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***IMPACT OF LOAN ASSESSMENT ON NON-
PERFORMING LOANS: A CASE OF
CONSTRUCTION AND BUSINESS BANK (CBB)**



Project Paper in Partial Fulfillment of the Requirements for the
Degree of Master of Science (MSc.) in Accounting and Finance



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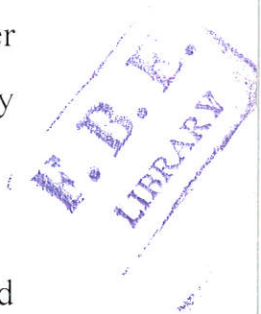


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Abstract

The study endeavors to examine the impact of loan assessment on non performing loans at construction and Business Bank (CBB) from the view point of both Accounting and Economic aspects. The accumulation of non-performing loans is attributable to lots of causes. Among these, the major one is inadequate loan assessment. This, in turn, aggravates non-performing loans, delays the economic recovery, creates liquidity problem, hampers the development of Bank's operational activists as well reduces profit.

Survey method was used to collect data from 48 employees of CBB who are working in the area of loan activity with the help of purposive (non-probability) sampling technique. The collected data was analyzed using descriptive statistics. Moreover, semi-structured and structured interview was also used to gather information that can be as cases studies from CBB's loan officers. In addition, questionnaires were prepared to CBB city branch managers and credit department employees.

The result of the study revealed that there are many factors contributing for the accumulation of non-performing loans in CBB. Among which, inadequate credit assessment is the major factor followed by real estate speculators and long term maturity of the loan.

Acronyms

NPL: Non-Performing Loan

CBB: Construction and Business Bank

NBE: National Bank of Ethiopia

O/D: Over Draft

L/C: Letter of Credit

FIRA: Federal Inland Revenue Authority

ICS: Internal Computer System

EIBI: Ethiopian Institute of Bank and Insurance

CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

Financial institutions transform financial assets acquired through market and constitute them in to a different and more widely preferable type of assets, which become their liability. This is the function performed by financial intermediaries (F. Fabozzi and F. Modigliani, 1996).

Financial intermediaries include depository institutions (commercial banks, saving & loan associations, saving banks & credit unions), Insurance companies, pension funds and finance companies. These intermediaries obtain funds by issuing financial claims against themselves to market participants, then investing those funds. The investment made by financial intermediaries can be in the form of loans and/or in securities (Ibid, 1996).

Among the depository institutions, banks are the most important financial institutions in the economy. They are the principal source of credit for many households, for most local units of government and for businessmen. The principal economic function of banks is to make loan. For most banks, loan accounts for half or more of their total assets and about two thirds of their revenue (Ibid, 1996).

One of the state owned commercial banks of Ethiopia namely Construction and Business Bank (CBB) has been involving in the provision of credit to almost all sectors of the economy (such as public enterprise, cooperatives and private firms) since its inception in 1965. In particular all state commercial banks in Ethiopia are facing escalated default rate. For instance at the end of 2002 the volume of non-performing loans of the state commercial banks alone stood 50% of the total loan portfolio of the bank (NBE annual report, 2002).

The accumulations of non-performing loans are attributable to lots of causes. These are manipulation by the debtors using political influence, the legal system that made credit recovery to be time consuming and difficult, inability to assess credit risk and return with

reasonable accuracy, Real estate speculators, lack of monitoring and inadequate regulations both by banks and the government (Hayes, Douglas, 1991).

Cottarelli, Carlo (1995) in his study bank lending and financial structure in Italy found evidence that, an increase in the riskness of loan assets is rooted in a bank's lending policy adducing to relatively unselective and inadequate assessment of sector prospects.

Hence, the study has undertaken empirical and qualitative data analysis for evaluating the credibility of the loan assessment practice and its impact on non-performing loans in Construction & Business Bank (CBB).

1.2. Statement of the Problem

Non-performing loans (NPLs) have substantial negative impact particularly on the performance of commercial banks and in general the overall economy of a nation. In chronic cases it will cause financial crises as in the case of Japan and East Asia.

One of the factors which increase the accumulation of NPLs is inadequate loan assessment, Mueller, P. Henry (1997). In turn, the accumulations of NPLs negatively affect the performance, profitability, competency, sustainability and growth of a bank. When the NPLs rate increases due to the contributing factors like inadequate credit assessment, the following problems would emanate.

- The per share value of banks' stock price declines.
- The development and expansion rate of banks reduce.
- The public confidence over the bank may erode. As a result the bank may loss its loyal and prominent customers.
- The capacity of bank's competitive position may decline.
- Investors may not be willing to invest their funds in the bank's stock or may be willing to invest at a price below the market.
- The capital structure of banks will be affected. In other way the bank may forces to be highly leveraged in return, highly leveraged financial institutions may go to bankruptcy.
- The administration costs of foreclosure loans will increase.

Hence, the writer of this paper wanted to see the credibility of the loan assessment practices and its relation with NPLs in CBB.

1.3. Objective of the Research

- **General Objective**

The over-riding objective of the research is to assess the impact of loan assessment on NPLs and to investigate the level of NPLs in CBB as a result of inability of loan assessments.

- **Specific Objectives**

- To analyze the credibility of loan assessments in CBB.
- To identify the problem area of the loan assessment.
- To evaluate the bank's lending strategy and procedural manual.
- To evaluate the level of cooperation between CBB and Federal Inland Revenue Authority (FIRA) to cross check the income statement submitted by individuals to these organizations.
- To evaluate qualification and experience of the bank's loan officers.
- To suggest remedial solutions to problems detected in the study.
- To make the study as a stepping stone for further study.

1.4. Significance of the Study

Loan assessment is the major function for granting loans to borrowers. Deficiencies in this regard would result in the enhancement of the accumulation of NPLs. In return, the bank's profitability would erode, additional administrative costs would be imposed and the bank's growth rate will be hampered.

Identifying the problem area of the loan assessment helps for the bank's decision makers and the concerned body to take corrective measures so as to reduce NPLs. Therefore, a study in this area is obviously of vital importance.

1.5. Scope of the Study

The study is specially limited to CBB's head office and its Addis Ababa branches (city branches) since most of the loans are disbursed in Addis Ababa. Time and financial constraints were also the reasons to limit the scope of the study only in Addis Ababa. The study highly focuses on the credibility of loan assessments in CBB and its impact on the accumulation of NPLs. Furthermore, the study focuses on the time period considered in evaluating NPL level and credit assessment quality indicators.

1.6. Hypothesis

Though there are many causes for the accumulation of NPLs to increase in both private and government owned banks, poor credit assessment is believed to be the main factor for the accumulation of NPLs in CBB. Thus, the writer of this study hypothesizes that most of CBB's NPLs are as a result of inadequate loan assessments. In addition, the writer believes that next to inadequate loan assessments the following factors may be the causes for the accumulation of NPLs in CBB. These are

- Long term maturity of the loans
- Lack of follow up
- Lack of monitoring
- High interest rate
- Inadequate regulations
- Lengthy of legal system
- Corruption
- Real-estate speculators
- Manipulation by the debtors using political influence

1.7. Operational Definition of Technical Terms

The following technical terms are defined within the context in which they are employed in the study.

Building and Construction Loans: refers to the construction of buildings, roads, dams and similar projects.

Competitive Advantage: A firm's profitability is greater than the average profitability for all firms in its industry

Credit to Collateral Ratio: The amount of loan per unit of collateral value (collateral value/amount of loan)

Domestic Trade and Service Loans: refers to the distribution of goods either produced locally or imported by way of whole selling or retailing.

Effectiveness: Able to bring about the result intended

Efficiency: Producing a desired or satisfactory result

Hotel and Tourism Loans: refers to catering food and beverages, room and other hotel services. It can also be related to car renting services for tour and travel business.

Lack of Monitoring: banks rely up on collaterals and guarantees in the allocation of credit and little attention was paid to earnings performance and cash flows

Lack of Monitoring: Indicates that banks rely upon collaterals and guarantees in the allocation of credit and little attention is given to the business earning performance and cash flow of the clients business.

Lending Strategy: Is designed by top management of the bank to gain competitive advantage by exploiting core competencies in loan activities for the purpose of providing value to customers, Mott, Hubert (April 1997).

Letter of Credit (L/C): Is an arrangement whereby a bank promising to pay the exporter on behalf of the importer up on presentation of shipping documents.

Loan officer or Credit Analyst: is an employee of the bank who conducts credit assessment.

Loans and Advances by Maturity: Is classification of loans on the basis of short term, medium term, and long term loans.

Long term loans: loans with duration of 5 to 30 years.

Medium (Intermediate) term loan: refers to loan maturities from one to five years.

Merchandise Loans: Is loans against the value of the inventories. Inventories or raw materials, goods in process and finished goods can be pledged as a security for the loan.

Non-Performing Loans (NPLs): According to National Bank of Ethiopia (NBE) non-performing loans means loans or advances where credit quality has deteriorated such that full collection of principal and/or interest in accordance with contractual repayment terms of the loans or advances in questions.

Package Loans: Two or more types of loans which extend to individual borrower with the same collateral.

Personal (Consumer) Loans: loans for the purpose of purchasing house-hold goods, electronic and/or electrical equipments for domestic use, automobile for own use and for pay out personal debts already constructed elsewhere.

Short term loans: it has a duration not exceeding twelve months.

Strategy Implementation: Is executing the formulated strategy to achieve set objectives

Tax Evasion: Paying income tax not in the right way. Keep out of the way

Transport and Communications Loans: all service activities such as distribution of products, packing & forwarding, transportation etc are categorized here.

Valued Customers: Is a customer who is loyal and have strong relation with the banks'. However each bank has their own criteria in selecting the banks' valued customers.

Working Capital Loans: A short term loans (for instance, loans for the purchase of inventories, loans for the payment of taxes, etc) that banks finance the working capital cycle of the applicants business. An example of working capital loan is Overdraft facilities.

Hypothesis: An educated, scientific and reason guided guess.

Purposive Sampling: The principle of selection is the researcher's judgment as to typicality or interest.

In addition, the writer uses the following terms interchangeably in this study- **informants and respondents and loan officers and credit analysts.**

1.8. Organization of the Study

This study comprises of five chapters. This first chapter is an introductory chapter consisting of background of the study, statement of the problem, objectives, scope, significance of the study, operational definition of technical terms and hypothesis. The second chapter deals with the review of the relevant literature, followed by chapter three which contains the methodology and research design. Chapter four covers the analysis and interpretation of data. The last chapter encompasses conclusion and recommendation.

CHAPTER TWO

2. LITRATURE REVIEW

The chapter reviews the existing literature on credit analysis of banking industries. The discussion covers credit analysis, non-performing loans and gives highlights on the history of Construction and Business Bank (CBB).

The numerous and varied risks in leading stem from the many factors that can lead to the non-payment of obligations when they come due. Losses sometimes result from "acts of God" such as storms, droughts, fires, earth quakes and floods. Changes in consumer demand or in the technology of an industry may actor drastically the fortunes of a business firm and place once profitable borrowers in a loss position. A prolonged strike, competitive price cutting, or loss of key management personnel can seriously impair a borrower ability to make loan payments. The Swings of the business cycle affect the profits of many who borrow from banks and influence the optimism and pessimism of business peoples as well as consumers. Some risks arise from personal factors that are difficult to explain. Edward W. Reed (1985) on his book commercial Banking suggests that in determining whether or not to grant a loan, a banker must attempt to measure the risk of nonpayment. This risk is estimated through a process referred to as **credit analysis**.

In a study of changes in loan pricing and business lending at commercial banks, Brady Thomas F. (1985) argued that character has historically been paramount factor of credit and a major determinant in the decision to lend money. The study suggests that bankers should make fairly accurate personality morale, profile assessment of prospective and current borrowers and guarantors. Besides, according to Ibid(1985) in considering personal interaction, the banker should try to draw some conclusions about staff morale and loyalty, study the personal credit report , do trade credit reference checking , check reference from present and former bankers, determine how the borrower handle stress .

According to Brick J.R (1984), rigorous loan to value ratio does not prevent loans from becoming non- performing, rather adequate credit assessment and fair prediction of

economic trend and close credit monitoring by the lender could keep the borrower to honor the loan contract.

So far different researchers have come up with different factors for the causes of non-performing loans in different countries. The differences in factors for non-performing loans different countries are ascribed to operating environmental differential of banks across the world. The issues to be emphasized are that bankers have to identify causes for non-performing loans and to seek solution in eliminating the occurrence of non-performing loans.

Studies reveal that the recent Asian financial crises were due to increased volume of non – performing loans. Non – performing loans create problems for the banking sectors balance sheet on the asset side. They also create a negative impact on the income statement as a result of provisioning for loans losses.

2.1. Classification of Non–Performing Loans

The extent to which authorities have been involved in developing criteria to distinguish between “ good “ and “ bad “ loans defers substantially between countries. Some countries use quantitative criteria for example number of days of overdue scheduled, payments, while other countries exclusively rely on qualitative norms (such as a variability of information about the clients financial status, management judgment about future payments).

In our country’s case, the National Bank of Ethiopia has issued directive number SBB/32/2002 pursuant to the authority vested in it by article 41 of the Monetary and Banking proclamation number 83 / 1994 and by article 15 (1) and 36 of the Licensing and Supervision of Banking Business proclamation number 54 / 1994. According to this directive, banks shall classify non–performing loans, weather such loans have pre–established Repayment schedule or not, in to the following three classifications using the criteria described below.

Pass - loans or advances in this category are fully protected by the current financial and paying capacity of the borrower and are not subject to criticism. In general any loan or advances 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.

Special Mention – Any loan or advances past due 30 (thirty) days or more, but less than 90 (ninety) days shall be classified under this classification.

Substandard- are non-performing loans or advances past due 90(ninety) days or more but less than 180 days shall be classified as substandard loans.

Doubtful – are non-performing loans or advances past due 180 (one hundred eighty) days or more but less than 360 (three hundred sixty) days shall be classified as doubtful.

Loss – Non-performing loans or advances past due 360 (three hundred sixty) days or more shall be classified as loss.

2.2. Objective of Credit Analysis

The principal purpose of credit analysis is to determine the ability and willingness of a borrower to repay a requested loan in accordance with the terms of the loan contract. A bank must determine the degree of risk it is willing to assume in each case and the amount of credit that can be prudently extended in view of the risks involved (W. Reed and K. Gill, 1985, PP.216-217).

The work of credit analysis includes the collection of information that will have bearing on credit evaluation, the preparation and analysis of the information collected and the assembling and retention of information for future use. Thus, the bank leading officer attempts to project the borrower and the environment including all possible hazards that may affect them, Ibid (1985)

2.3. Factors Considered in Credit Analysis

Some of the factors that affect the ability of a borrower to repay a loan are very difficult to evaluate but they must be dealt with as realistically as possible in preparing financial projections. This involves looking in to the past record of the borrower as well as engaging economize forecasting W. Reed and K. Gill (1985). Furthermore, they suggest that there are the ingredients that determine the lending Officer's faith in the debtors' ability and willingness to pay the obligation in accordance with the terms of the loan agreement. They specified three credit analysis factors in analyzing a loan request. These factors referred to us the three C's of Credit - Capacity, Character and Capital. Some writers like K.C. Shekhar (1982) classified the factors in to 5 C's. This refers to capacity, characters, capital, collateral and conditions. For our purposes of discussion, we shall use the K.C. Shekhar classification.

2.3.1. Capacity (Repayment Ability/Borrowing Capacity)

Banks are interested not only in the borrower's ability to repay but also in his or her legal capacity to borrow. Banks make few loans to minors, since they can disaffirm at a later date unless the proceeds of the loan are used for essential purpose when a loan is made to a minors, a Parent, guardians or other person of legal age is usually asked to cosign the note (W.Reed & K.Gill, 1985).

In lending to partnership, it may be advisable to require that all members of the partnership sign for the loan. If that is not feasible, the lending officer should determine whether the signing partners have authority to borrow for the partner ships (L.S. Dyer 1999).

In lending to a corporation, it is advisable to examine the character and bylaws to ascertain who has authority to borrow in behalf. In many cases, banks also follow the practice of requiring a corporate resolution signed by the members of the board of directors setting for the borrowing authority and designating the person or persons who have the authority to negotiate for loans and to execute borrowing instruments (National Institute of Bank Management, 1986).

J.H. Clemen's (1989) suggests that in lending, the ability to repay the credit per the terms of the contract is more important than having leverage to collect the credit through disposal of collateral. According to him there are two ways to judge repayment ability of business. These are

- Studying records of the business past performance through income statements
- Studying projections of future performance in the form of cash flow projections.

2.3.2. Character (Human /Management Factor)

The concept of character under K. Gill and W. Reed (1985) definition relates to credit transaction means not only the willingness to repay debt but also a strong desire to settle all obligations within the terms of the contract. A person of character usually possesses attributes such as honesty, integrity industry and morality, but character is a difficult thing to evaluate. It is entirely possible for a person not to have all these Qualities but to still wish to repay financial obligations. Character worthy of credit is largely function of a person's honesty and integrity.

J.H Clemens (1989) addressed character as "the banker should have complete confidence in the integrity and ability of the customer to use the money to advantage and to repay it within a reasonable period. In the absence of such confidence it is preferable to decline to lend, no matter how much security may be available."

Every banker needs to fix in his mind a clear picture of the ideal customer. This is true when the manager has known the customer well, by personal dealing with him and by repute over many years Sinkey, Joseph F.JR. (1996). Ibid (1996) also noted out that factor such as management goals, objectives and motivations need to be addressed. In a business loan assessment, adequate financial, technical and business management ability needs to be analyzed critically before making decision.

2.3.3. Capital (Financial Position)

Capital is the amount of funds invested by the borrower in a business to support both fixed asset and current assets in other words it described as "net worth support", E. Orgler (1995). Ibid (1995) suggests that banks should make sure that every borrower has sufficient equity to enable the creditors to recover their funds through the sales of assets other than the collateral pledged for the loan. If all else fails credit will not be supplied to business concerns unless capital has been supplied to the owners to support the debt.

The net worth of a firm is one measure of its financial strength. It is often one of the principal determinants of the amount of credit a bank is willing to make available to a business borrower (W.Reed and K. Gill).

2.3.4. Condition (Economy)

Economic conditions affect the ability of the borrowers to repay financial obligations but are beyond the control of the borrower and the lender, according to K.C. Shekhar (1982). In addition, Ibid (1982) stresses that economic conditions make up the environment within which business units and individuals operate, therefore, he noted out that the loan officer must become an economic forecaster.

According to Ibid (1982), the longer maturity of the loans, the more important economic forecasting becomes since there is a grater possibility of an economic downturn before the loan has been fully repaid. Many borrowers fare well in periods of prosperity but in periods of recession capital may be dissipated, income may decline and every character may diminish. These factors give rise to the nonpayment of debts. A bank lending officer must therefore, keep informed as to the economic pulse of the nation, the community and the industry in which he or she makes loans (Brick, J.R. 1984)

In extending credit to business borrowers, a bank is interested in the economic function performed by the business and its importance in the industry. Knowledge of what is happening in the industry is very important changes in competitive conditions, technology, the demand for products and distribution methods (W.Reed and K.Gill 1985).

2.3.5. Collateral (Security)

Collateral refers to the particular asset of the firm that the bondholders (in our case the bank) receive if the firm defaults on the bond/loan (Barrow and et al, 1981). Loans are frequently secured by assets of the borrowers, most cars, for example are purchased on credit and the automobile serves as collateral for the loan. The same is true for house and to lesser extent for house hold furnishings and appliances if the value of the pledged assets has not depreciated below the unpaid balance of the loan, the borrower has a strong incentive to continue the payments.

In relation to collaterals, Pronchnew, Herbert V (1989) suggests that banks can extend unsecured loans based on the borrower's integrity and financial condition, expected future income and past record of payment. Some companies are considered by banks to be prime borrowers and they receive the most favorable interest rate. Some companies have competent management, products and services that are well accepted in the market place, relative stable profits and a strong financial condition.

Security is taken in most instances to strengthen a weakness found in one or more of the credit factors such as the ability to create income (J.H.Clemens, 1989).

2.4. Relative Importance of the Credit Factor

Although all the factors maintained earlier are important in credit analysis, most bankers agree that the collateral available for a loan is generally the least important. As per K.C. Shekhar (1982), credit is granted with the expectation that the funds will be repaid as agreed, not that the pledged asset will have to be sold to provide the funds needed for repayment.

As per Muller, P. Henry (1997), every loan application is unique. He also marked out that one credit factor may be most important in one situation while another one is in second situations over the entire spectrum of credit analysis. However, character emerges as the most important factor if a borrower is of poor character.

2.5. Scope of Credit Investigation

The Scope of a credit investigation will vary depending on such determinates as the size and maturity of the loan, the operating record of the business, the security offered and the pervious relations with the borrower (W. Reed and K. Gill, 1985). No definite routine is followed since each applicant for credit may have some peculiar features that should be investigated more the roughly than others. The objective is to accumulate information that can be used to evaluate the applicant's character, asset, ability to create income and the probable economic environment. In the investigation of a business loan application banks like to know something about the history of the business, the firm's operating record, labor relations, experience in the development marketing of new products and sources of growth in sale and earnings (Ibid, 1985).

Yair E. orgler (1995) suggests that Banks should know about the nature and operation of the business, what types of products are handled or produced, what types of services are rendered, whether the goods are staple or styled, consumer or capital, luxury or necessity would be worthwhile information. The source and stability of raw materials and labors as well as the proximity to market are important. Buying and selling terms, distribution methods, extent of fabrication hazards in business and the importance of the business in the economy are important facts that will place the business in proper perspective.

The bank would certainly want information on the concern's financial condition. According to Grill, E. K (1983), this necessitates reviewing financial statements, investigating the possibility of contingent liabilities, and examining the insurances coverage. It may also be helpful to contact other banks with which the firm has done business, as well as suppliers and customers of the firm.

2.6. Sources of Credit Information

The many sources of credit information according to K.C. Shekhar (1982) include- interviews with loan applicants, the banks own records, a variety of external sources, inspection of applicants' places of business and applicants' financial statements.

2.6.1. Interview of Loan Applicants

In the interview with the applicants, Ibid (1982) emphasizes that lending officer must learn the reason for the loan and whether the loan request meets various requirements established in the loan policies of the bank. Even if the loan request is not in harmony with bank policy or violates some regulation established by law or a bank regulatory agency, the lending officer may offer the applicant advice regarding other possible sources of funds. The lending officer can also get some idea as to an applicant's honesty and ability and may form an opinion as to whether security will be necessary. Information about the history and growth of the business, the background of key personnel, the nature of the products and services, sources of raw materials, competitive position and plans for the future can be obtained through the interview, Ibid (1982).

2.6.2. Bank's Own Records

A bank may maintain a central file of all its depositors and borrower from which credit information can be obtained. For example it will show the payment record on previous loans, the balance carried in checking and savings accounts, and whether the applicant has a habit of overdrawing his or her account even if the applicant has never been a customer of the bank, Ibid (1982).

2.6.3. External Sources of Credit Information

National Institute of bank management, Bombay (1986) on its book "Bank lending" suggests that bank's should have collect information about the applicants from credit rating agencies, the firm's suppliers as to how promptly it has been paying its bills and the highest credit granted during the year, a recent Balance sheet and information as to the firm's sales and profits (if available), information from the usual size of the firm's deposit balances and in payment record under loan agreements and biographical information about the principals or owners of the business including their previous experience, outside business affiliations and past financial difficulties.

2.6.4. Inspection of Applicants' Places of Business

Business applying for loan should be willing to allow a loan officer to visit and tour their places of business. As per W. Read and K. Gill (1985) statement, an experienced loan

officer will learn a significant amount about how productive and well managed a business is from a tour of the facilities. The loan officer should note how well the business is organized and whether or not employees seem to be performing effectively.

If a firm is retailer, a visit during a normally busy period may indicate the strength of the firm's business as well as the proficiency of the sale staff. In the case of visiting manufacturing firms, particular note should be made of the equipment and the production layout. Equipment should be well maintained and if not modern, at least of sufficient efficiency to avoid creation of production bottlenecks, K.C. Shekhar (1982).

2.7. Analysis of Financial Statements

Financial statements are required of most borrowers especially if the amount involved is relatively large even in consumer credit, where loans are usually quite small, an applicant may be asked to list what he/she owns and owes, income and expenses, current bills outstanding, dependents, and other information that will reflect his/ her financial condition (J.H Clemens, 1989). The proper evaluation of information contained in financial statements is of great importance in the credit analysis process. Financial statements of borrowers and prospective borrowers are among the most important sources of credit information available to bank lending officers (Ibid, 1989).

In dealing with business borrowers in particular, banks find that historical financial statements, Pro forma statements and cash budgets provide not only a good basis for evaluating a loan applicant's financial condition and profitability but also the applicant's ability to generate cash flow, for operating purposes and making loan payments, (Ibid 1989).

According to W. Reed and K. Gill (1985), the usefulness of historical financial statements in making credit decisions depends, of course, on the timeliness and Quality of the statements. They also marked that the extent to which lending officers use financial reports and projections in evaluating loan proposals depends on such factors as the size, purpose, and maturity of the loan, and the amount of security being furnished.



Lenders use financial statements and budgets to estimate the extent of the borrower's need for funds, evaluate the probability of loan repayment, and estimate the potential loss if the borrower does not pay, and decide on the terms of the financing if a loan is to be made. Loan officers must avoid placing too much reliance on historical balance sheet information, since a firm's financial condition can deteriorate rapidly if it begins to incur operating losses. Information provided by prior income statements must also be used with discretion in view of the fact that past profits are often a poor indicator of future earnings, Yair E. Orgler (1995).

Again, Ibid (1995) suggests that lending officers should also examine pro forma financial statements and cash budgets that show what the borrower's financial condition, profitability, and cash requirements are expected to be in the future. A major value of historical financial statements is the help they provide in appraising the soundness of the borrower's cash and profit projections.

The validity of any conclusions drawn from financial statements can be no better than the information contained in the statements the financial statements of many small companies are not audited and thus must be evaluated with great care and a degree of skepticism. Many judgments are required in determining the book value of a firm's assets and the amount of earnings. Lenders are interested in the degree of conservatism with which these judgments have been made, K.C. Shekhar (1982).

It is not enough that the firm has been following Generally Accepted Accounting Principles, since this principle often permit a great deal of latitude in the recognition of income and expenses. If reliance is to be placed on a borrower's cash forecasts and pro forma financial statements, the loan officer must examine critically the underlying assumption that have been made with respect to important profit determinants such as sales volumes, selling prices, wage rates, and selling and administrative expenses, Ibid(1982).

2.7.1. Evaluation of Items on the Financial Statements

One Method of analyzing financial statements is to evaluate each significant item to determine its accuracy and reasonableness, Kishan, Ruby P. (2000). This method often

involves trimming down various items to more reasonable and conservative figures. A thorough analysis is made of each item that appears in the financial statement in an effort to appreciate fair value. But no reference is made to proportions, relationships ratios. Obviously, a bank credit analyst must have some knowledge of the business and statement items in order to appraise them properly.

2.7.2. Evaluation of Asset Items

L.S. Dyer (1999) stated that Account receivable should be analyzed carefully because they represent the nearest thing to cash and may be the principal source of repayment of short term loans. Information about the size, age and source of the accounts is important. The bank credit analyst should require on aging schedule of accounts receivable to allow identifications of receivables that many be of doubtful value. If many accounts are post due, they must be established. The possibility exists of a contingent liability if the accounts were assigned with recourses that is, the assignee promises to pay in the event the accounts receivable are not paid.

In many instances notes receivable arises because customers of the business are not paying their accounts according to the credit term, and notes are obtained in an effect to strength the firm's position. If notes receivable appear large in relation to accounts receivable (Sinkey, Joseph F. JR, 1996) a thorough investigation should be made to determine the soundness and liquidity of the notes. When notes receivable have been discounted with recourse, they should remain on the balance sheet as an assets item, and the amount of the loan should appear as a liability.

A bank credit analyst is interested in the age, liquidity, and price stability of the inventories, the degree to which they are free of risks of obsolescence and deterioration, the adequacy of insurance coverage, and the firm's method of inventory accounting. One must also know whether the inventories are based on physical counts, whether the firm uses the FIFO or LIFO Method of valuation. If one is thinking in terms of the probable liquidation value of the firms, then goods in process and supply inventories should be largely discounted because of their limited marketability (W. Reed and K. Gill 1985).

Normally, banks do not look to the sale of fixed assets as a source of funds for repayment of loan. However the debt is intermediate or long terms, fixed assets are likely to take on more significance. This is especially true when fixed assets taken as security for the loan. Usually, however, the principal importance of fixed assets in credit analysis is their role in generating income. The credit analyst should be certain that the firm is taking adequate depreciation, is maintaining the properties in good condition, and has adequate insurance coverage, Ibid (1985).

Intangible assets such as goodwill, trademarks, copyrights, patents, leaseholds and franchises are usually accorded little value by bankers. As general rule, bank credit analysts are interested principally in tangible assets and tangible net worth, Ibid (1985).

2.7.3. Evaluation of Liabilities and Net worth

Commercial banks are quite interested in the amounts and maturities of all liabilities for which loan applicant is responsible (Yair E. Orgler 1995). According to him, if a firm's accounts payable are large relative to its scale of operations, it may need additional equity capital or borrowed funds.

Careful investigation is usually made if there are notes payable to suppliers, since this may indicate that the firm has been slow in paying its trade obligation and has been asked or compelled to give notes to evidence the indebtedness, Ibid (1995). If the firm has obligations under conditional sales contracts, an investigation may be made to determine if any payments are past due, and if so, the penalties that are likely to be involved.

Yair E. Orgler (1995) suggests that if the firm owes a significant amount to its shareholder or officers on notes payable, the bank may ask that such liabilities be subordinated as a condition to granting the firm a loan. In many cases the analyst will want to review the amounts accrued for taxes and other expenses to evaluate their adequacy

Nilsen, Jeffrey (2002) stresses that the credit analyst is concerned with the nature and maturity of long term liabilities and the provisions that have been made for meeting the required payments. The default provisions of the various agreements and whether the loan

applicant is in full compliance are of interest also. For example, failure to pay interest on bonds or term loans can cause the entire unpaid balance to become due and payable immediately.

The owners' equity, or net worth, is an item on which bankers place great value in extending credit. In the case of proprietorships and partnerships, where the owners are individually responsible for the debts of the firm as well as for any debts they have contracted outside the business, it is important to consider not only the income and worth of the firm itself but also the owners' earnings assets, liabilities and net worth outside of the business (Ibid, 2002)

2.7.4. Evaluation of the Income Statement

A firm's earnings tell us something about the quality of the assets reported on the balance sheet as well as the effectiveness of the management. According to Cottarelli, Carlo (1995), the importance of income statement analysis increases with the maturity of the loan. Bankers may place more emphasis on balance sheet items in negotiation of short term loans, but with longer maturities the income statements takes on a greater significance. The firm's accounting practice should be examined carefully to see that no changes have been made that would cause the figures to be non comparable from year to year.

Income statement analysis is facilitated by developing a common size statement in which all items are expressed as a percentage of sales. The percentage figures are easily compared then with similar figures for previous periods and with the percentages of other firms in the same type of business. For example, if an analyst were to find that the selling expenses of years and that the percentage figure for the last year was considerably above that of other firms, reasons for this apparently unfavorable situation must be determined (Pehlivan, Hatice 1996).

W. Reed & K. Gill (1985) suggests that extraordinary income and expenses are given particular attention if they are substantial items. Extraordinary expenses might include losses on the sale of fixed assets, uninsured losses from natural causes, inventory shortages, and abandonment losses.

2.7.5. Evaluation of the Statement of Changes in Financial Position

Along with the balance sheet and income statement, firms should prepare a statement of changes in financial position covering the reporting period. This statement often is referred to as the sources and uses statement. Its purpose is to reflect changes in the firm's liquidity usually in terms of working capital during the year or other reporting period, Kishan Ruby (2000).

The statement shows additions or reduction of working capital from operations, from changes in asset accounts, and from changes in liability and net worth accounts. The statement is important to the credit analyst in assessing the impact of operations and certain management decisions on the firm's liquidity. For example, a firm's sales may have expanded significantly during the last year, and net income may be sharply higher. However, the increased level of operations was possible only because assets were expanded. Not only did the higher sales levels require more inventories, but accounts receivable grew and certain fixed asset investments were made, Ibid (2000).

2.8. Ratio Analysis

Figures on firm's balance sheet and income statement are often much more informative when related to other figures on those statements or to averages for comparable firms in the same industry. L.S. Dyer (1999) addresses that lending officers are interested in relationships that shed light on the direction in which a firm appears to be moving as well as on its current financial condition and recent profitability. In analyzing trends, the lending officer is concerned not only with the year to year and possibly month to month changes in aggregate quantities such as sales and profits, but also with the trends of such important ratios as net income to sales, current assets to current liabilities, and total debt to total assets.

According to Nilsen, Jeffery (2002), it is necessary to estimate the probability that the borrower's profits will decline to levels to that would make it impossible to comply with the repayment schedule of the proposed loan. This kind of forecasting usually requires a study of the competitive conditions, demand and supply conditions, and future prospects of

the borrower's industries. It also requires a careful analysis of the strengths and weakness of the borrowing firm itself: the quality of its management, the efficiency of its production organization, the effectiveness of its marketing, the health of its employee relations, the condition of its physical facilities, the availability and cost of labor and raw materials, the value of any intangibles such as patent right and licensing agreements, and the possibility of contingent liabilities.

Generally, it is unwise to consider a single financial ratio by itself without reference to other aspects of the firm's financial condition and profitability, Ibid (2002).

Table 2.1 commonly used financial ratios

No.	Type of Ratio	Name	Numerator	Denominator
1	Liquidity	Current ratio	Current assets	Current liabilities
2	Liquidity	Acid test ratio	Current assets- Inventories	Current liabilities
3	Activity	Turn over fixed assets	Net sales	Total assets
4	Activity	Turn over total assets	Net sales	Net fixed assets
5	Activity	Collection period	Accounts receivable	Daily Credit sales
5	*Activity	Turn over of receivables	Credit of sales	Inventories
6	Activity	Inventory turnover	Cost of sales	Inventories
7	Financial leverage	debt/Asset ratio	Total debt	Total assets
7	*Financial leverage	Debt/net worth ratio	Total debt	Net worth
8	Financial leverage	Fixed charges coverage	Earnings before fixed charges and Taxes	Fixed Charges
9	Profitability	Operation profit rate of return	Earnings before interest and Taxes	Total tangible assets
10	Profitability	Net profit margin	Net profit	Net sales
11	Profitability	Return on assets	Net profit	Total assets
12	Profitability	Return on common equity	Net profit minus preferred dividends	Common stock equity

Note: Ratios 5* and 7* are alternatives to 5 and 7.

When inventories vary widely from month to month, analysts sometimes relate the average month-end inventories for the year to cost of sales for the year to get an average turnover figure. However, this computation obviously does not indicate whether inventories at year-end were at a reasonable level, Ibid (2002).

Ratio analysis is useful principally in locating areas of possible difficulty or weakness. Once such areas have been discovered, it is necessary to investigate further to determine why the firm's ratios are out of line with those of other firms or with its own past norms (W. Reed and K. Gill (1985)).

According to W. Reed and K. Gill (1985) though coverage of fixed charges is widely used as a measure of financial condition, it is important to recognize the limitations of this ratio. The numerator of the ratio (earnings before taxes and fixed charges) is a very crude measure of a firm's capacity to make required payments, and the denominator does not include all payments that a firm may be required to make.

Nevertheless, the ratio is useful because cash inflows do depend to a considerable extent on earnings, and because payments under loan agreements and non-cancelable leases do in many cases represent a firm's most significant financial obligations. A projection of the coverage of fixed charges, however, is not an adequate substitute for detailed forecasts of cash inflows and outflows, Ibid (1985).

The fixed charges coverage ratio is not in terms of cash flows and does not take into account, for example, the cash required to finance an increase in net working capital or an increase in net fixed assets, Ibid (1985).

To evaluate properly a firm's ability to make future loan payments, cash forecasts should be prepared using various plausible assumptions as to sales volumes, selling prices, and costs. In this way it is possible to estimate the probability that the borrower will be able to comply with the repayment provisions of the proposed loan. Ibid (1985). In addition, they pointed out that profitability is often more important in judging the desirability of making a long-

term loan, whereas short-term loan decisions may rest more on the strength of a firm's liquidity.

2.9. Cash Budgets and Pro Forma Financial Statements

In evaluating a proposed business loan, it is not only important to consider how funds will be obtained for repayment of the loan but also to forecast what the borrower's financial condition will be at various times over the life of the loan (K.C. Shekhar 1982). Information of this kind is developed in cash budgets and pro forma financial statements. Although such statements will often be quite wide of the mark, their preparation and use are necessary when planning for the future.

Sinkej Josef (1996) further discussed that the accuracy of pro forma statements depends heavily on the assumptions made about future developments; so bank lending officers are interested in the reasonable of such assumptions. A forecast of a substantial increase in income, for example, based on an unprecedented rise in sales or a sharp decline in unit costs, would certainly be questioned.

All borrowers do not provide lending officers with pro forma financial statements. Many are not necessary. If the maturity is short and the loan well secured, elaborate statements are not required. In contrast, the longer the maturity, the greater the need for pro forma statements making a proper analysis of a loan request (Ibid, 1996).

W. Reed and K. Gill (1985) noted that cash budget for larger firms are typically prepared for the most part from the information contained in projected income statements and balance sheets. More elaborately, they discussed that satisfactory analysis of the projected sources and uses of cash can usually be prepared from the income statement and comparative balance sheet information. Sources of cash include decreases in assets and increases in assets and net worth of the firm. Uses of cash include increases in assets and decreases in liabilities and net worth.

Besides serving as a source of information from which cash budgets can be prepared, pro forma financial statements can be used directly in appraising the level of risk in a proposed

loan. For this purpose they can be subjected to ratio analysis in the same way as historical statements.

The usefulness of cash budgets and pro forma statements does not end with the approval of the loan. The borrower's actual performance and financial condition in future periods can be compared with the earlier projections. Such comparisons may give an either better or worse than expected, and this may be helpful in deciding whether any action should be taken to protect the interest of the bank (W. Reed and K. Gill 1985).

2.10. Organization Profile of Construction and Business Bank

Construction and Business Bank (CBB) is the successor of Housing and Saving Bank which was established by the merger of two financial institutions, the saving and Mortgage Corporation of Ethiopia S.C (SMC) and the Imperial Savings and Home ownerships Public association (ISHOPA) which were nationalized in 1975 at the onset of the socialist era of Ethiopia (<http://www.cbb.com.et>).

The savings and Mortgage Corporation of Ethiopia S.C was established in July 1965 with a capital of Birr 3,000,000. Share holders were the Commercial Bank of Ethiopia, Ethiopia Airlines, Cement Corporation, Ethiopian Electric Light and Power Authority (EELPA) and Agricultural and Industrial Development Bank (<http://www.cbb.com.et>).

And The Imperial Savings and Home ownership public association was founded on April 30, 1962 with a capital of Birr 1,000,000 out of the total 50% of the capital was emanated by the Ethiopian Government in the form of capital donation and remaining 50% by the US government in cash. The main reason for the establishment of Housing and Saving bank (HSB) was to encourage and further accelerate the rate of housing development for the improvement of the living standard of urban dwellers (<http://www.cbb.com.et>).

In 1992, an economic reform program was initiated by the government in order to stabilize the economy and deregulate economic activity characterized by central planning. As a result, in the financial sector, new laws providing the autonomy of the National Bank,

which is the central bank of the country and the establishment of private banks and insurance companies by domestic private investors, were promulgated. In connection to this, Housing and Saving Bank become Construction and Business Bank in September 1994. Consequently, Construction and Business Bank prepared a series of internal restructuring plans covering all aspects of its operations (<http://www.cbb.com.et>).

Accordingly, CBB has ventured into commercial banking operations. In the effort to develop itself into a full-fledge universal bank, the bank introduced new products/services such as short and medium term credit facilities, foreign banking and forex bureau services and western union money transfer services to the existing lines of business, commercial and residential construction financing. The bank was converted to Share Company as September 2001 (<http://www.cbb.com.et>).

CBB's Vision

CBB's vision is to become customers' first choice bank in the country

CBB's Mission

CBB's mission is to render Construction and commercial loans and other banking products and services by employing modern technologies, deploying honest and motivated staff and thereby creating value to stockholders.

CBB's Values

- Treating customers with utmost respect, dignity and impartiality.
- In CBB customers come first.
- Delivering quality services with skilled motivated inspired, ethical and presentable staff supported by modern ITC.
- Transparent working procedure is a norm.
- Equal employment opportunity.
- Fair treatment of staff.
- Committed to the welfare of the community
- Committed to team spirit and teamwork.

Financial Highlight and manpower

- The balance sheet of the bank as at June 2007 revealed:
 - Total assets: Birr 1,889.8 million.
 - Loans and advance: Birr 1,138.3 million and
 - Total deposits: Birr 1,136.3 million.
 - The capital of Construction and Business Bank S.C. reached Birr 212.2 million
- The total staff strength of the Bank at the end of June 2007 stood at 893 of which 607 are clericals and the remaining are non-clericals.

Branches: As of Jan 2008 CBB branch network reached 30 in numbers of which 15 are in Addis Ababa (city branches) and the remaining are outlying branches. Most of the branches of the bank are located in business-developed centers. The bank made unreserved effort to enhance its service through equipping branches with the state of the art of technology such as SWIFT (<http://www.cbb.com.et>).

Construction and Business Bank S.C. commenced offering Western Union Money transfer services in the year 2000. It has now twenty two locations (Branches) and its transaction volume is showing a steady growth over the years and particularly one of its location i.e. piazza branch has shown an amazing achievement and earned recognition which has enabled it to be selected as a member of Western Union TOP TEAMES-CLUB 500 for two consecutive years, in 2003 and 2004. CBB has 25 correspondent banks throughout the world as at October 2002 (<http://www.cbb.com.et>).

CHAPTER THREE

DATA AND METHODOLOGY

This chapter deals with the research design and methodology of the study. It consists of methodology, sources of data, sample size and sampling techniques, data collection instruments and data analysis tools.

3.1. Research Design and Approach

After the research problem and both the general and specific objectives are stated, related literatures were reviewed to gather empirical and theoretical facts which are related with the problem in focus. Before the data collection stage began, questionnaires were constructed. By bearing in mind the research objectives, a survey method was followed. To meet the objectives and obtain reliable data, semi-structured and structured interview questions for CBB's loan officers were prepared. Experts' opinions were also gathered through depth interview. The obtained data were qualitative and quantitative in nature.

3.2. Sources of Data

Both primary and secondary data were used in this study. The primary data was collected from two sources. Questionnaires for both CBB's city branch managers and loan officers were the first source. The other source was interview which was prepared for CBB's city branch and head office credit department loan officers. Secondary data was collected from CBB's yearly annual reports, publications, lending strategy and procedural manual.

3.3. Sample Size and Sampling Techniques

To undertake this study, gathering accurate data was of a paramount importance. To do so, appropriate sampling techniques were needed to be used, which according to Robson (1993) depends on three situations: nature of the population, the type of investigation, and the degree of precision at a minimum cost. In light of this consideration and taking the

significance of this study into account, purposive sampling technique was employed appropriately. The population of this study was divided into two groups based on the role played: CBB's city branch managers and loan officers. Currently CBB has 30 branches of which 15 branches are located in Addis Ababa (City branches). Within the city branches, there are 15 branch managers and 33 loan officers (included head office credit department loan officers). Therefore, all of them (a total of 48 in number) are the sample population of this study.

The basic criteria adapted to select the sample were two. The informants should be an employee of CBB and they should also have an experience on credit assessment activities.

3.4. Data Collection Instruments

Employing multiple data collection instruments favor the researcher in improving the quality of data (Robson 1993). As a result, three methods namely: questionnaire, interviews and reviews of secondary data were used to collect the relevant data.

Questionnaire: A questionnaire consisting of closed and open-ended questions for the survey was prepared. The questionnaires were distributed for all the sample population. It was filled by the researcher during the interview. In general, the questions revolved around the credibility of loan assessment practice and its impact on non-performing loans in CBB. Further, the questions stress about CBB's lending strategy and procedural manual.

Interview: un-structured and semi-structured questions were prepared for the in-depth interview. The questions highlight on various areas such as the capacity of the loan officers, their satisfaction on the job, way of credit assessment, CBB's general loan procedure and problems of CBB's credit procedure manual. The interview was made for all of the loan officers.

3.4.1. Procedures in Developing the Instruments

Research papers with similar areas of this study were reviewed. With the help of hints from the studies and other related literatures, both the questionnaires and interview questions were developed in English language. The questionnaires and interview questions were

given to the advisor of this study to take constructive corrections. Modifications were made according to the corrections given.

3.5. Method of Data Collection

The questionnaires of the survey were filled-out through interviews by the researcher. The researcher has also conducted the in-depth interviews by himself.

3.6. Data Analysis Tools

An attempt was made to employ the relevant data analysis tools which are in compliance with the very nature of the data at hand. The qualitative responses of both the interviews and the questionnaires were analyzed through descriptive statistics. Time series analysis, charts and tables were also employed to analyze the gathered data.

In addition, the notes were taken during the interview and the information obtained from secondary data was used to carry-out triangulation analysis between the findings of the informants and the written materials. Furthermore, the data analysis is presented by compiling the information gathered from both the interviews and questionnaires.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATIONS

This chapter deals with the analysis and interpretation of data gathered through questionnaire and interview. It also contains discussions on the secondary data.

For the sake of convenience, the analysis is divided into seven parts. In all the seven sections, responses from the respondents and reference materials are treated together to make triangular analysis whenever necessary.

4.1. CBB's Lending Strategy and Procedural Manual

As per the lending strategy of CBB/EFY/1999, the bank is providing different types of credit to a large number of economic sectors which various based on maturity and purpose of the loans. These sectors include: residential construction loans, business loans (include long-term business construction and package loans), medium term business loans (for furnishings, purchase of truck, purchase of machinery & equipment and for working capital loans), short term business loans (include short-term working capital, OD facility and LC facility) and personal (consumer) loans.

The table which is interpreted and analyzed under this section presents responses of the respondents basically incorporated to identify the problems on the bank's lending strategy and procedural manual so as to show the gap between the actual implementation and the lending strategy as well as the procedure manual. This table is a summary of six questions.

Table 4.1 Evaluation of the Bank's Lending Strategy and Procedural Manual

Questions	Number of respondents			
	Yes		No	
	Freq	%	Freq	%
1. Does CBB provide				
- manufacturing and distribution loan	48	100		
- International trade loan	48	100		
- Domestic trade loan	48	100		
- Transportation and communication loan	48	100		
- Building and construction loan	48	100		
- Hotel and tourism loan	48	100		
- Agricultural loan			48	100
- Merchandise loan			48	100
- Personal (consumer) loan	48	100		
- Working capital (OD facility) loan	48	100		
- Unsecured loan	48	100		
2. Does CBB have a credit Procedural manual?	48	100		
- Is it adequate to make the credit assessment?	7	14.6	41	85.4
- Do you use it when you make a credit assessment?	48	100		
- Is it subjected to annual revision?			48	100
3. Does CBB's lending procedure have problems?	29	60.4	19	39.6
4. Does CBB accept collateral other than building?			48	100
5. Do you use the same credit analysis format for different loan types?				
6. Do you make processes to grant loans for a person			48	100
-Who had bad credit worthiness with any other banks			48	100
-Who has bad credit worthiness with any other banks			48	100

As can be seen from the table, all of the respondents disclosed that the bank provides loans to its borrowers in accordance to what is stated under its lending strategy except the merchandise loan. Merchandise loan is not still in effect according to the respondents' expression. It is worth to mention here that banking management must decide what types of loans would be best for the bank by taking important considerations (such as risk of the

loans, need for diversification, need for liquidity, capabilities of bank personnel, relative profitability of the loans and the type of customers the bank wants to serve) in making this decisions, (W. Reed and K. Gill, 1985).

In relation to CBB's credit procedural manual, the above table indicates that CBB has a credit procedural manual. However, some 85.4% of the respondents disclosed that CBB's credit procedural manual is not adequate to make the credit assessment. The respondents further argued that CBB's credit procedure manual have the following major problems- it lacks flexibility, it does not show how to tackle problems when they occur in the credit assessment process, and it does not also consider the dynamism of environment since it is not revised annually.

Apart from the above description, the respondents noted that personal (consumer) loans are extending to the clients against their rent income. According to the informants, the rent agreement between the lesser (here the borrower) and the lessees (here the client of the borrower) is not authenticated by the pertinent bodies (the credit procedure manual does not require authenticated agreements). The borrower brings the contract agreement to the bank as a source income and the bank extends the loan simply by determining the borrower's capacity along with by investigating the sufficiency of his or her collateral value. As per the informants' opinion (85.4%), the rent agreement may be a fake (it may be prepared by the borrower himself without incorporating the other party) or may be prepared by the collusion between the bank's loan officer and the borrower (like bribe). This in return makes the loan to become default and thereby increases the accumulation of non-performing loans in CBB, as per the respondents' conclusion.

On the other hand, the majority of the respondents (14.6%) indicated that CBB's credit procedural manual is adequate to make the credit assessment. With regard to this, all respondents use the bank's credit procedural manual when they make loans to their borrowers. The recent CBB's credit procedural manual was designed in the year 2003.

As can be illustrated from the above table, CBB's lending procedure has got a problem. Slightly more than sixty percent (60.4%) of the respondents described that, the leading

procedures are too cumbersome and time consuming. Therefore, it makes the loan assessment to become too long and as a result most of the loan applicants are dissatisfied with the bank's service delivery. According to the respondents, they even shift their attention to other banks. This in return affects the profitability of the bank.

On the other side, some 39.6% of the respondents expressed that CBB's lending procedure manual is problem free. They demonstrated that the manual is competent enough as compared to other banks and as a result CBB has been carrying out its activities smoothly. However, the respondents believed that because of the lengthy loan process, some of the loan applicants were dissatisfied. However, according to the 39.6% of the informants their dissatisfaction can be solved since the problem is within the domain of the bank's reach.

With regard to securities (collateral), all of the respondents displayed that CBB does not accept collaterals other than building as well it does not also extend loans to the borrowers without security (collateral). However, CBB's lending strategy (CBB/EFY/1999) states that loans can be extended for valued customers of CBB by holding a vehicle and/or machinery as a collateral given that the vehicle and the machinery should be in a very good condition and with less than five years of service. In relation to this issue, W. Reed and K. Gill (1985) suggests that banks can extend unsecured loans by taking into consideration the borrower's integrity, financial condition, expected future income, past record of repayment, the company's management, the company's product and service, and its relative stable income with the most favorable interest rate.

Again table 4.1 reveals that different credit analysis format is used by the loan officers for different loan types. However as can be observed, there is only one format for all types of loans as it is shown in the annex part of this study. This format includes six major components- background information, credit information, market assessment, technical assessment, organization and management and financial analysis. As it is discussed in the second chapter of this study, many writers suggests that the following points should be include in the credit assessment part:- capacity to borrow, character, ability to create income, ownership of assets (collateral), economic condition, credit information, financial statement analysis, ratio analysis, cash budgets and technical analysis.

The last item which table 4.1 incorporates is the issue of bad credit worthiness. All of the respondents explained that CBB does not extend loans to those who currently have or had bad credit worthiness with any other banks. According to Yair E. Ogler (1995), loans should not be based entirely on the borrower's history and reputation, because the borrowers may be contracted today but they are paid in the future. However, the loan officer should give weight heavily on the past record of a borrower when he or she evaluates the eligibility of the borrower for a credit.

4.2. Non-Performing Loans in CBB

One of the objectives of business enterprises is survival. The survival of business organizations is assured in so far as profit is generated. Non-performing loans have a direct impact on bank's profitability. National Bank of Ethiopia (NBE) has issued a directive Number SBB/32/2002 which requires banks not to book income on NPLs. The directive also forced banks to make provision on such loan to maintain financial stability.

Although the accumulation of non-performing loans in CBB is declining from time to time, it is still beyond the acceptable level of the NBE requirements. With regard to the NBE requirements, the acceptable level of non-performing loans is 15% of the bank's total outstanding loan portfolios (NBE directive number SBB/32/2002).

Table 4.2 Trends of Non-Performing Loans in CBB

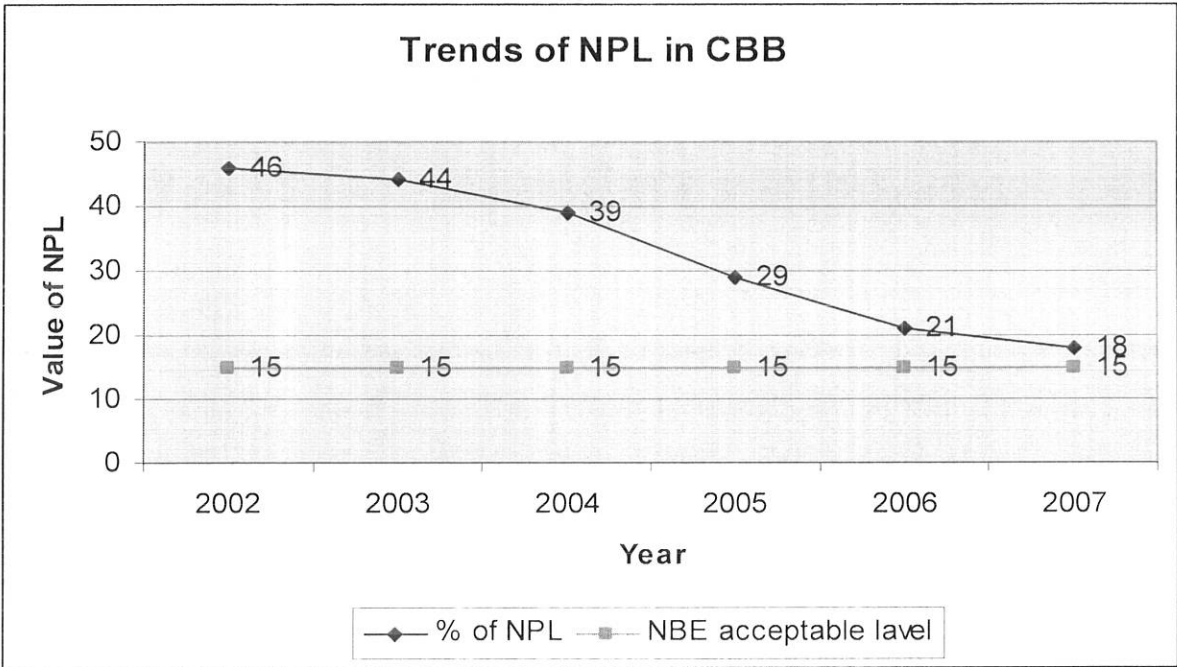
In 000'

	2002	2003	2004	2005	2006	2007
s	325426.15	332900.12	379837.68	556387.26	853039.96	995801.46
cial mention	60621.00	17231.09	27583.73	14381.51	11212.33	65183.88
standard	56067.24	25244.16	16698.69	8776.51	2803.59	29050.71
subtful	16499.82	10627.00	16401.71	13754.60	6675.71	16029.01
s	255481.26	244716.98	227189.82	212724.11	218476.21	180819.07
al NPL	328048.32	280588.14	260290.22	235255.22	227955.51	225898.79
al portfolio	714095.47	630719.35	667711.63	806023.99	1092207.80	1286884.13
io(Total NPL / al portfolio)	0.46	0.44	0.39	0.29	0.21	0.18

Source: CBB's yearly annual reports

Table 4.3 indicates that the bank’s non-performing loans have been decreasing for the last six consecutive years. The ratio column of this table shows that CBB does not meet the NBE requirements within the stated period. The existing high proportion of NPL still poses a red light for the bank and desires a lot of effort to bring the NPLs to the minimum acceptable level. This would in turn enable the bank to retain a sustainable market share in the industry.

Fig 4.1 Trends of Non-Performing Loans in CBB



As can be easily seen from the above figure, the number of NPLs in CBB has decreasing from time to time. However, it is still above the maximum acceptable level set by NBE.

Basing the above table 4.2, related questions are forwarded to the respondents to find out what the causes for the accumulation of NPLs in CBB. The summary of the questions are depicted as follows.

Table 4.3 Factors Contributing for the Accumulation of Non-Performing Loans in CBB.

Questions	Number of respondents			
	Yes		No	
	Freq	%	Freq	%
1) What factors made CBB's non-performing loans to increase				
- Inadequate loan assessment	39	81.2	9	18.8
- Manipulation by the debtors using political influence	11	22.9	37	77.1
- Real estate speculators	35	72.9	13	27.1
- Lack of monitoring			48	100
- Inadequate regulation	29	60.4	19	39.6
- Lengthy of legal system			48	100
- Corruption	22	45.8	26	54.2
- Lack of follow up	31	64.6	7	35.4
- Long term maturity of the loan	28	58.3	10	41.7
- High interest rate			48	100

As can be seen from the above table 4.3, inadequate loan assessment is the major contributing factor for NPL to accumulate. The greater majority of the respondents (81.2%) declared that the accumulation of NPL in CBB is caused primarily as a result of inadequate loan assessment. According to the respondents, loan assessment requires knowledge of forecasting, being aware of the country's economic condition, knowing the nature of the borrowers' business and understanding of globalization trends. As per the informants' explanation, the competency of some of CBB's loan officers is under questionable. A detail discussion will be presented about it in section 4.7.

In addition, the respondents (81.2%) disclosed that CBB mostly focuses on the current performance of the borrowers in order to extend loans. As per the information gathered through interview, based on the applicants actual one year current income statement as a principle, all the loan officers make financial projection of the applicants business simply by increasing 5-10% and 3-5% on the total revenues and the total expenses (except

depreciation and some fixed expenses) respectively in each of projected income statements for all types of business. Therefore, according to the respondents' description, granting loans in this way increases the probability of the loans to become default. According to them, due to this fact the financial projection made by the credit analysts does not adequately address the true nature of the borrowers' business market conditions. Apart from this, the respondents again demonstrated that more than one third of the NPLs in CBB are the result of inadequate loan assessments. As with financial projection, K.C. Shekhar (1982) noted that forecast of a substantial increase in income, for example, based on an unprecedented rise in sales or a sharp decline in unit costs would certainly be questioned.

The respondents (81.2%) further explained that they do not usually have enough information about the market condition of a particular industry to make credible market assessment. As they said, the business people and the society mostly do not release reliable information about their income and business. The respondents have also indicated that if the loan officers take too much time to gather pertinent market information in order to make credible market assessment, as a result the customers may be disappointed. This may lead CBB to lose its customers. Again in return, CBB's profit may decline since customers have the opportunity to go to other banks. Moreover, 81.2% of informants revealed that due to inadequate credit assessment, CBB loses its profit in each year of the business operation since CBB not to book income on NPLs. However, interest income on NPLs records under memorandum accounts until the default loans come in to the normal repayment status.

On the other hand some 18.8% of the respondents indicated that CBB's NPLs are not the result of inadequate loan assessment. Rather, they noted that it is the result of other factors (such as corruption, long-term maturity of the loan and real estate speculators). With regard to credit assessment, G. Edward (1983) suggests that banks must adequately assess the market condition of the borrowers businesses before the loan is granted.

As per the information from the above table, majority of the respondents (77.1%) denoted that CBB's NPLs are not the result of manipulation by the debtors using political influence. According to them, no loans are extended to borrowers through political influence. However, slightly more than twenty percent (22.9%) of the respondents indicated that loans

are granted to applicants due to political influence. They expressed that out of those loans which are granted due to political influence by now some of them are default loans. The respondents have also attempted to mention the bad loans which are caused as a result of political influence.

As table 4.3 depicts, the other factor which contributes to the increase of NPLs in CBB is real-estate speculators. Real estate speculators mostly request massive loans by projecting high growth in demand and price for their properties. Based on the speculators projection and their collateral value, CBB has been extending huge amount of loan to the real estate speculators almost for three decades. By now, nearly one fourth of the loans given to the real estate developers are categorized under non-performing loans, as per the 72.9% of the respondents'. On the other hand, some (27.1%) of the respondents do not agree this.

Apart from this, according to all the respondents table 4.3 reveals that lack of monitoring is not a factor for the accumulation of NPLs in CBB. In relation to this, the respondents' disclosed that CBB strictly relies up on the earning performance and cash flow of the borrowers before the loans are extended to the borrowers.

In relation to source of repayment L.S Dyer (1997) dictates that the primary source of repayment for most loans, however, is the revenue generated through the borrowers' capacity. Therefore, banks should give more emphasis on determining the borrowers' ability to earn a sufficient amount of money to repay the loans.

As can be seen from the above table, the inadequate regulation by the National Bank of Ethiopia (NBE) is also one of the causes for the accumulation of NPLs in CBB. Slightly more than half of the respondents (60.4%) noted that NBE's regulation in-terms of NPLs are not adequate to reduce the accumulation of non-performing loans. They further explained that NBE issued a directive SBB/32/2000 about the maximum level of NPL that banks can hold. According to the directive, the maximum level of NPL is 15% of the total outstanding loan portfolios of each bank. However, forcible measures have not been exercised by NBE for the implementation of the directive accordingly.

On the other hand some 39.6% of the respondents revealed that NBE's regulation by itself does not have an impact for the accumulation of NPL in CBB. With regard to regulations, Brick John (1984) stresses that bank's lending strategy is highly regulated for a number of reasons. For one it is done to protect the safety of the bank. For another, it is done to encourage or limit particular kinds of lending seeking certain output to the national economy.

In relation to the legal system, table 4.3 indicates that the legal system is not the cause for the accumulation of NPLs in CBB. All the respondents demonstrated that based on the mandate given to the banks by the legal body, all banks can sell the pledged collateral of the defaulter borrower within a short period of time through auction of course after giving a 45 days prior notice. Due to this fact, all the respondents denoted that the legal system is not the factor for the accumulation of NPLs in CBB.

Like table 4.3 above this, corruption is one of the factors which contribute for the accumulations of NPLs in CBB. As per the 45.8% of respondents' explanation, illegal loans were granted to loan seekers by lobbying the loan officers and credit committees in different kinds. The respondents further discussed that out of the loans granted in this way, more than 50% of them by now are categorized under NPLs. On the other hand, some 54.2% of the respondents do not agree with this. They noted that, though there is corruption, it is not as such exaggerated which leads to the accumulation of NPLs in CBB.

Again table 4.3 indicates that lack of follow up does also have an impact on the accumulation of NPLs in CBB. Most of the respondents (64.6%) disclosed that there is no as such strict follow up once the loan has been made. Due to this reason, according to them, some borrowers even divert the loan they got to other business directions without the acknowledgment of the bank of course contrary to the contract agreement. The respondents further explained that out of the total CBB's NPLs some of them are the result of lack of follow up. The other 35.4% of the respondents revealed that there are other factors which are the causes for CBB's NPL, apart from lack of follow up. With regard to this, K.C Shekhar (1982) states that once the loan has been made, the lending officer should usually

supervise the loan. More elaborately, the loan officer has to have close contact with the borrower during the life of the loan.

With regard to interest rate, it can be clearly seen from the table in focus that CBB's loan interest rate does not have much influence on the loans to become default. All the respondents dictated that CBB's loan interest rates are lower (better for borrowers) when it is compared with other banks loan interest rates. However, according to the respondents, the percentage of NPL's of CBB is higher than the percentage of NPLs of other banks. Therefore interest rate is not the factor for the growth of NPLs in CBB as per the respondents' notification. It is worth to mention here that, W. Reed and K. Gill (1985) suggests that competitive rates must be meeting by the banks when the loans are desired.

As can be observed from the table 4.3, one of the factors for the accumulation of NPLs in CBB is the long term maturity of the loans. The large majority of the respondents (58.3%) agreed that out of the total outstanding CBB's loan portfolios, more than 75 percent are long-term loans. Due to this fact, according to them the probability of the long term loans to become default increases since it is difficult to predict the economic condition of the nations', political condition as well the existence of the borrowers business for a long period of time. Therefore, according to the respondents some of CBB's NPLs are the result of long-term maturity of loans. However, some 41.7% of the respondents disclosed that granting loans on a long-term maturity bases is not the factor for the accumulation of NPLs in CBB.

The gathered information from CBB's loan officer's and branch managers marked that there is no coordination between CBB and Federal Inland Revenue Authority (FIRA) regarding the income statement submitted by businessmen to the two organizations. According to the respondents, they do not have any mechanism to crosscheck the credibility of an individual's income statement he or she submits to the banks and FIRA. Slightly more than one tenth of the respondents (12%) expressed that they have even found an individual who declared two different income statements within the same fiscal year to the bank and FIRA.

Mostly, based on the respondents' opinion, individual borrowers declare a higher profit when they come to bank to seek loans beyond their capacity. Due to their false high profit declaration, some times banks unknowingly grant loans to applicants by considering their reliable collateral value. After some time, the borrower would realize that his/her investment return may not be beyond the interest of the bank. So, according to the respondents' expression the borrowers may not be able to pay their loan repayments properly. Then, gradually their loan would become bad loan. Therefore, the respondents suggest that it is better if there is cooperation between the bank and FIRA in order to extend the right amount of loan to the eligible person. To reinforce, the cooperation is important for all parties- the bank, borrowers and FIRA. More elaborately, the cooperation helps in the one hand to protect the bank not to lose its money and also to protect the borrowers' not to lose their investment. In the other hand it helps FIRA to collect appropriate tax revenue from the business people.

To sum up, though CBB's non-performing loans are the result of many factors, table 4.3 reveals that inadequate loan assessment is the major contributing factor for the accumulation of NPLs in CBB.

4.3. Factors Considered in Credit Analysis in CBB

Many factors are considered by banks' credit people in analyzing a loan request. They are the ingredients which determine the lending officers' faith in the debtor's ability and willingness to pay the obligations (W. Reed and K. Gill, 1985).

The following table 4.4 presents the responses of the respondents in relation to the factors which are considered by CBB's loan officers when they analyze loan requests.

Table 4.4 Factors Considering in Credit Analysis

Questions	Number of respondents			
	Yes		No	
	Freq	%	Freq	%
Do you consider the following factors when you analyze a loan request?				
- Collateral	48	100		
- Condition			48	100
- Capital	48	100		
- Characters	48	100		
- Capacity	48	100		

As can be seen from the table above, CBB’s credit analysts consider the 5’c (collateral, conditions, capital, characters and capacity) of credit analysis factors except condition when they make a credit assessment. For the sake of convenience, the responses of the informants are summarized as follows.

Collateral

Based on the information obtained from the respondents, CBB requires only fixed asset collaterals (i.e. building) for each type of loans. According to the respondents, before a loan is processed, the value of the pledge collateral is estimated by the bank’s engineers to ensure whether or not it sufficiently covers the principal loan amount, loan interest and any costs associated with the loan along the life of the loan.

Basically, as per the respondents expression, they usually investigates the legal right of the borrowers whether he or she pledges the building as a collateral for the loan, the collateral readiness for sale(in case of liquidation) and the sufficiency of the collateral value for the loan before they hold the building as a collateral for the loan. After all these things are verified the collateral would get appropriate insurance coverage. Apart from this, the respondents noted that the minimum credit to collateral ratio in which CBB requires is 1:1.2 for individual loan and 1:1.1 for package loans. In relation to this, Wilson Jeffrey (2002) stated that the value of the collateral should exceed the amount of the loan in order

to reduce risk since the bank may be forced to liquidate the collateral in case of default on the part of the borrowers.

Condition (Economy)

All the respondents disclosed that they do not review the economic condition of the country when they make a credit assessment. As per them, they give more emphasis on the market condition of the borrowers' business rather than the overall economy of the country. Moreover, according to the respondents' declaration, getting updated information on the country's economic condition is difficult. Consequently, they discussed that the bank does not provide them with the necessary reference materials about country's economy. They further noted that the bank does not have an internet access for the bank's employees' except for ICS department and top management office.

With regard to economic condition, L.S. Dyer (1999) suggests that bank lending officers must be informed as to the general economic pulse of their nation, community, industry and business firm in which they make loans. In relation to this, CBB's credit procedure manual also stresses that loan officers should analyze the country's economic condition both at macro and/or micro level when they make credit assessment. In addition, K.C. Shekhar (1982) noted out that the loan officers must become an economic forecaster.

Capital

As can be seen from the table above, all the respondents critically evaluate the borrowers' capital during their credit investigation. Besides, as per the information obtained through interview, majority of the respondents (81%) disclosed that under their credit investigation they carefully evaluate the sources of the borrower's capital (debt-capital structure) and its sufficiency to determine the amount of loan in which the borrowers can get.

The rest 19% of the informants disclosed that they simply review the borrowers' business capital when they make credit assessment. The informants further stated that they check whether majority of the borrower's capital is from its own source or from debt. Their attitude towards this is that, if the value of the collateral is sufficient and the income statement and cash flow of the borrowers business with a positive balance, they consider

this as sufficient criteria to extend loans to indicate applicants. In relation to this, E. Orgler (1995) stated that banks should make sure that every borrower has sufficient equity to enable creditors to recover their funds through the sale of assets other than collateral pledged for a loan.

Character

As it is stated by K. Gill (1985) character is a difficult thing to evaluate. Like table 4.4 above, all the respondents expressed that they have been attempting to evaluate the character of borrowers during the review of a loan request. Mostly, according to the respondents, they make evaluation of the applicant's character through desk interview and by gathering information about the applicants' credit worthiness from different sources. They further noted that they determine the character of borrowers by looking into the clients' business management ability and financial & technical performance of the applicants business. With regard to this, W. Reed and K. Gill (1985) suggest that character worthy of credit is largely a function of a person's honesty and integrity.

Capacity

As can be illustrated from the above table 4.4, capacity is one of the factors which is considered by CBB's credit analysts when they make credit assessment. According to the informants' descriptions, they make cash projection and review the income statement of applicants' business in order to determine their financial standing. Apart from this, the informants disclosed that loans cannot be extended to minors and insane persons unless they have legal parents or guardians. On this issue, J.H Clemens (1989) stresses that in lending, the ability to repay the credit per the terms of the contract is more important than having leverage to collect the credit through disposal of collateral.

With regard to capacity, again the respondents indicated that they consider factors like historical background, type of organization, nature of the business, ownership and management, bank and trade relation, financial position and operating records, legal consideration and the business trend.

4.4. Scope of Credit Investigation in CBB

Even though the subject matter of each analysis varies greatly, the following factors are considered by CBB's loan officers in producing of a credit analysis report. These are background information (purpose of the loan, location, and nature of the business), credit information, market appraisal, technical appraisal, organization and management, financial appraisal and conclusion and recommendation.

Table 4.5 presents the summary of the responses of the informants regarding the scope of credit investigations.

Table 4.5 Scope of Credit Investigation

Questions	For short term loans				For medium term loans				For Long term loan			
	Yes		No		Yes		No		Yes		No	
	Freq.	No	Freq.	No	Freq.	No	Freq.	No	Freq.	No	Freq.	No
What are the factors you consider during your credit investigation?												
• Economic analysis			48	100			48	100			48	100
• Industry analysis	48	100			48	100			48	100		
• Company analysis	48	100			48	100			48	100		
• Technical analysis	48	100			48	100			48	100		
• Financial analysis	48	100			48	100			48	100		
• Ratio analysis	48	100			48	100			48	100		

Based on the above table, economic analysis in general is not considered by the bank's credit analysts when they make loan assessment (see the reasons under section 4.3 of this study). Further the respondents noticed that the bank's structured credit analysis format does also neglect the economic analysis part. However, CBB's credit procedure manual stresses that credit analysts should assess the economic condition of the country during their credit investigation.

In relation to industry analysis, table 4.5 reveals that all the respondents analyze the market condition of a particular industry during the review of a loan request. According to the

informants, they were not and are not able to get tangible information about the market conditions of a particular industry since the society and the business community delivers insufficient information about the market. Given the above facts, they further explained that they are forced to give more emphasis to company analysis rather than industry analysis.

As can be observed from the above table, all the respondents have discussed that company analysis is believed to be one of the most and the basic part of loan assessment. To reinforce this, the respondents have been analyzing business firms of borrowers to determine whether or not the applicant's business has financial healthy business plan and solid management setting. They also noted that they usually do business firms analysis by reviewing the firms' financial statements.

Table 4.5 also depicts that technical analysis is one of the parts of CBB's credit analysis report. Based on the information obtained through interview, the credit analysts use technical analysis so as to spot price trends in the market to predict what will happen in the future. With regard to this, Slater, John (1986) stated that lending banks should try to analyze the financial market prices and volume of their customer business using technical analysis.

Table 4.5 again entertains the responses of the respondents to questions about financial and ratio analysis. As it can be seen from the table, all the respondents declared that financial and ratio analysis is usually done by the loan officers for all loan types. This will be discussed in detail under section 4.6 of this study.

The above factors which are depicted in table 4.5 are not used to grant loans to salaried people. CBB calculates the salary and age of salaried loan seekers to determine their repaying capacity. To sum up, CBB's loan officers conduct credit assessment using the following major factors- industry, technical, company, financial and ratio analysis.



4.5. Sources of Credit Information

As it is defined in chapter two sections 2.6, most of credit information sources according to K.C Shekhar (1982), include interviews with loan applicants, bank's own records, external sources, inspection of applicants' places of business and applicants' financial statements. In light with this information, the following sources of credit information were described by the respondents in making credit assessment.

Table 4.6 presents the summary of sources of information which CBB applies in order to make a credit assessment.

Table 4.6 Sources of Credit Information

Questions	Number of respondents			
	Yes		No	
	Freq	%	Freq	%
What do you use to get information on the clients credit worthiness information?				
- Interview with loan applicants	48	100		
- The bank's own record	48	100		
- External sources			48	100
- Central bank (NBE)	48	100		
- Inspection of applicants' places of business	48	100		
- Applicants' financial statements	48	100		
- Other individual banks'			48	100

As per the information from the above table, the major sources of credit information which CBB's loan officers use are- the bank's own record, central bank (NBE), interview with loan applicants, applicants' financial statement, and inspection of applicants places of business. J.H Clemens (1989) in this regard denoted that financial statements of borrowers are among the most important sources of credit information available to banks' lending officers.

It is not common to CBB's loan officers to be obtained information about the credit worthiness of borrowers through external sources including other individual banks. According to the respondents, they do not get information from the external sources due to the following reasons: 1) most business organizations are not willing to disclose reliable financial information of their business to the public, (2) there are no well organized agencies which provide credible information about the quality, performance and status of business organizations (like credit rating agencies) and (3) the underdeveloped culture of the society in relation to delivery of pertinent information about the particular business organizations and the total market condition of the country.

Apart from this, the respondents explained that they do not attempt to get borrowers credit worthiness information from other individual banks since all banks borrowers credit information are stored at the NBE credit information center. Consequently, the informants disclosed that each bank must update its clients' credit information at the end of every month in NBE credit information center through network connections. Despite the fact that, therefore every bank could simply and easily get borrowers credit information from the NBE credit information center.

4.6. Financial Statements Analysis

Financial analysis is the process of identifying the financial strength and weakness of a firm by properly establishing relationships between items of the balance sheet and the income statements, J. H Clemens (1989).

Based on the information obtained from the informants, the following section presents the summary of how financial analysis is done in CBB.

4.6.1. Evaluation of the Balance Sheet Items

According to the respondents' declaration, the major balance sheet items which are analyzed by the loan officers during their credit investigations are current asset items (cash, receivables and inventories), fixed assets, liability accounts and owner's equity.

With respect to the informants' explanation, inventories are carefully and critically evaluated by the loan officers when the source of the loan repayment is from the

borrower's business. As per the informants' notification, inventories are valued at the lower cost of market. Moreover, the contacted CBB's loan officers indicated that they look in to the inventory turnover in order to determine whether the inventory is slow moving or not. This will enable them to see the profitability of the applicants' investment.

Most of the respondents (91.7%) revealed that they have faced problems in relation to the valuation of the borrowers' inventories. According to them, most of the businesses people who come to CBB in relation to loan request do not have adequate accounting system. So, as per the respondents' notification it is difficult to the credit analysts to evaluate the age and liquidity of the inventories of the borrower's business,. Moreover, CBB loan officers' use a mechanism of cross checking in order to know whether or not the amount of actual inventories coincide with the figures presented in the balance sheet statement through sample physical count. With regard to this, W. Reed and K. Gill (1985) suggest that a bank's credit analyst must be aware of the age, liquidity and price stability of the inventories. In addition the analyst should also know whether or not the inventories are based on the physical count and method of valuation (FIFO or LIFO).

In relation to receivables, the informants indicated that they make investigations over the receivables accounts of applicants in order to determine its soundness and liquidity. However, the respondents refuted that they do not make investigations over the receivables if the size of the borrowers business and the amount of the requested loan is too small (in this case loans which are less than Birr 100,000 are termed as small loans). As with the receivables, L.S. Dyer (1999) stated that account receivables should be analyzed carefully since it represent the nearest thing to cash and may also be the principal source of repayment of short-term loans.

In addition, fixed assets are evaluated by CBB loan officers if it is part and parcel of the borrowers' business operations. Consequently, The respondents discussed that when fixed assets (in this regard the building) are taken as a security for the loan and if they are not part of the applicants' business, loan officers of the bank do not include them as balance sheet item of the business. Depreciation would not be calculated too. In this process loan

officers take collateral to determine credit to collateral ratio of the loan. This is done to ensure that security should sufficiently cover the requested loan.

According to the informants, CBB uses pooling accounting system so as to determine depreciation expenses of electronic equipments and furniture's. Declining balance method of accounting is also used by CBB to determine depreciation expense of other equipments. The maximum service year considered by CBB for electronic equipments is four years. Furniture & other equipments should have only five years of service. In addition, depreciation expense of buildings are determined based on the straight line method of accounting for a maximum of 20 years and declining balance method of accounting is applied for machineries which serve for a maximum of five years.

The liability and owner's equity accounts are the major concerns of the loan officers when they make financial analysis. Thus, the respondents marked that they critically review the nature and maturity of the liability accounts in order to determine whether the applicant's need a working capital loan, the applicant's meets the obligations of the bank appropriately and timely or to know the applicant's creditors and/or suppliers. In this regard, Yair E. Orgler (1995) stresses that commercial banks are quite interested in the amounts and maturity of all liabilities for which loan applicants are responsible. Again, Nilsen Jeffery (2002) stated that credit analyst should be concerned with the nature and maturity of long term liabilities.

4.6.2. Evaluation of Income Statements

CBB gives a greater emphasis to income statements to determine the capacity of the borrowers in which how much he/she has to deserve the loan. The respondents indicated that unless otherwise the borrowers' financial statements are audited by an independent audit firm, the bank will be forced to prepare its own financial statements on behalf of the borrowers through a detail investigation. According to them, the degree of investigation is based on the strength and weakness of the applicants' accounting system. More elaborately, if the borrowers accounting system is strong and organized detailed investigation would not be conducted rather they only focus on the major parts of the financial statement items and vis-à-vis.

Based on the actual income statement of borrower business, the loan officers make a projected income statement for the entire loan life. As per the respondents' expression, the projected income statement is mostly done by increasing 5-10% and 3-5% in each of the projected income statement total revenues and expenses(except fixed expenses like depreciation) respectively.

Again based on the actual and projected income statements, the loan officers make the actual and projected cash flows. Furthermore, the respondents mentioned that loans can be extended to borrowers only if the projected income and cash flow statements are subjected to a positive balance.

It was found that, after the preparation of the actual and projected income statement and cash flow statement, the actual and projected balance sheet of the borrower business will be finalized. Moreover, according to the respondents, CBB requires a one year actual income and balance sheet statements of borrowers when they request for a loan. With regard to financial statements, Cottarelli Carlo (1995) suggests that banks should require a two or more years of the borrowers financial statements to make the trend analysis and thereby compare the performance of the applicants' business easily by developing a common size statement in which all items are expressed as a percentage of sales.

4.6.3. Ratio Analysis

Figures on the firm's balance sheet and income statement are often much more informative when related to other figures on those statements or to averages for comparable firms in the same industry as per L.S. Dyer (1977). Based on the information obtained from the informants, there are five types of financial ratios in which CBB's loan officers are uses when they make ratio analysis these are: current ratio, return on asset, debt/equity ratio, net profit margin ratio and debt/asset ratio.

According to the respondents, mostly they compute the financial ratios for each type of loans. However, as per them, the values of these ratios are not beyond the figures printed on the paper. Their argument is that no one within the bank considers the financial ratios in

locating areas of possible difficulty or weakness in the financial statements. To clarify, the computation of the financial ratios is uses only for the consumption to fulfill the bank's requirement.

Again, the respondents marked that even if the bank attempts to consider the financial ratios, the bank may not be got available information easily regarding the industry average of the businesses. It is worth mention here that, in analyzing trends, the lending officer is concerned not only with the year to year and possibly month to month changes in aggregate quantities such as sales and profits, but also with the trends of such important ratios as net income to sales, current assets to current liabilities, and total debt to total assets, according to L.S. Dyer (1999).

4.7. CBB's Loan Officers Qualification, Experience and Related Issues

The table which is interpreted and analyzed under this section presents the responses of CBB's Head office credit department and city branch loan officers (33 in numbers) for questions basically incorporated to identify their experience, qualification and job satisfaction and related issues. Therefore, the analysis made under this section does not characterize competency of all loan officers of the bank. All the information is obtained by using questionnaire and interview.

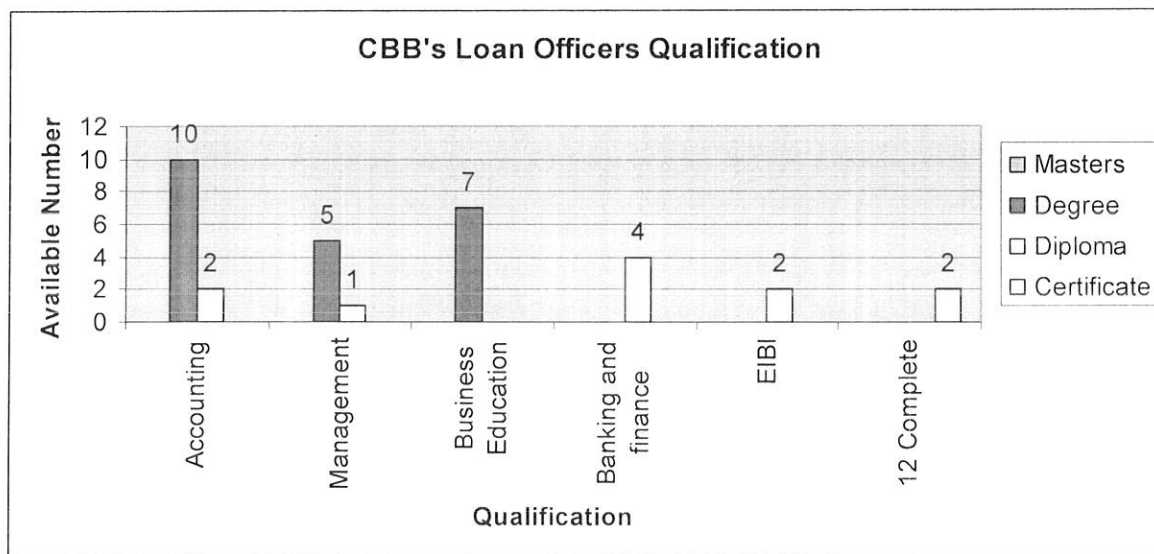
Table 4.7 Loan Officers' Qualification

Qualification	Number of Respondents							
	Certificate		Diploma		Degree		Masters	
	Freq	%	Freq	%	Freq	%	Freq	%
Accounting			2	6.1	10	30.3		
Management			1	3	5	15.1		
EIBI			2	6.1				
Banking and Finance			4	12.1				
Business Education					7	21.2		
12 Complete	2	6.1						

According to the above table, some 30.3% of the officers have first degree in Accounting. Slightly more than twenty percent (21.2%) of the respondents have degree in Business

Education and 15.1% of the informants have first degree in management. It can also be seen from the above table that some 6.1% of the respondents have Diploma from EIBI and the rest 6.1%, 3%, 12.1% and 6.1% of the respondents have Diploma in Accounting, Management, Banking and Finance and Certificate respectively. More elaborately, the great majority of the respondents (66.7%) are degree holders and the rest are diploma holders. This implies that CBB has educated employees for its loan service activities.

Fig. 4.2 Loan Officers Qualification



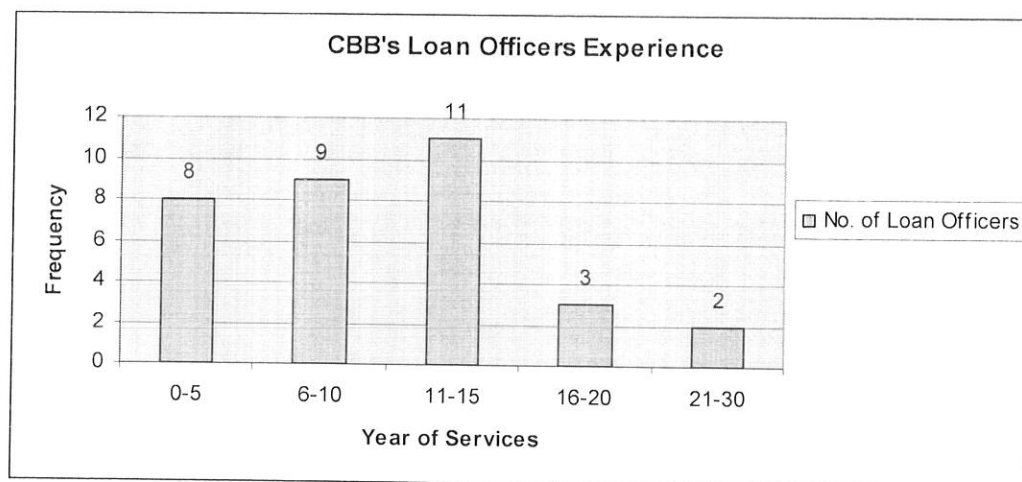
As can be observed the above figure, majority of the loan officers (10 in number) are graduate of Accounting (Degree) and seven Business Education (Degree) graduates are assigned as loan officer.

Table 4.8 Loan Officers Experience

Service year of the respondents	Frequency	%
1-5 years	8	24.2
6-10	9	27.3
11-15	11	33.3
16-20	3	9.1
21-30	2	6.1
> 30	0	0

Table 4.8 depicts that nearly half of the informants (33.3%) service years falls in the category of 11-15 years of service. More than twenty percent (24.2%) of the respondents have served for 1-5 years. On the other hand, only 15.2% of the officers have served for more than 16 years and 27.3% of the respondents served for 6-10 years.

Fig. 4.3 Loan Officers Experience



As with the figure 4.2, the majority of loan officers (11 in number) fall in the category of “11-15” years of service and out of the total loan officers, 5 of them are categorized under “16-30” years of service.

Table 4.9 Loan Officers Job Satisfaction and Related Questions

Questions	Number of Respondents			
	Yes		No	
	Freq	%	Freq	%
1. How does the bank assign loan officers?				
- Merit	14	42.4	19	57.6
- Qualification	25	75.8	8	24.2
- Experience	24	72.7	9	27.3
2. Do you take credit assessment training				
- Before you are assigned?			33	100
- After you are assigned?	13	39.4	20	60.6
3. Do you have confidence on the loan officers' capacity?	24	72.7	9	27.3
4. Are you satisfied with your job?	3	9.1	30	90.9
4. Have you learnt experiences of other banks regarding to credit assessment?			33	100

As can be seen from the table above, more than forty percent of the respondents (42.4%) disclosed that CBB's loan officers are assigned on the bases of their merit. However, majority of the informants (57.6%) depicted that merit is not the factor for the assignment of CBB's loan officers. According to them, it is done based on qualification, experience and sometimes based on friendship.

Table 4.9 reveals that qualification is one of the major factors during the recruitment of CBB's loan officers. However, contrary to this, some 24.2% of the informants mentioned that experience and hospitality takes the major share in the assignment of loan officers rather than their qualifications. There argument here is that, CBB requires degree holder for the position of loan officer however, CBB's personnel and administration department has assigned a diploma holders for the position of loan officer.

To sum up, in the assignment of loan officers, qualification takes the greater value, followed by experience and merit. According to the above table, all the respondents disclosed that they did not take the experience of other international and/or local banks in relation to credit assessment

With regard to credit analysis training, all the respondents declared that CBB does not provide training before they start the job. However, according to the 39.4% of informants, they have been trained after two years of their assignment on the job. The remaining 60.6% of the respondents indicated that still they have not taken credit analysis training.

Apart from these, table 4.9 reveals that 72.7% of the informants do not have any objection on the capacity of CBB's loan officers. Their reason behind this is that all the loan officers have an acceptable level of qualification and experience. However, more than one fourth of the informants stand against this view. As per them, one fourth of the loan officers assigned not on the basis of their performance but by friendship and ethnicity. However, they believe that these loan officers have an acceptable level of qualification.

As can be observed from the table 4.9 above, the majority of the respondents (90.9%) are not satisfied by their job. According to them, the salary and other benefits which they earn

is not sufficient especially when it is compared to employees of other banks with the same position. Furthermore, they disclosed that, promotion is unthinkable since branch expansion is too slow. However, few of the respondents (9.1%) revealed that they are satisfied by their jobs.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

This part of the study presents conclusion and recommendations forwarded based on the major findings.

5.1. Conclusions

Based on the major findings presented under the important sections of the data analysis part, the following conclusions are drawn

5.1.1. CBB's Lending Strategy and Procedural Manual

According to the result of the study, CBB includes the merchandise loan under its lending strategy since 1999. However, this loan is not still in effect. After the formulation of lending strategy, being unable to implement the lending strategy appropriately leads the bank to face an opportunity cost plus wastage of resources (like R&D costs) since lending strategy would formulate by considering the capability and resource of the bank to obtain competitive advantage over the rivals. Due to this, CBB may be losing its competitive advantage.

As the study revealed, CBB's procedural manual is not adequate to make the credit assessment since it is outdated (is not revised annually), time consuming, cumbersome and inflexible. Due to this, CBB may lose its valued and new customers. As a result, CBB's actual profit may decrease in a higher value from the expected. In return, CBB's per share value of the stock may be reduced and the share holders earning power may also decline.

Pertaining to collateral, CBB does not accept collaterals other than building for loans. However, CBB's lending procedural manual stated that valued customers can get loans by pledging vehicles and machineries. A contradiction in this regard creates dissatisfaction on the bank's valued customers. As a result, they may be terminated their relations with the bank and shift to other banks. Due to this, CBB's profit decline, the bank's image be announced badly and the bank's market share in the industry may be reduced.

5.1.2. Non-Performing Loans in CBB

The study noted that the percentage of CBB's NPL is still above the maximum acceptable level of the NBE requirements. However, from time to time CBB's NPLs have been declining. This would be a good experience to CBB in as to how it should regulate its loan portfolios. The writer of this study believes that CBB has shown an important progress in reducing the percentage of NPLs.

It was evidenced in the study that inadequate loan assessment is the major contributing factor for the accumulation of NPLs in CBB. According to the information from the respondents, inadequate loan assessment is caused due to loan officers forecasting problem, lack of business knowledge, wrong financial statements projection techniques and inadequate industry information. Again, the study noted that more than one third of the accumulated of CBB's NPL's is the result of inadequate loan assessment. This may greatly affect the bank's competitive position, its capital structure (the bank may be forced to be highly leveraged), the development and expansion rate of the bank and public confidence.

The replies of the informants disclosed that other than inadequate credit assessment, the following factors have contributed for the accumulation of NPLs in CBB. These are manipulation by the debtors using political influence, real estate speculators, inadequate regulations, corruption, lack of follow up, and long term maturity of the loan.

The respondents confirmed that there is no coordination between CBB and FIRA regarding the income statement submitted by businessmen to both firms. According to the respondents' declaration, due to this fact, the businessmen have the chance to declare different income statements for the bank (to seek loan beyond their capacity) and FIRA (to make tax evasion) within the same fiscal period. Due to this, all the parties may face problems. In one hand, the bank may loss its money; and on the other hand borrowers may lose their investment (when they face a debt which they cannot handle). Apart from this, FIRA may loss its appropriate revenue from taxes.

5.1.3. Factors Considered in Credit Analysis in CBB

Almost all the respondents refuted that except economic condition CBB loan officers does consider the 5'c (which are also termed as credit analysis factors) in which they make credit assessment. These are collateral, capital, character, capacity, and conditions (economy). However, the degree of their value which CBB give to them is different. According to the informants, CBB gave a greater value to the borrowers' capacity followed by collateral, capital, and character.

As per the response from the informants, CBB does not consider the economic condition of the nation under its credit investigation. The reason behind this is that CBB does not provide the necessary reference materials about the country's economy to the loan officers. However, everybody can get updated information about the Ethiopian economic condition simply by login to the Ethiopian Economic Associations website and/or in the following websites: <http://www.nbe.gov.et> and <http://www.mofaed.org>.

Being unable to properly determine and/or forecast the country's economy has a major problem on the bank's performance especially on its outstanding loan portfolios. In one way or other, this can indirectly affect the borrowers business and the bank's profit. Therefore, if the nation's economy has the power to affect negatively, most of the outstanding loans of the bank may become default. In return, the bank's NPLs increase and consequently its profit would decline. In relation to economic factors, K.C. Shekhar (1982) stresses that economic conditions make up the environment within which business units and individuals operate, therefore, he noted out that the loan officer must become an economic forecaster.

5.1.4. Scope of Credit Investigation in CBB

The study depicted that whether the loan maturity is short term, medium or long term, CBB includes the following major factors under its credit investigation– company analysis, industry analysis, technical analysis, financial analysis, and ratio analysis. .Economic analysis is totally forgotten by CBB's credit analysts under their credit investigation report.

5.1.5. Source of Credit Information

The information obtained from the respondents and the bank's credit procedure manual indicates that the major sources of credit information in which CBB uses to make credit assessments are interview with loan applicants, the bank's own record, inspection of applicant's places of business, Central bank (NBE) and the applicants' financial statements. Information from external sources and other individual banks are not considered by CBB loan officers.

In relation to external sources of information, the writer of this study believe that CBB does not take adequate efforts to gather the borrowers' credit information from external sources. This may leads the bank not to have full information about its borrowers. To clarify, CBB may extend loan to a person who has bad record within the society regarding the attainment of his/her obligations (like in "Ekub", credit association, etc...). Consequently, this borrower may apply his/her bad character on the bank's loan. Due to this, the bank's NPLs would increase then consequently, the profit of the bank decline.

5.1.6 Financial Statements Analysis

In light with financial statements, the study revealed that borrowers' financial statements have been critically and carefully examined by CBB's credit analysts before loans are extended. However, due to borrowers' inadequate accounting system, CBB's credit analysts would not be able to make credible credit assessment.

With regard to income statement, CBB mostly requires a one year applicants' income statement so as to determine the capacity and viability of the business. However, making judgment and forecast the viability of the applicants' business by basing on a single year financial statement is not enough to identify the exact nature of the business. More elaborately, there are lots of factors (like extra ordinary and infrequent items) which need to be considered. Otherwise the bank may extend higher/lower amount of loan to its borrowers. This factor increases/decreases the applicant's business profit for one moment.

Again, the study marked that mostly CBB uses a fixed percentage (ranges from 5-10% for revenues and 3-5% for expenses) in each types of business to make financial projection for the entire loan life. However, some businesses may grow more than what the bank sets (business growth rate) and some may not. As a result, the bank may extend unjust amount of loan to borrowers. In both scenarios, the bank may not be benefited since the earlier increases the probability that the loan become default and the later may decrease the profit of the bank.

According to the respondents, CBB does not effectively utilizes the financial ratio results in determining areas of possible difficulty or weakness in the financial statements as well to compare the performance of applicant's some year business operations. They noted out that the computation of the financial ratios is uses only for the consumption to fulfill the bank's requirement. However, to L.S. Dyer (1999) suggests that in analyzing trends, the lending officer is concerned not only with the year to year and possibly month to month changes in aggregate quantities such as sales and profits, but also with the trends of such important ratios as net income to sales, current assets to current liabilities, and total debt to total assets.

5.1.7. CBB's Loan Officers Qualification, Experience and Competency

It was evidenced in the study that there are thirty three loan officers in all CBB city branches and head office credit department. Out of which, nine of them are diploma holders, twenty two are degree holders, and the rest are 12 complete. The writer of this study believes that majority of CBB's loan officers have an acceptable level of qualification for the bank's loan activities. Therefore, the loan officers' qualification is an added value to CBB to compete within the industry.

The study also noted that majority (11 in number) of the loan officers have served the bank for a range of 11-15 years. More than twenty percent (8 in number) of the respondents have served for 1-5 years. On the other hand, only 15.2% (5 in number) of the officers have served for more than 16 years and the rest served for 6-10 years. In general, in the eyes of the writer CBB's loan officers have very good experience to make credible loan assessment. Most of the respondents (75%) on their part disclosed that CBB's loan officers

are competent to do credible loan assessment. The rationale behind this is that majority of loan officers have an acceptable level of qualification and experience.

It was also indicated that majority (90.9%) of the loan officers are not satisfied by their job. Their dissatisfaction is caused due to low salary level and slow promotion. Clearly, employee dissatisfaction affects the day to day activities of the operation. Due to this, CBB may not be able to deliver quality services to its customers. In turn, the customers may also be dissatisfied regarding the service delivery and they may be forced to use other banks.

5.2. Recommendations

Based on the aforementioned conclusions, the researcher forwarded the following recommendations.

CBB should try to implement its lending strategy effectively which are mainly involved in the merchandise loans and collaterals (machinery and vehicles which provides by valued customers). More elaborately, CBB should formulate the lending strategy by considering its resources and capabilities so as to implement the lending strategy properly and utilize them efficiently and effectively, in return, to take competitive advantage over its rivals. Moreover, in order to retain its valued customers.

It is recommended that CBB's lending procedure manual should be revised annually. It should also be flexible and communicable so as to tackle loan problems easily. By doing so the bank would be able to provide quality and fast loan services to borrowers.

Though the percentage of CBB's NPLs reduction is generally appreciable, it needs further improvement and extra efforts to meet NBE requirement. By doing so CBB NPLs decreases as a result the bank's profit increases.

Both FIRA and CBB should be cooperated with each other regarding the businessmen income statement to minimize the risk of default loans in the bank's side and to avoid or

minimize tax evasion on the side of FIRA. Apart from this, it contributes to reduce the nation's budget deficit as well stimulate the public service activities.

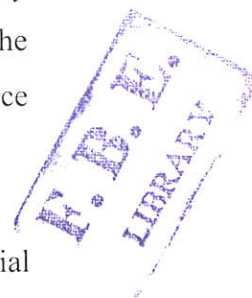
CBB should assess and evaluate the country's economic condition before it extends loans to borrowers. Economic condition is the major factor for the accumulation of NPLs. Therefore, in each type of loan (especially for loans with maturity time are greater than one year) CBB loan officers should monitor, assess and forecast the pulse of the nation's economy. In addition, CBB should incorporate the economic analysis under its credit investigation report.

Based on one of the conclusions, the writer of this study recommends that CBB should attempt explicitly and/or implicitly to obtain the applicants credit information from external sources. The writer believes that external sources are important to easily identify the borrowers' behavioral patterns in conjunction with other sources.

Although financial statements are given more emphasis by CBB loan officers when they make credit investigation, the method they use to forecast and make projection of the borrowers business is not wise. Therefore, it is recommended that CBB's credit analysts should use different forecasting techniques based on the nature of the business when they make financial projection of the applicants business upon the loan life. This reduces the probability of the loans from becoming default. In return, the bank's NPLs would reduce and as a result CBB's profit would increase.

In addition, CBB should require borrowers to bring two year and/or more of their financial statements when they come to the bank for loan request. This leads CBB's to identify easily the performance of the borrowers business within consecutive years and to make comparable and trend analysis in order to forecast the viability of the business. As a result, CBB provides the available amount of loans to the borrowers.

It is good if CBB's credit analysts analyze the financial ratios properly and attempt to make decision based on those ratios since the ratios determine areas of possible weakness in the financial statements rather simply computes it for the fulfillment of the bank's requirement.



Though CBB has qualified and experienced loan officers, their job dissatisfaction hampers the bank to deliver quality loan services to borrowers. Therefore, the writer of this study recommends that CBB should provide competent industry salary to its loan officers as well motivates them by providing different incentives and promotion.

APPENDIX

Construction & Business Bank
_____ Branch

_____ Loan proposal of
W/o/ Ato _____ town

Loan Officer: _____

Date _____

2

For Long Term and/or package Loan Proposal

1. Background Information

1.1. Name of the applicant _____

1.2. Address:

1.2.1. Personal Address

City/Town _____ Sub city/Woreda _____ Kebele _____

House No. _____ Tel. No. _____ P.O. Box _____

1.2.2. Project/Business address of the Applicant: City/Town _____

Sub city/ Woreda _____ Kebele _____ House No. _____

Tel. No. _____ P.O. Box _____

1.3. Applicant's experience in business

1.4. Describe the types of business in detail and why the loan has been requested

2. Credit Information

2.1. Applicant's past relation with our bank: Describe the applicant's past relationship with our bank and manner of meeting his contractual obligation.

Date Granted	Amount Granted	Due Date	Monthly Repayment	Purpose of loan	Date Settled

Additional remarks (if any) of the applicants credit relation.

/ 2.2. Applicant's present credit relation with our bank.

Date Granted	Amount Granted	Due Date	Monthly Repayment	Outstanding Balance As at		Purpose of loan	Collateral		Repayment Status
				Interest	Principal		Type	Value	

Additional remarks (if any) of the applicants credit relation with our bank.

/ 2.3. Applicant's past credit relation with other banks: Describe the applicant's past relation with other banks and manner of meeting his contractual obligation.

/ 2.4. Present credit relation with other banks (if applicable)

Date Granted	Amount Granted	Due Date	Monthly Repayment	Outstanding Balance As at		Purpose of loan	Collateral		Repayment Status
				Interest	Principal		Type	Value	

Additional remarks (if any) of the applicants credit relation with our banks.

(Make detailed market, technical, organization Management and financial assessments as per the following guideline. Your assessment report should follow the same sequential Pattern.)

3. Market Assessment

3.1. General

- State about the importance of the project/business

3.2. Demand for the Products/Service of the business

- Identify and state users of the product/service including the prospective ones. Then make an estimate of total demand for the product/service. (Hint: total demand can be estimated by collecting data from similar business, ministry offices, city councils, chamber of commerce etc.)

3.3. Supply of similar Products/Services

- Identify existing suppliers in the area. State quality of products/services rendered by the existing suppliers.
- Make an estimate of total products/services to be supplied by existing suppliers and the share of the project in reference to the total market.
- State the competitive advantage (or benefit) the project may have over other competitors (i.e. low production cost, brand name etc., if there is any).

3.4. Demand-supply Gap

- Determine if there is a demand supply gap by comparing the results of estimates under 3.2 and 3.3 above. Then comment on the product/service.

3.5. Price determination

3.5.1 Start with current prices of the products/services

3.5.2 Assume a price increase/decrease considering expected competition

3.5.3 Would the price be competitive – would there be sufficient margin to reduce price as compared with competitors.

3.6 Distribution Channel (if applicable)

- Wholesale
- Retail
- Both

4. Technical Assessment

4.1. Location

Although the relative importance of the various factors of production/service i.e. land, raw material, utilities, transportation, labour, infrastructure etc. may vary depending on the type and purpose of the loan each factor should have to be evaluated to decide suitability of location

4.2. Physical Layout and construction status (where applicable)

4.2.1. Plot area, details of built in area

4.2.2. Details of usable area

4.2.3. Amount of work done and work to be done (if the loan is for construction)

4.3. Furniture and Equipment (where applicable)

4.3.1. Draw essential furniture and equipment items for the business then identify and compare those that are currently available for use (list them out along with their unit price) and those that are proposed for procurement.

4.3.2. Comment on the condition of the existing furniture and equipment.

✓ 4.4. Machinery (where applicable)

4.4.1. List down all existing machinery and their status (if available)

4.4.2. List the type of machinery to be purchased and their availability in the

local market or if they are to be imported; the suppliers comment on prices, installation and test runs.

X 4.4.3. Appropriateness of technology in the light of

- Cost
- Operating
- Quality
- Image
- Type of skill required (skilled, semi-skilled, unskilled) to cope up with the technology etc.

✓ 4.5. Availability of infrastructure (facilities)

- Accessibility (seasonality, all weather road)
- Water (adequacy of water supply)
- Power (present supply, future expansion requirements)
- Communications (telephone, fax, mail etc)

✓ 5. Organization and Management

Indicate who manages the firm. Show the manpower needs (how it will be staffed)

✓ 6. Financial Analysis

✓ 6.1. Existing Investment

- Prepare a schedule to show the existing investment as shown below:

<u>Investment</u>	<u>Original Cost (Br.)</u>	<u>Book or Depreciation Value (Br.)</u>
-------------------	----------------------------	---

1. Building
2. Machinery

6.2. Planned investment

~~X~~ 6.2.1. Furniture, Equipment and Machines:

In your technical assessment (Item No. 4.3 & 4.4) you should identify the entire essential furniture, equipment and machineries that are to be procured.

Check fairness of proforma invoices and in as much as possible try to check if the right vendor supplies the proforma invoices.

X 6.2.2. Working Capital Finance Determination

- a) First determining the actual net working capital (the difference between the actual total current assets and current liabilities)
- b) Identifying why the working capital loan is required (start-up working capital, increase in the type of the product/service to be rendered)
- c) Determining the length of the operating cycle of the business (i.e., the average lapse of time between the investment in goods and services and the final conversion back to cash).
- d) Determining amount of working capital needed to cover additional costs (material, labour and overhead costs) and expenses for the operating cycle.
- e) Determining loan payments, settlement of payables and other cash outlays in the operating cycle.
- f) Considering storage and other capacity constraints.
- g) Considering cash on hand and identifying short term cash sources.

6.3. Source of Finance

Use the following table format show amount of investment to be raised from own source and bank loan.

Details of Investment Cost

Type of Investment	Total Cost	Own Contribution	Bank Loan
i) Building			
ii) Furniture & Equ.			
1.			
2.			
3.			
.			
.			
.			
iii) Machinery			
1.			
2.			
3.			
.			
.			
.			
iv) Working Capital			
Total Investment			
Percentage			

6.4. Financial Projection

6.4.1. Draw actual balance sheet, actual income statement and actual cash flow statement for established business

6.4.2. Draw projected balance sheet and projected income statement and projected cash flow at least for five years.

6.5. Join the statements in 6.4.1 and 6.4.2 to show the trend (i.e. comparative statement)

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Website

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Brief historical background of Construction and Business Bank from <http://www.cbb.com>

Addis Ababa University School of Graduate Studies
Department of Accounting and Finance
(Questionnaire Prepared for CBB Loan Officers and Branch Managers)

Muluken Shenkut
Senior Graduate Student

Date _____
Place _____

I am a graduate student in AAU carrying out a research under the topic “Impact of Loan Assessment on Non-Performing Loans: A Case of construction and Business Bank.”

The principal purpose of this questionnaire is to obtain data for a study intended to investigate the impact of loan assessment on non-performing loans as well as the credibility of loan assessment practice in CBB. Therefore, your cooperation in providing the data collections through the questionnaire and interview will be used strictly for academic purpose.

Thanks in Advance

- Position in the Bank _____
- Years of Service _____
- Qualification (e.g. Diploma in Accounting) _____

1) In which of the following loan types does construction and Business Bank (CBB) have provided to its Customers?

Types of Loan By Sector	Tick In the Box				
	Loans by Maturity				
	Yes	No	Short term	Medium Term	Long Term
Manufacturing and Distribution					
Import and Export Trade					
Domestic Trade & Service					
Transport & communication					
Building & Construction					
Hotel & Tourism					
Agriculture					
Merchandise					
Stockholders Loans					
Personal or Consumer Loans					

If others please specify _____

2) Does CBB Provides unsecured loans for its customers?

If Yes, in what base?(Hint on the bases of borrower's integrity, Financial Condition...)

If No, why?

3) Do you use the bank's standardized criteria to make a Credit analysis?

Yes No.

4) Do you think that the bank's standardized credit analysis forms are adequate to make the credit assessment?

Yes No.

5) Do you use the same credit analysis format for all types of loans before granting the loan?

Yes

No

6) Depending up on the maturity of the loan types, which one of the following factors are considered by the bank's credit people under the credit investigation?

	Tick in the box		
	For Short Term Loans	For Medium Term Loans	For Long Term Loans
Economic Analysis			
Industry Analysis			
Company Analysis			
Technical analysis			
Financial Analysis			
Ratio Analysis			

7) Do you use the above factors in Question 6 to grant loans to salaried people?

If Yes How? _____

If No, in what condition do you facilitate the loan?

8) Do you consider the following 5'c credit analysis factors when you analyzing the loan request?

5'c credit analysis factors	Tick in the box	
	Yes	No
Collateral		
Condition		
Capital		
Character		
Capacity		

8.1 If any, please specify _____

8.2 How do you evaluate them? _____

9) From where do you get the clients credit worthiness information?

Sources of credit information	Tick in the box	
	Yes	No
Interview with loan applicant		
The Banks own record		
External Sources		
Central Bank		
Inspection of applicants places of business		
Applicant's Financial Statement		
Other Banks		

10) Does the bank have a credit procedural manual?

Yes No

10.1. If yes, does it properly and sufficiently addresses how to conduct a
Credit assessment?

Yes No

If yes how do you say so? _____

If No, how do you say so? _____

11) Do you think that the bank's lending procedure manual has got a problem?

Yes No.

If yes, in which part? _____

12) What causes non-performing loans to accumulate in CBB?

Causes on non-performing loans	Tick in the Box	
	Yes	No
Inadequate loan assessment		
Political influence		
Real estate speculators		
Lack of monitoring		
Inadequate regulation		
Lengthy of the legal system		
Corruption		
Lack of follow-up		

If other please specify _____

13) If your answer in Question 10 is yes, how it affects the general condition of the bank?
 (Hint: Profitability, customer satisfaction, market shares, liquidity problem...)

14) Do you make processes to grant loan for a person who have and/or had bad credit worthiness from any banks?

Yes No

If yes how? _____

If no why? _____

15) Is there any cooperation between the Bank and Federal Inland Revenue Authority (FIRA) in order to cross check the income statement of the clients?

Yes No

16) If your answer in question 14 is yes, have you come across an individual borrower who submitted different income statements for the bank and FIRA within a particular fiscal period?

Yes

No

If yes, does it have an impact on non-performing loans? Please specify.

17) Which financial statement components are given more emphasis by the bank when loan assessment is made? (Hint: profit, Account receivables, liability accounts...).

18) Which types of financial ratios are commonly used by the bank?

18.1 How do you evaluate them? _____

19) On what ground does the loan categorized under non-performing loans?

20) Does the bank accept collateral other than buildings?

Yes

No

21) What is the minimum ratio of a credit to collateral security does the bank requires before granting a loan?

22) Do you prepare projected financial statements of the applicants' business?

If yes, in what base? _____

If No, how do you forecast the future existence of the applicants business? _____

23) Does the bank accept un-audited financial statements of the applicants?

Yes

No

If yes how do evaluate it? _____

24) Does the bank provide loan to minors and/or insane persons?

Yes

No

If yes how? _____

If no why? _____

25) Does the bank's procedural manual revise annually?

Yes

No

24) Give your comment or suggestion regarding the credit assessment of CBB?

Thank You

Interview Prepared for CBB's Loan Officers

Position in the bank _____

Years of Service _____

1. Who approves the processed loans?
2. Could you please specify the general procedures to grant the loan?
3. How long the loan processes takes on average? Please specify for each loan types.
4. Do you use a ratio analysis in your credit analysis part?

If yes for what purpose and how do you compare it?

If No, why?

5. Do you think that the existing lending strategies are sufficient to make the credit assessment effectively?

If Yes, how?

If No, why?

6. How do you evaluate the reliability of the applicants' source of income if it is based on a contract agreement (e.g. rent income agreement)? Does the contractual agreements are authenticated by the legal body?

7. How the bank assigns loan officers?

Merit Qualification Experience Competency

Why do you say so?

If other, please specify

8. Do you believe that the current loan officers have the capacity to conduct the credit assessment effectively?

If yes, why do you say so?

If No, why do you say so?

9. Have you learnt experiences of other competent local and/or international banks regarding the credit assessment?

10. Does the bank give training before and after the loan officers are assigned?
11. Do you take credit analysis training?
 - If yes, when?
 - If No, why?
12. Are you satisfied on your job?
 - If Yes how?
 - If No, why?
13. Are there any factors that make you uncomfortable to conduct a credit analysis?
 - If yes, please specify
 - If No, how?
14. How do you evaluate the applicants' income statement and Balance Sheet?
15. During your evaluation of the applicants' business, do you examines the firm's Accounting practice?
 - If yes how?
 - If No, why?
16. Do you prepare projected financial statements of the applicants' business?
 - If yes, in what base?
 - If No, how do you forecast the future existence of the applicants' business?