% of its target. During 2016/17 fiscal year, the Bank planned to collect 6 billion birr but it collected 4.56 billion birr (76%) of the targeted. Performance of the Bank during the indicated period was slightly better than the 2015/16 fiscal year performance which was 71% of its targeted plan. During 2017/18 fiscal year, the performance of the Bank on loan collection was 79% of its plan which was better than the preceding fiscal year. During this fiscal year, the Bank planned to collect 6.09 billion birr and actually collected 4.84 billion birr which was 79% of the targeted. During the fiscal year 2018/19, the Bank set plan to collect 6.93 billion birr but the actual loan collection performance of the Bank was 4.99 billion birr 72% of the targeted plan.

The actual loan collection performance of DBE from 4.09 Billion Birr in 2014/15 reached to 4.99 Billion Birr with average annual growth rate of 5.17%

Figure 4. 27 Loan Collection Performance of the Bank



Source: DBE Annual Report of 2014/15 - 2018/19

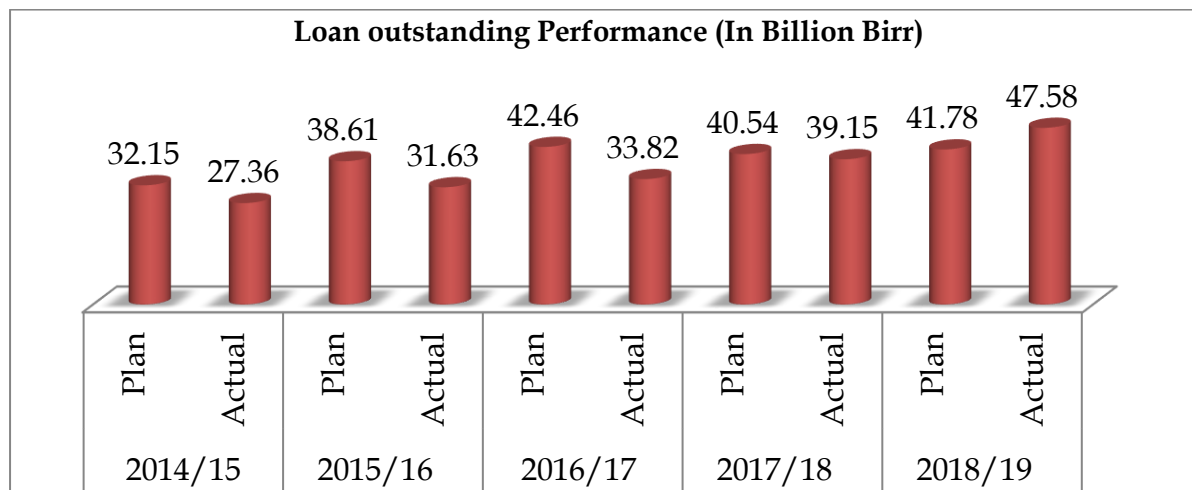
In general, the performance of the Bank on actual loan collection was steadily increasing for the last five years. The Bank only registered best performance and above its plan during the fiscal year of 2014/15 which was more than 100% of the targeted. After the 2014/15 fiscal year, the performance of the Bank on loan collection began declining and the Bank failed to attain its targets; particularly the Bank registered less performance on loan collection during the fiscal year of 2015/16 and 2018/19 which were 71% and 72% of the target respectively.

☞ Performance on Loan Outstanding

It is the total amount yet to be paid to the Bank in the future including due and undue principal and interest loans. Based on the result of table above, the loan outstanding performance of the Bank for the last five years is explained as follows;

- During 2014/15 fiscal year, the targeted loan outstanding position was 32.15 billion birr while the actual loan outstanding at the end of the fiscal year was 27.36 billion birr which 85% of the planned target.
- During 2015/16 fiscal year, the Bank planned to have 38.61 billion birr loan outstanding but the actual loan outstanding position of the Bank at the end of the fiscal year was 31.63 birr 82% of the plan. The performance of the Bank during fiscal year was slightly less than the preceding year.
- In 2016/17 fiscal year, the actual loan outstanding was 33.82 billion birr (80% of the targeted plan). During this fiscal year also the performance of the Bank decreased slightly compared to the preceding year.
- During 2017/18 fiscal year, the actual loan outstanding position of the Bank was 39.15 billion 97% of the targeted plan and it was the best performance.
- In 2018/19 fiscal year, the Bank planned to have 41.78 billion birr and registered more than the targeted plan 47.58 billion birr 14% more than the targeted plan.

Figure 4. 28 Loan Outstanding Performance of the Bank



Source: DBE Annual Report of 2014/15 - 2018/19

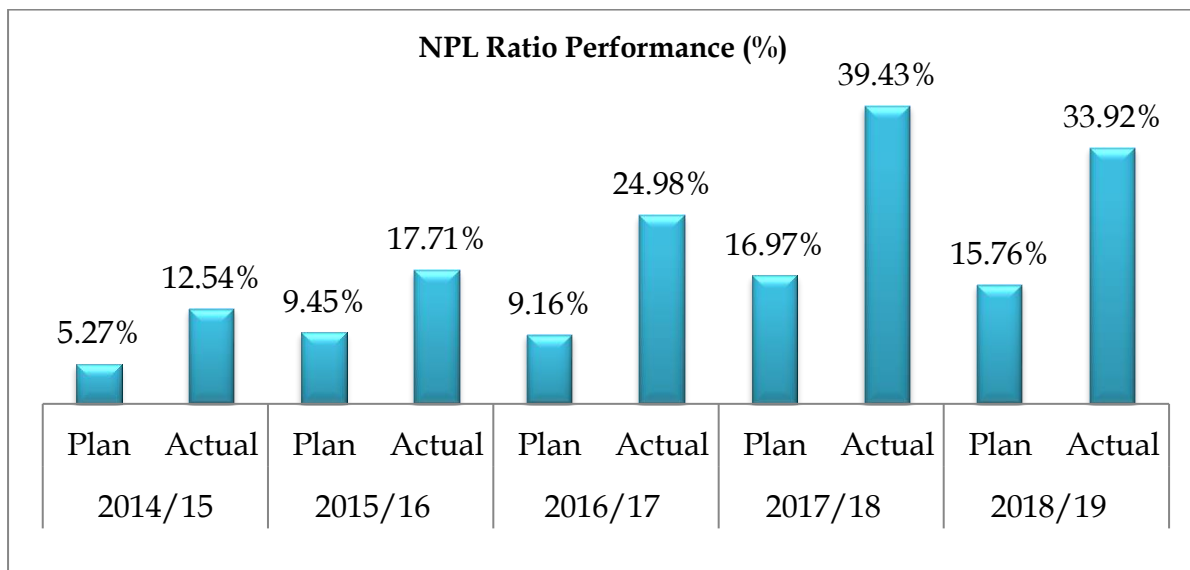
In general, as can be seen from the above figure, the total actual loan outstanding positions of the Bank were increasing during the last five fiscal years.

☞ **Non-Performing Loan Performance**

A non-performing loan (NPL) shall mean bad debts as defined by NBE for development financial institutions as per in the Directives No SBB/52/2012 of January 19, 2012. In line with the non-performing loans, the performance of the Bank is very low and the actual non-performing loan ratios of the Bank during the last five years have been stated on the above table 4.8. Accordingly;

- During 2014/15 fiscal year, the targeted NPL ratio of the Bank was 5.27% but the actual NPL ratio of the Bank was 12.54% which was 42% higher than the targeted plan.
- In 2015/16 fiscal year, the Bank planned to have 9.45% NPL ratio, however, the actual NPL ratio of the Bank reached 17.71% (5.6 billion birr) which was 53% higher than the targeted plan. This implies that the performance of the Bank in minimizing the NPL Ratio during the fiscal year was poor in relation to the target.
- The Planned NPL ratio of the Bank during 2016/17 was 9.16% while the actual NPL ratio of the Bank reached 24.98% (8.45 billion birr) that is 46% higher than the targeted plan.
- During the fiscal year of 2017/18, the actual NPL ratio of the Bank reached 39.43% (15.44 billion birr) which was 43% higher than the planned target.
- In 2018/19 fiscal year, the Bank targeted 15.76% NPL ratio at the end of the year but the actual NPL ratio of the Bank was 33.92% (16.14 billion birr) which was 46% higher than the targeted plan.

Figure 4. 29 NPL Ratio Performance of the Bank



Source: DBE Annual Report of 2014/15 - 2018/19

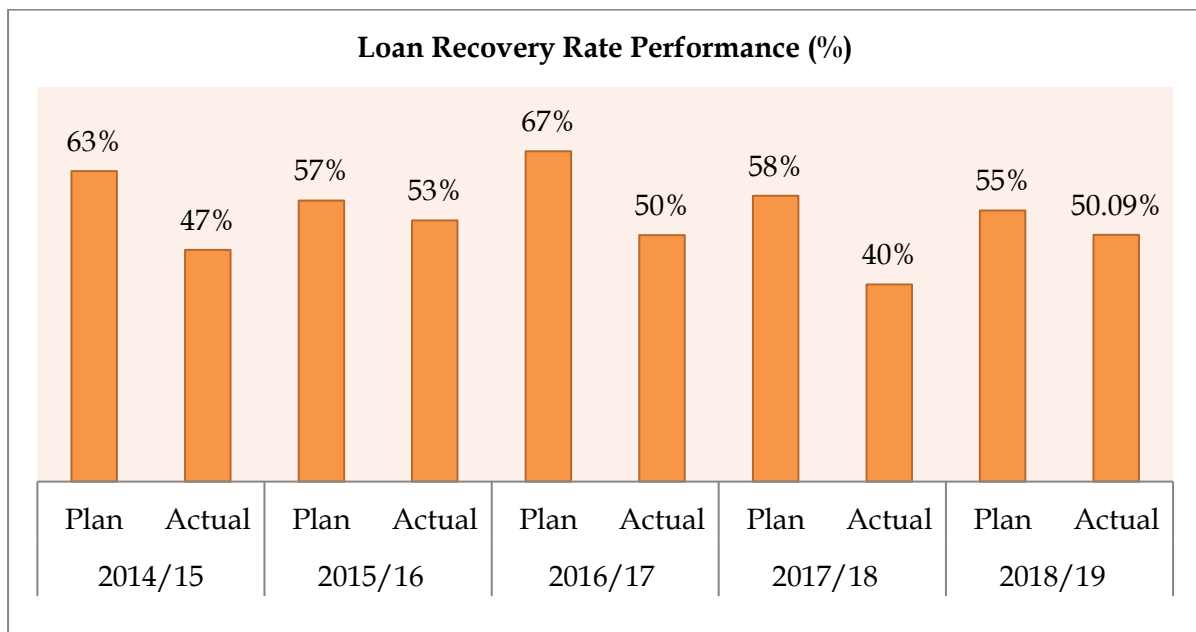
In nutshell, the NPL ratio of the Bank was increasing for the last five years and the performance of the Bank in reducing NPL ratio has not been sufficient. Besides, even the Bank did not approach to its plan in minimizing the NPL Ratio in the last five years. So, the Bank needs to take appropriate measures to minimize the NPL ratio so as to improve its performance and get its loan back.

☞ **Loan Recovery Rate Performance**

During the last five fiscal years, the loan recovery rates of the Bank were fluctuating from time to time.

- During the 2014/15 fiscal year, the planned loan recovery rate of the Bank was 63% and the actual performance was 47% which is 75% of the target.
- In the 2015/16 fiscal year, the targeted loan recovery rate was 57% while the actual performance was 53% which was 93% of the plan.
- During the fiscal year of 2016/17, the targeted Loan Recovery rate of the Bank was 67% and the actual achievement was 50% and it was 75% of the targeted plan.
- However, during the fiscal year of 2017/18, the targeted Loan Recovery Rate of the Bank was 58% and the actual performance was 40% which was 69% of the targeted performance.
- In 2018/19 the Bank targeted 55% Loan Recovery Rate and achieved 50.09% which was 91% of the targeted.

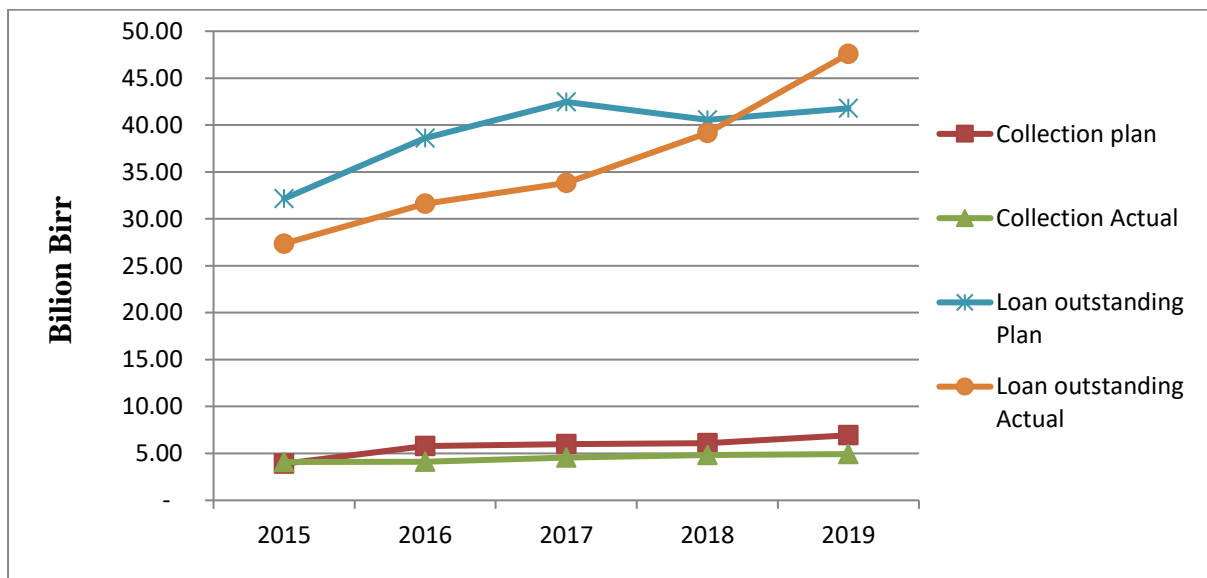
Figure 4. 30 Loan Recovery Rate Performance of the Bank



Source: DBE Annual Report of 2014/15 - 2018/19

In general, the performance of the Bank on loan recovery rate was fluctuating and the Bank didn't achieve full of its target in last five years. The Bank registered least performance (40%) on Loan Recovery Rate during the fiscal year of 2017/18 which was 69% of the target. Hence, the Bank has to work on recovering its loans so as to be successful and achieve its goals.

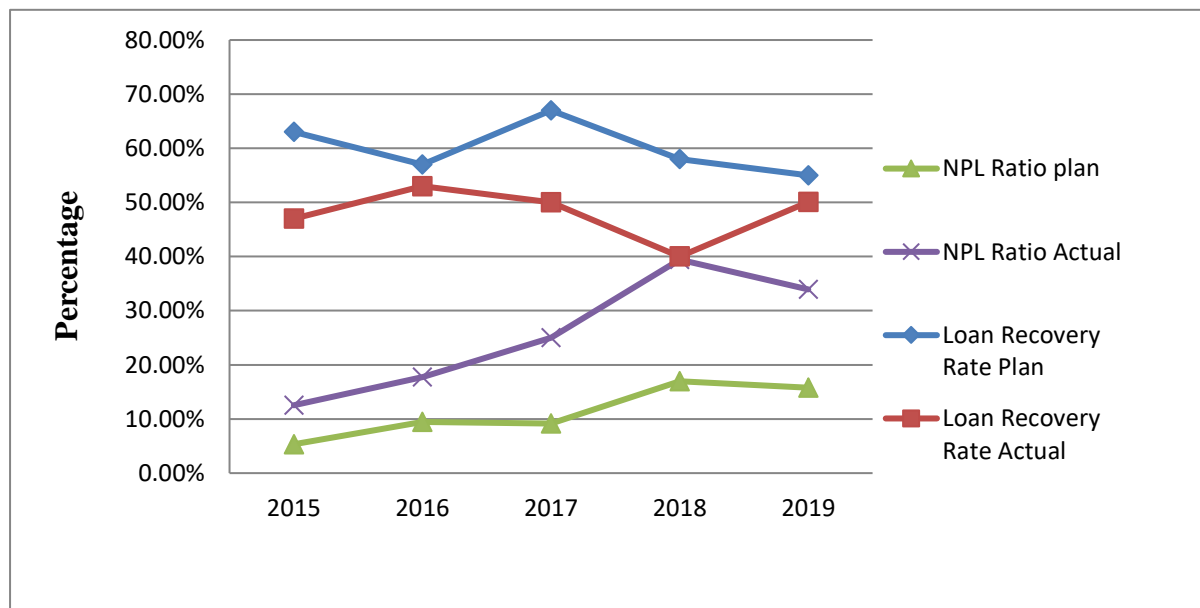
Figure 4. 31 Loan Collection & outstanding Plan and Actual



Source: DBE Annual Report of 2014/15 - 2018/19

The above figure indicates that actual loan outstanding has been increasing steadily and it also surpassed the plan that the working units has set. On the other hand, the amount of actual loan collection has not shown a progress that should have been matched with the Bank`s actual loan outstanding. Unlike our loan outstanding the amount of planned loan collection has been above the actual loan collection amount in the previous three years. The implication is that the loan processing units should take care of disbursing the planed loan amount so that it would have no impact on our loan collection. They should also plan and make efforts to match their collection plan and hence the actual loan collection amount to be in line with the amount of actual loan outstanding that the Bank has. This is a signal that the working units have given less weight for collection efforts as compared to the disbursement process. This has worsened the loan recovery rate of the bank (See Figure 4-32). The loan recovery rate both the plan and the actual has been declining while the planed and actual NPLs has shown increments. The effort that working units has exerted for loan recovery and reduction in NPLs is very poor. At least, if there were no improvement, they should have maintained the same level of loan recovery rate and NPL ration targets in their plan.

Figure 4. 32 NPL Ratio and Loan Recover Rate Plan Vs Actual



Source: DBE Annual Report of 2014/15 - 2018/19

In nutshell, the NPL ratio of the Bank was increasing for the last five years and the performance of the Bank in reducing NPL ratio has not been sufficient. Besides, even the Bank did not approach to its plan in minimizing the NPL Ratio in the last five years. So, the

Bank needs to take appropriate measures to minimize the NPL ratio so as to improve its performance and get its loan back.

4.3.3 Top Non-Performing Loans of DBE

As indicated in project evaluation and portfolio management directorate report (for the fourth quarter ended June 30, 2019). The largest five borrowers of the bank accounted for birr 10.47 billion (22.16%) excluding commitment balance of the total loan portfolio of the bank. If in any case these borrowers fail to meet their contractual obligation in servicing their debts, it will be a big loss to the bank. They all belong to loan under the head office and therefore, the concerned units are required to intensify the follow up activities and give the necessary technical assistance to minimize the risk of default. (Refer Table 4-10 below).

Table 4.10 The Largest 5 Borrowers of the Bank

Sr. No	Name of Clients	NO. of Loan	Total Outstanding Excluding Commitment Balance	%share to total outstanding Excluding commitment balance
1	Tendaho Sugar Factory	1	3,118,095,642.45	6.60 %
2	Ayka addis Textile & Investment Group Plc.	3	2,676,981,984.94	5.67%
3	BMET Energy Telecom Industry Trade Plc.	2	1,884,273,900.58	3.99%
4	MNS Manufacturing Plc.	2	1,489,779,044.23	3.15%
5	Amhara Credit & Saving Institution S.C.	22	1,302,003,602.03	2.76%
	Total	30	10,471,134,174.23	22.16%

The largest top twenty borrowers of the bank stood at birr 9.57 Billion. This accounts for 20.26% of the total portfolio of the bank excluding commitment balance and & 59.33% of the total NPLs of the bank. Of Top 20 NPLs four borrowers constitute the highest such as AYKA ADDIS Textile & Investment Group Plc. with the amount of birr 2,676,981,984.94

(5.67%), BMET Energy Telecom Indus Trade Plc. birr 1,884,273,900.58 (3.99%), MNS Manufacturing plc. Birr 1,489,779,044.23 (3.15%) and ETUR Textile Plc. birr 1,029,452,674.47 (2.18%) at June 30, 2019 respectively. The total non-performing loan status has been shows that manufacturing sector higher NPL ratio as compared to other sector in addition to this textile and garment sub-sector higher total NPL ratio.

Table 4.11 Top 20 Non-Performing Loans

No	Project name	Sector	Loan status	Total outstanding without commitment balance	%age share to Bank's total NPLs	%age share to Bank's total Outstanding without commitment balance
1	AYKAADDISTEXTILE&INVESTMENT GROUPPLC	Manufacturing	substandard	2,676,981,985	16.59%	5.67%
2	BMETENERGYTELECOMINDUS TRADEPLC	Manufacturing	Loss	1,884,273,901	11.68%	3.99%
3	MNS MANUFACTURINGPLC	Manufacturing	substandard	1,489,779,044	9.23%	3.15%
4	ETURTEXTILE PLC	Manufacturing	Doubtful	1,029,452,674	6.38%	2.18%
5	NUREDINABDULETIF	Manufacturing	substandard	366,210,341	2.27%	0.78%
6	MAJANG AGRO INDUSTRYPLC	Agriculture	substandard	319,324,485	1.98%	0.68%
7	KANORIA AFRICA TEXTILE PLC	Manufacturing	Doubtful	308,397,146	1.91%	0.65%
8	SEKA AGROPROCESSINGPLC	Manufacturing	Doubtful	251,468,115	1.56%	0.53%
9	MYSHOES ANDLEATHERMANUFACTPLC	Manufacturing	Doubtful	187,268,941	1.16%	0.40%
10	GIZALTEXTILEPLC	Manufacturing	Doubtful	175,092,178	1.09%	0.37%
11	DELEOPOLEINTERNATIONALHOTELPLC	Service	substandard	165,790,930	1.03%	0.35%
12	YIRGALEMADDISTEXTILEFACTORYPLC	Manufacturing	substandard	146,892,906	0.91%	0.31%
13	ALEMGENETTRADEANDINDUSTRYPLC	Manufacturing	Loss	133,246,433	0.83%	0.28%
14	DANIELMESELEGE BREYES	Manufacturing	Doubtful	78,080,865	0.48%	0.17%
15	TERICORDIAINTEGRATEDFARMPLC	Agriculture	Doubtful	68,669,342	0.43%	0.15%
16	RUCHI AGRIPLC	Agriculture	Loss	68,135,732	0.42%	0.14%
17	SULTANANDHIS FAMILY PLC	Manufacturing	Doubtful	62,080,985	0.38%	0.13%
18	IDCINVESTMENTPLC	Manufacturing	substandard	55,960,006	0.35%	0.12%
19	TAGYROSE INTEGRATEDFARMPLC	Agriculture	Doubtful	53,090,734	0.33%	0.11%
20	KIDANEWELDEMARIAMTEKLU	Agriculture	substandard	52,991,259	0.33%	0.11%
Total				9,573,188,003	59.33%	20.26

The largest top ten manufacturing borrowers of the bank stood at birr 6.87 Billion. This accounts for 18% of the total portfolio of the bank excluding commitment balance and & 53% of the total NPLs of the bank as indicated in project evaluation and portfolio management directorate report (for the fourth quarter ended June 30, 2019) at June 30, 2019 and different follow up report CRMD and PRLR. The researcher observed from the follow up report these projects has both internal and external problems which in turn has great impact in their loan repayment.

External problems

- Political unrest/instability
- Market problem
- Foreign currency shortage
- Power interruption/fluctuation
- Local raw material quality and availability problem
- Sudden government policy changes
- Unnecessary government intervention.

Internal problem

- Due diligence problem in which companies that must not get loan will get the service specially foreign borrowers for which we do not have sufficient information (CIC , detail KYC assessment report), lack of enough criteria to verify equity, tracing source of equity, it is more of subjective lacks objectivity, employee skill problem.
- Appraisal problem such as over financing & under financing, planning problem, lack of clear procedure, financing for unfeasible projects, missing important parts, not using realistic data, wrong financial assumption, lack of understanding external factors, absence of contingency strategy, raw material not properly considered, lack of technical database, lack of modern appraising software, ineffectiveness of project data management.
- Poor collection culture and delay in taking action and lack of collection strategy.
- Little attention was paid to maintaining or improving collections capabilities.
- Collection method not forced but by serving reminder at CRMD/branch, Corruption network & Bureaucracies in the Bank.
- Unethical DBE engineering evaluation, additional loan and unlimited rescheduling
- Weak collateral in case project defaults, Policy unsupported by procedure manual etc.

The largest top five agricultural borrowers of the bank stood at birr 562 million. This accounts for 1.19% of the total portfolio of the bank excluding commitment balance and 3.49% of the total NPLs of the bank as indicated in project evaluation and portfolio management directorate report (for the fourth quarter ended June 30, 2019) at June 30, 2019 and different follow up report CRMD and PRLR. The researcher observed from the follow up report these projects has both internal and external problems which in turn has great impact in their loan repayment.

External problems

- Political unrest/instability Market problem
- Unnecessary government intervention.
- Bad climate condition and weak insurance compensation coverage
- Lack of necessary support from stakeholders
- Land overlapping problem
- Data reliability problem
- Infrastructure problem
- Security problem
- Effect of brokers in lowering their selling prices

Internal problem

- Environmental issue (pollute river & lake, deforestation, etc.)
- Equity contribution delay have strong impact on project implementation delay
- Project implementation delay and quality problem in the construction
- Due diligence problem in which companies that must not get loan will get the service specially foreign borrowers for which we do not have sufficient information (CIC , detail KYC assessment report), lack of enough criteria to verify equity, tracing source of equity, it is more of subjective lacks objectivity, employee skill problem.
- Appraisal problem such as over financing & under financing, planning problem, lack of clear procedure, financing for unfeasible projects, missing important parts, not using realistic data, wrong financial assumption, lack of understanding external factors, absence of contingency strategy, raw material not properly considered, lack of technical database, lack of modern appraising software, ineffectiveness of project data management.
- Poor collection culture and delay in taking action and lack of collection strategy.

- Little attention was paid to maintaining or improving collections capabilities.
- Collection method not forced but by serving reminder at CRMD/branch, Corruption network & Bureaucracies in the Bank.
- Unethical DBE engineering evaluation, additional loan and rescheduling are unlimited.

4.4 Analysis of data from Key Informant Interview and Follow up reports

As a policy Bank, DBE is entrusted to serve as a tool for the country's development through providing medium and long term credit to Commercial Agriculture, Agro-processing, Manufacturing, Mining & Extractive Industries and SMEs and technical support to viable projects that are selected as priority areas by the government.

DBE NPL ratio has remained relatively high as compared to the directive set by the National Bank of Ethiopia. DBE increased its risk exposure, issuing old and new products designed around predefined guidelines. However, DBE paid little attention to maintaining or improving collections capabilities.

DBE loan collection challenges can be basically segmented into three interrelated sources which are Bank, customers and external related factors. Hereafter, each segment has been discussed one by one.

4.4.1 Bank Related Factors

➤ DBE Credit Management Challenges

a. Due Diligence

The first problem is observed on lack of proper implementation of knowing your customer (KYC). The due diligence challenges include but not limited to: Insufficient due diligence format; Lack of enough criteria to verify equity; Tracing source of equity; Capacity problem; employee skill gap etc. It is more of subjective and lacks objectivity. Due to this, companies which must not get loan can get the service especially foreign borrowers for which we could not get sufficient information (CIC and detailed KYC report) because of ineffective support from different stakeholders.

b. Credit Appraisal

The second challenge is observed on credit appraisal. The project appraisal is the second deterministic factor on project success next to KYC. The challenge observed on credit appraisal include: Not using realistic data; Wrong financial assumption; Lack of clear procedure; Over and Under financing due to Projection problem; Financing unfeasible projects; Lack of understanding on external factors; Absence of contingency strategy; Raw material not considered properly; Not outsourcing complex projects beyond their capacity; Lack of technical database; Lack of Appraising modern software; employee skill gap etc.

c. Credit Approval

The existence of conflict of interest is observed in approving loans due to customer relationship management director & project appraisal director at corporate level and branch manager & district appraisal team manager at district level being members of corporate/district loan approval committee. All of them also appear at approval committee after they have already approved project proposals at their respective work units.

d. Loan Disbursement

After the project is approved, disbursement will follow. I have also observed some critical problems on disbursement. It includes: Equity contribution delay, poor disbursement inspection report, vague statement on PRLR policy such as high debt equity ratio; Additional loan and rescheduling are unlimited; Loan rescheduling and interest capitalization sometimes not properly functioning; Lack of customer grading system to serve loyal customers; inappropriate disbursement. In the case of inappropriate disbursement which is parallel disbursement for machine purchase and civil work, has an impact on the project implementation since sometimes the purchased machines arrives before civil work completed.

e. Purchasing

The other problem observed is on purchasing of machineries and equipment, raw material, vehicles etc. The problems include: Bulk purchase with escalated price; sometimes obsolete machineries which is not aligned with customer preference; Machinery purchase delay etc.

f. Loan Collection

Problems are also observed directly on loan collection. It includes: Second hand machinery efficiency problem in manufacturing specifically textile and garment and rain fed agriculture but now the bank has changed the policy; policy change on interest; Poor collection culture and delay in taking action; Little attention was paid to maintaining or improving collections capabilities; Lack of collection strategy; Collection method not forced but by serving reminder; Increasing number and amount of NPL; Weak support from Branch Project Follow up directorate to districts; Under planning on loan collection on DBE annual plans etc.

g. Risk Identification and Mitigation

It is well known that some sectors such as textile and garment, rains fed etc. are defaulting much as compared to other sectors financed by the Bank. Thus, DBE should take strong measures. All projects financed by DBE have risks. If a potential risk of the project is not identified early, then the project will be at a high risk to complete as per schedule, within budget and to meet the expected quality. Poor risk identification and remedial action taking is observed in DBE.

h. Project Follow-up, Evaluation and Knowledge Management

The Bank lacks independent project follow-up unit which can be used as a check and balance, and deliver important inputs for remedial decision making. Project implementation delay and lack of quality on construction are problems related with follow up. The follow up made so far are not meeting quality and quantity standards especially for projects nearing to NPL. The other structural problem is evaluations are not made at project level rather they are made at sect-oral level. Even though it is difficult to do evaluation for every project, it is better to do evaluation for large scale projects. The Bank also lacks knowledge management which fosters the reuse of intellectual capital, enables better decision making, and creates the conditions for innovation.

➤ Bank`s Bad Image, Corruption and Unnecessary Intervention

Reputational risk is a hidden danger that can pose a threat to the survival of the biggest and best-run companies. Reputational risk refers to the potential for negative publicity, public perception or uncontrollable events to have an adverse impact on a company's reputation

thereby affecting its revenue. It is obvious that DBE is suffering of reputational risk. Because of DBE's bad reputation, the Bank is not getting quality customers rather mostly filled by customers with wrong perception which are real contributors for increasing NPL.

The other factor is corruption and misconduct of employees which is accompanied by lack of transparency and accountability. It is observed in unethical engineering valuation, unnecessary rescheduling and additional loan by credit staff, problematic hard currency delivery at international Banking Directorate etc.

Unnecessary political intervention from Office of the Prime Minister, Ministry of Foreign Affairs, Ministry of Trade and Industry, Ethiopian Investment Commission, Embassies and Consulate in foreign country and National Bank of Ethiopia; but now there is substantially improvement due to government reform implementation in the country etc.

In addition to the above, unnecessary intervention from the Bank's higher officials are posing burden on the staff as well as on the Bank. Thus, the Bank should strive to fight the corruption network and bureaucracies.

➤ **Structural and Human Resources (HR) Bottlenecks**

Different structures were developed and implemented by the Bank and still implementing reform. However, there are still structural bottlenecks. Some of them include: Lack of independent Follow-up unit; Research and Project Data Management Directorate restricted to data collection only; etc.

One important team in the mix is human resources (HR), who often serve "behind the scenes", as the backbone of an organization. Problem observed in HR include: Not assigning the right employee at the right place according to knowledge, experience, skill etc.; Lack of essential training on time; Corrupted placement, promotion and transfer; Alignment problem etc.

4.4.2 Customer Related Factors

➤ **Wrong Perception and Poor Repayment Culture**

Customers are not willing to pay back their debt on time. This is revealed by customer's wrong perception that it is government Bank which does not take concrete measures in case

of default that is manifested by willful defaulter promoters. Even if they have the capacity to repay their loan, they will not repay due to the Bank's gap that is reminder basis rather than forced basis.

➤ **Project Management Problem**

Because of lack of enforcement to establish a modern company, almost all DBE financed projects face project management problem. Some of the problems include DBE financed projects: Lack of strategic and annual plan; Lack of sufficient working capital; Lack of performance evaluation via annual reports; Poor record keeping; Stock management problem; Running a business which they do not have any knowhow; Poor financial management exclusively foreign companies; Weakness in accepting feedback from the Bank; Some projects not implementing corporate social responsibility etc.

➤ **Under Capacity Production**

If projects are not producing as per the plan set in the project appraisal, project viability will be questionable. The major problem observed on customers on DBE financed projects is producing under capacity. Producing under capacity is attributed by: Used machinery inefficiency problem; Labor efficiency problem; Infrastructure problem specially for agricultural projects in remote area such as road; Capital capacity problem which is observed in lack of timely equity share financing that have strong impact on project delay and working capital shortage; Expanding the project without success assurance of the original project; Market problem & High competition in the international market; High fixed cost; High financial cost; Shortage of foreign currency; Shortage of quality raw material etc.

➤ **Rent Seeking Behavior of Customers**

Rent seeking behavior of customers is a tough challenge for the Bank. Some of the problems include: Loan diversion for other purposes other than the project; Capital flight by foreign borrowers through over invoicing and under invoicing; Prioritizing local market than international market of exporting projects; Hiding their genuine information about their financial status; Changing entire business structure without consent from the Bank; Frequent request for loan rescheduling and interest capitalization instead of repaying their loan;

Community dissatisfaction due to lack of Corporate Social Responsibility (CSR) and harsh environmental issues etc.

4.4.3 External Factors

➤ Market Problem

Any financed project by DBE need to buy raw material and sale its products on local as well as international market based on the appraised project and make profit so that it will pay back its debt on time. Most companies financed by DBE face market problem. Some of the problem contributing include: Poor local raw material quality and availability problem; Cost escalation of raw materials; countrywide labor efficiency problem and poor working culture resulting in poor production; Effect of brokers in lowering their selling prices; High competition in the international market with low market prices etc.

➤ Lack of Necessary Support from Stakeholders

DBE needs stakeholders support for smooth implementation of financed projects. Some of the problem include: Foreign currency shortage from National Bank of Ethiopia for the import of raw materials and machineries etc.; Logistics bureaucracies and higher local transportation cost from Ethiopian shipping and Logistics Services; Delays in customs clearance from Customs Commission and Ministry of Revenue; Political instability and social unrest from Federal and Regional Governments; Supply chain problem from government suppliers specially for rain fed agriculture such as improved seed varieties, fertilizers etc.; Power interruption from Ethiopian Electric Utility; Government sudden policy changes; Land overlapping problem from Federal and Regional Land Administration Office; Bad weather condition and weak compensation coverage from Insurance companies; Data reliability problem from concerned government bodies specially foreign investors (CIC, Detail KYC report); Unnecessary government intervention from Ministry of Foreign Affairs, Ministry of Trade and Industry, Economic diplomats from out sea Embassies, and Ethiopian Investment Commission, and National Bank of Ethiopia etc.;

Table 4.12 Summary of Major Loan Collection Challenges

External Factors	Borrower Related Factors	Bank Related Factors
<ul style="list-style-type: none"> • Political unrest/instability • Supply chain problem • Market problem • Foreign currency shortage • Logistics bureaucracies, delays in customs clearance processing and higher transportation cost. • Power interruption/fluctuation • Local raw material quality and availability problem • Cost escalation of raw materials • Countrywide labor efficiency problem and poor working culture • Sudden government policy changes • Unnecessary government intervention 	<ul style="list-style-type: none"> • Project management problem • Lack of strategic plan, annual plan, budget and annual reports • labor efficiency problem • Poor repayment accompanied by poor repayment culture and wrong perception that it is government Bank which do not take concrete measures in case of default that is manifested by willful defaulter promoters • Even if they have the capacity to repay their loan, they will not repay due to the Banks gaps that is reminder basis rather than forced basis at CRMD/branches • Stock management problem • Capital capacity problem which is observed in equity share financing & working capital shortage • Running a business which they do not have any knowhow 	<ul style="list-style-type: none"> • Bad image of the Bank • Due diligence problem in which companies that must not get loan will get the service specially foreign borrowers for which we do not have sufficient information (CIC , detail KYC assessment report), lack of enough criteria to verify equity, tracing source of equity, it is more of subjective lacks objectivity, employee skill problem • Appraisal problem such as over financing & under financing, planning problem, lack of clear procedure, financing for unfeasible projects, missing important parts, not using realistic data, wrong financial assumption, lack of understanding external factors, absence of contingency strategy, raw material not properly considered, lack of technical database, lack of modern appraising software, ineffectiveness of project data management • Poor risk identification and remedial action taking • Second hand machinery efficiency problem and rain fed agriculture but now policy changed • Not assigning the right employee at the right place • Poor collection culture and delay in taking action. Little attention was paid to maintaining or improving collections capabilities. Lack of collection strategy. Collection method not forced but by serving reminder at CRMD/branch

External Factors	Borrower Related Factors	Bank Related Factors
<ul style="list-style-type: none"> • Bad climate condition and weak insurance compensation coverage • Lack of necessary support from stakeholders • Land overlapping problem • Data reliability problem • Infrastructure problem • Security problem • Effect of brokers in lowering their selling prices 	<ul style="list-style-type: none"> • Policy gap on expanding the project without longer success assurance of the original project • Producing under production capacity • Poor financial management exclusively foreign companies • Loan diversion for other purposes • Capital flight by foreign borrowers by Over invoice and under invoice • Community dissatisfaction due to lack of CSR and harsh environmental issues • Rent seeking behavior of customers • High competition in the international market • High fixed cost • High financial cost • Prioritizing local market than international market • Hiding genuine information about their financial status e.g. Manipulated Audit report • Weakness in accepting feedback from the Bank • Changing entire business structure without consent from the Bank • Frequent request for loan rescheduling and interest capitalization instead of repaying their loan 	<ul style="list-style-type: none"> • Structural problem: if project follow-up directorate is organized as the previous structure the Banks collection will increase • Corruption network & Bureaucracies in the Bank • Alignment problem • Corruption network & Bureaucracies in the Bank • PRLR policy seems like a procedure • Vague statement on PRLR policy such as high debt equity ratio • Unethical DBE engineering evaluation • Additional loan and rescheduling are unlimited • Lack of independent follow-up unit and not using results for improvement • Environmental issue (pollute river & lake, deforestation, etc.) • Loan rescheduling and interest capitalization sometimes not properly functioning • Foreclosure and acquired asset not covering project cost • Bulk purchase with escalated price, obsolete machineries which is not aligned with customer preference and machinery purchase delay • Project implementation delay and quality problem in the construction • Lack of customer grading system which identifies best performers • Increasing number and amount of NPL projects • Equity contribution delay have strong impact on project implementation delay • Weak support from Branch project follow-up directorate for districts • Weak collateral in case project defaults • Policy not supported by procedure manual • Employee dissatisfaction

Source: Document review of financed projects and KII & FGD with Loan officers, Managers, Directors and Customers

CHAPTER FIVE

5 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

In this chapter the major findings of the study are summarized, conclusions are drawn based on the finding, and recommendations are forwarded for Development Bank of Ethiopia, the regulatory body and policy decision makers.

5.1 SUMMARY

Development bank of Ethiopia is state owned and specialized financial institution with the mandate of providing long, medium and short term loans to feasible and viable projects of commercial agriculture, agro processing and manufacturing sectors following government priority area. Providing of credit only could not support the economic development of the country unless an effective monitoring and evaluation system is put in place to ensure efficient and effective utilization of the fund/credit for the intended purpose. More importantly, the Bank must ensure in advance that the loan will be repaid timely in accordance with the terms and conditions stipulated in the contractual agreement.

The main objective of this study is to assess loan collection challenge, by investigating strategic objective and mandate clarity; organizational structure and leadership effectiveness, due diligence assessment strength, existence of strong feasibility analysis, reliable loan approval process, clear and well-structured loan/project follow up process, and existence of effective and efficient loan collection strategy or scheme.

For this study both primary and secondary data sources were used to make an assessment on the quality of loan for the bank in different sectors and the level of NPL ratio. The primary data were collected from 107 employees of the bank and the secondary data were collected from DBE annual report for NPL ratio for and the last seven years has been taken from project Evaluation and Loan Portfolio Directorate. To this end, mean, median, and mode of statistical tools were used to understand the opinion of DBE staffs regarding the credit assessment practices how to the view in relation to NPL ratio.

To understand the staffs' perception regarding the Loan Collection Challenge & the way forward, a structured questionnaire was developed with five Likert scale. The scale was 1 for strongly disagree, 2 for disagree, 3 for neutral, 4 for agree and 5 for strongly agree. For each

selected bankers perception questions, the median of the several opinions of the employees have been taken for analysis purpose. The questions were mainly related to the perception regarding the credit assessment put into practise like credit assessment method, monitoring and evaluation, collateral coverage, and skill capacity of the employee on non-performing loan ratio of DBE. The primary information was collected from 107 staffs those having direct relation with credit management of the bank. The findings of the study are analysed with Tables, Figures, with SPSS 25. Regarding the opinion of DBE staffs on different factors affecting NPL ratio, the researcher tries their responding by using descriptive tools. The staffs' opinions of the bank have fall in the disagreed category in most case.

5.2 CONCLUSIONS

The objective of this study is to assess the challenges of loan collections in DBE and to suggest the possible way forwards, the study has conducted analysis of primary and secondary data obtained from working units of the credit process. Primary data collection instruments were Survey through structured questioner, Key informant Interview and focus group discussion. Secondary data on financed projects and the banks credit operation were obtained from Human Resource Management Directorate, Project Evaluation and Loan portfolio Management Directorate and Strategic planning, change and communication Directorate.

The result of this study revealed that:

- Working units in the credit process are not well organized based on functional requirements especially their team arrangement and staff deployment.
- Working units are categorized only to share working loads not based on specialization of activities required. There is no specialization in services based on creation of departments.
- There is no independent unit assigned for loan / debt collection. And there is no clearly defined procedure manual and guideline for loan collection. Loan collection is an additional task given to a customer relationship officer.
- The bank has more outstanding loan in the Manufacturing sector (about birr 30 billion) then followed by the agriculture sector (about birr 10 billion) in terms of amount. But the bank has more customers in the agriculture sector (1136) than in the

manufacturing sector (970) which implies loan concentration in the manufacturing sector. This is associated with the amount of NPLs too. The Bank has more clients with NPLs in the agriculture sector (776>256) but in terms of amount still the manufacturing sector leads (Birr 10.4 Billion> Birr 8.3 Billion).

- From the agriculture sector, oil crops, fiber crops and horticulture are the main sub sectors that absorb the largest share of the Bank's NPLs.
- From the manufacturing sector, manufacturing of textile and garments and agro processing are the main sub sectors that absorb the largest share of the Bank's NPLs.
- When it is analyzed in detail the agriculture sector loan is the most risk area for DBE.
- The assessment of the loan collection performance by the bank also revealed that working units showed less effort for collections as compared to disbursements. Disbursements are above plan and steadily growing. But collections are below plan and showed no progress and not matched with the increments in Banks Loan outstanding at least in terms of planned collection.
- The main challenges for loan collection are related to problems associated with lack of :
 - ✚ Clarity of Mandates and Strategic Objectives
 - ✚ Effective organizational Structure and leadership
 - ✚ Strong due diligence, appraisal, approval and loan collection strategy

There are also bank related, external factors and customer related factors identified as a challenge for loan collection in DBE (Table 4-11).

The possible way forwards to improve loan collection in DBE are:

- Immediate Establishment of an independent loan collection team with clearly defined collection procedure manual and guideline.
- Business model revision and departmentalization of services

- Structural Reorganization
- Modernizing Bank`s credit process
- Capacity Building in Human Resource Management

5.3 RECOMMENDATIONS/THE WAY FORWARD

After thoroughly investigating and analyzing the challenges related to loan collection through the review of loan follow-up report document and analysis of secondary data related to lending practices of DBE, Key informant interval and the survey assessment through structured questioner, the researcher has forwarded the following remedies to improve the existing loan collection practice as well as to give some insights for the improvement in the Banks credit process.

5.3.1 Immediate Actions

Currently, as the results from the analysis indicate, there has been less effort and due consideration given to the loan collection process in DBE. A customer relationship management officer is conducting a collection activity. This leads to ineffective and personal biasness loan collection scheme which is prone to Client-contact officer unintended benefit ties at the expense of the Banks Loan recovery. As a result:

- The Bank should establish an independent internal loan collection teams/ units responsible for loan collection which are also responsible and accountable for their miss deeds.
- The establishment of a monitoring and evaluation unit which will supervise over all projects progress and the activities of the internal loan collection units (may under the internal audit). The monitoring and evaluation team meant to supervise the unintended benefit linkage between the loan collector and the client at the expense of the bank.
- Establishment of a clearly defined procedure manual and guideline for the loan collection teams.
- Establishment/contracting of a debt collection agency for sophisticated delinquent loans which are beyond the capacity of the internal loan collection team.

The established new loan collection team should follow a comprehensive forced based loan collection strategy based on customer grading. The customer grading enables the bank to develop a “carrot and stick “Mechanism. Those who pay their loan based on their contract agreement should get an incentive. The intensive packages may be reward of access to subsequent loans and “stepped lending” after loan graduation. Access to subsequent loans provides strong motivation for repaying. In “stepped lending”, first-time borrowers start with a low loan amount and gain access to higher loan amounts once they have successfully repaid their loan. In order to make this incentive effective, access to follow-up loans needs to be contingent upon achieving a high level of on-time performance.

The other carrot mechanism may be clients Access to preferential services. On-time repayment can be used to trigger access to services otherwise not available to the customer. Examples of such services could be “parallel loans” and “easy-access loans”. Parallel loans may be given for short-term financing needs, e.g. for working capital requirements. Easy-access loans are granted with reduced red tape in the loan appraisal procedures. These loans may take the form of an overdraft facility or shorter, simpler application forms and fast appraisal procedures. For the agricultural lender, this is an important way of reducing administrative costs on loans to clients who are likely to maintain a good repayment performance.

The bank may also give financial incentives for clients with excellent repayment performance like a financial discount for repaying all installments on time. This discount may be in the form of a cash reimbursement once the full loan amount has been repaid or when each installment is paid. These repayment incentives, of course, need to be calculated into the overall interest rate applied to the loans in order to maintain the profitability of the Bank.

A stick strategy is also required when late repayment occurs. In case there are late repayments the loan collection team should make an immediate on-site visit. This is because; one delinquent client can have a profound influence on the repayment behavior of others. Rumors can spread quickly if it is thought that a lender is lenient about repayments. Other borrowers are then likely to delay their payments as no serious action is feared. Immediate on-site visits after a short time of delayed payment is, therefore, an effective means of instilling the idea those late payments are unacceptable. They ensure a speedy appraisal of the reasons for the late payment. The visit may be within 5 days of the loan becoming overdue. It

is also advisable to make visits to clients even before problems in repayment have occurred. Loan collection team should visit borrowers who have had repayment problems in the past, prior to the due date of an installment.

A clear policy should be in place regarding further follow-up after the immediate on-site visit. A decision-tree can be useful to provide guidance on which steps are to be followed to increase pressure on the borrower to repay and what additional information on the reasons behind the late payment should be collected.

The policy instruments should be clearly defined and classified in stages. Say measures at:

- **Soft stage :** In this case may for clients who fulfill their debt repayment regularly
- **Pre-litigation stage:** For clients who are unable to pay their loan for valid and justifiable reason and has the probability of with minimal support. All supports are made with great care and precaution and with clearly defined criteria and conditions to support the customer before legal actions are taken on him/her.
- **Litigation stage:** That defaulter has less probity of meeting its debt obligations. Here the Bank should take all legal actions to recover its loan through collateral and asset acquisition.
- **Post-Litigation stage:** it is all about setting the conditions for foreclosure and writ-off accounts

The bank may also use financial penalties. Delayed payments cause financial and administrative costs for the lender. To cover (at least part) of these costs and to provide an incentive for punctual payments, delinquency fees should be applied. These fees can either be charged on the total amount or be restricted to the loan installment due for payment. The penalty may apply either from day one of the late payment or following some additional leeway.

Losing access to subsequent loans is a very powerful penalty. It must be made clear when access to subsequent loans will be denied and when there is scope to discuss the circumstances and consider further lending. It is also important not to create an impression of automatic right to further loans, however, even if punctual repayments are being made, as

loan appraisal must still be adequate. Regulations for first-time borrowers should be stricter than those for long-time clients of the bank.

If the immediate action taken by the loan collection team when repayment is late does not bring the desired result, further action is needed. A systematic process is needed to help officers decide whether to initiate debt collection mechanisms or whether to enter into negotiations with a client to reschedule or restructure the loan.

The first step in handling loans that have turned problematic is to undertake an analysis of the borrower's situation. If the result of this analysis is a lack of repayment willingness, quick and prompt debt collection measures should be initiated. If a lack of repayment capacity prevails, the future prospects for the borrower's business, the importance of the customer to the bank and the value of a continued business relationship with the customer should be evaluated. If this analysis appears negative, debt collection measures should be initiated. If the analysis is positive, a rescheduling plan needs to be established in order to get the business and the loan back on track.

Situation Analysis: Gathering information about the reason for default is critical. The customer is the best source of information on the reasons for default. Additional sources, such as neighbors, suppliers, clients, other financial institutions, should also be consulted to confirm the validity of the information given. This information-gathering process is usually done by the loan collection team or a specialized group within the bank to offer a more objective approach, less influenced by the existing customer relationship.

Rescheduling and restructuring: Once a borrower's problem has been analyzed, a recovery plan may be put in place. The first decision to be made in this context is who will establish and carry out this recovery plan. Some banks decide that the loan officer responsible for the loan should also set-up the recovery plan. A major rationale for this decision is the idea that the loan officer who has carried out the initial loan appraisal should be responsible for collecting the loan. In addition, the loan officer has an indispensable and unique body of knowledge about the customer's situation.

Rescheduling refers to a change in the term structure of an existing loan. Restructuring takes it a step further, with a possible "refueling" of the borrower by adding fresh loan money to

the existing obligation. Both options are extremely delicate and should be handled with the greatest care.

It is important to bear in mind, that both rescheduling and restructuring are extremely costly for the financial institution. These options should only be chosen if the value generated by maintaining the client relationship and bringing in the outstanding loan exceeds the costs incurred by the loan process. It is also important to understand that the extra time spent on a problem loan is basically unproductive – it serves to protect bank assets but it does not generate additional revenue.

Key criteria for the decision about whether to reschedule or even restructure a loan include the following:

- Reasonable prospects that the borrower can again generate enough profits to repay the debt within a stated period of time;
- Clear definition of an appropriate financial plan and cash-flow projections (an update of the loan appraisal analyses should be carried out);
- Full borrower commitment to resolving the problem;
- Improvement of the lender's control over the lending situation (e.g. strengthening the collateral situation by adding guarantors or other forms of collateral).

The basis for rescheduling or restructuring loans is a realistically revised cash-flow projection for the borrower. Revised repayment plans are designed according to these new projections. Continuous and close supervision of the implementation of recovery plans is important.

There is a clear policy to avoid the possibility of “ever-greening” loan portfolio quality by repeatedly rescheduling and restructuring loans. Internal control measures also ensure that this phenomenon does not materialize.

Debt collection: If measures taken to collect late payments do not provide the results needed and rescheduling or restructuring is either not wanted or not possible, debt collection is the final step in following up on problem loans. Collecting pledged collateral through the courts is often a costly and lengthy procedure, especially if registers are sketchy or collateral is unregistered. Debt collection through claiming collateral items may take months, sometimes

even years. So financial institutions in many countries have found ways to avoid involving the courts and increase the speed of debt collection by making a contract agreement over the ownership of specified assets of the client.

5.3.2 Subsequent amendments in the Bank`s credit process, organizational structure and Business model

a. Business model revision and Departmentalization of services:

As it has been discussed in the analysis part, in DBE we have a business model of lease financing and project financing on direct lending basis. The bank also gives financial services on on-lending/Whole sale basis. When we compare the non-performing loan of the bank mainly it emanates from the direct lending business model. Many development banks in developing and developed countries for example, South Africa, Mexico, Germany, Nigeria, and Croatia follow on lending/ subsidiary business model. They lend the money for retail commercial banks agreed upon the intended purpose of loan and transfer the liability of end customers to them. So DBE has to think of it and modify its business model. This will have at least two advantages.

- Able to have more outreach through many of the retail commercial bank branches
- Reduces the risk of default and transfer its liability as commercial banks better know and have more expertise in assessing customers

The experience of other countries is also showed as development banks are sector specific. For example in South Africa there are three development banks. Development bank of South Africa specialized in financing SMEs, Industrial Development Corporation specialized in providing finance to the manufacturing sector whereas the Land Bank of south Africa gives finance to the Agriculture sector.

In the case of DBE, it is possible to have separate departments specialized into financing of sectors, May be the SME financing Department, Agriculture and agro processing financing department, the manufacturing sector financing department. This departmentalization of our services will increase the efficiency of our services.

b. Structural Reorganization:

The survey result undertaken has shown that working units are categorized based on loan amounts or simple to share loads and there no a clearly defined and clear cut functionally identified arrangements in the credit process. A customer relationship officer under take activates from KYC assessment then follow-up and then the collections. This creates inefficiency and leads to a difficulty of insuring pure check and balance system in the credit process and accountability will not be clearly assigned. Therefore, all the activities that are undertaken in the credit process should be clearly identified with milestones and teams should be assigned for each/group of activities with defined responsibility and accountability. Assignment of staffs in each team should be based on the relevance of proficiency they have with the task. Staff deployment to teams should be based on the proficiency she/he has to the tasks/activities performed in the team. A civil engineer should be a member of a technical team for making valuation of buildings. A hydraulic engineer should be a member of technical team who make estimation of the infrastructural requirements for irrigation project. For an employee graduated with risk management, it is better to assign him in a team working for KYC assessment. So the bank should rearrange the existing teams on functional basis and assign staffs based on their competency and proficiency they have to perform that activity. The teams should perform their activity professionally and independently but in interconnected manner. There should be a system established for each team to be accountable for the activities undertaken by it.

The risk management and internal audit directorates of the bank should be reorganized with clear functional responsibilities and accountabilities to discharge their monitoring and evaluation role. The weak role that the existing internal audit and risk management department leads to the existence weak check and balance system in the Bank and specifically in credit processing units.

c. Modernizing Bank`s credit process

In addition to departmentalization and restructuring of the credit units based on functional responsibilities/ activates undertaken, DBE should modernize its credit process. Nowadays there exist a multitude of software tools aiding the credit process. The KYC process, the appraisal process, the loan collection process, the follow-ups we made etc. should be automated. Automation not only improves efficiency and agility of our services, it also

enhances our monitoring and controlling system. The study showed that credit process is full of haphazard and conflict of interests. There are prevailing problems from KYC to debt collection. Therefore it is important to make a detailed assessment and modernization of the process by undertaking necessary measures these may include:

- Regular and continuous revision of the Bank's credit policy to be in line with macroeconomic and regulatory changes
- Establishment of a system of independence but interconnectedness through strong check and balance system among the working units of the credit process. This enable to eliminate the problem of
 - Unnecessary government political intervention in credit decision;
 - Bank's higher official unprofessionally intervention on the activities of lower level experts in the credit process.
 - The role of customer relationship management director and project appraisal director at corporate level and branch manager and district appraisal team manager at district level should be limited to presenting and explaining the loan proposal.
- Produce a clearly defined loan and debt collection procedure manual separated by phases (soft phase, pre litigation phase, litigation phase, and post litigation phase).
- Insure a check and balance system through establishment of an independent system of monitoring and evaluation for each and every working unit in the credit process. The results from the survey showed that there is conflicting interests rather than coordination effect among working units of the credit line.
- Due diligence and appraisal process should be automated to prevent manual manipulations and increase efficiency of service delivered.
- The formats and parameters used in the KYC and appraisal process needs revision
- Modern data warehouse system to be used as an input for the credit process should be established. The biggest challenge for the KYC and the appraisal process is availability of reliable and verifiable customer and project related data. This has led to

the appraisal and approval of project on subjective judgment of the experts in the credit process which has resulted to defaults of many projects.

- Projects implementation and progress follow-up should be monitored and evaluated regularly by an independent body not participated in the credit process.

The existing loan restructuring is prone to “loan greening”. It should be re assessed and a strict and comprehensive guideline for loan restructuring should be developed.

d. Capacity Building in Human Resource Management

The results from the study have revealed that human resource management in DBE is very poor. The staff deployment, promotion and remuneration, delegation systems are full of flaws and irregularities. Position is associated highly with years of stay rather than performance or education attainment. The Bank should develop a set of KPIs for each and every employee and should develop a system of incentives and promotions according to the performance not by the traditional way of years of stay with the Bank. The system should enable the employees to compete with each other based on performance and achievements. This brings employees motivation at their work and hence increased the attainment of the banks set strategic objectives.

In general:

- Develop individual performance based incentive packages;
- Set clearly defined set of duties and responsibilities for staffs in each and every working unit and make accountable for their deeds;
- Develop a capacity development program through trainings and other mechanisms to make use of updated tools, techniques and technologies of the development banking institutions which are used in each working units of the bank;
- Employee recruitment, transfer, placement and promotion should be based on ethical behavior, knowledge, skill, and experience and avoid office politics, nepotism, friendship & corruption;

- Employees should be oriented to work towards achieving the same goal and get necessary trainings;
- Introduce job rotation, job description and specification for each job position;
- Work diligently and intelligently on image building through TV or radio programs to avoid reputational risk that the Bank facing currently;
- Developed a strong controlling mechanism that enables the bank to take strict measures on those staffs who deal unethically and misbehave at the expense of the bank`s working institutional set up.

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APPENDIX

Addis Ababa University
College of Business and Economics
MBA in Financial Service
Research Questionnaire

Dear Respondent,

This questionnaire is prepared to collect data from Development Bank of Ethiopia especially directly engaged in daily project financing service operation to undertake this for partial fulfilment of MBA in Banking on the title “Assessment of Loan collection Challenges In the case of Development Bank of Ethiopia”. The information you provide will be used only for analysis of the study which I am conducting as partial fulfilment of the MBA degree in Banking.

I kindly request you to respond freely and honestly as your response has great value in identifying the challenges of loan collection and suggest sound strategy for decision makers on how to increase the loan collection of the Bank.

Moreover, I assure you that all your responses will be kept strictly confidential and used only for academic purpose.

If you need any clarifications, please contact me through my e-mail address:

yosefdb@gmail.com or please give me a call at 0911-82-17-05.

Thank you for your valuable time and response in advance.

Yours Sincerely,

Yosef Tesfaye

General instruction:

- No need to write your name
 - Please make (✓) mark in the box that best describes your response
 - Please write your opinion on the blank space provided and for some items you can use other sheets of paper if the space provided is not sufficient.
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1. Age < 20 21-30 31-40 41-50 >50

2. Gender Male Female

3. Educational level Diploma 1st Degree 2nd Degree PHD

4. Years of service in the Bank

Less than 5 years 6 – 10 years 11 – 15 years 16 – 20 years over 20 years

5. Current position in your organization.....

In the following sections, please kindly indicate (✓) mark to express the extent to which your agreement or disagreement on the given statement from the choices:

1. 1= strongly Disagree
 2. 2= Disagree
 3. 3= Neutral
 4. 4= Agree
 5. 5= Strongly Agree
-

I. Banks mandate and structural arrangement assessment

1. Mandate clarity and strategic objective assessment

No	Description	1	2	3	4	5
1.	DBE has precisely formulated missions ¹					
2	There is a system in place in the Bank that effectively ranks projects against mission benchmarks, so that those projects achieving the highest score can be prioritised and those failing the test can be abandoned					
3	DBE has realistic actionable strategic objectives					
4.	DBE strategic objectives ² are realistic which takes in to account the experience and feedback from the operational teams; not only through top-down but bottom-up elaboration					
5	DBE strategic objectives are clear and measurable, with targets defined by sector, geography, product etc.					
6	DBE strategic objectives are consulted with shareholders, other stakeholders, approved at the highest level, communicated to staff and publicized externally.					
7	DBE has clearly defined KPIs ³ matching with its missions.					
8	The bank is assessed effectively and factually against its given KPIs by independent experts					

¹**A mission statement** defines what line of business a company /organization is in, and why it exists or what purpose it serves. If it is precisely formulated it guides the management team in implementing strategies that help reinforce a company's identity and achieve its goals. It is important for Motivating employees.. Inspiring customers Strategic planning, Setting values and Understanding why a business exists

2 A Strategic Objective is a high level statement that outlines what exactly an organization wants to achieve, with a clearly stated deadline.

³ **KPIs (key performance indicators)** are a set of quantifiable measures that an organization uses to gauge or compare performance in terms of meeting its strategic and operational goals. KPIs should be SMART (Specific, Measurable, Achievable, Result oriented, and Time bounded)

2. Organizational Structure and Leadership Effectiveness

No	Description	1	2	3	4	5
1	DBE has internal organisation with a clear separation of duties between the operational client-facing teams on the one hand and truly independent teams assessing credit, environmental and compliance risks on the other hand					
2	DBE has a good mix of staff of various origins and a Board of Directors reflecting different geographies, backgrounds and agendas, acting as a foil for patronage in a particular sector, or region					
3	There is recruitment of competent employees, their training and their rotation.					
4	There is Well-defined hierarchy of authority within the working unit and at bank level.					
5	Division of labour in DBE is based on functional specialization					
6	Rules covering rights and duties of positions are articulated and in place for working units of DBE					
7	There are clearly set Procedures for dealing with work situations in the working units					
8	Communication is characterised by Impersonality of interpersonal relations in DBE					
9	In the bank, employee selection and promotion is on the basis of technical competency					
10	DBE Senior managements are clear & transparent and designed to promote effective credit process of the bank.					
11	DBE Management staffs within the credit unit have the necessary experience, competencies and integrity to manage the businesses and people under their supervision					
12	Our management staffs selected through an appropriate promotion or recruitment process which takes into account the qualifications required for the position in question					
13	Senior management of the staff provide adequate oversight of those they manage, and ensure that the bank's activities are consistent with the business strategy, risk appetite and the policies approved by the board					
14	Senior management of DBE has the quality to delegating duties to staff and to establish a management structure that promotes accountability and transparency throughout the bank					
15	Senior management of DBE has the quality to implement business strategies, risk management systems, risk culture, processes and controls for managing the risks, financial and non- financial, to which the bank is exposed and concerning which it is responsible for complying with laws, regulations and internal policies.					

II. Loan Process Units Assessment Questions

3. Due Diligence Assessment questions

It is known that KYC is a fundamental practice to protect the Bank from fraud and losses resulting from illegal funds and transactions.

No	Description	1	2	3	4	5
1	DBE has successful Customer Identification Program in place to make effective risk assessment, both at the institutional level and at the level of procedures for each account.					
2	To make sure a potential customer is trustworthy; DBE has made strong customer due diligence (CDD) ⁴ assessment to effectively manage risks and protect the bank against criminals, terrorists, and Politically Exposed Persons (PEPs) who might present a risk.					
3	DBE has a program to monitor its customers on an on-going basis to manage risks (made On-going Due Diligence).					
4	The KYC assessment provides effective tools of managing risks.					
5	DBE has clearly defined Customer Acceptance Policy.					
6	DBE has a system in place to do effective corporate know your customer assessment too (KYB).					
7	There is independent audit testing of customer due diligence to evaluate the adequateness and comprehensiveness of KYC/CDD policies, procedures, and processes on regular basis					
8	DBE made a software ⁵ assisted KYC assessment which ease personal manipulation of parameters					
9	The team of experts making KYC are independent of other working units in the credit process and management interference					
10	The team of experts undertaking KYC are highly professional and a system is there to make them accountable.					

⁴There are three levels of due diligence:

- **Simplified Due Diligence** (“SDD”) are situations where the risk for money laundering or terrorist funding is low and a full CDD is not necessary. For example, low value accounts or accounts.
- **Basic Customer Due Diligence** (“CDD”) is information obtained for all customers to verify the identity of a customer and assess the risks associated with that customer.
- **Enhanced Due Diligence** (“EDD”) is additional information collected for higher-risk customers to provide a deeper understanding of customer activity to mitigate associated risks. In the end, while some EDD factors are specifically enshrined in a country’s legislations, it’s up to a financial institution to determine their risk and take measures to ensure that their customers are not bad actors.

11. What are the Basic problems associated with the KYC assessment task in DBE?

12. What are the remedies you suggest to improve the quality of KYC assessment practise in DBE?

4. Appraisal Assessment questions

No	Description	1	2	3	4	5
1	Strong Market Appraisal Team and verifiable demand-supply gap assessment exists. .					
2	There exist strong “Management appraisal” team					
3	There exist strong “Technical appraisal” team					
4	There exist strong “Financial appraisal” team					
5	There exist strong “Socio economic appraisal” team					
6	DBE has reliable, up-to-date and verifiable data warehouse and information collection system used by the appraisal team.					
7	There is independence and autonomy of tasks to be done by different appraisal teams and working units in the credit process.					
8	There are a adequate and professional mix of all experts in each appraisal teams					
9	There is a regular independent auditing to evaluate credit appraisal process, procedures and verification of information used in the appraisal process.					
10	The team of experts in each appraisal team are highly professional and a system is there to make sure they are accountable.					

11. What are the basic challenges that are encountered by the appraisal teams?

12. What are the basic remedies that should be undertaken to improve the quality of projects appraised in DBE?

5. Approval Assessment questions

No	Description	1	2	3	4	5
1.	The loan review team in DBE has clear and objectively verifiable Credit Risk Grading system.					
2	Loan proposals sent to the loan review team is in proper Credit Line Proposal (CLP) duly supported by required information and documentary evidence.					
3	The team of experts making approval of loan are independent to the other working units in the credit processes and make decisions objectively.					
4.	The Loan Review Team has strong capacity of Promptly identifying loans with well-defined weaknesses.					
5	The Loan Review Team has a procedure to critically assess the adequacy of and adherence to loan policy and procedures, and ensures that the loan portfolio complies with NBE policies					
6	The Loan Review Team makes an objective assessment of portfolio Quality and provides regular feedback to management and directors					
7	It regularly Identifies relevant trends that could affect collectability of the loan portfolio, and isolates certain potential problems					
8	Identifies loan documentation weaknesses and discrepancies in credit file reporting, while providing appropriate corrective recommendations.					
9	The experts in the loan review team are from different disciplines and accountability is in place for the decisions the made.					

10. What are the existing challenges for the Loan Review team?

11. What remedial solutions you suggest to as a remedy for such challenges?

12. Based on your perception what are the main reasons for the swelling of NPL and loan collection challenges?

13. What measures the bank should undertake to improve its loan collection and reduce its NPL?

6. Follow-up

No	Description	1	2	3	4	5
1.	There is ' <i>open communication</i> ⁶ established between the follow-up team and the borrower					
2	The loan follow-up team has always at hand up-to-date and complete Loan files containing all the documents (loan application, loan assessment, collateral records, memos, loan agreement, etc.) with a complete historical and on-going record of the relationship between the Bank and the borrower.					
3	The loan follow-up team used computerised loan monitoring systems ⁷ .					
4.	The loan Follow-up team under take effective Periodic direct monitoring of clients					

⁶ A monitoring system in place with the agreement of the two that provides the information needed to oversee loan portfolio quality at any given time, identifying potential problems at the earliest moment possible

⁷ Use Automatic Report generating Software for loan follow up the status of a client any time.

5	There is a system established to indirectly monitor clients					
6	There is timely Monitoring of actual loan repayment performance of Clients and periodic reporting of Loan portfolio review report, Due payment report, Past-due payment report, Loan portfolio at risk report with their reasons.					

7. What are the main reasons for loan default in DBE?

8. What strategies the bank should follow in the future to minimize loan default?

7. Loan Collection strategy assessment

No	Description	1	2	3	4	5
1.	DBE has Instilled the culture that making late payments by clients is unacceptable. It uses “carrots” ⁸ and “sticks” ⁹ to keep late payments to a minimum.					
2	There is a strict delinquency follow-up in DBE					
3	DBE has strong and systematic process of managing Defaults					
4.	A system for critical situation analysis is in place to investigate reasons for default by customers and to signal dangers when it occurs.					
5	Rescheduling and restructuring strategies as a remedy for default loans are handled with the greatest care ¹⁰ (Taken as last resort options for repayment).					

⁸ Includes Loan graduation (reward of access to subsequent loan, stepped lending), Access to preferential services (parallel loans, easy-access loans), Financial incentives (may be financial discount for repaying all installments on time)

⁹ When late payment occurs Immediate on-site visits (insure a speedy appraisal of the reasons for the late payment, say within 5 days of the loan becoming overdue even before due date for those clients who have repayment problem); Financial penalties

¹⁰ Rescheduling or restructuring of a loan is after in-depth analysis of the situation and business prospect of the client and make sure:

- Reasonable prospects that the borrower can again generate enough profits to repay the debt within a stated period of time;
- Clear definition of an appropriate financial plan and cash-flow projections (an update of the loan appraisal analyses should be carried out);
- Full borrower commitment to resolving the problem;
- Improvement of the lender’s control over the lending situation (e.g. strengthening the collateral situation by adding guarantors or other forms of collateral).

6	DBE has effectively debt collection mechanisms including the collection of pledged collaterals and guarantees legally and strategically.					
7	Default loan in depth situational analysis is made with team of experts well awarded of the client business.					

8. What are the main reasons for loan default in DBE?

9. What are the main challenges for loan collection in DBE?

10. Don't you think that treatment of loan default through Rescheduling and restructuring lead to **"ever-greening" loan portfolio** quality with-out loan repayment? If yes, what should be the remedy?

11. What do you suggest as effective means of loan collection mechanism to minimize default?

12. What mechanisms of effective debt collection the bank should use to minimize its NPLs?
