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Addis Ababa University  
College of Business and Economics  
Department of Accounting and Finance

Assessing Factors that Affect Non-Performing Loan in Ethiopian Commercial  
Banks: A Case of Selected Commercial Banks

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A Thesis Submitted to Department of Accounting and Finance in Partial  
Fulfilment of the Requirement for the award of Degree of Master of Science in  
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Advisor: Abebaw Kassie (PhD)  
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Addis Ababa

**DECLARATION**

I, the undersigned, certify that the thesis was written entirely by myself and was guided by Dr. Abebaw Kassie. Each and every source of information used in the thesis has been properly credited. I further affirm that the thesis has not been submitted, in whole or in part, to any other institutions of higher learning with the intention of obtaining a degree.

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## ABSTRACT

*The study aims to assess the major bank specific, customer specific and macro factors that affect Nonperforming loans in case of 5 selected commercial banks namely, Commercial bank of Ethiopia, Awash bank, Bank of Abyssinia, Dashen bank and cooperative bank of Oromiya since they are top 5 banks in their asset position and registered highest profit in the fiscal period of 2022G.C. To achieve this objective both descriptive and explanatory research design with mixed research approach was used. A total of 151 samples were selected from the 5 banks who are engaged in credit activity. Interviews and questionnaires were the main data sources used in the data collection process. A range of publications, bank policies and guidelines, online articles, and other textual materials were also examined in order to collect secondary data. Using computer-loaded SPSS software, descriptive statistics such as mean, frequency, percentage, and standard deviation were processed for data analysis. The study result has found that poor credit assessment, credit monitoring, banks profitability which can be associated with aggressive lending, rapid credit growth and bank's great risk appetite, elongated process of loan approval and fails to have technological advancement as bank specific causes while diversion of loan fund, lack of knowledge and experience of customers about project management and willful default as customer related factors for the existing of loan default. Besides the inflation rate, the level of GDP, political instability and frequent changes of rule and regulations has influence on the rise of NPL. However, the study outcome failed to support the existence of relationship between collateralized lending and interest rate on occurrences of nonperforming loans. In general, according to the study, banks should implement effective due diligence assessment and strong monitoring policies so as to have a better loan portfolio. Moreover the banks should consider the effect of customer related and external influences in availing a loan.*

**Key word:** - Banks, Commercial, Non-performing loans

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## Acronyms

CBE	Commercial bank of Ethiopia
CBO	Cooperative bank of Oromiya
CPI	Consumer Price Index
DBE	Development bank of Ethiopia
ER	Exchange Rate
FDI	Foreign direct investment
GDP	Gross domestic products
INF	Inflation rate
KYC	Know your customer
NBE	National bank of Ethiopia
NPL	Non-performing loan
OLS	Ordinary least square
SPSS	Statistical Package for Social Sciences
TB	Treasury Bill

## **CHAPTER I: INTRODUCTION**

This chapter begins with the background of the study that gives some insight on the issues of nonperforming loans (NPLs), statement of the problem part which gives a clear description and justifies the reason to carry out this study. Following this, both general and specific objectives of the study, research questions, significance of the study, scope & limitation of the study, terms and finally organization of the paper, are included respectively.

### **1.1 Background of the study**

Since loans generate the largest portion of a bank's gross profits, loan portfolio management has a significant impact on the bank's profitability (Akmel, 2019). When lending money to the economy's investment activities and projects, a default risk is taken by financial institutions. This leads to the accumulation of Non-Performing Loans (NPLs), which negatively affects the financial institutions' profitability (Akmel, 2019). One of the main causes of financial institution insolvency, which in turn causes a crisis in the banking sector and ultimately harms the entire economy, is non-performing loans (NPLs) (Mohammed et al, 2012) as cited in (Gebeyehu, 2020).

Under the Ethiopian banking business directive, non-performing loans are defined as “loans or advances whose credit quality has deteriorated such that full collection of principal and/or interest in accordance with the contractual repayment terms of the loan or advance is in question” (NBE SBB/68/2018) .

Increased profit margins from the generation of credits as loans maintain the banking system's deposit balance. However, the banks' capacity to return the deposit amount on the due date would be in doubt if the loans are not repaid within the predetermined time period and fail to generate income. Thus availing loan becomes the most risky service due to the credit risk which has a direct relation with NPL. Hence, one of the primary causes of financial institution insolvency, which ultimately hurts the entire economy, is non-performing loans (Hou, 2007). Thus the elimination of non-performing loan is very useful to improve the performances of the financial institutions; the purge of non-performing loans is an essential condition. Consequently so as to control the non-performing loans, it is essential to understand & give due consideration to the root causes of these non-performing loans particular in the financial sector.

There are numerous reasons why loans don't work out and they differ throughout nations. NPLs can arise from factors specific to the bank which is internal or macroeconomic conditions & customer specific conditions which is outside of the banks. Major causes of non-performing loans have been identified in other countries, including national economic downturns, insider lending, political connections among bank owners, customers' failure to disclose material information during the loan application process, and inadequate training among loan officials(Waweru and Kalani, 2009) as cited in (Abebe, 2019). Considering these facts, this thesis attempts to assess factors that affect nonperforming loans in Ethiopian selected commercial banks focused on main bank specific, customer specific and the overall external determinants.

## **1.2 Statement of the problem**

Loans are a risky part of the economy even though they are a significant source of revenue for banks and their main assets. Aynalem (2016) indicated that Credit risk, which evaluates the financial vulnerability related to money lent to borrowers, is a natural risk for lenders. That is also why credit risk management is one of the most critical risk management activities carried out by firms in the financial services industry. Actually, of all the issues that banks face, credit risk is seen to be the worst because bad debts would hurt banks' profits (Mulatu, 2018). It must be remembered that credit risk results from uncertainty regarding a particular counterparty's capacity to fulfill its obligations. One of the main factors contributing to financial fragility is the degradation of loan quality, which would occur if the uncertainties came to pass (Negera, 2012).

Ahmad and Bashir (2013), also point out that whenever financial vulnerabilities are explored, NPLs are the main focus. The liquidity and profitability of the bank, which are the key factors in determining the efficiency of the bank, are impacted by non-performing loans (Gezu, 2014). As loan default rates rise, there are fewer opportunities to generate income and boost bank profitability. Once more, a bank's liquidity risk increases due to a mismatch in the maturities of its assets and liabilities, which lowers the bank's total credit rating and damages its reputation or goodwill (Badar and Yasmin, 2013 as cited in Nigatu, 2019). Unresolved non-performing loans (NPLs) pose a serious risk to the banks' ability to operate profitably by depreciating their assets, reduction of income through accumulation of losses and increased provisions to compensate for

these losses (Kunt and Detragiache, 1998 as cited in Tsige, 2013). Furthermore, it discourages the financial institution to refinance the defaulting client, which put the defaulters once again into vicious circle of low productivity (Nigatu, 2019).

Since the majority of bank assets are held by loans, the factors that affect NPLs shall be pictured to enhance the quality of the asset. An in-depth analysis of the data is necessary, regardless of whether default is determined by chance, unanticipated conduct, or particular circumstances in a certain scenario (Asfaw et al, 2016). In Ethiopian context, like other countries of the world, Ethiopian commercial banks are also grieved from a serious financial problem exhibited by the effects of NPL's. So they are expected to ease their NPL as low as possible so as to improve the profitability and robustness of the framework (Aynalem, 2016).

Supporting this, several studies has been conducted in worldwide including Ethiopia to study the causes of non-performing loans. Previous studies, such as (Saba et al, 2012), (Makri et al,2014) and (Selma & Jouini,2013) studied about NPL in the cased of US Banking Sector, Euro zone and on three countries (Italy, Greece and Spain) respectively. Even though many studies are carried out globally to look at the factors that contribute to non-performing loans, Ethiopian circumstances should be taken into account. This is due to the fact that, it is difficult to make generalization about the NPLs for the developing economy based on the result of developed economy without making any research. In case of Ethiopia, among others Wondimagegnehu Negera(2012) tried to asses bank specific determinants of NPL ,i.e relationship between credit admittance policy, loan underwriting & risk assessment , credit monitoring , collateralized lending ,credit culture , credit terms and price , rapid credit growth & greater risk appetite and bank ownership structure & size with loan default on bank which started operation before 2007/2008. Besides Zelalem Tsige (2013) focused on bank specific factors such as Loan growth ,Operational efficiency , Financial performance , Income diversification: , Ownership structure , Bank size and microeconomic factors of Real GDP growth ,Real Interest rate , inflation, Real effective Exchange rate. On the other hand Gadise Gezu(2014) conducted a research to examine both bank specific (loan to deposit ratio, capital adequacy ratio, return on asset and return on equity) and macroeconomic factors(lending rate, inflation and effective tax rate). Furthermore Delil Akmel (2019) focus only on bank specific factor specially the relationship a credit assessment ,credit monitoring & follow up,

collateralized lending , borrower credit culture & high lending interest rate with loan default in some selected banks while Kalkidan Abebe (2019) assesses the bank specific, customer related and external factors in case of Development bank of Ethiopia. Alternatively Dereje Abebe(2021) studied determinants of non-performing loans in Ethiopian commercial banks focusing on Bank specific factors such as income diversification, capital adequacy, loan growth and Operational efficiency & Macro-economic factors of Lending Rate, Real GDP growth, Inflation rate (INF) and exchange rate based on panel data analysis on the time period from 2010 to 2019 .

As shown above, some researches explain either the bank specific such as Wondimagegnehu Negera(2012) or Zelalem Tsigie (2013) or macroeconomic factors while the other focuses on a single bank like Kalkidan Abebe (2019) . Besides most of the researcher has used the same variables and they have found unrelated results. For instance Abebe(2021) has found that lending rate and loan growth of banks have significant effect on Non-performing loans whereas Akmel(2019) indicates that the role played by banks' quick loan expansion, lending rate & ownership type of the bank to the happening of NPL is quite minimal. Moreover Gezu(2012) study shows that inflation rate had negative but, insignificant effect on NPL of commercial banks in Ethiopia while Abebe(2021) confirmed that there is a negative but significant relationship between inflation rate and NPL. Conversely, the current technological, economic, social & political environment is changing very quickly. Consequently, the existing knowledge gap along with the very danger of NPLs initiates this research. Therefore the aim of the research was to assess the main determinants of NPLs of selected commercial banks in Ethiopia related to bank specific, customer specific and external variables by adding the effect of the new bank specific factor of digitalization (technological advancement) and external variable of the political instability, banking rules & regulation on NPL of banks.

### **1.3. Research Question**

The study incorporated the following three specific research questions in order to achieve the broad objective

- What are bank specific determinants of NPLs in selected Ethiopian commercial banks?
- What are customer specific determinants of NPLs in selected Ethiopian commercial banks?
- What are macro determinants of NPLs in selected Ethiopian commercial banks?

## **1.4 Objectives of the study**

### **1.4.1 The study or general objective**

The overall objective of this study was to assess factors that affect non-performing loans in selected commercial banks of Ethiopia.

### **1.4.2. Specific Objectives**

In line with the above general objective of the study, the following specific objectives were set for the study.

1. To assess the main bank specific determinants of non-performing loans in selected Ethiopian commercial banks.
2. To assess the main customer specific determinants of non-performing loans in selected Ethiopian commercial banks.
3. To assess macro determinants of non-performing loans in selected Ethiopian commercial banks.

## **1.5. Significance of the study**

The findings of this study, in the opinion of the researcher, will help to learn more about the factor that have contributed to the rise in non-performing loans in Ethiopian commercial banks & is going to benefit various stakeholders. It will be advantageous to many financial sector players, including employees, investors, consultants, researchers, and decision-makers, among others, who have a direct or indirect connection to the loan processing. The results and suggestions will particularly aid Ethiopian commercial banks in understanding how to enhance the quality of their loans, and helps to overview their financial performance through loan provisions. Bank staff will have the opportunity to limit operational losses as they affect profitability by locating documents important to loan management. Furthermore, this study will provide the commercial bank management with the necessary impetus to control these identified variables and will equip them with the knowledge of how to enhance loan performance. This is because by being aware of the factors that influence nonperforming loans, a bank manager is better able to focus on loan quality as opposed to loan quantity. As an alternative, this study will assist investment advisors in their ability to advise clients on investments based on factors such as fundamental of non-performing loans, which have an impact on the bank's profitability other than the financial losses situation. Additionally, the ability to recognize how much the quantity of non-performing loans influences their return on investment will help investor's avoidance of the NPLs component when making investment decisions. Alternatively, the study results will

provide a useful reference document to loan policy makers and national banks. It will help the regulatory body to assess its approach to banking supervision with regard to ensuring banks retain asset quality. In general, this research will help private and public banks to better understand and reduce credit risk by recognizing the root cause of the NPL and taking the required action. Last but not least, this study will serve as a reference for other academics working in this related field who wish to learn more about the factors that affect loan default.

### 1.6 Scope & limitation of the study

This study looked at bank specific factors (Credit processes & credit monitoring, Bank profitability, Collateral security, Manpower Structure and technological advancement/digitalization), customer specific factors (Diversion of fund, Willingness of borrower to pay back the loan) and external factors (Inflationary Pressure, Gross Domestic Product, Lending Rate/Interest Rate, Political instability, and banking rules & regulation) that affect non-performing loans.

The researcher decided to limit this study to the selected commercial banks found in Ethiopia namely Commercial bank of Ethiopia, Awash bank, Bank of Abyssinia, Dashen bank and Cooperative Bank of Oromiya targeted on head offices - credit department. These banks are selected judgmentally since they are top 5 banks in registering highest profit in the period 2022 G.C and have a highest amount of total assets. Accordingly they were expected to have more experience on the lending activities as the banks profit and asset position is directly related with the overall loan portfolio. Besides, the study focus was at head office as large amount of loans & huge projects are financed at the center rather than districts or regions. Moreover, in order to get needed information for the study, the proximate of the study area plays a vital role. Accordingly, the result of this study can't necessarily represent all Ethiopian commercial banks and the results may be difficult for generalization.

### 1.7 Definitions

Loan categories as per the NBE directive SBB/ 69/2018 are depicted as follow:-

1. **Pass:** This type of advances and loans is completely protected by the borrowers' present financial situation and capacity to pay, thus it is not open to criticism. In general, any loan or advance or portion thereof, which is fully secured, both as to principal and interest, by cash or

cash substitutes, shall be classified under this category regardless of past due status or other adverse credit factors.

2. **Special mention:** - any loan or advance past due 30 days or more, but less than 90 days.
3. **Substandard:** - non-performing loan or advance past due 90 days or more but less than 180 days shall at a minimum be classified substandard.
4. **Doubtful:** - non-performing loans or advance past due 180 days or more but less than 360 days shall be classified at a minimum as doubtful.
5. **Loss:** - non-performing loan or advances past due 360 or more shall be classified loss.

### **1.8 Organization of the study**

The essay is organized into five chapters. Introduction is covered in the first chapter and comprises background information, a problem statement, a list of research questions, the study's purpose, its importance, scope and limitations. The reviewed related literature is presented in the second chapter. In the third chapter, the research techniques are provided, and in the fourth chapter, data analysis and interpretations are covered. Lastly, the summary, conclusion, and suggestions of the study are included in the fifth chapter.

## **CHAPTER 2: REVIEW OF RELATED LITERATURE**

### **2.1. Introduction**

This chapter presented the theoretical underpinning of the study, together with a summary of pertinent literature and a knowledge gap discovered by the literature reviews.

### **2.2. Theoretical Literature**

#### **2.2.1. Banking Sector & Role of banks**

Banks collect deposits from individuals with excess funds and lend these funds to those in need, aiming to generate profit and increase shareholder value. Banks function as financial intermediaries, ensuring efficient use of currency within the economy(Abebe,2019). Loans, which offer higher returns than deposits, are a major source of banks' earnings, making them highly profitable assets. Consequently, banks strive to issue as many loans as possible while maintaining the security of these loans and prepayments (Akmel, 2019).

Every nation's banking industry contributes significantly and is crucial to the expansion of its economy. The role that banks play in attracting deposits and effectively directing resources towards the most profitable job and investment possibilities in the nation demonstrates their dedication to development (Negera, 2012).

The function of a bank has substantially increased and is no longer just about taking deposits and giving out credit(Fourie et al., 1998; Valdez, 2000) as cited in (Negera, 2012). Additional tasks that can be done by the banks are depicted here under:-

- Money creators
- Managers of the payment system
- Creators of indirect financial securities
- Information intermediaries
- Financial 'spectrum fillers'
- Foreign exchange dealers

Even though banks carry out the aforementioned tasks, they view lending as their most crucial duty because it generates the majority of their profits. Thus, the management of the loan portfolios has a major impact on the banks' financial success.

### **2.2.3. Loans and Advances**

Savings deposits are gathered by banks, which subsequently lend the money to borrowers. Thus, lending is the industry's beating heart. Most banks' largest portion of assets is loans, which account for creating the majority of operating income and the greatest risk exposure for banks.

Loans are money that is provided for someone for a specified period of time usually on fixed interest terms related to the base interest rate with the expectation to be repaid fully. The principal will be arranged to be repaid either on regular repayment pattern or in lump sum on the maturity date. Different countries have distinct laws that define loans and advances.

- In the context of Ethiopia, Asset classification and provisioning directive No SBB/69/2018, loans and advances are defined as:

Loans or Advances means any financial assets of a bank arising from a direct or indirect advance (i.e. unplanned overdraft, participation in loan syndication, the purchase of loans 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 dates or on demand, usually with interest. The term includes a contractual obligation of a bank to advance funds to or on behalf of a person, claim evidenced by lease financing transaction in which the bank is the lessor, and an overdraft facility to be funded by the bank on behalf of a person. The term does not include accrued but uncollected interest or discounted interest.

A bank's main job is to move deposits from surplus to scarcity units by lending those funds out in the form of loans and advances to various businesses, public institutions, and private citizens. However, because of non-performing assets in recent years, banks have become much more cautious about making loans (Sontakke and Tiwari, 2013).

### **2.2.4. Nonperforming Loans (NPL)**

Bankers naturally aim to achieve a balance between the concerns of generating profit through lending and, simultaneously minimizing risk of loan default because it would affect earnings and subsequently, the capital. As a result, banks should be cautious when issuing loan advances

because they have a larger risk of defaulting on the loan (Gezu, 2014). To put it another way, loan losses or defaulted loans put a bank in a difficult situation, especially when they are most common. Banks can't completely ensure that the loans they issue will be repaid, even while they have security for those loans.

It is well acknowledged that bank failures and financial crises in both developed and developing nations are frequently correlated with the amount or proportion of non-performing loans (NPLs). They could be identified early by the borrower's violation of the conditions of the arrangement. According to the Ethiopian Banking Business Directive, non-performing loans are defined as advances or loans whose credit quality has deteriorated to the point where it is uncertain if the entire principal and/or interest will be collected in compliance with the conditions of the loan or advance's contractual obligation. When principle and/or interest are due and unpaid for 90 (ninety) consecutive days or more after the due date or maturity of a loan or advance with pre-established repayment schedules, the loan or advance is considered non-performing for the purposes of this Directive. Consequently in accordance to NBEs directive SBB/ 69/2018, Non-performing loans are those loans which are past their due dates and classified as substandard, Doubtful and loss.

Banks should use various mechanisms to recognize early warning signs regarding their loans. The regulation and monitoring process will be successful when there is strong legal as well as institutional framework of the banking business (Akmel,2019). This is why most countries need to provide strict regulation regarding non- performing loans. NBE surveillance mechanisms require banks to submit key financial data such as the composition of lending and the scale of non- performing loans on a regular basis, in order to identify all the risks to which each bank is exposed. This helps the banks not to make any decision which results in financial distress. Base on the above mentioned directive, commercial banks are legally required to make provisions with the following categories

**Table 1. Minimum percentage of loans provided to provision**

<b>Classification Category</b>	<b>Minimum provision</b>
Pass	1%
Special mention	3%

Substandard	20%
Doubtful	50%
Loss	100%

*Source: NBE directive no. SBB/69/2018*

### **2.2.5. Theories related to NPL**

The main theories that explain the root reasons of NPL in any financial institution are reviewed in this section. Principal agent problem, information asymmetry problem & adverse selection theory and moral hazard theory are all included in the theoretical review.

#### **A. Principal agent problem**

The principal agent theory, developed in the 1970s by a group of economists and theorists, highlights the hazards that frequently occur when one individual or association, known as the "agent," represents another person or group, known as the "principal."

When one party (the agent) decides to work for another party (the principle) in exchange for some benefits, the principle agent problem occurs. The agency theory is becoming increasingly popular as a way to explain why businesses perform financially. It clarifies the connection between an organization's management and its owners, who are usually the people who hold its shares.

Typically, a company's management is viewed as an agent employed by its owners to increase total shareholder value through profitable operations.. Theoretically, it is expected that the management will prioritize the owners' interests, boost the financial prosperity of the company, and ensure that their choices and actions result in maximizing the shareholders' wealth (Abebe, 2021).

Managers may not always prioritize the shareholders' interests and may instead prioritize their own personal objectives. The root of this issue is that managers are driven by their own personal interest. The diligent efforts of managers solely result in the enrichment of the shareholders, not themselves. From this point forward, it implies that managers acting as agents may engage in activities that put their own interests ahead of the owners of the company. In line with the theory, it is highly probable for the financial outcomes of the organization to decline in such situations.

Various strategies can be implemented by shareholders to guarantee that an organization's management acts in the best interests of the business. One possible tactic is to incentivize management with rewards, which can serve as motivation. Alternatively, shareholders may issue threats, such as a hostile takeover, to exert pressure on management to fulfill their responsibilities to the organization (Abebe, 2021). The principal may also have to bear agency costs, such as the expense of an audit, in order to oversee the management's functioning.

### **B. Information Asymmetry & Adverse Selection**

Financial markets manifest a situation of unequal information when one individual in a transaction possesses greater knowledge than the other, thus leading to the possibility of a more knowledgeable decision being made. Any circumstance that involves a borrower and a lender can also result in this situation where the borrower neglects to reveal their actual adverse financial condition.

The concept of information asymmetry suggests that identifying reliable borrowers can be challenging, leading to issues of adverse selection and moral hazards. As stated by the theory, the entity with a better knowledge of a particular item involved in a transaction holds an advantage in bargaining better transaction terms than the other party, namely the lender (Asari, et al, 2011 as cited in Abebe, 2021). The party with less knowledge about a particular transaction may make either a correct or an incorrect decision regarding its execution. Typically, borrowers possess complete knowledge regarding their financial condition and repayment capacity during the lending procedure. Despite seeking loans, individuals may not reveal all information to the bank, thereby gaining access to greater financing than they would usually qualify for.

This theory is pertinent in cases where incomplete information is present and indicates that distinguishing reliable borrowers from unreliable ones can be challenging. This can result in adverse selection and moral hazard issues, leading to a substantial increase in non-performing loans.

### **C. Moral Hazard**

There is a possible threat in the financial market where the borrower may carry out unfavorable actions that could decrease the chances of repaying a loan, causing unease for the lender. The

situation arises when the individual who borrows is aware that any errors made will be covered by another party. The thought of moral hazard suggests that one party in a contract may choose to engage in riskier behavior if they believe that any negative consequences of their actions will ultimately be shouldered by the other party (Stiglitz and Weiss 1983; Stiglitz, 1990) as cited in (Sangwani , 2019).

The assumption suggests that an unequal distribution of information can create obstacles for banks in anticipating the likelihood of borrowers taking measures to guarantee repayment to the banks. Although moral hazard cannot be completely eradicated, banks can mitigate its impact by ensuring credit facilities are backed by strong collateral that holds a value at least equal to the disbursed loan amounts.

### **2.3. Empirical literature review**

According to various researches, such as Zelalem Tsige (2013), Gadise Gezu(2014),Delil Akmel(2019), Derje Abebe(2021), it is evident that a number of factors lead to non-performing loans.. Some of which the banks may still directly regulate while others are completely out of their control. Basically they can be grouped into three categories namely, bank specific factors, Customer (borrower) specific factors and external factors. Some of them will be discussed in the following section:-

#### **2.3.1. Bank specific Factors Affecting NPLs**

##### **A. Credit processes & credit monitoring**

The entire lending process includes customer selection, screening to application, credit assessment, approval, and repayment monitoring & portfolio management. Thus knowing the customer, conducting an accurate credit evaluation through 5C's (character, capacity, capital, condition and collateral), effective credit approval and using regular follow up in terms of legal, financial and physical follow up are the critical actions that need to be performed in order to minimize the NPL. In doing so the banks shall keep their lenses focused and pay keen attention to details from the onset. Besides in drawing credit contracts, the banks' legal team must ensure that all necessary clauses are included in the contract in order to keep the bank from any future liabilities (Boudriga et al., 2009 as cited in Gezu, 2014). Moreover, it is vital that banks divide the business units accountable for monitoring from those in charge of loan origination.

Asfaw et al.(2016) in his study of factors affecting NPL in case of development bank of Ethiopia central region has pointed out that banks that employ a strong KYC policy in recruiting customers would have a better loan quality. The loans are vulnerable to default if the bank manages credit risk inadequately. Additionally, borrowers who are admitted with ease typically default. The study's overall findings show that instances of nonperforming loans are primarily caused by borrowers who are readily accepted and inadequate credit risk management. But, the results also showed that tight project performance monitoring and control is thought to result in good loan quality. Furthermore, with adequate oversight, even badly evaluated and advanced loans could work admirably. This suggests that inadequate credit analysis or assessment at the outset would be replaced by follow-up.

Mulatu(2018) through Multivariate time serious model of vector auto regressive , vector error correction model and Johansen approach for the time series data and OLS model for cross sectional data has found that the variables, poor due diligence assessment, non-credit worthy project financing, lack of proactive measurement for the sign of default, are explanatory variables that increase or significantly impact the occurrence of NPLs projects in Development Bank of Ethiopia. However the researcher discovered that poor Credit risk Management, overestimation of cash flow, poor follow-up, unable to provide timely decision, are insignificant factors for increment of nonperforming loan projects in Development Bank of Ethiopia.

Akmel (2019) tries to find determinants of non-performing loan in the case of Ethiopian commercial banks by focusing on bank specific determinants. By using purposive sampling and descriptive statistics data analysis method with SPSS software, the researcher has found that poor risk assessment, poor monitoring and follow up of loans and advances, as the top ranking factors causing occurrences of NPLs.

## **B. Bank Profitability**

Bank earnings may reflect the risk taking behavior of bank managements. Banks with high profitability are less over stressed for revenue creation and thus less forced to engage risk credit offering. However some banks may emphasize earning more than others. Consequently banks with greater need of earning might adapt more aggressive lending policies by increasing the

credit size. Consequently they will experience high level of problem loans since they are tempted to grant and to engage in more uncertain credits to defend their profitability.

Gezu (2014) conducted a study on both macroeconomic and bank specific determinants of NPL on commercial banks of Ethiopia through explanatory research design and panel data analysis on the time period from 2002 to 2013. The study shows that banks profitability measured in terms of return on equity, banks capital adequacy ratio had negative and statistically significant effect on NPL of commercial banks of Ethiopia.

Asfaw et al.,(2016) work resulted that aggressive lending, bank's great risk appetite and compromised integrity in approving credit cause large volume of nonperforming loans. Moreover, it is believed that an increase in credit expansion can lead to NPL. However, the finding indicated that having a large no of borrowers alone is not the root cause of loan defaults.

Oyanka(2019), based on his paper on determinants of NPL in case of commercial bank of Ethiopia & Dashen bank district in southern region has found that aggressive lending, rapid credit growth and the banks great risk appetite is a problem which related to credit size for the occurrences of loan default. According to the finding, this causes are higher in private bank when compared with state owned bank. Thus commercial banks with greater risk appetite (credit size) tend to record higher loss.

Abebe (2021), tried to assess determinants of NPL in Ethiopian commercial banks based on panel data analysis on the time period from 2010 to 2019 through both descriptive and econometric analysis. The study result has indicated that there are positive relationships between loan growths with non-performing loan.

### **C. Collateral security**

Assets given by the borrower to the bank as security are referred to as collateral, and they can significantly reduce the bank's risk of suffering financial loss in the event of a loan default. It may ensure the borrower's commitment to repay the borrowed funds to the bank.

Generally banks avail loans based on cash flow principal. However the collateral standing of the borrower is also assessed as a second way out. The collateral security are relied upon when the cash flow (interest and principal) associated with the loans are not paid. Banks assess collateral's worth quantitatively and perceived ease of liquidation qualitatively. Lenders typically prefer getting their money back from the project they are funding, and they only utilize the security as a last resort.

According to Akml(2019), security is required among others, to ensure the full commitment of the borrower, to provide protection for the borrower default from the planned course of action outlined at the time credit is extended, and to provide insurance. His study has highlighted that the relation between NPLs and collateral is neutral in view of the respondents. Conversely poorly valued collateral or difficulties in recovery are factors contribute to bad loans (Oyanka, 2019).

#### **D. Manpower capability**

Keeping a skilled and contented workforce will improve the bank's lending performance. Hence, aggressive, dishonest, and unrealistically high target-oriented banking also encourages staff to make quick, uninformed decisions that result in the disbursement of substandard credit facilities. In order to help banks find productive employees, regular staff performance reviews must be done. Besides, reorienting underperforming employees inside the Bank is necessary.

About the capacity, authority, and bank policy of credit performers and how these affect the likelihood of non-performing loans (NPLs), Asfaw et al., (2016) has found that the amount of non-performing loans can be positively impacted by project appraisers, selection officers, and managers who possess the necessary qualifications and skills.

#### **E. Technological advancement/digitalization**

Most of Ethiopian banks process the loan applications through manually which may result in lengthy process. However by leveraging advanced technologies such as artificial intelligence and machine learning, financial institutions can analyze the financial history and needs of the borrower to accurately assess their creditworthiness and identify the most suitable and contextual products for their needs. By digitizing and automating the lending process, the platform is transforming traditional banks into digital lenders. So far cooperative bank of Oromiya has launched Michu, its first collateral free digital lending platform in Ethiopia that

provide loan without collateral. With a one-year repayment period, digital loans up to 150,000.00 Birr will be available for small and medium-sized businesses in Ethiopia through the artificial intelligence-driven Michu platform from CBO. Besides, Bank of Abyssinia is under final process to start digital lending through a system called Apollo. As per the knowledge of the researcher, there is no study which assesses the relationship between technological advancement and NPL.

### **2.3.2. Customer specific variables**

On the other hand customer specific elements like the borrower's refusal to repay the loan, borrower's credit culture, lack of experience in project managements, Customer money being diverted for an unforeseen purpose and failing to disclose crucial information will affect non-performing loans. In the process of lending, the borrowers normally have full information about their financial status and their ability to repay loans. However, when applying for loans, they may fail to make full disclosures to the bank so that they can access more financing than they could possibly qualify. Conversely diversion of funds occurs when the borrowed funds are not used for the primary purpose they were intended for and as such, many projects become halfway completed. In such case the funds were meant for an income generating project but the borrower decides to divert into a different business thus leading to loan default. Regarding to this, (Mulatu, 2018), in his study on development bank of Ethiopia has found out that lack of Commitment by borrowers, loan diversion and poor repayment character of borrower, are insignificant. However, 80% of the respondents are believed that one of the main causes of the NPL in DBE is the use of funds for unforeseen purpose (Abebe, 2019).

### **2.3.3. External Factors**

General macroeconomic and social factors affect the customers' ability to service loans. These main causes includes inflation rates, interest rates, gross domestic product (GDP), political instability and bank rules & regulations which will be discussed briefly in turn.

#### **A. Inflationary Pressure**

Theoretically, inflation should lower the real value of debt and ease lending. High inflation, however, might cause nominal interest rates to increase, which would make it harder for borrowers to repay their loan. It can raise tax burden by artificially inflating income and profits thanks to its attraction with the tax system. Moreover, inflation raises the cost for businesses to

change prices. Finally, because inflation reduces the real worth of monetary holdings, it caused people to store less cash and visit banks more frequently. The debtors' actual income may suffer when their wages are frozen.

Sangwani (2019) indicated that inflation is the rate at which the average price of the country is growing. Inflation usually lowers a currency's purchasing power, meaning that a given amount of money might not purchase the same quantity of products and services. Generally speaking, rising inflation puts debtors under excessive stress, which may impair their ability to repay debts.

Negera(2012) describe inflation as the state of rising prices across the board in an economy. It indicates a consistent and widespread increase in the overall cost of products and services, which resulted in a decline in the money's purchasing power. Likewise, an economy may suffer greatly if inflation goes up quickly and unexpectedly. Meanwhile, because borrowers can pay back loans with worthless birr, inflation typically shifts resources from lenders and savers to borrowers. This implies that the quality of the loan portfolio decreases and borrowing prices increase in line with inflation.

Conversely, Ahmad & Bashir (2013) in their study with OLS method has proved a negative relationship of inflation rate with the occurrence of NPL and Gezu (2014) study shows Inflation rate had negative but, insignificant effect on NPL of commercial banks in Ethiopia. Moreover Abebe(2021) confirmed that there is a negative but significant relationship between inflation rate and NPL.

### **B. Gross Domestic Product (GDP)**

The year-on-growth of GDP is typically used by economists to calculate the percentage growth in the value of economies. Das and Gosh (2007) as cited in Sangwani (2019) were able to identify a link between GDP growth rate and NPL of banks. Sales and turnovers of enterprises typically increase when the GDP growth rate rises. An expansion of the economy will make it easier to repay loans, which will enhance the performance of NPLs.

Ahmed & Bashir(2013) finding of the significant negative relation between growth in GDP and NPLs suggest that increase in economic growth results in the increase debt paying ability of

individuals and firms because of the greater economic activities and earnings of the individuals and firms, consequently resulting in the decline of NPLs.

Selma and Jouini (2013) by using the method of panel data on Micro and Macro Determinants of Non-Performing Loans, they found that, problem loans vary negatively with the growth rate of GDP, the profitability of banks' assets and positively with the real interest rate.

### **C. Lending Rate/Interest Rate**

One of the main economic factors affecting the prevalence of NPLs is lending rates. It is the expense of borrowing money. The interest rate spread is the amount of difference between the costs of short-term borrowing from the return on long-term loans. Banks' performing assets are impacted by interest rate spread since it raises the cost of loans for borrowers (Joseph, 2011) as cited in (Gezu, 2014). The cost of using the money a borrower borrows from lenders is represented by the interest rate. Interest can be compared to paying rent on your money. In order to control the pursuit of monetary objectives, monetary regulators (NBE) typically accept that the loan rate is a rate of return. However under the directive no NBE/INT/12/2017, the national bank of Ethiopia has gave freedom for banks to set lending rate on loans and advances.

Concerning to this, different researchers has found various results. For instance the significant negative relation between interest rate and NPLs suggest that because of the high interest rate only those borrower and investors borrow from the banks that have the ability to pay back their loans form future income and earnings of projects (Ahmed & Bashir, 2013). Moreover, as per the result of Akmel(2019) the contribution of high interest rates of bank to occurrences of NPLs is quite minimal. On the other hand there is a positive relationships between lending rate with non-performing loan (Abebe, 2021).

### **D. Political instability**

There is political instability in different places of Ethiopia. Most projects financed by the bank burned, stolen, and left without owner and forced to turn into non-performing loan. This concern commenced the researcher to assess political instability as a factor that affect non-performing loan. So far the researcher had gotten only one research which was done on 2019 by Kalkidan Abebe.

Several projects were destroyed by protestors during the last four years of unrest in several parts of the country. Thus, the project's owners were obliged to flee the country rather than repay the debt. These factors greatly distress the bank's projects/borrowers, preventing them from functioning successfully and repaying the loan in line with the repayment schedule contract, and eventually leading to nonperforming loans. Political instability becomes one of the major external factors of NPL in DBE specially the last four years (Abebe, 2019).

#### **E. Banking rules and regulations**

The National Bank of Ethiopia (NBE) was given authority to license, oversee, and regulate financial organizations, including banks, insurance companies, microfinance institutions, savings and credit cooperatives, by the Monetary and Banking Proclamation No. 83/1994. Based on its authority, NBE has formulated various directives which regulate the overall credit process of the bank. The researcher had gotten no previous research on the influence of bank rules and regulations on NPL. Therefore the effect of frequent changes of the rules and regulations about credit and its processes on NPL of banks is assessed in this study

#### **2.4. Summary & Research Gaps**

Several factors influence the NPLs of the financial sectors. In this study, the researcher concentrated on the bank-specific, customer-specific and external factors that influence non-performing loans at selected commercial banks in Ethiopia. Due to the decisions and actions of officials and staff members, internal factors or bank specifics are brought about by internal operations and activities of the bank. These elements are under the manager's control, and he or she can prevent them by employing the proper techniques, identifying and removing weaknesses, and streamlining the process. The external environment, which has an impact on how choices are implemented as well as government laws, is what causes outside elements, which bank managers have no influence over.

Numerous researches on the causes of NPLs have been conducted in various nations. Even though the causes of NPLs are still up for debate among scholars, situational factors such those at the bank and national levels as well as the state of the country's legal and regulatory framework may play a role. In order to settle these arguments, further research on the factors that influence NPLs is required. According to the researcher's knowledge, even though a lot of research has been done on the factors that influence nonperforming loans made by banks, some

of earlier studies either concentrated on bank-specific factors or macroeconomic factors. Among others, Aynalem(2016), Akmel(2019) focused on bank specific determinants while Gezu(2014), Gebeyehu(2020), Abebe(2021) included both Bank specific or macro-economic factor that causes NPL in Ethiopian commercial banks. On the other hand Oyanka(2019) & Asfaw et al., (2016) in their study has incorporated Bank specific & customer specific determinants. Besides, some studies focused on a single commercial bank case. Asfaw et al.,(2016), Mulatu(2018), Kalkidan(2019), Gebeyehu(2020) has focused on determinants of NPL in case of Development bank of Ethiopia while Nigatu(2019) study was in case of Commercial Bank of Ethiopia and Dashen Bank District in Southern Region of Ethiopia. Moreover, Aynalem(2016) has assesses factors affecting Non-Performing Loans In Case of Commercial Bank of Ethiopia.

In contrast the current technological, economic, social & political environment is changing very quickly. Furthermore as per the knowledge of the researcher there is no sufficient study which incorporated the bank specific, customer specific and external factors affecting the level of NPL in Ethiopian commercial banks. Thus in order to assure the continued operation of Ethiopia's banking institutions, it is preferable to carry out this analysis. Therefore the purpose of this study was to assess the factors that affect NPLs of selected commercial banks in Ethiopia with three categories by adding the effect of the new bank specific factor of digitalization (technological advancement) and macro variable of the political instability and banking rules & regulation on NPL of banks.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1. Introduction**

This study assessed the factors that affect NPLs in selected commercial banks of Ethiopia. In view of that, this chapter presents the research procedures that were used to carry out the study including research design, population & sampling design, data type & sources, data collection instruments and data analysis.

### **3.2. Research Design**

A research design is a comprehensive plan that outlines the techniques and steps for gathering and evaluating the necessary data (Gezu, 2014). The choice of research design depends on objectives that the researchers want to achieve. Since this study was designed to assess the factors that affect NPL, explanatory and descriptive research designs were used. Explanatory research design attempts to determine whether a relationship exists between the bank specific, customer specific and macro variable while descriptive research design was used to describe the state of respondents thought which were gathered through questionnaire and interview.

### **3.3. Research approach**

There are three types of research approaches namely, quantitative, qualitative and mixed methods research approach. Quantitative research approach is used to answer question about relationships among measured variables with the purpose of explaining, predicting and controlling phenomenon. Qualitative research, in contrast to quantitative research, is a collection of methods that use a less rigid and more structured approach to gain insight rather than trying to measure anything (Gezu,2014). Thus, the mixed approach was used in order to fulfill the study's objectives and analyze the relationship between the occurrence of NPLs and its drivers in order to close any gaps that may arise from using only one of the approaches mentioned.

### **3.4. Population, Sampling and sample size**

Sample design considers the population or sample frame, sample size, and sampling methods. Due to limitations that make it difficult to include the complete research population, a sample is chosen.

Thus due to time and financial limitations, only a representative sample of the judgmentally selected banks were surveyed. Thus sample was chosen on purpose and accordingly top five Ethiopian commercial banks with highest profit and has a greater amount of assets in the recent

fiscal period as of 2021/2022G.C were the entire target population for this study. Since the profit and asset values are directly linked with the performance of the availed loans, they are used as a benchmark for selecting the banks.

**Table 2. Selected commercial banks**

<b>Selected bank</b>	<b>Gross profit(in billion)</b>	<b>Total Assets(in billion)</b>
Commercial Bank of Ethiopia (CBE)	27.5	>1 trillion
Awash Bank	7.5	183.4
Abyssinia Bank	4.6	149.4
Dashen Bank	3.8	117.1
Cooperative Bank of Ethiopia	2.8	114.6

**Source;**-*Audited financial statements of the selected bank as of 2021/2022G.C*

Furthermore, not all bank employees and authorities were included, as only a small number of personnel actually conduct bank lending. As a result, only people who work in the credit monitoring, credit analysis and customer relation teams at the chosen institutions were included in the sample frame through purposive sampling methods. A total sample of 151 professionals in the selected commercial banks were selected out of 244 credit staffs as part of the study. The researcher used this number of samples by assuming the target groups have better understanding and information about the study.

**Table 3 . NO of employees in each selected banks**

<b>Selected bank</b>	<b>No of employees</b>	<b>Sample</b>	<b>%</b>
Commercial Bank of Ethiopia (CBE)	87	54	36%
Awash Bank	52	32	21%
Abyssinia Bank	47	29	19%
Dashen Bank	31	19	13%
Cooperative Bank of Ethiopia	27	17	11%
<b>Total</b>	<b>244</b>	<b>151</b>	<b>100%</b>

$$\begin{aligned}
 \text{Sample size} &= N / (1 + N(e^2)) \\
 &= 244 / (1 + 244(0.05^2)) \dots \dots \text{at 95\% confidence interval} \\
 &= \underline{151}
 \end{aligned}$$

### **3.5. Sources of data and data collection method**

Primary and secondary data were collected, arranged, and analyzed for this study. Structured self-administered questionnaire prepared by the researcher & unstructured interviews were used in the survey's execution in order to assess the main causes of NPL. The questionnaires were used for data collection so as to get first-hand information within short period of time and fewer budgets whereas interview was to acquire a further data on the respondents thought and facial expression.

The self-administered questionnaire was delivered to the selected experts engaged in loan related activities. Three components were making up the questionnaire, which was written in English. The first set of questions was designed to collect participant profiles (background information). The second section deals with the variables that affect loan default or the occurrence of non-performing loans, and the remaining questions were constructed so that respondents rank the variables that affect non-performing loans in order of their importance when compared with other factors in the list.

### **3.6. Data Analysis and Interpretation**

After carefully coding and consistency-checking the information obtained from the survey questionnaire, it was placed into the SPSS spreadsheet. Descriptive statistics such as percentage, frequency, mean, and standard deviation were used to analyze the data. The percentage and frequency were used in order to show grouping of data relatively and mean and std. dev. to show the average value and their dispersion to the mean. Additionally, the information obtained from the questionnaire and interview was interpreted using a narrative qualitative data analysis type.

### **3.7. Ethical Issues**

The study was done on a voluntary basis, with due consideration given to obtaining each participant's agreement. The researcher seeks to respect the privacy and rights of participants. There was no deviation from the research's outcome when the findings were presented. Furthermore, the researcher fully acknowledged every source of information used in the study

## CHAPTER 4: RESULTS AND DISCUSSION

### 4.1. Introduction

In this chapter the data's obtained from respondents of selected commercial banks are presented, interpreted and analyzed briefly so as to assess the factors that affect NPL and to set possible conclusion & recommendation.

### 4.2. ANALYSES ON THE GENERAL PROFILE OF RESPONDENTS

#### 4.2.1. Survey response rate

A total of 151 structured questionnaires were disseminated to employees of the selected commercial banks who work at head office and deals with credit related works (such as credit analyst, customer relationship manager and recovery/monitoring officers). Out of total distributed questionnaires, 142 were completed and collected. As the result the response rate was 94.04 percent & the analysis was made on the substantial number of responses.

**Table 4. Response rate survey**

Description	Number of respondents
Sample size	151
Completed & returned questionnaires	142
<b>Response rate</b>	<b>94.04%</b>

Source: Survey outcome and own computation

#### 4.2.2. Respondent's profile

In this section, the respondent's general profile such as gender distribution, the banks they work for, banking experience and their current positions are presented and discussed as follows:-

**Table 5. Gender and Educational Background of Respondents**

Gender			
Description	Frequency	Percent	Cumulative Percent
Male	96	67.6%	67.6%
Female	46	32.4%	100.0%
Total	142	100.00%	
Educational background			
Description	Frequency	Percent	Cumulative Percent
Degree	22	15.5%	15.5%
Masters	120	84.5%	100.0%
Total	142	100.00%	

Source:-Survey result and researcher own computation

As shown in the table 4.2 above, the gender distribution of the respondents indicated that 67.4% of the respondents were male while the remaining 32.4% were females. Conversely, out of the total respondents, 15.5% were first degree holders, 84.5% were master's holders and none of respondents hold a diploma and doctorate degree (PhD). This figure explains that the majority of respondents have met the required educational qualifications which can improve their excellence in order to execute their activity efficiently and effectively.

**Table 6.Number of Respondents in each selected bank**

<b>Bank of respondents</b>			
<b>Description</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
CBE	48	33.8%	33.8%
Awash Bank	20	14.1%	47.9%
Bank of Abyssinia	32	22.5%	70.4%
Dashen Bank	25	17.6%	88.0%
cooperative Bank of Oromiya	17	12.0%	100.0%
Total	142	100.0%	

Source: Survey outcome and own computation

As shown above, regarding to the respondents category based on the employer bank, 66.2 percent of survey respondents were employed in private bank while the remaining 33.8 percent were employed in state owned bank. Hence, it shows most of sample respondents were belongs to private commercial banks. Alternatively, as the process of administration of loans and advances both in private and state owned banks is under taken in compliance with the directives , rules and regulations set out by National Bank of Ethiopia, Banking Supervision Directorate, variance in the mix of respondents will not have effect on the findings.

**Table 7.Position of respondents in their respective bank**

<b>Current position in the bank</b>			
<b>Description</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Credit Analyst	38	26.8%	26.8%
Recovery/monitoring Officer	25	17.6%	44.4%
Customer Relationship Manager	77	54.2%	98.6%
Director	2	1.4%	100.00%
Total	142	100.00%	

Source: Survey outcome and own computation

Concerning to the position of respondents, from the total samples around 38(26.8%) of the respondents were credit analysts, 25(17.6 percent) were Recovery/monitoring Officer, 77(54.2 percent) were Customer Relationship Manager and 2 (1.4 percent) were Credit Directors. The result may indicate that, the banks have greater number of number of credit relationship managers other than remaining positions.

**Table 8.Respondents’ experience in the banking credit process**

<b>Experience of the respondents in Bank credit Process</b>			
<b>Description</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Less than one year	2	1.4%	1.4%
1-5 years	32	22.5%	23.9%
6-10 years	60	42.3%	66.2%
10-15 years	41	28.9%	95.1%
Above 15 years	7	4.9%	100.0%
Total	142	100.00%	

Source: Survey outcome and own computation

Regarding experience of lending in the banking industry, 1.4 percent of respondents had less than one year experience, 22.5 percent of respondents had 1-5 years of experience, 42.3 percent had lending experience for 6-10 years, 28.9 percent of respondents had 10-15 years of experience and 4.9 percent stated to have more than 15 years of exposure in the area. The reliability of the data is thought to have been positively impacted by the fact that a large majority of those surveyed had extensive experience in credit-related activities. Thus it is believed that the respondents had adequate understanding and information related to the credit and NPL which absolutely helps the researcher to have relevant and reliable data that contributes to the quality of the survey results.

#### **4.3. Factors that Affect Bank Lending**

The purpose the study was to assess the factors that affect NPL in Ethiopian commercial banks. The factors were categorized into three divisions as related with the bank, the customer and macro determinants outside of the both the bank and customer. In section two of the structured questionnaire, respondents had to indicate whether they agreed or disagreed with a number of statements pertaining to the aforementioned components. Thus, respondents from each bank reflect their own feelings; based on their experience, their banks credit operation culture, own policy and procedures in administrating credit facilities, external environment and the overall

lending rules and regulations. Accordingly, responses were reflected in different ways and are summarized in the following sections.

#### 4.3.1. Bank specific factors

Banks specific determinants of nonperforming loans naturally vary across banks due to the uniqueness of each bank. One bank might have strength or weakness on particular aspect. That particular issue may or may not be the case in other banks unlike the macroeconomic factors that is typical for all operators in particular geography or so. However, in the subjective question in the survey, respondents from the five surveyed banks gave various responses. The fact that a particular factor is pinpointed by all surveyed banks indicates how widespread that cause could be in the Ethiopian banking sector.

**Table 9. Credit processes & monitoring and occurrences of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
Poor Due Diligence Assessment and inefficient know your customer(KYC)study of the bank lead to loan default	77	54.2	63	44.4	2	1.4	-	-	-	-	1.47	0.529
Good loan underwriting does not ensures loan performance	6	4.2	12	8.5	12	8.5	72	50.7	40	28.2	3.90	1.044
Loan follow up, Strict monitoring and Controlling of loan performance lead to high loans quality	94	66.2	44	31.0	1	0.7	-	-	3	2.1	1.41	0.718
Poorly assessed and advanced loans may perform well if properly monitored	82	57.7	47	33.1	6	4.2	6	4.2	1	0.7	1.57	0.821
<b>Overall mean</b>	<b>2.0880</b>											
<b>Overall standard deviation</b>	<b>0.32779</b>											

Source: - Survey outcome and own computation

Table 9 presents data's regarding variables that suggest association between credit monitoring and process and the occurrence of nonperforming loans. From the total responses 98.6 percent of the respondents agree that Poor Due Diligence Assessment and inefficient know your customer (KYC) study of the bank plays a major role in leading the loan to default. The findings of this

study are corroborated by Nigatu(2019) which indicated that Poor credit analysis and Poor credit risk assessment are causes for the occurrences of non-performing loans. Besides, this result is consistent with the findings of Asfaw et al.(2016), in which the respondents believed that a bank's know your customer (KYC) approach results in high-quality loans.. The view held among the respondents is that banks with stronger KYC policies and better risk assessments will have higher-quality loans. In addition, those surveyed stated that a bank will make a high-quality loan if it evaluates the borrowers' past credit history, capacity to pay back debt, capital invested, market value of the security given, and terms & conditions of credit. Furthermore, a detailed review of all the documents received from applicants, including the information inquiry report, is necessary to determine the level of reliability of the data acquired.

Conversely, 78.9 percent of the respondents were disagree on the assertion that good loan underwriting does not ensures loan performance while 8.5% of the respondents have neutral insight regarding the impact of good underwriting for NPL. The findings make it clear that, before granting credit facilities, all accountable officials involved in credit administration must conduct thorough and in-depth analyses to ascertain the potential borrowers' firms and associated merits. The result is supported by the finding of Akmel (2019) which states that good underwriting process would assist the officers and managers to establish, essentially, the extent to which the borrower is able to service the debt by the income generated from businesses. This would make it easier for the officers and managers to ascertain whether the borrowers had enough revenue from their business to repay their debit. The prospective borrower's business and financial management, organizational structure, credit history or general track record, and full profile are among the details about the client. Besides, as indicated in the literature part there is nothing important than knowing potential customer. If the underwriting process is carried out poorly, the non-potential borrowers will easily admitted. In essence, the infringement of the objectivity of credit appraisal and assessment is the cause of the non-performing loans. In addition the interview respondents expressed the concern that, the bank's non-performing loan (NPL) may rise if it has a tendency to take on more risks when handling lending concerns. The possible explanation here is that, to give a loan or not, a bank takes into account the quality of a borrower which is reflected in its past and projected profit performance, the strength of its balance sheet (for example, capital and liquidity) the nature and market for its product, economic & political conditions in the country in which it is based, the quality &

stability of its management and its general reputation and standing. According to Hassan et al. (2015) the bank must ascertain the objective of the loan, evaluate its viability, and ascertain how the money needed to cover interest and capital repayment will be regenerated.

With regard to loan follow up and monitoring, 97.2 percent of the respondents support the assertion that having a strong loan follow up, Strict monitoring and controlling of loan performance lead to high loans quality. Besides, most of the respondents (90.8%), perceived that the poorly assesses loans may perform well if the bank properly monitor it. The finding is supported by the results of Akmel(2019) & Arega(2016) which concludes that strict loan monitoring ensures excellent loan performance. The findings showed that tight oversight and management of the performance of the loans taken out is thought to provide high-quality loans. Verifying that the funds are being used for their intended purposes and that the original justifications for the loan are still in place are the two main objectives of loan monitoring. Conversely, loan follow up means checking if the money borrowed is being paid back on time and making sure the payments continue for the whole loan period. Once funds are disbursed the concerned banks cannot afford to rest on their laurels and expect all payments to come in on the due dates without problem. Hence, to reduce the occurrence of bad loans every effort of follow-up must be carried to the utmost degree and take timely action when necessary. This suggests that inadequate credit analysis or assessment at the outset would be replaced by follow-up. However, even though loan monitoring involves funding, increasing funding might guarantee loan performance. Alternatively the respondents of Assefa(2017) didn't support the argument that loan would perform well only by proper monitoring, if proper assessment is not carried out while advancing the credit. This indicates that follow up would never substitute credit analysis or assessment.

According to the interview, one of the main reasons for loans not being paid back is because the bank did not properly assess the customer's ability to pay and did not keep track of the loan. Poor underwriting practices, a lack of familiarity with potential borrowers, improper borrower monitoring, and a failure to identify warning signals in a timely manner are the main causes of banks' financial losses. When banks don't pay attention to what people do with the money they borrow, they can't see the risk of losing that money. The interview respondents gave

due attention to the loan monitoring and follow-up. Follow up the financial stability of a borrower can be done by periodically scrutinizing the operations of the accounts, examining the stock statements and ascertaining the value of security. One of the ways banks follow up on loans is by paying the borrower periodic visits to learn about the status of the borrower's business activities and provide guidance as needed. Additionally, borrowers have a tendency to focus more on loan repayment if banks treat them well. Otherwise borrowers would be tempted to divert the fund to other purposes, as was also learnt through the in-depth interview

In general the outcome indicates that, poor assessment and KYC policies, loan follow up, monitoring and controlling is directly related to loan performance. Therefore the bank should conduct due diligence by making every possible examination available. Besides, every follow-up, controlling, and monitoring effort must be carried out to the highest extent possible in order to reduce the incidence of bad loans.

**Table 10. Bank profitability and occurrences of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
Having high profitability ensures loan performance	52	36.6	50	35.2	15	10.6	17	12.0	8	5.6	2.15	1.207
Aggressive lending to increase the banks income leads to large NPL	59	41.5	48	33.8	16	11.3	15	10.6	4	2.8	1.99	1.105
Having quick credit growth doesn't increase the banks NPL	10	7.0	23	16.2	13	9.2	73	51.4	23	16.2	3.53	1.156
The Bank's great risk appetite doesn't result NPL	14	9.9	19	13.4	11	7.7	63	44.4	35	24.6	3.60	1.270
<b>Overall mean</b>	<b>2.8204</b>											
<b>Overall standard deviation</b>	<b>0.52791</b>											

Source: - Survey outcome and own computation

Looking at the responses on the relationship between banks profitability and occurrences of NPLs, 71.8 percent of the respondents agreed that having high profitability ensures loan performance. The main reason behind is the larger the bank size, the more resources to evaluate and process loans while focusing on selective borrowers as well as legal environment. However the finding is not in line with Gebyehu (2020) which found that a profitability of a company measured by Return on asset of the bank has positive effect on NPL of the bank suggesting that NPL increases in parallel with the bank's increased profitability. This implies that the bank pays

attention to NPL in order to enhance the bank's financial performance during periods of lower earnings and overlooks it during periods of higher profitability.

On the other hand, around nearly 75.3 percent were of the opinion that aggressive lending leads to occurrences of large NPLs volume/rate while 13.4 Percent disagree on this. This result is supported by Negera(2012) and Oyanka(2019) indicated that aggressive lending, a bank's high risk appetite, fast credit growth, and a lack of compromised integrity in credit approval are issues that are linked to credit size and the likelihood of loan failure. The bank makes majority of their incomes by charging interest on loans and advance. If the borrowers don't pay back their loans, the bank doesn't make as much money and might not be profitable. If the availed loans become NPL, the regulatory organ requires the banks to make a provision from their incomes based on the loans category. This in turn affects the income after tax values. In contrast, as explained in the principal agent theory, the people who work for a company should try to make as much income as they can for the owners. So as to achieve this, managers may employ aggressive lending practices.

Conversely, out of the survey participants, 67.6 & 69.0 percent of the respondents disagree with the assertion that quick credit growth and great risk appetite do not result NPL. The result is in line with Abebe(2021) which indicates that loan growth has positive and significant impact on NPLs as loan growth has a positive significant association with NPLs. As indicated in Tefera (2017) banks with better risk position (lower non-performing loans) have higher inclination to extend loans. Yet, when bank have higher non-performing loans in the portfolio, may be more concerned about the risky, and hence, have lower tendency to grant loans. Since loans are illiquid assets, increase in the amount of loans means increase in illiquid assets in the asset portfolio of a bank. It indicates that the surveyed banks that emphasize on loan growth do so at the expense of credit quality. Even if it is virtually impossible to eliminate loan losses entirely, Ethiopian private commercial banks have been strongly adhere to sound credit analysis principles that framed by a sound credit policy. But the majority of the interviewees stated that even if banks have been working on the quality of their loan they should reduce the frequency and depth of loan problems. They should concentrate lending in fields where it possesses a demonstrated expertise,

and a bank should not lend outside its trade area. Lending difficulties can be reduced if management establishes and adheres to loan policy guidelines that restrict unacceptable activity.

Overall, the study's findings suggest that when banks pursue an aggressive riskier lending strategy and experience rapid loan growth may end up with higher NPLs.

**Table 11. Collateral and occurrence of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
Good type and location of the offered collateral can have a positive effect in decreasing the level of NPL	19	13.4	30	21.1	39	27.5	39	27.5	15	10.6	3.00	1.207
Loans availed on clean basis without adequate collateral tends to default	57	40.1	10	7.0	35	24.6	21	14.8	19	13.4	2.52	1.462
<b>Overall mean</b>	<b>2.7746</b>											
<b>Overall standard deviation</b>	<b>1.1339</b>											

Source: - Survey outcome and own computation

Collaterals are assets held by the Bank to lower the risk of default. It is a guarantee of loan repayment that a borrower provides to a bank. Whether or not all loans must be supported by suitable collateral depends on the Bank's policy. However the credit worthiness, which is the ability to pay the loan with sufficient cash flow, should always come first; it should never be a backup plan. In the banking environment, security is required among others, to ensure the full commitment of the borrower, to provide protection from the borrower default from the planned course of action outlined at the time credit is extended, and to provide insurance in case of the borrower default.

As shown in the above table ,47.1 percent (strongly agree and agree) of the survey respondents agree, 28.2 percent were disagree and 24.6 percent were neutral to the assertion that loans availed on clean basis without adequate collateral tends to default. Alternatively, 34.5 percent of the respondents were agree with the view that the Good type and location of the offered collateral can have a positive effect in decreasing the level of NPL and ensuring the loan

performance, while 38.1 percent were disagree and 27.5 percent were neutral on the positive effect of the location and type of collateral on the level of NPL.

The interview discussion demonstrates that having enough collateral to secure the loans does not ensure that they would be repaid. This is as a result of various political and law sanctions, unexpected accidents, depreciations and etc. Moreover, the collaterals never insure adequate cash flow and the repayment capacity of the borrowers in which the banks assess in priority when approving a loan. Some of the interview respondents argue that, as the very purpose of the bank is providing the required finance to the productive sector, selling the collateral should not be the option when the borrower defaults. Instead, careful analysis of the business viability of the borrowers prior to granting the loan is believed to reduce the NPL of the bank. Conversely, some of the respondents are of the view that borrowers would service the loan if they have pledged collateral for fear that it would be foreclosed in case of default despite of its type and location. Therefore from the above discussion, it is possible to draw the conclusion that there is little association between collateralizing loans and loan default, and the average result may imply that non-collateralized loans are not likely to default.

**Table 12. Manpower capability and occurrence of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
Having knowledgeable, experienced and skilled man power in loan activity ensures loan performance	71	50.0	51	35.9	9	6.3	8	5.6	3	2.1	1.74	0.959
Credit performers in the bank have autonomous power in appraising and selecting projects	39	27.5	79	55.6	15	10.6	8	5.6	1	0.7	1.96	0.823
<b>Overall mean</b>	<b>1.8521</b>											
<b>Overall standard deviation</b>	<b>0.70908</b>											

Source: - Survey outcome and own computation

As indicated above, inefficient knowledge/experience of credit service employees is perceived to cause NPL as evidenced by 85.9% of respondents agrees and strongly agree, whereas, 7.7% and 6.3% of respondents disagreed & neutral respectively regarding inefficient knowledge/experience of credit

service employees as a cause of NPL. Besides, 83.1% of respondents agree with the claim that, Credit performers in the bank have autonomous power in appraising and selecting projects. Therefore, having competent and experienced employees who can independently appraise projects can guarantee a good underwriting procedure and risk assessments, which in turn ensure the performance of the loan. Making informed loan decisions undoubtedly depends in large part on the qualification, experience, and capability of the lending officer. The possible explanation here is that, the knowledge and experience of lending officers in dealing with lending matters allows them to make proper loan processing and analysis and make the right and wise loan decision, these all factors altogether lead to an increase in quality of loans. Besides, if the loan performers have autonomous power in appraising and selecting projects, the credit lending process will be reliable and free from biases. Therefore knowledgeable, experienced and skilled man power in loan activity ensures loan performance.

**Table 13. Technological advancement/digitalization and occurrence of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
Elongated loan processing time in loan granting and Unable to provide timely decision due to using traditional loan processing techniques resulted NPL	66	46.5	43	30.3	16	11.3	17	12.0	-	-	1.89	1.029
Employing outdated technologies in loan appraising and follow up process doesn't result NPL	8	5.6	17	12.0	13	9.2	43	30.3	61	43.0	3.93	1.234
<b>Overall mean</b>	<b>2.9085</b>											
<b>Overall standard deviation</b>	<b>0.56687</b>											

Source: - Survey outcome and own computation

As indicated in the above table, 76.6% of respondents agree that NPL was caused by prolonged loan processing times in loan giving and an inability to provide timely decisions as a result of using conventional loan processing methods. Furthermore, 73.24% of respondents disagree for the view that using outmoded technology for loan appraisal and follow-up doesn't lead to NPL.

In the banking sector, technological advancements boost security and operational effectiveness while also enhancing the entire customer satisfaction. For instance, client profile screening is accelerated and improved with know-your-customer (KYC) systems. Besides it will help to provide timely decisions for the requests. It means that, if the bank employs updated technologies and can provide timely decisions, the credit assessment and monitoring will be effective. Besides, the customers will have the required working capital on the required season and their business can perform as planned. Consequently the operations will not be disturbed and the client will be able to repay the loan timely.

#### 4.3.2. Customer specific factors

**Table 14. Customer specific factors and occurrence of NPLs**

Description	Strongly agree		Agree		Neutral		Disagree		Strongly Disagree		Mean	SD.
	Freq.	%	Freq.	%	Freq.	%	Freq.	%	Freq.	%		
The use of loan for unintended purpose which is diversion of fund can cause NPL	86	60.6	49	34.5	2	1.4	3	2.1	1	0.7	1.47	0.703
There is a relationship between loan default and borrower's culture	51	35.9	51	35.9	19	13.4	18	12.7	3	2.1	2.09	1.095
Carelessness and dishonest of customers about credit can cause NPL	79	55.6	58	40.8	2	1.4	2	1.4	1	0.7	1.51	0.672
Insufficient knowledge and experience of customers about credit and project management may result NPL	60	42.3	71	50.0	7	4.9	3	2.1	1	0.7	1.69	0.728
<b>Overall mean</b>	<b>1.6896</b>											
<b>Overall standard deviation</b>	<b>0.53254</b>											

**Source:** - Survey outcome and own computation

Customers-related aspects influence how borrowers repay their loans. These are factors that emanate from borrowers and have strong bearing on occurrences of loan default. In accordance to the study, the main customer-related causes of the bank's bad loan accumulation and the escalation of defaulter customers were due to diverting the approved loan for an unintended purpose, borrower's culture, customers failing to disclose important information during the application process and having insufficient knowledge and experience about credit and project management

The response shows that, there is a highly relationship between NPL and diversion of loan fund as 95.1% of the respondent agreed that diversion of granted loan and used it for unintended purpose could be the result of loan default. Using the approved funds for unforeseen purposes causes cash flow problems, which ultimately results loan default. NPLs were influenced by speculating, which focuses on investing in high-risk assets to make high return, and the misallocation of capital for needless corporate expansion.

It could also be noted that 71.8 percent of respondents believed loan default in some areas is attributed to the culture of the borrowers. This means that in order for the banking industry to effectively lend and collect loans and advances, the culture of borrowers and society as a whole must be given adequate consideration. It is therefore considered a prerequisite to study borrowing culture. Credit culture which focuses on the borrower’s decision to take a loan without thinking of the future results to defaulted loan.

Conversely, dishonest of the customer and insufficient knowledge & experience of customers about credit & project management were believed to cause NPL as agreed by 96.4% and 92.3% of the respondents’ respectively. As most of the businesses in country are family owned, inexperienced and untrained project managers may leads project failure. Besides they may not be aware of the credit terms, economic situations and the overall operation of the business. Moreover if the borrower neglects to reveal their actual financial condition, the problem of information asymmetry takes place and the underwriting process will have a misleading result.

This means that the bank needs to closely monitor both its loans and its borrowers; it also needs to update its policy for follow-up assessments; it needs to closely evaluate the know your customer study that is completed when a customer applies for a loan; it needs to thoroughly evaluate the customer's commitment and experience; it needs to take swift legal action against those who divert loans to other businesses and educate others about it; and, finally, it needs to work with borrowers to collect arrears on loans and prevent the bank from going into bankrupt.

**4.3.3. External factors**

**Table 15.External factors and occurrence of NPL**

Description	Strongly agree	Agree	Neutral	Disagree	Strongly Disagree	Mean	SD.
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	<b>Freq.</b>	<b>%</b>	<b>Freq.</b>	<b>%</b>	<b>Freq.</b>	<b>%</b>	<b>Freq.</b>	<b>%</b>	<b>Freq.</b>	<b>%</b>		
Inflation experienced on the goods and services can make a rise in the level of NPL	62	43.7	47	33.1	13	9.2	14	9.9	6	4.2	1.99	1.146
An increase in gross domestic products of the country may reduce the level of NPL	40	28.2	46	32.4	24	16.9	23	16.2	9	6.3	2.39	1.229
Loans with high interest rate tend to turn to NPL	29	20.4	44	31.0	24	16.9	28	19.7	17	12.0	2.71	1.318
Political unrest and rebellion in various parts of the country does not increasing the level of NPL	10	7.0	16	11.3	4	2.8	57	40.1	55	38.7	3.92	1.231
The maximum number of allowed iterations can reduce NPL	54	38.0	35	24.6	22	15.5	17	12.0	14	9.9	2.31	1.353
Change of banking rules and regulations issued by the governing organ has effect on the level of NPL	58	40.8	40	28.2	21	14.8	12	8.5	11	7.7	2.14	1.263
<b>Overall mean</b>	<b>2.5786</b>											
<b>Overall standard deviation</b>	<b>0.67771</b>											

Source: - Survey outcome and own computation

External factors are referred to those elements which are beyond the customer and the banks that can affect the level of loan performances. Among others, it includes inflation rate, GDP, Interest rate, political unrest and the overall loans rules and regulation set out by the directing organ.

Concerning to the inflation rate, about 76.8% of the respondent agreed, 9.2 % becomes neutral and the rest 14.1 % of the respondents disagreed that inflation experienced on the goods and services can increase the level of NPL. The theoretical justification is that high inflation might lead to nominal interest rates rising, which would make it more difficult for borrowers to repay their loans. By increasing revenue and profits artificially, it can increase the tax burden. Because high inflation is unpredictable and typically results in a large degree of variability in the rates of price increases of the specific items and services that make up the overall price index, it increases the volatility of corporate earnings. Both the likelihood that businesses will experience losses and the likelihood that they will experience windfall profits are increasing. However, this result is not in line with Tsige (2013) in

which the coefficient estimate of inflation was negative and statistically significant at 1% significant level. It stated that the existing higher inflation rate in Ethiopia was in favor of borrowers since it can make debt servicing easier by reducing the real value of outstanding loan. On the other hand, according to Ahmed and Bashir (2013) & Gezu (2014), the result indicated that there is a negative significant relationship between NPL and inflation. Inflation causes banks' equity value to decrease, which increases the riskiness of the institutions. In an attempt to increase the value of their equity, banks begin making large loans in order to demonstrate short-term profitability. They also reduce the amount of money they spend on credit evaluation, allocation, monitoring, and control in order to reduce costs associated with low-quality borrowers, which causes the number of non-performing loans to rise.

On the other hand, the above table also indicates that only 60.6 percent of the respondents agree with while 22.5 percent disagree and 16.9 percent were neutral for the assertion that loan with high GDP tend to reduce the level of NPLs. This result was in consistent with the findings of Ahmed & Bashir (2013) and Tsige (2013). They have found negative significant relationship between NPL & growth in GDP.

According to the relationship, GDP growth raises personal income, which in turn raises people's capacity to pay off debt because of more economic activity and earnings for both individuals and businesses. This, in turn, causes a decrease in non-performing loans (NPLs). Positive GDP growth was always accompanied by an increase in overall economic activity and the amount of cash owned by families and companies. These requirements helped to lessen the possibility that borrowers would put off paying their debts. Therefore, the results indicated that one of the key factors influencing non-performing loans (NPLs) in Ethiopian commercial banks was real GDP growth. However, Gebyehu (2020) study result was a positive relationship in which when economic growth is higher, NPL is higher also due to the borrowers are using economic growth opportunity for further investment instead of repaying the loan.

The above table also indicates that only 51.41 percent of the respondents agree with while 31.69 percent disregard and 16.9 percent were neutral for the assertion that loan with high interest rate tend to turn to NPLs. In other words, charging big interest rate doesn't necessarily lead to loan default. Therefore the relation between NPL and highest interest rate is not strong. In contrary

some of the respondents from the interview argue that high interest rate leads to loan default and low interest rate initiate borrowers as well as easy to repay. In addition on the literature part also state interest rate has a direct effect on consumers' ability to repay a loan. When interest rates are low, people are willing to borrow because they find it relatively easy to repay their dept.

The above table also indicates that only 18.3 percent of the respondents agree with while 78.8 percent disagree and 2.8 percent were neutral for the assertion that Political unrest and rebellion in various parts of the country does not increasing the level of NPL. A number of projects were burned by protestors during the time of unrest held in different part of the country in the last four years. Therefore, the owners of the project were forced to leave the country rather than settling the loan. These factors distress highly the projects/borrowers of the bank, protect them from performing well & paying the loan based on repayment schedule contract and finally turned to nonperforming loans.

From the total respondents, 62.6% & 69% of them agree with the assertion that the maximum number of allowed iterations can reduce NPL and Change of banking rules and regulations issued by the governing organ has effect on the level of NP. The NBE under its directive NO SBB/69/2018 limits the number of renegotiation for short and medium term loan to be 5 and 6 for the long term loans. Thus, if the loan restructuring has reaches its limit, the customer will not has any option other than paying the repayment regularly otherwise it will be transferred into work out departments which resulted a negative history. Besides, the NBE issue various rules and regulations that has a direct or indirect effect on the national economy. This in turn affects the business of the borrower and then the loan repayment capacity.

#### 4.5. Ranking

**Table 16. Ranking of factors that cause NPL**

<b>Description</b>	<b>Rank</b>
Poor Credit processes & credit monitoring	1
Inefficient and incapable man power	2
Diversions of fund	3
Unwillingness of borrower to pay back the loan	4
Political instability	5
Inflationary Pressure	6

Frequent change of banking rules and regulations	7
Low level of Gross Domestic Product (GDP)	8
Low Bank Profitability	9
Low level of technological advancement/digitalization	10
High Interest Rate	11
Insufficient collateral	12

Source: - Survey outcome

As indicated in the above table, the respondents were asked to rank the factors causing NPL. Accordingly, Poor Credit processes & credit monitoring, Inefficient and incapable man power, Diversion of fund, Unwillingness of borrower to pay back the loan and Political instability were as top 5 factors that contribute for the increasing rate of NPL in order of sequence. On the other hand, the influence of uncollateralized loans and charging high interest rate were low since they are ranked as eleventh and twelfth. Hence the bank should adjust its monitoring/follow-up assessment, its credit risk assessment and customer related causes by strictly following the default loan and defaulters of credit to keep the health of the bank. In general, a bank's management should therefore give careful consideration to credit risk and methods for identifying and minimizing it when deciding whether or not to grant loans.

## **CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1. Introduction**

This chapter sums up the results of the study. Therefore, it starts with the summary; then provides the conclusion. Then after, recommendations of the study and areas for more research are also presented.

### **5.2. Summary of findings**

The main aim of the study was to assess the factors that affect non-performing loans in selected Ethiopian commercial banks by using both primary and secondary data's. Among the bank specific factors, the study found that the credit assessment & monitoring of the banks is the major cause. The result depicts that Poor Due Diligence Assessment and inefficient know your customer (KYC) study of the bank cause loan default. Consequently, this result is found to be consistent with the finding made by Asfaw et al.(2016) which says that Non-performing loans are influenced by poor risk management and credit analysis. The outcome further indicates that insufficient credit monitoring is the root cause of nonperforming loans. Tight project monitoring, control, and follow-up are essential for high-quality loans. Furthermore, if properly monitored, even loans and advances with poor evaluations and advances could perform well. If the bank doesn't pay enough attention to the borrowers and how it uses the money, it might not recognize the risk involved. Therefore, the goal of loan monitoring or follow-up is to ensure that the final use of funds is compliant with the approval terms and conditions as well as the intended use. The study results support Negera's (2012) conclusion that credit monitoring and follow-up are essential to guaranteeing loan collection, which is consistent with empirical research.

In the meantime, it was thought that loan default was caused by aggressive lending, banks' excessive risk appetite, and rapid credit growth. Rapid credit growth, which is interpreted as an indicator of excessive risk-taking in lending, is thought to be a warning sign of declining loan portfolio quality. This result is in consistent with and supports the empirical study of Abebe (2021) which found that loan growth has a positive significant association with NPLs. On the other hand respondents agree with the assertion that having high profitability and skilled &

experienced man power ensures loan performance. As persistent by Lemma (2022), due to skilled employees and qualitative information bases, larger banks are more effective in credit analysis and monitoring their debtors. Besides they will not practice aggressive lending practices in order to increase their incomes. However it doesn't support the finding made by Gezu (2014) in which bank profitability measured in terms of ROA has positive and statistically significant impact on NPLs by arguing that commercial banks in Ethiopia are less incentive to increase return via in utilizing its assets.

In contrast, only 47.18 percent of the respondents are of the view that loans availed on clean basis without adequate collateral tends to default and neutral respectively. Besides, 34.51% of the respondents agree with the assertion of good type and location of the offered collateral can have a positive effect in decreasing the level of NPL & 27.5 percent were neutral. Therefore, based on the respondents' perspective, collateral has little bearing on the likelihood of loan default. In addition, the lengthy loan approving process and fails to have advanced technology in loan approving and follow up process were the causes for the existence of NPLs.

Regarding the reasons specific to the customer, the outcome reveals that the factors were the customer's credit culture, the borrower's lack of knowledge and experience in the proposed business, deliberate default, and loan diversion. The outcome supported the empirical research of Negera (2012), which found that deliberate borrower defaults, their lack of knowledge, fund diversion for unforeseen uses, and past-due financing have a substantial impact on non-performing loans (NPLs). Borrowers who took out a loan to expand their business or make new investments may end up using it for other wasteful activities like purchasing luxuries. The others is that borrowers who obtained short term loans from banks may use the fund for capital expenditures that do not generate immediate income to repay their debt in accordance to the sated agreement. This suggests that, unless fully addressed through a thorough credit worthiness assessment supported by KYC during loan application and properly monitored after being implemented, customers' unique factors have an impact on the prevalence of non-performing loans (NPLs).

Moreover, the study's result shows that rise inflation rate, political instability, and frequent changes of banking rules and regulations are also the cause for the occurrence of nonperforming loans. The theoretical foundation that inflation rate resulting rise in the level of NPL is that due to high inflation rate, the tax burden raise by artificially inflating the income of the business. Besides in may cause nominal interest rates to increase, reduce the real worth of monetary holdings raises the cost for businesses to change prices. Accordingly the NPL level of the bank will rise due to the inflation experienced in the country. On the other hand as explained by Ahmed and Bashir (2013) with the inflation the equity value of the banks declines, resulting in the growth of banks riskiness. Banks in order to improve their equity value, start extensive lending to show short run profitability and decline its expenditures on credit evaluation, allocation, monitoring and controlling to achieve short run cost efficiency. This results in the allocation of funds to low quality borrowers and leads to the growth in NPLs. However this result doesn't support the research findings of Abebe (2021) which got negative significant effect on NPLs revealing that in times of low inflation, people can honor their loan obligations due to the reduced real burden of such repayments as general prices rise.

On the other hand the survey result suggested that a rise in the level of country' GDP level has a positive effect in reducing the level of NPL. The result of the study is consistent with the existing study's findings. It supports the finding by Ahmed and Bashir (2013) that found a negative significant relationship between NPLs and growth in GDP. The negative relation suggests that growth in GDP increases the income of individuals, resulting in the increase in debt paying ability of individuals and decline in the NPLs ratio. It also advocate that increase in economic growth results in the increase debt paying ability of individuals and firms because of the greater economic activities and earnings of the individuals and firms, consequently resulting in the decline of NPLs. Conversely, Abebe (2021) and Lemma (2022) have found insignificant negative and positive relationship between GDP growth rate and loan default.

The result of the study also suggests that political instability experienced in the country and the frequent changes of banking rules and regulations (specifically credit related) are also the cause of NPL. Conversely, there is no strong relationship between the interest rate and NPL. Most of the respondents disagree and were neutral for the assertion of Loans with high interest rate tends to turn to NPL. It doesn't support the negative significant association finding by Gezu

2014 & Mulatu(2018) who argued that with the increase in interest rate, deposits and lending rates of the banks increases. Individuals with the funds starts savings with banks to earn on their funds and investors with the profitable business projects feel reluctant to borrow and invest in projects whereas opposite is valid in case of decline in when individual and investors are more keen borrow for consumption and invest in risky projects. On the other hand Abebe( 2021) has found positive and statistically significant impact of lending rate on the level of NPLs implying due to other extraneous factors, decrease in lending rate reduces the levels of NPLs for commercial banks in Ethiopia.

### **5.3. Conclusion**

All commercial banks render different kinds of services; among which provision of credit is the major one as bank lending is the core function of commercial banks. When a bank avails a loan, the loan may not be collected because of many factors and those uncollected loans are said to be NPLs or bad loans. Identifying the causes of NPL plays important role in designing credit advancing process and also legal frame works. The basic objective of this research has been to assess the borrower, bank specific & external determinants of NPLs. For the achievement of the objective the study used survey of employees of banks by employing structured questionnaire and unstructured interviews and secondary data were collected from written documents, reports, and internet. As a result, the observed findings of the study suggested the following conclusions:

- Among the bank specific factors that accounted for the incidence of NPLs, it was found out from the study conducted that Poor credit assessment and mooting, low profitability which leads to aggressive lending and great risk appetite, having incapable workforce and lack of technological advancement are the possible causes for the rise of NPL. This implies that the bank needs to focus on credit monitoring or follow up system to creditworthiness and project capacity to repay a loan and the risk associated with the loan.
- Regarding customer's related factors, the result also shows that Customer fund diversion lack knowledge and experience of customers about project management, carelessness & dishonest, Unwillingness of borrower to pay back loan due to lack of proper education in the business area, intentional(willful) defaults by borrowers were identified as a likely

customer specific factors. This indicates that like to bank specific factor, customers' specific factors has a significant impact on NPL.

- From the study it is also concluded that political instability, macroeconomic factors such as inflation rate, GDP, interest rate were found out as the potential external cause of NPL.

## 5.5. Recommendation

According on the aforementioned conclusions, the researchers provided the following recommendations

- If the risk involved is not appropriately identified and reduced, loan providing is a very risky business. Thus the bank should adapt pre- and post-credit risk evaluations in order to reduce the possibility of loan default. Additionally, they shall implement a competent loan processing scheme, as well as an overall careful analysis and assessment system. Banks should put in place a vibrant credit process that would encompass issues of proper customer selection, robust credit analysis, authentic sanctioning process, proactive monitoring and follow up and clear recovery strategies for sick loans. The bank need to focus on credit information sharing of other banks and exploit the application of know your customer (KYC) principle, which plays an important role in reducing the probability of risk associated with poor credit assessment and the occurrence of NPL. In addition, it is recommended for the bank to communicate with the borrowers and make signal on a timely basis regarding their loan repayment status.
- After the loan is disbursed, the bank must continue to monitor credit in a timely manner to ensure that borrowed money is being used for its intended purpose. The bank needs to make physically powerful follow-up whether the disbursed funds are being used for the intended purpose or not through enhanced timely credit monitoring after the loan is being released. The bank should attempt a lot in improving its loan quality by strengthening its loan follow up/monitoring system, undertaking regular and continuous project follow up on active projects in order to identify defaulters and to take timely action based on the follow up report.
- To strengthen their expertise and aptitude in handling lending issues and enable them to make sensible loan decisions that lower the amount of NPL, banks must offer their lending officer's high-quality, up-to-date trainings. Since quality loan approvals are the

consequence of competent staff processing loans, the number of NPL will be reduced. Credit management should be viewed as part of a co-coordinating group effort made by all department involved with customers to minimize bad debtors that affects negatively bank profit.

- In order to promote the credit culture of potential investors, the bank could also arrange forums for raising knowledge of its credit services as well as business and financial management. Loan officers should give borrowers financial advice on how to use loans wisely, how to allocate resources and should make decisions quickly to fulfill their needs. If so, the management of the banks' asset utilization is enhanced, this in turn lowers the number of NPLs in the nation's commercial banks.
- The government can also play important role in improving the level of NPLs in the economy by influencing the macroeconomic variables. For instance, governments can overcome the current energy crisis by starting new power projects to provide regular and low cost power supply and natural gas to the industry, which will result in the increased production, low level of unemployment, economic activities in the economy and high exports.
- During the credit assessment process, the effects of outside elements like political unrest and market failure should be taken seriously.
- For banks to prevent predatory lending and unhealthy competition that would pick default-prone borrowers, a balanced strategy of profit maximization and risk management is necessary.
- NBE should always make sure that regulations governing bank loans are prudent in light of global best practices, macroeconomic conditions, the stage of development of banks, and the state of the economy in general.

## **5.6. Future Research**

Through a survey of credit performers, this study tries to pinpoint external, bank-specific, and customer-specific factors that have an impact on nonperforming loans utilizing specific variables in 5 selected Ethiopian commercial banks. Therefore, it is advised that future researchers conduct similar studies by expanding the sample of banks, taking into account more variables, and include the defaulter's response. Future studies on newly established banks may also be uired so as to validate the consistency of the findings and to produce additional finding.

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## APPENDIX -I

### Questionnaire

ADDIS ABABA UNIVERSITY  
COLLEGE OF BUSINESS AND ECONOMICS  
DEPARTMENT OF ACCOUNTING AND FINANCE  
MSC PROGRAM

Dear respondent,

My name is Yabsira Bizuwork and I am currently working with the research component of the Master of Science in Accounting and Finance at Addis Ababa University, College of Business and Economics. This questionnaire is prepared to conduct research for the title of "Determinants of Non-performing Loans in the selected Ethiopian banks". The purpose of my study is to identify the main factors affecting Nonperforming loans in Ethiopia. To this end, the study intends to gather information from selected credit related practitioners (credit managers, analysts, recovery (monitoring) officers, credit committee members, risk officers etc) through a self-administered questionnaire. The participation is fully voluntary and responses will be confidential. The results will be also reported without compromising the anonymity of respondents. Thus, your accurate and frank responses are imperative for the successful accomplishment of the study.

I would appreciate your favorable consideration in completing the enclosed questionnaire and assisting me in the research endeavor. In case you have any questions please call +251-938-04-64-41 or email Yeabserabizuwork.16@gmail.com.

#### **N.B**

- ❖ No need of writing your name
- ❖ Your confidentiality maintained sincerely
- ❖ Use ✓ up on given choices alternatives.

Thank you in advance

Yabsira Bizuwork

**Section One - Background Information**

1. Please indicate your gender

Female

Male

2. What is your level of education?

Diploma

Masters

Degree

Doctorate

If others, -----

3. Which bank do you work?

CBE

Dashen Bank

Awash Bank

Cooperative bank of Oromiya

Bank of Abyssinia

3. What is your current position in the Bank?

Recovery/monitoring officer

Credit analyst

Customer Relationship manager

Director

Other, Please specify.....

4. Indicate your experience in the Banking credit process

Less than 1 year

1-5 years

6-10 years

11-15 years

Above 15 years

**Section Two: - Questions on Determinants of Nonperforming loans.**

- ✓ Please indicate your degree of agreement or disagreement to the statement pertaining to **bank specific factors** and the occurrence of NPLs (1-strongly agree, 2-Agree, 3-Neutral, 4-Disagree, 5-Strongly disagree).

Description(Bank specific factors)	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
<b>F. Credit processes &amp; credit monitoring</b>					
Poor Due Diligence Assessment and inefficient know your customer(KYC)study of the bank lead to loan default					
Good loan underwriting does not ensures loan performance					
Loan follow up, Strict monitoring and Controlling of loan performance lead to high loans quality					
Poorly assessed and advanced loans may perform well if properly monitored					
<b>G. Bank Profitability</b>					
Having high profitability ensures loan performance					
Aggressive lending to increase the banks income leads to large NPL					
Having quick credit growth doesn't increase the banks NPL					
The Bank's great risk appetite doesn't result NPL					
<b>H. Collateral security</b>					
Good type and location of the offered collateral can have a positive effect in decreasing the level of NPL					
Loans availed on clean basis without adequate collateral tends to default					
<b>I. Manpower structure/Capability</b>					
Having knowledgeable, experienced and skilled man power in loan activity ensures loan performance					
Credit performers in the bank have autonomous power in appraising and selecting projects					
<b>J. Technological advancement/digitalization</b>					

Elongated loan processing time in loan granting and Unable to provide timely decision due to using traditional loan processing techniques resulted NPL					
Employing outdated technologies in loan appraising and follow up process doesn't result NPL					

- ✓ Please indicate your degree of agreement or disagreement to the statement pertaining to customer specific factors and the occurrence of NPLs (1-strongly agree, 2-Agree, 3-Neutral, 4-Disagree, 5-Strongly disagree).

Description(Customer specific factors)	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The use of loan for unintended purpose which is diversion of fund can cause NPL					
There is a relationship between loan default and borrower's culture					
Carelessness and dishonest of customers about credit can cause NPL					
Insufficient knowledge and experience of customers about credit and project management may result NPL					

- ✓ Please indicate your degree of agreement or disagreement to the statement pertaining to **external factors** and the occurrence of NPLs (1-strongly agree, 2-Agree, 3-Neutral, 4-Disagree, 5-Strongly disagree)..

Description(External factors)	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
Inflation experienced on the goods and services can make a rise in the level of NPL					
An increase in gross domestic products of the country may reduce the level of NPL					
Loans with high interest rate tend to turn to NPL					
Political unrest and rebellion in various parts of the country does not increasing the level of NPL					
The maximum number of allowed iterations can reduce NPL					
Frequent Change of banking rules and regulations issued by the governing organ has effect on					

increasing the level of NPL					
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**Section Three: - Ranking the Determinants of Nonperforming loans.**

- ✓ Please rank the factors that cause occurrences of NPLs in the Ethiopian Banks by Ranking the factors in order of their importance in contributing to the occurrence of NPLs from 1 – 12(1 –highest ,12 – lowest)

Description	Rank
Poor Credit processes & credit monitoring	
Low Bank Profitability	
Insufficient collateral	
Inefficient and incapable man power	
Low level of technological advancement/digitalization	
Diversion of fund	
Unwillingness of borrower to pay back the loan	
Inflationary Pressure	
Low level of Gross Domestic Product (GDP)	
High Interest Rate	
Political instability	
Frequent change of banking rules and regulations	

- ✓ please use the space below if you have further comments on the determinants of nonperforming loans of Ethiopian Banks

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**End of questionnaire**

**Thank you!!!**