



**CAUSES AND IMPACTS OF NON PERFORMING LOANS ON THE OPERATIONS OF  
MICRO FINANCE INSTITUTIONS: A CASE OF SPECIALIZED FINANCIAL AND  
PROMOTIONAL INSTITUTION**

**MASTER OF BUSINESS ADMINISTRATION THESIS**

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**WOLKITE UNIVERSITY, WOLKITE, ETHIOPIA**

**JULY, 2020**

**WOLKITE UNIVERSITY  
SCHOOL OF GRADUATE STUDIES**

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**A THESIS SUBMITTED TO THE DEPARTMENT OF MANAGEMENT,  
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FOR THE FULFILLMENT OF THE REQUIREMENTS FOR THE  
DEGREE OF MASTERS OF BUSINESS ADMINISTRATION (MBA)**

**JULY, 2020**

## DECLARATION

I, Abera Abomsa, I declare that this thesis entitled “*Causes and impacts of nonperforming loans on the operations of MFIs: A case of Specialized Financial and Promotional Institution*” is outcome of my own effort and study and that all sources of materials used for the study have been duly acknowledged.

*To the best of my knowledge, this study has not been submitted for any degree in this university or any other university. It is offered for the fulfillment of the degree of Masters of business Administration.*

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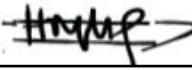
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## **Acronyms**

CBS-----	Commercial Banks
IFAD-----	International Fund for Agricultural Development
IMF-----	International Monetary Fund
MFIs-----	Microfinance Institutions
MFT-----	Microfinance Transparency
NBE-----	National Bank of Ethiopia
NPLs-----	Nonperforming Loans
RUFIP-----	Rural Financial Intermediary Program
SFPI-----	Specialized Financial and Promotional Institution
SPSS-----	Statistical Package for Social Sciences

## **Abstracts**

*The study was conducted to examine both the Causes and impacts of nonperforming loans on the operations of MFIs particularly focusing on Specialized Financial and Promotional Institution. Loan portfolio is the major assets of any financial institution to sustain in the industry, but once some portion of this asset is unexpectedly stop producing interest incomes, the quality of loan portfolio also negatively affected. This research study adopted descriptive and explanatory research design on the causes of nonperforming loans of Specialized Financial and Promotional Institution, and data has been collected mainly through primary source using questionnaire from SFPI staffs. A case study approach was also used to collect secondary data by reviewing the annual reports and income statement to identify the extents of NPLs impacts on the operation activities of SFPI. So, 65 staffs were taken as samples based on stratified random sampling method of sample selection by using mathematical formula. For data analysis, descriptive statistics including mean, frequency, percentages, graph, pie chart and simple excel were used. Regression analysis used through SPSS software version 20. This research study found out the major causes of NPLs which significantly affecting the portfolio quality of the institution. Therefore, At 5% level of significance and 95% level of confidence, inadequate monitoring and follow up, wrong timing of credit delivery, inefficient management information system, ineffective credit approval, and credit appraisal variables were causing nonperforming loans of SFPI. The study also found out that nonperforming loans contribute mostly to interest incomes that generated from the total loan portfolio was eaten for the provision of bad debt in five years analysis. Also the study indicates a net operating profit of the institution was eroded due to provisioning payments for nonperforming loans (bad debts) and available funds for loans are significantly declined as nonperforming loans increase. Further study revealed that agricultural loan sector, petty trade loan sector and WEDP loan sector has the highest share of NPLs and followed by others sectors such as, micro energy loan sector, individual loan sector and service sector. To mitigate the problems of nonperforming loans some strategic issues and mechanisms were recommended to the management of SFPI. These measures are: appropriate credit approval, adequate monitoring and follow up before and after loans granted to the customers, Continuous branch supervision to ensure timely credit delivery, credit diversification strategies, implement effective and efficient Management information systems and mechanisms to control the health of loan portfolio.*

**Key Words:** *Nonperforming Loans, Performing Loans, Microcredit and Credit*

## **CHAPTER ONE:**

### **1. Introduction**

Professor Muhammad Yunus imagined the means of poverty alleviation in 1970 and established microfinance institution in 1976 to overcome the challenges of poor people by providing financial services to women living in Bangladeshi village. Microfinance institutions play a major role in poverty alleviation to promote the economic development of the country. Now a day the vision of Professor Mohammed Yunus expanded all over the World to alleviate poverty by delivering financial and non-financial services to the poor households. Microfinance institution is the provision of financial and non- financial services to both urban and rural poor and low income people for the purpose of small business activities (Mohammed, A. D. and Hasan, Z., 2008). The delivery of financial services has been viewed as an anti poverty tool of development programs in Ethiopia (Wolday, 2000). Banking sectors in Ethiopia has not been serving the rural and urban poor people due to high collateral requirements to secure credit.

In developing countries like Ethiopia, there is a growing recognition that microfinance can be an effective tool in creating sustainable product services that can bring direct, measurable and beneficial impact on the livelihood of the poor (Tesema Alemu, 2000). Microfinance institutions (MFIs) are institutions that provide suitable financial and other services using innovative methodologies and systems at cost to meet the needs of low-income sections of the population and act as financial intermediaries (Wolday, 2000).

#### **1.2 Background of the study**

Microfinance industries play a key role in the development of an economy by upgrading the living standards of poor people those living in urban and rural area of the country. The development role undertaken by Microfinance industries determines the step for development of economy. Hence the stability of Microfinance industries is a key for the development of an economy. Extension of credit facilities is one of the major activities of all Microfinance institutions including public and private banks, cooperative and cooperatives Unions. This is usually evidenced by the large proportion that loans constitute in the overall operating assets of these lending institutions. Healthy loan portfolios are therefore vital for lending institutions in view of their impact on Liquidity, lending capacity, earnings and profitability of the MFIs

(Gerald Pollio & James Obuobi, , 2010).

Microfinance Institutions (MFIs) currently provide financial services such as saving mobilization and provisions of credit, and providing non- financial services like, capacity building on business development to urban and rural communities (Wolday, 2000).

Some of loans borrowed to the clients by the lending institutions unluckily become nonperforming and result in bad debts with adverse consequences for the overall financial performance of the institutions. The issue of loan default (NPLs) is becoming an increasing problem that threatens the sustainability of MFIs. High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing (Ntiamoah et al., 2014).

According to (Rawlin, 2012), the principal aim of any business is to make profits. That is why any asset created in conduction of business should generate income for the business. Since this issue is applicable for the Banks and Microfinance industries business, MFIs should give due consideration on the management of loans because lending is the main business of MFIs and loan is normally the main assets and vital source of revenue for the MFIs. Specialized Financial and Promotional Institution (SFPI) is one of the leading microfinance institutions from Ethiopian microfinance institutions. Currently the institutions facing the challenge of a growing non-performing loan portfolio that have adverse effect on the operations of the institution and the situation calls for corrective measures to control it.

Specifically, the objective of the study would identify underlying reasons for non-performing loans at Specialized Financial and Promotional Institution (SFPI); determine the trend of the occurrence of nonperforming loans in SFPI, the impact of nonperforming loans on the operation activities. Additionally, it will be important to examine the activities distribution of nonperforming loans and the also come up with implementable strategies to address some of the causes of the incidence of nonperforming loans.

The immediate consequences of nonperforming loans are the reduction in profitability through disposal costs like provisions for credit losses and direct write-offs for bad debts and shrinking of loan able funds. Large amounts of non-performing loans in the banking and non banking financial systems have at many times threatened the failure and actually merged and collapsed banks and microfinance institutions. Many researches on the causes of bank failure show that poor quality of loan portfolio is statistically a major predictor of bankruptcy. The current issue in

credit & risk management is nonperforming loans. The growth of NPL's is a threat on economy as well as which declining trade (Deservigny & Renault, 2004) described that NPL's has got a latest measurement now as an assets, interest rate & credit management. Increasing threats of NPL's bring impact on bank balance sheet and income statement causes constant Banks failures, the Central Bank provides guidelines and services in order to manage credit, overdraft, advances, Bankers approval, commercial documents, leases, guarantees, bills discounted and contingencies are interrelated with credit risk of Banks. (Benjamin Opoku Antwi, 2016), High interest rate and overtrading were the other leading causes of the company's collapse. It was also discovered that the MFI does not comply with various regulatory policies in their daily operations. Accordingly, Banks and microfinance institutions in Ethiopia are not insulated from the problem of nonperforming loans. Due to this, the study tries to identify the causes of NPLs on the operations of microfinance institutions and the strategies to reduce the incidence of NPLs by taking a case study of Specialized Financial and Promotional Institution.

### **1.3 Statement of the Problem.**

More attentions given by number of researchers to overcome the poor loan management that contributes to nonperforming loans (NPLs). Now a day it is an important issue for number of microfinance institutions in Ethiopia to control the causes of nonperforming loans (bad debt). Because number of researches conducted on nonperforming loans were considering only banking industry rather than microfinance instructions, and this research was considering the problems of nonperforming loans in microfinance industry. Many countries are suffering from Nonperforming Loans in which Financial sectors are unable to get profit out of loans (Pettersson Jessica and Wadman Isac, 2004). If the loan is well managed; it will increase the bank's profitability and sustainability in the future. However, if failed to do so, it will be the major threat to their survival (MacDonald, 2006). NPLs in Specialized Financial and Promotional Institution (SFPI) are increasing from year to years as the amount of portfolio increases. However, the loans granted to borrowers become nonperforming and adversely affecting the performance of the institution due to ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, inadequate monitoring and follow up, credit diversion, management information systems and poor credit culture. SFPI is one of microfinance institution with nonperforming loans ratio increasing from 2.29% in 2015 to 2.31% in 2016 and decreasing by 1.59% in 2017 and 1.43% in 2018 and after a slight decrease the ratio started increase by

1.48% in 2019.

NPLs affect the micro financial institutions liquidity and profitability which are the main components for the overall efficiency of the microfinance institutions. An increase in nonperforming loans provision diminishes income. The increasing rates of nonperforming loans problem calls for an effective strategy to overcome before it beyond institutional capacity to control the rate of loan NPLs/default in Specialized Financial and Promotional Institution.

## **1.4 Objectives of the Study**

### **1.4.1 General objective of the study**

Identifying to what extent ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, inadequate monitoring and follow up, credit diversion, and management information systems causes nonperforming loans and effects of nonperforming loans on interest income, operating profit and loanable funds of Specialized Financial and Promotional Institution (SFPI)

### **1.4.2 Specific objectives of the study**

- i. To identify the causes of nonperforming loans in Specialized Financial and Promotional Institution (SFPI).
- ii. To determine the trend of NPLs in SFPI.
- iii. Assessing the effect of NPLs on Interest income, operating profit and Loanable funds.
- iv. To identify the activities or sector with the highest burden of NPLs

## **1.5 Research Questions**

This research find answers to the following questions:

- i. To what extent ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, inadequate monitoring and follow up, credit diversion, and management information systems causes nonperforming loans in Specialized Financial and Promotional Institution (SFPI)?
- ii. What is the trend of NPLs in the last five years?
- iii. What effect does the occurrence of NPLs (bad debts) have on interest income, operating profit, and loan able funds?
- iv. Which sector has the highest burden of Non-Performing Loans?

## **1.6 Significance of the study**

The loan portfolios of lending institutions are a major assets that of generate significant amount of revenue. The quality of loan portfolio will be an important issue to determining the financial performance of the microfinance institutions. This study was conducted to identify the main causes that negatively affect the performance of MFIs.

The findings of this study would enable Specialized Financial and Promotional Institution adopts workable strategies to control the problem of a growing non-performing loan portfolio in the institution and thereby improve its financial performance and profitability to sustain in the industry.

Secondly, the study could be initiate the Specialized Financial and Promotional Institutions management to give due emphasis on the management of these identified causes and provides them with understanding of activities that could be enhance their loan performance. This is due to the fact that knowing the causes that determine the nonperforming loan would be help the Specialized Financial and Promotional Institution's management to concentrate on the quality of loan rather than increasing its quantity.

Additionally, the study could serve for different stakeholders such as financial sectors, donors, and for other researchers. Furthermore, the finding of this study initiates the researcher for further studies and references for other related research works in the future.

## **1.7 Scope / Delimitation of the study**

The study delimited in its title to examine the causes and impacts of nonperforming loans on the operations of microfinance institutions. The results of the study should be of great importance to the microfinance sector in general and SFPI in particular.

The study is trying to address the issue from a total of 17 branches, the researcher was used 12 selected branch of SFPI found in Oromia regional state and Addis Ababa town administration and the five years data was considered starting from 2015 - 2019. It is preferable to undertake the study from relevant employees credit officers, branch managers, senior management of operation department and credit division perspective because they are more prone to have understanding and knowledge about the practices of the institution nonperforming loans issues and are completely the concern of SFPI to overcome the issues of nonperforming loans, so employees have better understanding about the management of loan disbursement and

repayment. However, due to financial constraint this research study has not covered the remaining five branches of SFPI.

Finally, the study was finding out the causes of nonperforming loans and the way how to manage such problems to achieve the financial performance of the institutions.

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

The study paper has been organized in to five chapters: The first chapter is made up of the background of the study, background of the organization, statement of the problem, objectives of the study, research questions, and, significance of the study, scope of the study, organization of the paper, and definition of terms. Chapter two reviews literatures on the overview of microfinance in Ethiopia, loan classification and provisioning, implication of NPLs for MFIs, Reducing the incidence of NPL and the challenges facing microfinance institutions.

Chapter three describes the research methodology. Here, the research design, target population, the sample size and sampling technique, the research instrument and data collection procedures are outlined. Chapter four deals with data analysis, interpretation, discussions and the fifth chapter contain summary of findings, conclusions and recommendations of the study.

### **1.9 Operational Definition**

**Performing Loans:** - Loans that are paid principal and interest based on the agreement signed between two parts and timely back to the lender.

**Nonperforming loans:** a loan whose credit quality has deteriorated and the full collection of principal and/or interest as per the contractual repayment terms of the loan/advances is in question and delayed for more than 90 days(NBE, 2008).

**Credit risk:** The risk arises as result when the borrowers fail to conclude its financial contract according to the agreement with lender. It is an asset default by counter party.

**Borrower:** - The one who borrows money from the lender (MFIs).

## **CHAPTER TWO**

### **2. REVIEW OF RELATED LITERATURE**

#### **2.1 Theoretical Literature Review**

This study chapter composed based on the existing literatures related to the research problem and it is divided as follows: Overview of microfinance institution in Ethiopia, Lists of Microfinance institutions in Ethiopia, Microcredit and Microfinance, Performing and non performing loans in MFIs, Classification and Provisioning, Implication of NPLs, Loan processing in MFIs, Reducing the incidence of NPLs, the Challenges facing micro finance institutions in Ethiopia and Empirical literature review on the Causes of NPLs.

##### **2.1.1 Overview of Microfinance in Ethiopia**

Microfinance Institutions in Ethiopia provides credit and saving services to the poor people those living in urban and rural areas of the country. It is for this reason that there has been continuous encouragement for microfinance sector to be managed well so as to be used as a tool for poverty reduction and women empowerment. As commonly understood, the term micro finance refers to the activities of financial and social intermediation services directed to low income population group. The financial intermediation refers to loans, savings, insurance, transfer services and other financial products targeted at low income population group. The social intermediation, however, refers to group formation, development of self-confidence, training in financial skills, and arrangement capabilities among the poor section of the society. This idea is supported by (Robinson, 2001) that microfinance industry strives to provide services that help the low-income poor reduce financial risk, improve their management skills, increase their productivity and therefore their income, collect higher returns on investments, provide financial and emotional security, and improve the overall quality of life for their families.

Globally, the concept of microfinance started with a Bangladeshi economist, Professor Muhammad Yunus, when he granted a few dollars to a basket maker in the year of 1974. In Ethiopia the development of microfinance institutions is a recent phenomenon. The proclamation, which provides for the establishment of microfinance institutions, was issued in July 1996 accordance with proclamation No. 40/1996. Since then, various microfinance institutions have legally been registered and started delivering microfinance services (Wolday, 2000). In particular,

the Licensing and Supervision of Microfinance Institution Proclamation of the government encouraged the spread of Microfinance Institutions (MFIs) in both rural and urban areas as it authorized them among other things, to legally to carry out the following activities accordance with NBE article 3 of the same proclamation; Providing credit services for urban and Rural clients, Accepting savings as well as demand and time deposit, Drawing and accepting drafts payable within Ethiopia, Borrowing money for its business purpose against the security of its assets or otherwise, Purchasing such income generating financial instruments as treasury bills, acquiring, maintaining and transferring of any moveable property, Providing counseling services to its clients, Encouraging income generating projects for urban and rural micro-operators and Managing funds for micro financing business.

MFIs operate in a niche market as they address the needs of those clients who are considered 'high-risk' by bigger banks. High-risk groups or individuals are characterized as those with very few assets, requiring very small loans, high degree of close follow-up, business appraisal and evaluation, as well as those engaged in activities whose income is fluctuating such as small-holder farmers or petty traders. Thus, the MFIs cater for a market with an operationally acceptable demand level and where clients can be protected from the unreasonable conditions of the informal money lenders. Such MFIs, however, charge high administrative costs and higher charges for risk coverage, which is in addition to the market interest rates, and taking advantage of the niche market for microloans (Sunita, 2003).

Although the Government of Ethiopia has allowed private ownership of financial institutions, the financial sector is still dominated by large public financial institutions. Also within the microfinance sector, the major Microfinance Institutions (MFIs) are owned by regional governments/endowment companies. In recent years, the state and regional governments have made a major push to increase financial services for agriculture, micro and small enterprises and low-income households (IFAD, 2009).

The Ethiopian microfinance sector is characterized by its rapid growth, an aggressive drive to achieve scale, a broad geographic coverage, a dominance of government backed MFIs, an emphasis on rural households, the promotion of both credit and savings products, a strong focus on sustainability and by the fact that the sector is Ethiopian owned and driven. The industry has a strong focus on loans to the very poor, as indicated by the relatively small loans when compared to neighboring countries. Sector outreach is impressive and the financial performance of the

sector is considered good, although the operational margins and profitability are low. MFIs have also mobilized a significant amount of savings, thereby improving financial as well as operational sustainability (MFT, 2011). The MFIs are motivated to extend the frontier of financial intermediation to those traditionally excluded from conventional financial markets, the poor. A natural question is, thus: how efficiently are they doing this? Previous studies on the efficiency of financial intermediaries consider MFIs and CBs as completely different sectors. The two industries are conventionally left separate in efficiency analysis of financial firms, even though MFIs are motivated merely to extend financial services to those who were not able to access the conventional banking services (Hundanol, A. Berhanu, W., 2012).

The Ethiopian government identified a number of priority areas of actions as part of the government's poverty reduction and development programs. One of the priority areas acknowledged is the provision of support to microfinance institutions. In this regard the government is working hard to solicit funds from international donors for supporting the microfinance sector, hence the IFAD and AFDB supported Rural Financial Intermediation Program (RUFIP) and the European Union supported Micro and Small enterprise Development program (Meklit, 2005). Generally, the contribution of microfinance institutions for the development of the country's economy is viewed as multidimensional: such as, poverty eradication, women's empowerment, creating job opportunity, finance mobilization, capacity building on business development and so forth.

### **2.1.2 Microcredit and Microfinance**

#### **Microcredit**

Microcredit is the provision of financial services for the poor people in small amount of loan to improve the very small business. Today, there are millions of poor people around the world who turn to be entrepreneurs through the micro-credit sector. (Yirsaw, 2008)

#### **Microfinance**

Microfinance refers to the provision of financial services primarily savings and credit to the poor and low income households that don't have access to commercial banks (Arsyad, 2005). Microfinance is the provision of financial services for the poor people to improve their business activities. Microfinance is the provision of a broad range of financial services such as - deposits, loans, pension services, payment services, money transfers and insurance products - to the poor and low-income households. Microfinance refers to small scale financial services primarily

credit and savings provided to people who farm or fish or herd who operate small enterprises or micro enterprises where goods are produced, recycled, repaired or sold. (Robinson, 2001) Microfinance stands for financial services addressed to the poor as targeted clients with different motives to use such services.

### **2.1.3 Performing Loans**

A loan may be considered as performing if payments of both the principal and interest charges are up to date as agreed between the lender and the borrower. According to European Central Bank (2016) a performing loan will provide a bank with the interest income it needs to make a profit and extend new loans. Therefore the deduction of loans that are up to date in terms of principal and interest payment are described as performing loans and they constitute the healthy asset portfolio.

### **2.1.4 Nonperforming Loans**

According to NBE the loan shall be categorized as a nonperforming loan when principal and/or interest due in line with the contractual agreement is unpaid for more than ninety days. On the other hands, European Central Bank (2016) a bank loan is considered non-performing when more than 90 days passes without the borrower paying the agreed installments or interest. Non-performing loans are also called “bad debt”. This reduces its capacity to provide new loans. (Fofack, 2005), consider non performing loans as loans which for a relatively long period of time do not generate income, that is both the principal and interest on these loans remain unpaid for at least 90 days. A non performing loan may also refer to one that is not earning income and full payment of principal and interest is no longer anticipated, principal or interest is 90 days or more or the maturity date has passed and payment in full has not been made.

Accordingly the IMF’s Compilation Guide on Financial Soundness Indicators, NPLs is defined as:

“A loan is nonperforming when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons such as a debtor filing for bankruptcy to doubt that payments will be made in full" (IMF, 2005).

The problem of NPLs in MFIs is a widespread phenomenon in Africa and some East Asian

countries such as India and Bangladesh. Therefore, any loan whose repayment has been outstanding for at least 90 days is considered a non performing loan. According to (Berger, A. and R. DeYoung, 1997) such loans could be injurious to the performance of the financial institutions.

### **2.1.5 Loan Classifications and Provisioning**

According to NBE directives number MFI/18/2006, the licensed microfinance institutions in Ethiopia are required to report their credit risk and assets on every quarter bases to National bank of Ethiopia as a way to review portfolio and minimizing nonperforming loans. Nonperforming loans and advances of microfinance institutions classified in to three categories: (1) Standard, (2) Doubtful, (3) Loss based on the number of days the loan is past due.

**Table 1 Loan Classifications and Provisioning**

<b>NO</b>	<b>Category</b>	<b>Number of days past due</b>	<b>Minimum Provisioning</b>
1	Standard	91-180 days	25%
2	Doubtful	181-365 days	50%
3	Loss	>365 days	100%

### **2.1.6 Implications of NPLs in Microfinance Institutions**

The interest income generated from loans contributes significantly to the profitability performance of the microfinance institutions. However, when loans become delinquent, it has a serious negative effect on the health and operations of the MFIs. One of the reasons is that, in line with the National Bank of Ethiopia regulations, the lending institution has to make provision and this can be ultimately reducing the profit level of microfinance institutions.

Again, large non performing loan portfolio tends to undermine the Microfinance Company's ability to grant more credit. This is because the loanable funds tend to deplete when repayment of loans delays or fail to come.

Another important implication of nonperforming loans; which is sometimes described as 'toxic asset' is the loss of confidence on the part of depositors and investors leading to liquidity challenges. Yet again, another implication of non performing for the microfinance institutions is the that huge amounts written off as bad debt adversely affect the growth of the shareholders wealth since the profit which is re-invested(ploughed back) into the business to grow the capital base is reduced as a result of provision for credit losses. In a similar token, dividend payment is

equally negatively affected because the provisions for credit losses are deducted before dividends are declared.

Some foreign literatures indicate that failing banks have huge amount of nonperforming loans prior to failure and that asset quality is a significant predictor of insolvency (Berger, A. and R. DeYoung, 1997). The issues discussed above show the gravity of the implication of nonperforming loans on the operations of MFIs and this study attempts to identify the major causes of these NPLs among other objectives and proffer some suggestions aimed at reducing the incidence of NPLs in Specialized Financial and Promotional Institution (SFPI).

### **2.1.7 Loan Processing in MFIs**

The MFIs should ensure the overall customers credit backgrounds and their strength in the expected loan repayment to mitigate the risk of default. Lending involves a lender providing a loan in return for a promise of interest and principal repayment in future (John Kay Associates Limited, 2005). Because of this risk of default in loan repayment, lenders needs to project into the future and make sound judgment that will ensure that repayment is effected at the agreed date. Available literature places so much importance on the lender's role in ensuring good decisions relating to the granting of loans in order to minimize credit risk. The lender must always aim at assessing the extent of the risk associated with the lending and try to reduce factors that can undermine repayment. The lender should gathering all the relevant information that will assist lenders in making sound credit decision. Besides this, microfinance institutions have to implement good credit procedures and requirements usually contained in credit policy manual to guide saving and credit officers staff and their target clients in order to expect continuous repayment. MFIs consider the standards of good lending before granting loans are as follows:

1. The character of the prospective borrower: the overall borrower's personality is gathered before granting loans.
2. Amount being requested by the customer: Checking the amount requested by borrower's based on his /her capacity before filling contractual agreement to borrow.
3. Interest margin and relevant fees: Microfinance institution check whether borrower's agreed on the interest ranges and related fees before granting loans to borrowers.
4. The purpose of the loan: MFIs considers customers business plan before lending loans and for what business purpose they secure loans.
5. Capacity: Ability of the borrower to manage business successfully.

6. Source of repayment

7. Loan guarantee provided by the customer: Collateral types pledge by customers before granting loans.

8. Technical and financial viability of the business

Besides this, groups, individuals and micro and small enterprises that apply for loans from MFIs through five stages prior to obtaining approval.

### **1. Preliminary Screening and Selection**

The customers those needs credit services are make contact with the institution and are carefully screened and asked to answer specific questions regarding the status of their business and household accounts, in order to establish whether they qualify under MFIs eligibility guidelines. This is one of the most critical stages in the loan processing procedures since it is the stage where the information about the business and creditworthiness of the customer is analyzed.

### **2. Training to target clients**

In this stage, the training shall be conducted on the lending and operational policies and procedures of the MFIs before the applicants applying for a loan. The operation officers are responsible person for organizing and conducting training to potential clients on the lending and operational policies and procedures of MFIs to overcome the issues of nonperforming loans.

### **3. Loan Application**

The operation officers of the institution undertake to visit the applicant's businesses and household in order to verify the information taken at the initial stage to evaluate the strengths and background of the potential clients.

### **4. Loan Appraisal and Approval**

The overall information thus developed by operation officers /credit and saving officers/ is organized into a formal loan appraisal and presented with recommendations to the branch manager for approval. The loan amount and tenure are determined based on the adequacy of the cash flows generated by the borrower's business, sufficient personal collateral and or guarantors agreeing to co-sign the loan agreement.

### **5. Monitoring and Repayment**

After disbursement, the operation officers /credit and saving officers/ frequently visits the borrower's business to ensure that the credit facility is being used for the specific purposes for which the loan was granted, and to remind borrowers of their next repayment date. According to

(Rouse, 1989) this is one area many lenders pay little attention but if it is properly followed, the incidence of NPLs can be reduced considerably. Things that help in the monitoring and control process to minimize the incidence of NPLs are as follows:

- Ensuring the utilization of the loan for the intended purpose
- Identifying early warning signals of any problem relating to the operations of the business that are likely to affect the performance of the loan
- Ensuring compliance with the covenants of the loan facility.
- Affording the lender the opportunity to discuss the problems and prospects of the borrower's business.

The action that should be taken by MFIs in NPLs recovery are; discussions shall be held with borrower's family and guarantor(s) to minimize the cost behinds loan recovery, and if the borrowers are unwilling to repay legal action is initiated against the borrower and guarantor(s) to recover any amounts owed.

### **2.1.8 Reducing the incidence of NPLs**

NPL's can be reduced if granted to well deserving applicants; thus applicants who have demonstrated the willingness and ability to pay. A Credit analysis has to be well carried out to ensure that a good credit decision is made to avoid adverse selection.

Furthermore, loan has to be monitored to ensure repayment is made as and when it is due so as to avoid default. (John Kay Associates Limited, 2005) The MFIs should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments and sometimes renegotiate loans if the borrower is in difficulty. Accordingly, MFIs should be mitigating the causes of NPLs by applying the 5c's of lending. The 5c's of credit are explained below.

#### **Character**

Understanding borrower's character is important to financial sectors to have significant comfort with the character of its prospective borrowers. Indicators such as credit rating and borrowing history coupled with more qualitative factors such as honesty and integrity all support a case for a borrower's willingness and ability to repay a loan.

#### **Capital**

All financial sectors that engaged in provision of credit needs to understand the capital position of the prospective borrower's business or personal wealth. More capital represents the borrower's

ability to withstand volatility. It also demonstrates the commitment an owner of a borrowing entity maintains. A strong capital position reassures a lender of repayment capacity in a borrower.

### **Capacity**

Understanding capacity to repay a loan is critical for a bank during the underwriting process. Capacity is determined by the borrower's ability to generate cash flow to service the interest and principal on the loan. Strong cash flow from borrowers' normal business activities demonstrates capacity to repay debt and mitigates the probability of default.

### **Conditions**

Financial sectors should understand the broader market conditions affecting the industry, segment, market and overall economy in which its borrowers engage in commerce.

Strong industry growth or economic conditions support a business' ability to generate cash and repay debt.

### **Collateral**

The lending institutions give attention on the reality of borrower collateral before granting loan. In the event a borrower is not able to repay debt with its cash flow, a lender must rely on the quality and sale ability of borrower collateral to repay the loan. A strong analysis of the borrower's collateral supporting a loan is an important step in granting a loan.

## **2.1.9 The Challenges facing micro finance institutions in Ethiopia**

The main challenges facing the microfinance institutions in Ethiopia include inadequate funding for capacity building, inadequate infrastructure, absence of credit reference bureau, inadequate credit delivery and management, inadequate location selection, inefficient management information systems, ineffective monitoring and evaluation.

### **1 Capacity Building**

Currently, the competition of MFIs is increasing due to yearly expansions of MFIs branches. Accordingly, to stay in the microfinance industry Operation staffs are the backbones of all microfinance institutions in Ethiopia to overcome the main challenges of nonperforming loans. Beside this, lack of updating the staff capacity in training and increasing demand for higher pay levels make human resources one of the most difficult problems in the sector. Capacity building in the form of a skilled and professional human capital base and adequate access to funding is

essential for the building of a sustainable and efficient microfinance sector. In line with private sector business, MFIs need to start seeing training as an investment rather than expense. As part of this they need to pay more attention to training and capacity development as a part of an integrated HR management that includes HR retention ([www.MicroSave.org](http://www.MicroSave.org)).

## **2. Inadequate Logistics and Infrastructure base.**

Inadequate infrastructures in rural areas of the country such as motorcycles and car arrangement, communication and information technology, roads, and electricity results in high operational cost within the microfinance sector. The current limited supplies of these resources limit operations and drives up the cost of MFIs. In respect of logistics arrangement and infrastructure development, it is important to provide adequate logistics such as motorcycles, car, telecommunications and information technology to support the operations of microfinance institutions to make them more efficient. In Sharma and Zeller's study (1999), trying to achieve "marginal impact of credit services" may be the cause of concentration of branches of credit organizations in the area with better access to transport and communication infrastructure where clients' income covariance seem to be lower. Branches with poor locations may cause inconvenience in communication resulting in inefficiency in consultant services and services related to loan collection.

## **3. Absence of Credit Reference Bureau**

In Ethiopia one of the bottlenecked issues for all MFIs were lack of an efficient risk management mechanism that will help to control the borrowers having bad credit history and mitigate double loan borrowers. To effectively identify these bad defaulters, MFIs requires referencing solution that will enable them submit and share data at the same time as processing their customers' credit application. The credit reference bureau is important to working in collaboration with all MFIs to provide credit reference of prospective borrowers to lending institutions. The impact of introducing credit information sharing systems on firms' access to finance and found that credit bureau reforms have had a greater impact on firms' access to finance in countries where contract execution is weaker but the study did not focus on nonperforming loans (Peria, M. S. M. & Singh, S., 2014). The idea is to prevent borrowers with double loans and unsatisfactory credit history before granting loans. Knowing the credit history of any loan applicant is important to make sound credit decision for MFIs. This type of cross-checking mechanism will reduce the

incidence of loans going bad since the organization will avoid lending to borrowers with unsatisfactory credit record.

#### **4. Inadequate location (site) selection to gather information**

The main challenges to identify the target clients in microfinance industry are lack of adequate and reliable information's increasing through a time due to location problems. These problems adversely affect the ability to properly target the right clients in order to meet the specific needs of such clients. According to (Bhatt, 2002) locations of lending institutions affect the transaction costs of the borrowers and lenders. It is easier for lenders to acquire information and provide assistance to the borrowers and easier for the borrowers to travel to the lenders with shorter.

### **2.2 Empirical Literature Review**

There have been various findings from the different studies that have explained the possible causes and impacts of nonperforming loans.

According to (Setergie, 2013), The study conducted on Credit Default Risk and its Determinants of Microfinance Industry in Ethiopia found out the results using descriptive statistics poor business performance, credit diversion, loan size, education, income, loan supervision, suitability of repayment period, availability of other credit sources and screening mechanism are significantly increase bad debt (credit default). According to (Diriba Merga Eren, Hundessa Adugna Yadeta, 2018), the study conducted on assessment of Causes of Loan Default in Wasasa Microfinance S. C, results show that burden of interest, operational inefficiency and Poor customer handling are the four major internal causes of the loan default while political instability, poor business plan, existence of illegal business and price fluctuation are four major external causes of loan default.

(Korankye, 2014), study conducted on the causes and control of loan delinquency/default in microfinance institutions in Ghana, found out the causes of loan default to include; high interest rate, inadequate loan sizes, and improper client selection. Measures to control default were found to include training before and after disbursement, reasonable interest rate, monitoring of clients, and proper loan appraisal. It was recommended among others that MFIs should have clear and effective credit policies and procedures and must be regularly reviewed. It was concluded that the government and hence Bank of Ghana should regularly monitor and supervise the MFIs so as to ensure safety of clients' deposits and customers' confidence.

The study that were conducted by (Barongo W. M., 2013) on the factors contributing to nonperforming loans in nonbanking institutions in Tanzania specifically national social security funds found out that the inadequate investment analysis, government intervention, few loan/investment officer compared to the workload, lack of knowledge on investment appraisal techniques for investment officers, inefficient loan policy as well as inefficiency of monitoring mechanism in assuring timely loan repayments are factors leading to increasing trend of nonperforming loans.

According to (E.Mensah, 2016) study on the analysis of non-performing loans in Ghana particularly referring Dunkwa Area Teachers Co-operatives Unions was found out from the study that in the four year period, DATTCU had substantial amount of its loans going waste as a result of Non-Performing loans. This affected the performance of DATTCU by reducing operating profits and interest incomes. Additional revealed that a low rate of education has negative effect on the rate of NPL's. Business failure was adjudged to be the major cause of non-performing loans, and crop failure among others was also identified as causes of non-performing loans. It was further found out from the study that Business and agricultural sectors had chunk of the non-performing loans recorded by DATTCU.

(Murty, 2017) Study the factors influencing non-performing loans in commercial banks in Selangor state of Malaysia examines that consumers' income, economy of the country and bank interest rates statistically influence non-performing loans in commercial banks in Selangor state of Malaysia.

In a study done by (Maina, G.E and Kalui, F.M, 2014) where they assessed institutional factors contributing to loan defaulting in MFIs in Kenya. The study used primary data. The study target population compromise 59 MFIs. A descriptive survey design was used to carry out a census of 59 microfinance institution in Kenya, this is because of the small size population .The data was collected through a structured questionnaire and administered to MFIs loan officers for response. A total of 48 questionnaires were administered of which 45 were adequately respondent to and considered for analysis, this formed 94% response rate. The findings indicated that all the three factors tested had a significant impact on the loan default rate which are credit policies, loan recovery procedures, and loan appraisal process that are viewed as critical drivers of loan delinquency occurrence.

(Warue, 2012) Examine that MFIs need a monitoring system that highlights repayment problems

clearly and quickly, so that loan officers and their supervisors can focus on delinquency before it gets out of hand.

(Sheila, 2011) Is of the view that proper and adequate appraisal is a key to controlling or minimizing default. This is the basic stage in the lending process. According to (Anjichi, 1994) the appraisal stage is the heart of a high quality portfolio. This includes diagnosing of the business as well as the borrower. Before beginning the process of collecting information on the client for the purpose of determining credit limits, the loan officer should have specific information available which will guarantee that the data and figures provided by the client will have a pro-margin error (Sheila, 2011).

(Ahmad, 1997), mentioned some important factors that cause loan defaults which include; lack of willingness to pay loans coupled with diversion of funds by borrowers, willful negligence and improper appraisal by Credit Officers. (Balogun, E.D. and Alimi, A., 1988) also identified the major causes of loan default as loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes. In addition, some research findings and publications indicate that non performing loans are caused by poor management. (Berger, A. and R. DeYoung, 1997).They argues that managers in most banks or MFIs with the problem of nonperforming loans do not practice adequate loan underwriting, monitoring and control.

A World Bank policy research working paper on NPLs in Sub-Saharan Africa revealed that NPLs are caused by adverse economic shocks coupled with high cost of capital and low interest margins (Fofack, 2005).

(Bichanga, W.O and Aseyo.L., 2013), conducted a study on the causes of loan default within MFIs in Kenya. They used a target population comprised a total of 400 loan borrowers and 200 MFIs out of which a sample of 150 was picked using simple random sampling for each stratum. The data was collected by use of structured and semi-structured questionnaire. The data was analyzed from questionnaires using both quantitative and qualitative techniques and tabulated by use of frequency tables. The study found out that loan repayment default was as result of non supervision of borrowers by the MFIs, and also as a result of inadequate training of borrowers on utilization of loan funds before they received loans. The findings also revealed that most borrowers did not spend the loan amount on intended and agreed projects.

The main objective of this study was to identify the causes and impacts of NPLs in the operations of MFIs particularly in SFPI.

**2.3. Conceptual Framework**

The main objective of this study is to identify the causes and impacts of NPLs on the operations of MFIs particularly in SFPI. Diagrammatical description of variables below indicates relationship existing between nonperforming loans and causes of NPLs. NPLs is caused by ineffective credit appraisal, ineffective credit approval, Inadequate monitoring and follow up, wrong timing of credit delivery, Credit diversion and inefficient management information system. NPLs influencing interest income, operating profit and loanable funds. Based on the objective of the study, the following diagram is framed.

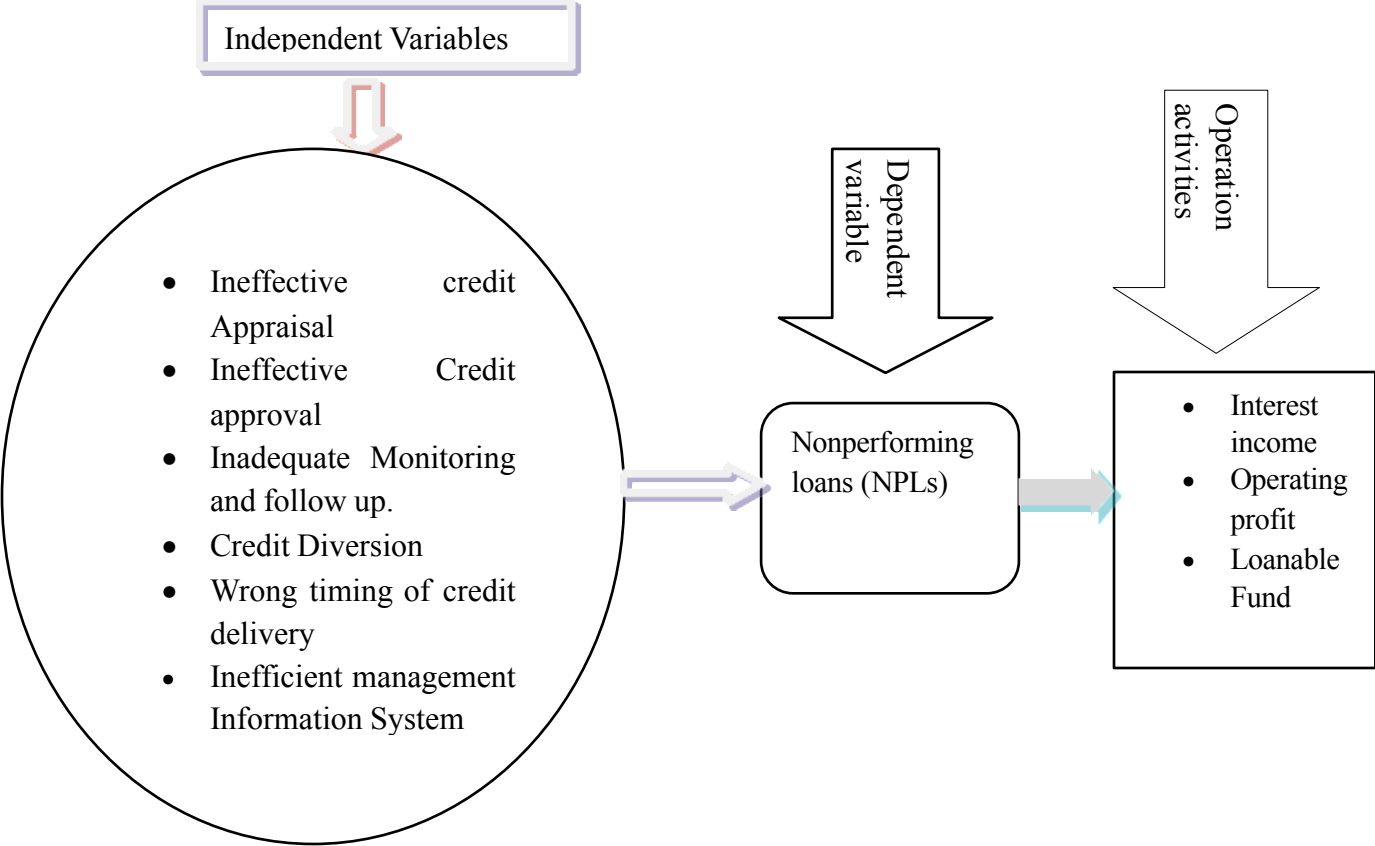


Figure 1 Conceptual Framework  
**Source: extracted by the researcher**

## CHAPTER THREE

### 3. RESEARCH METHODOLOGY

#### 3.1 Research Design

This research study was employed quantitative approach to generate useful information on the causes and impacts of nonperforming loans in Specialized Financial and Promotional Institution. The descriptive and explanatory designs was used in order to analyze primary data because the main interest is to identify the causes of nonperforming loans and the case study approach was appropriate to examine the effects of nonperforming loans on the operations of SFPI. According to (Donald and Pamela, 1998), a descriptive study is concerned with finding out the what, where and how of a phenomenon. Descriptive research design was chosen because it enables the researcher to generalize the findings to a larger population. What is most important is that a particular research strategy will enable the researcher to answer a particular research question(s) and realize the objectives (Saunders M, Lewis P and Thornhill A., 2007).

The explanatory type of study with a quantitative approach was employed to analyses the collected data. The research design, used in this study used panel data analysis of cross-sectional and time series data. According to (Gujirati, 2003) explanatory research is devoted to finding causal relationships among dependent and independent variables. Since the research is cause and effect type it is more appropriate to use explanatory.

#### 3.2 Population and Sample Size

The total loan officers and branch managers available in the selected branches of SFPI were 186 in numbers. In this study out of seventeen (17) branches of SFPI twelve (12) targeted and having large loan portfolio branches was selected based on purposive sampling techniques. This sampling technique was used because these branches are more experienced in large loan disbursement and repayment.

From the total population 65 was selected by using stratified random sampling techniques. Because the level of operation staff workers were the same. The mathematical formula used in sample size determination is given below at 1-10% precision level (Yamane, 1998).

$$n = \frac{N}{1 + N(e)^2}$$

Where, N=total population (186)

n= sample size

$e$  = precision level

Therefore, the sample size used was obtained as;

$$n = \frac{186}{1 + 186(0.1)^2} = 65$$

### **3.3 Sources of Data**

In this study the researcher was used primary and secondary data as a source of information for the research. The administration of questionnaires forms the basis of primary data. Data collected from this source was focused on the background characteristics of respondents and their knowledge on the operational activities of Microfinance; particularly microcredit, challenges affecting the operations of microfinance and the impact of NPLs on the operations of MFIs.

Secondary data obtained from annual reports and financial statements of the institution were used to support the primary data.

### **3.4 Methods of Data Collection**

#### **3.4.1 Primary Data**

In primary data collection the structured questionnaires were used in the data collection. The structured questionnaires were used to get the unbiased opinion of respondents. The questionnaire also contained Likert-type items that were designed in a simple to answer format. Likert-type items use an interval scale that specifically uses five anchors of; strongly agree, agree, neutral, disagree and strongly disagree. The likert type items measure the level of agreement or disagreement. They are good in measuring perception, attitude, values and behavior, and it is very useful in the conversion of qualitative responses into quantitative data values through data-coding (Zikmund, G.W., Babin, B.J., Carr, C.J. & Griffin, M., 2010.)

Due to the scattered location of institution branches, the researcher was physically present to distribute the questionnaires to all branch respondents. The researcher was physically travel to twelve branch offices namely Woliso, Holeta, Fitcha, Muketuri, Sheno, Gimbichu, Debrezet, Akaki, Merkato, Shola, Kirkos and Geresu Duki branches to collect questionnaires.

### **3.4.2 Secondary Data**

The secondary data were obtained by use of case study from the sources of published documents, annual reports and financial statements of the institution. The information collected from these sources were covered a period of five years from years 2015 to 2019. The use of this type of information was so helpful in several ways to the study and it is less expensive to collect in terms of time and money. (Saunders 2007 quote by Stewart and Kamins, 1993) As stating that secondary data are likely to be of higher-quality than could be obtained by collecting empirical data. The data will have very useful information needed to answer the research questions like loan portfolio of the institution, provision and charge for credit loss (i.e. provision for bad and doubtful debt) and profitability during the five-year period.

### **3.5 Data Analysis**

The Primary data using likert scales, questionnaires were used to collect quantitative data. (Clason, D. L., & Dormody, T. J., 1994), Described the difference between likert type items and likert scales. They identified likert type items as single questions with five-level multiple choices. While multiple questions may be used in a research instrument, there is no attempt by the researcher to combine the responses from the items into a composite scale. Because of these conditions, likert-type items fall into the ordinal measurement scale. The descriptive statistics recommended for ordinal measurement scale items include mean and mode or median for central tendency and frequencies for variability, (Harry N. B & Debra A. B. , 2012). Likert scale data, on the other hand, are data that are analyzed at the interval measurement scale. Likert scale items are created by calculating a composite score (sum or mean) from four or more likert type items; therefore, the composite score for likert scales should be analyzed at the interval measurement scale.

This study used the procedures for likert scales with appropriate data coding in collecting and analyzing the qualitative data. SPSS 20 version was used to analyze the collected primary data.

The secondary data that obtained by case study approach from financial sources of the institution were analyzed by use of simple MS excel, graphs and pie charts.

### **3.6 Ethical Issues**

This research will benefit microfinance institutions in general and Specialized Financial and

Promotional Institution in particular by providing in-depth understanding the causes and impacts of nonperforming loans and its controlling mechanism to achieve sustainable financial performance. The study was informs respondents the purpose of the questions and the study considers the confidentiality of the response by not asking to state name. While conducting the study, emerging ethical issues was considered and given attention. So the output of the research will not harm the wellbeing of MFI and society.

### **3.7 Reliability and Validity**

#### **3.7.1 Test of Reliability**

In order to ensure reliability of questionnaires, the study standardized the measurement for all of respondents. This enabled to reduce external source of variation such as boredom, fatigue and biases. Designing measurement directions that had no variation from one respondent to respondent and broadening the sample of items tested reliability.

#### **3.7.3 Test of Validity**

The study tested internal validity of the questionnaires ability to measure causal relationship of nonperforming loans. In order to be confident with the instrument, the researcher administered the instrument to each branch operation staffs respondents discussion in order to test the adequacy and coverage of the causes of nonperforming loans. Participants agreed in principle for items to include in the questionnaires to adequately covering causes of nonperforming loans under study. Using staffs those are responsible issue and approve loans (loans officer) form SFPI well the instrument meets the standard, more over the instrument was tested to see if it was in conformity with predicted correlation with other theoretical propositions. This brought confident for the instrument to produce intended results.

## **CHAPTER FOUR**

### **4. DATA ANALYSIS AND PRESENTATION OF FINDINGS**

#### **4.1 Introduction**

This chapter contains data analysis and interpretation of findings. The objective of the study was to find out the major causes of nonperforming loans on the operations of Specialized Financial and promotional Institution (SFPI).

The research was conducted on sample size of 65 respondents from 12 branches of SFPI all respondents completed and returned the questionnaires properly filled in making a response rate of 100%. Frequencies was used for single response questions, and Linker scale was used for multiple questions , the data collected based on a linker scale of 1-5 points were used in computing the analysis. To make the study more understandable the findings were presented by using tables, graphs and pie charts with explanations.

## 4.2 Background of respondents

The study was inquiring information about the background of the respondents' that is gender, age and educational level. This information is more important to check the appropriateness of the respondents in answering the questions on the causes and impacts of NPLs on the operations of Specialized Financial and promotional Institution (SFPI).

### 4.2.1 General characteristics of the respondents

**Table 2 Characteristics of the respondents**

Variable	Items	Frequency	Percentage
Gender	Male	58	89.2%
	Female	7	10.8%
Total		65	100%
Age	18-25	5	7.7%
	26-33	38	58.5%
	34 and above	22	33.8%
Total		65	100%
Educational Level	Diploma	9	13.8%
	Degree	55	84.6%
	Masters	1	1.5%
Total		65	100%

Source: Survey of questionnaire 2019

The table above illustrates that, majority 58(89.2%) of the respondents were male and remaining 7(10.8%) respondents that included in the sample were females. This indicates most of the SFPI works were performed by male than females.

The findings conducted on the age of respondents indicate; greater parts (38) of the respondents were 26-33 years old. This indicates from 100% of the total respondents 58.5% is between 26-33 years old, 22 respondents were 34 and above years old and 5 respondents were 18-25 years old which indicates 33.8% and 7.7% respectively.

The findings conducted on the educational level shows 55(84.6%) of the respondents have a Bachelor's degree, 9(13.8%) of the respondents have a diploma and 1(1.5%) of respondents have a Masters degree. So, many loan officers and branch managers of SFPI are degree holders. This educational levels of the respondents were shows more of them are knowledgeable enough to give reliable information about the causes of nonperforming loans.

#### 4.3 Respondents Opinion on the fairness of Interest Rate Charged by SFPI

The respondents were asked to describe the interest rate charged by SFPI and the results are illustrated in table below.

**Table 5 respondents opinion on the interest rate charged by SFPI**

Variable	Items	Frequency	Percentage
Interest Rate	Agree	10	15.4%
	Strongly agree	51	78.5%
	Disagree	4	6.2%
<b>Total</b>		65	100%

The findings in table 5 indicates that; majority 51 (78.5%) of the respondents were strongly agreed that the interest rate charged on loans by SFPI was fair, 10 (15.4%) of the respondents were agreed that the interest rate charged on loans was high and the rest 4 (6.2%) were of the disagreed that the interest rate charged on loan by SFPI was low. Accordingly, the above finding indicates that the interest rate charged on loans by Specialized Financial and Promotional Institution (SFPI) is fair.

#### 4.4 The major causes for the occurrence of nonperforming loans.

**Table 7 Opinions of the respondents on the causes of nonperforming loans in SFPI.**

Causes of NPLs	Mean	Std. Deviation
The organization considers the wrong time of credit delivery	4.85	.507
The organization considers ineffective credit appraisal procedures	4.82	.682
The organization considers ineffective client screening and selection	4.08	.539
Recovery of loans is influenced by business failure	3.92	.407
Recovery of loans is influenced by high interest rate charged on loans	3.91	.491
Recovery of loans is influenced by delay approval of loans	2.95	.372

Recovery of loans is influenced by poor weather conditions	2.09	.491
--	------	------

The findings in table above shows, the respondents strongly agreed that; the organization considers the wrong time of credit delivery (mean=4.85), the organization considers ineffective credit appraisal procedures (mean=4.82), the organization considers ineffective client screening and selection (mean=4.08), recovery of loans is influenced by business failure (mean=3.92), and recovery of loans is influenced by high interest rate charged on loans (mean= 3.91). They also agreed that; recovery of loans is influenced by delay approval of loans (mean=3.98), recovery of loans is influenced by management information systems (mean=2.95), and Recovery of loans is influenced by poor weather conditions (mean=2.09). This illustrates that wrong time of credit delivery was the main factors causes for the occurrence of nonperforming loans.

#### 4.4.1 Factors hinders effective credit appraisal

**Table 8 Respondents response on the factors hinders effective credit appraisal.**

<b>Factors consider in effective credit appraisal</b>	<b>Mean</b>	<b>Std. Deviation</b>
The organization considers effective client screening and selection	4.91	.423
The organization considers Customer's collateral before extending a loan.	4.89	.616
Considering mechanism to check applicant's borrowing history with other financial institutions.	4.57	.984
The organization considers Client's characters before extending a loan.	4.02	.124
The organization assesses customers capacity to pay back in order to qualify for the loan	3.97	.248
cohesiveness of the group	3.58	1.382
adequate training before credit appraisal	3.49	1.050
Absence of credit reference bureau to check whether client's borrowing from other MFI's	3.08	1.368

Source: Survey of questionnaire 2019

The findings in table 6 above illustrates, the respondents were strongly agree that; The organization considers ineffective client screening and selection (mean= 4.91), The organization considers Customer's collateral before extending a loan (mean= 4.89), Considering mechanism

to check applicant's borrowing history with other financial institutions (mean= 4.57), The organization considers Client's characters before extending a loan (mean= 4.02), The organization assesses customers capacity to pay back in order to qualify for the loan (mean= 3.97), cohesiveness of the group (3.58), adequate training before credit appraisal (3.49) and absence of credit reference bureau to check whether client's borrowing from other MFI's (mean=3.08). This implies that the ineffective credit appraisal in SFPI was highly affected by ineffective client screening and selection.

**4.4.2 Factors influencing effective credit approval**

**Table 9 Respondents responses on the factors influencing effective credit approval.**

<b>Factors influencing effective credit approval</b>	<b>Mean</b>	<b>Std. Deviation</b>
The organization considering overlapping of loan repayments	4.83	.675
Ineffective credit appraisal by loan officers	4.25	1.076
Customer's inability to meet credit approval requirement.	4.02	.944
Liquidity problems	4.02	.330
Ineffective understanding of customers business activities	3.91	1.155
Inflexible credit approval procedures	3.78	1.192

Source: Survey of questionnaire 2019

As per the findings in table 7, the respondents strongly agreed that; The organization considering overlapping of loan repayments (mean= 4.83), ineffective credit appraisal by loan officers (mean= 4.25), the respondents also agreed that ineffective understanding of customers business activities (3.98), Customer's inability to meet credit approval requirement (mean= 4.02), Liquidity problems (4.02), Ineffective understanding of customers business activities (3.91) and inflexible credit approval procedures (mean=3.78). This indicates that credit approval is mostly influenced by overlapping of loan repayments.

**4.4.3 Factors influencing effective timing of credit delivery.**

**Table 10 Respondents opinions on the factors influencing effective time of credit delivery.**

	<b>Mean</b>	<b>Std. Deviation</b>

The organization considers insufficient loan-able funds	4.74	0.834
Unscheduled credit delivery program	3.98	0.450
Ineffective understanding of customer's business activities.	3.89	0.534
The organization considers effective credit approval procedures.	3.17	0.651

Source: Survey of questionnaire 2019

The findings in table 8 above, the majority of respondents were strongly agreed that; the organization considers insufficient loan-able funds (mean=4.74), Unscheduled credit delivery program (3.98), Ineffective understanding of customer's business activities (3.89) and the organization considers effective credit approval procedures (mean=3.17). This implies that insufficient loan-able funds were highly influencing the effective time of credit delivery.

#### **4.4.4 Factors affecting adequate monitoring and follow up to control the health of loan portfolio.**

**Table 11 Factors hinder adequate monitoring and follow up of loan portfolio.**

<b>Factors consider in adequate monitoring and follow up</b>	<b>Mean</b>	<b>Std. Deviation</b>
Inefficient logistic facilities	4.77	0.702
Ineffective convincing strategies to recover problem loan.	4.06	0.556
Staffing Problem.	3.98	0.696
Availability of road networks.	3.97	0.529
Inefficient legal actions to recover problem loans.	3.52	0.986
Write off actions for the quality of loan portfolio	3.40	1.378

Source: Survey of questionnaire 2019

The findings in table 9 above, the majority of respondents were strongly agreed that; inefficient logistic facilities (mean=4.77), ineffective convincing strategies to recover problem loan (4.06), Staffing Problem (3.98), Availability of road networks (3.97), inefficient legal actions to recover problem loans (mean=3.52 ) and Write off actions for the quality of loan portfolio (3.40). These illustrate that monitoring and follow up of loan portfolio highly influenced by Lack of logistic facilities.

#### **4.4.5 Factors account for credit diversion by borrowers**

The respondents were requested to state which factors account for diversion of funds by borrowers. The findings are presented below.

**Table 12 Respondents responses on the factors accounts for credit diversion by borrowers.**

<b>Factors accounts for credit diversion</b>	<b>Mean</b>	<b>Std. Deviation</b>
The organization considers enough capacity building on business activities before granting loans to customers	4.83	.651
The organization considers proper monitoring after loan to insure whether the credit is used for the intended purposes.	3.94	.496
The organization considers borrowers credit plan to avoid under and over financing	3.89	.937
The organization considers ignorance of lending terms and conditions	2.05	.837

Source: Survey of questionnaire 2019

The findings in table 10 shows the respondents strongly agreed that; the organization considers enough capacity building on business activities before granting loans to customers (4.83), the organization considers proper monitoring after loan to insure whether the credit is used for the intended purposes (3.94) and the organization considers ignorance of lending terms and conditions (2.05). This implies that credit diversion by borrowers was affected by capacity building on business activities before granting loans to customers.

#### **4.4.6 Factors influencing management information system implementation.**

**Table 13 Opinions of the respondents on the factors influencing MIS**

<b>Factors influencing MIS</b>	<b>Mean</b>	<b>Std. Deviation</b>
Management concerns about MIS	4.88	.625
Insufficient funds to purchase the system	3.92	.539
Absence of proper human resources to retrieve data	2.89	.437

Source: Survey of questionnaire 2019

The findings in table 11 shows the respondents strongly agreed that; management concerns about MIS (4.88), insufficient funds to purchase the system (3.92) and Absence of proper management information system to retrieve data (2.89). This shows that; management information system was highly caused by lack of management concern to purchase MIS.

#### 4.5 Techniques employed to monitor the health of loan portfolio.

The respondents revealed that the techniques employed to monitor the health of loan portfolio include: Portfolio at Risk (PAR) techniques to monitor the overall contaminated loan portfolio and ageing analysis also used to monitor the monthly injured loan portfolio.

#### 4.6 Better Security/collateral used to secure loans from SFPI.

The respondents revealed that the better collateral used to secure loans from Specialized Financial and Promotional Institution is group guarantee and property guarantee like building and car.

#### 4.7 Diagnostic Tests: Classical Linear regression Assumptions

##### 4.7.1 Correlation analysis for the causes of nonperforming loans

The data was transformed using SPSS statistics and correlation analysis was conducted to determine the relationship between causes/indicators/ and nonperforming loans. Pearson's product moment coefficient of correlation was used to determine the nature as well as the degree of the relationship between each cause and each cause of nonperforming loans.

**Table 14 Correlation Matrix**

		<b>Correlations</b>						
		NPLS	Credit appraisal	Credit approval	Credit delivery	Monitoring	Credit diversion	Mis
NPLS	Pearson Correlation	1	-.239	.096	.467**	.553**	.313*	.465**
	Sig. (2-tailed)		.055	.448	.000	.000	.011	.000
	N	65	65	65	65	65	65	65
Credit appraisal	Pearson Correlation	-.239	1	.060	-.069	.009	-.112	-.160
	Sig. (2-tailed)	.055		.636	.586	.943	.373	.202
	N	65	65	65	65	65	65	65
Credit approval	Pearson Correlation	.096	.060	1	-.132	-.056	.001	-.157
	Sig. (2-tailed)	.448	.636		.296	.657	.993	.212

	N	65	65	65	65	65	65	65
Credit delivery	Pearson Correlation	.467**	-.069	-.132	1	.451**	-.040	.355**
	Sig. (2-tailed)	.000	.586	.296		.000	.753	.004
	N	65	65	65	65	65	65	65
Monitoring	Pearson Correlation	.553**	.009	-.056	.451**	1	.338**	.332**
	Sig. (2-tailed)	.000	.943	.657	.000		.006	.007
	N	65	65	65	65	65	65	65
Credit diversion	Pearson Correlation	.313*	-.112	.001	-.040	.338**	1	.219
	Sig. (2-tailed)	.011	.373	.993	.753	.006		.080
	N	65	65	65	65	65	65	65
Management information system	Pearson Correlation	.465**	-.160	-.157	.355**	.332**	.219	1
	Sig. (2-tailed)	.000	.202	.212	.004	.007	.080	
	N	65	65	65	65	65	65	65

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

It is observed that the strong correlation among the cause of nonperforming loans is that between each credit delivery, monitoring and Management information system are 0.451 and 0.355 respectively. This shows that monitoring, credit delivery and management information system are more or less causes of nonperforming loans of SFPI. The correlation between monitoring, credit delivery, management information system, credit diversion, credit approval and nonperforming loans is 0.553, 0.467 and 0.465, 0.313 and 0.096 respectively. This shows that these variables were positively correlated and relatively strong. In the other hands the correlation between credit appraisal and nonperforming loans is -0.239. This indicates that the variables was negatively correlated and relatively week.

#### 4.7.2 Multicollinearity

The term multicollinearity refers to a situation in which there is an exact (or nearly exact) linear relation among two or more of the input variables, (Hawking, 1983). Theoretically, if any linear combination of one set of explanatory variables is nearly perfectly correlated to a linear combination of any other set of explanatory variables, then a multicollinearity problem is present.

**i) Pearson Correlation Test for Multicollinearity**

However, before estimation was done, data exploration is an important step. To start with, to check whether multicollinearity is present or not a simple correlation coefficient matrix was conveyed. (Gujarati, 2003), establishes a rule of thumb, which says that multicollinearity is a serious problem when the correlation coefficient is 0.8 or above. Thus, table 14 though correlation is present, multicollinearity is not a serious problem in our data.

**Table 15 Pearson Correlation Test for Multicollinearity**

		<b>Correlations</b>					
		Credit appraisal	Credit approval	Credit delivery	Monitoring	Credit diversion	Mis
Credit appraisal	Pearson Correlation	1	.060	-.069	.009	-.112	-.160
	Sig. (2-tailed)		.636	.586	.943	.373	.202
	N	65	65	65	65	65	65
Credit approval	Pearson Correlation	.060	1	-.132	-.056	.001	-.157
	Sig. (2-tailed)	.636		.296	.657	.993	.212
	N	65	65	65	65	65	65
Credit delivery	Pearson Correlation	-.069	-.132	1	.451**	-.040	.355**
	Sig. (2-tailed)	.586	.296		.000	.753	.004
	N	65	65	65	65	65	65
Monitoring	Pearson Correlation	.009	-.056	.451**	1	.338**	.332**
	Sig. (2-tailed)	.943	.657	.000		.006	.007
	N	65	65	65	65	65	65
Credit diversion	Pearson Correlation	-.112	.001	-.040	.338**	1	.219
	Sig. (2-tailed)	.373	.993	.753	.006		.080
	N	65	65	65	65	65	65
Mis	Pearson Correlation	-.160	-.157	.355**	.332**	.219	1
	Sig. (2-tailed)	.202	.212	.004	.007	.080	
	N	65	65	65	65	65	65

\*\* . Correlation is significant at the 0.01 level (2-tailed).

*Source: Own survey, 2019*

**ii) VIF multi collineraity test**

The multicollinearity test in table below (table 15), summarizes the un-standardized and standardized coefficient, t-statistic and statistics for collinearity for all of six explanatory variables. The t-statistic helps the researcher to determine the relative importance of each variable in the model. Among the statistics for collinearity, tolerance is the one, which is used to determine how much the independent variable, are linearly related to one another. Tolerance is the percentage of the variance in a given predictor that cannot be explained by the other predictors. A variance with a very low tolerance contributes little information in to a model, can cause computational problem. Practical experience indicates that very low values of tolerance (0.1 or less) are indicating a problem.

Variance Inflation Factor (VIF) is the other indicator of multicollinearity and it is the reciprocal of the tolerance, i.e. very high values of VIF (10 or more) indicate a problem. i.e., it is an indication that the associated regression coefficients are poorly estimated because of multicollinearity. But in this study, there is no variables with the value of tolerance less than 0.10 and no variables whose VIF values are greater than 10. This means that there is no evidence for the presence of multicollinearity in this study.

**Table 16 Variance Inflation Factor (VIF)**

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
1 (Constant)	1.115	.691		1.614	.112		
Ineffective credit appraisal	-.182	.093	-.182	-1.948	.056	.953	1.049
Ineffective credit approval	.129	.061	.196	2.105	.040	.967	1.035

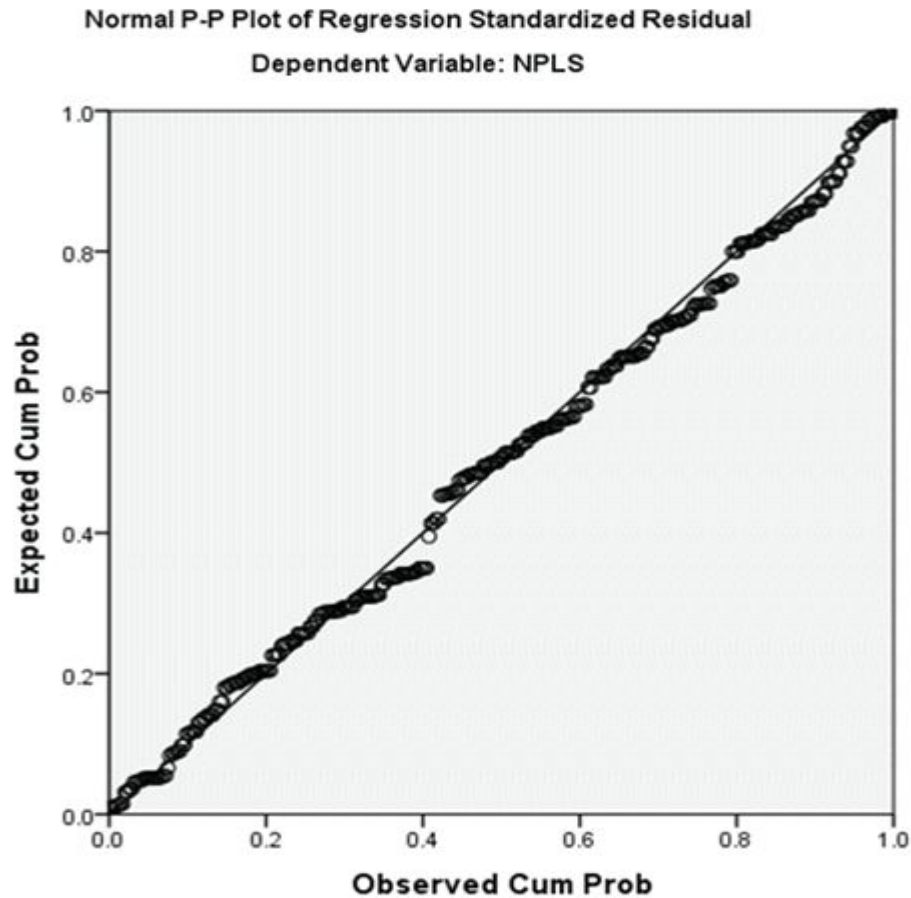
Wrong timing of Credit delivery	.202	.087	.256	2.319	.024	.688	1.454
Inadequate Monitoring and follow up	.226	.079	.325	2.866	.006	.651	1.536
Credit diversion	.118	.086	.141	1.375	.174	.798	1.253
Inefficient Management information system	.197	.086	.238	2.300	.025	.782	1.278

### iii) Normality Tests

#### Test of Normality of residuals

(Brooks, 2008) Noted that in order to conduct single or joint hypothesis test about the model parameter, the normality assumption must be fulfilled. This is because normality is used to describe as the data on the dependent variable are normally distributed for each of the possible combinations of the level of the independent variables or each of the variables is normally distributed. For this study graphical testing normality was made and presented below.

For the p-p plot, if the selected variable matches the test distribution, the points cluster around a straight line. As it is observed from the below p-p plot it looks a normal distribution. Based on this result, the residuals from this regression appear to conform to the assumption of being normally distributed.



**Figure 3. Normal P-P Plot**

In general, since the normality assumption is fulfilled based on looking at p-p plot, it can be concluded that the inferences the researcher made about the population parameter from the sample parameter is somewhat valid.

The below table 16: shows that, R value is 0.718. The larger the value of R display that there is strong relationship among observed and predicted value. To evaluate the study models, the value of  $R^2$  has been considered to determine the amount of variance in the dependent variable which is explained by all the independent variables in the formula (Pallant, 2007, p.158). In this study, the specification correlation  $R^2$  reached 0.516; this means that the independent variables explain 51.6% of the dependent variable. Typically the practical experience shows that, values of  $R^2$  below **0.2** are considered weak, between **0.2** and **0.4**, moderate, and above **0.4**, strong. Therefore, this value (51.6%) is strong to explain or the researcher assures that the model does fit. The remaining of the ratio, 48.4% is called the unexplained variation, meaning that it can be explained by other variables.

The other one is, Adjusted R<sup>2</sup>. Adjusted R<sup>2</sup> is attempts to correct R<sup>2</sup> to more closely reflect the goodness of fit of the model in the population. The reason is unlike the R<sup>2</sup>, the adjusted R-squared gives the percentage of variation explained by only those independent variables that in reality affect the dependent variable. This means, an Adjusted R<sup>2</sup>value is a better measure of “goodness of fit” of a regression model than the R<sup>2</sup> value as it compensates for the number of independent variables included in the regression model. There is a rule of thumb which can be used to determine the adjust R<sup>2</sup> value as follows:

**When the adjusted R<sup>2</sup> < 0.1:** poor fit, **0.11 to 0.30:** modest fit, **0.31 to 0.50:** moderate fit, **>0.50:** strong fit (Muijs, 2004, p. 166). Therefore, the value of adjusted R<sup>2</sup> in this study is reach 0.466. This indicates that the model is moderately fit by 46.6%, and thus the data fit the model well.

#### 4.8 Inferential Statistics

The study applied regression analysis to determine the causes for nonperforming loans of Specialized Financial and Promotional Institution (SFPI).

##### 4.8.1 Regression Analysis

Multiple linear regression analysis was used to investigate the relationship among variables (independent) on the nonperforming loans of Specialized Financial and Promotional Institution (SFPI). Therefore to code, enter and compute the measurements of the multiple linear regressions the statistical package for social sciences (SPSS V 20) was used for the study.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (Nonperforming Loans) that is explained by independent variables (ineffective credit appraisal, ineffective credit approval, wrong timing of credit delivery, Inadequate monitoring and follow up, Credit diversion, and inefficient management information systems).

##### 4.8.2 Model Summary

**Table 17 Model Summary**

Mode	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.718 <sup>a</sup>	.516	.466	.18885

a. Predictors: (Constant), Management information system, Credit approval, Credit appraisal, Credit diversion, Credit delivery, Monitoring and follow up

R denotes the correlation coefficient and the overall correlation coefficient of the estimated model is 0.718 and indicates strong relationship between dependent and independent variables.

R square is the proportionate variance of the dependent variable (Nonperforming loans) explained by the independent variables. In the estimated model independent variables that were studied, explain only 51.6% of the non-performing loans of Specialized Financial and Promotional Institution  $R^2$ . From the determination coefficients, it can be denoted that there is a strong relationship between dependent and independent variables given a  $R^2$  value (coefficient of determination) of 51.6%. This indicates that, further research should be conducted to observe the other factors (46.6%) that influencing non-performing loans of Specialized Financial and Promotional Institution (SFPI).

#### 4.8.3 ANOVA Results

Table 18 ANOVA of the Regression

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	2.205	6	.367	10.302	.000 <sup>b</sup>
Residual	2.069	59	.036		
Total	4.273	65			

a. Dependent Variable: NPLS

b. Predictors: (Constant), Management information system, Credit approval, Credit appraisal, Credit diversion, Credit delivery, Monitoring and follow up

The significance value is 0.001 which is less than 0.05 thus the model is statistically significant in predicting how inefficient management information system, ineffective credit approval, ineffective credit appraisal, Credit diversion, wrong timing of credit delivery, Monitoring and follow up causes Non-performing Loans. The F critical at 5% level of significance was 0.036 Since F calculated is greater than the F critical (value = 10.302), this shows that the overall model was significant.

**Table 19 Coefficients of determination**

<b>Coefficients<sup>a</sup></b>						
Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	
	B	Std. Error	Beta			
1	(Constant)	1.115	.691		1.614	.112
	Ineffective Credit appraisal	-.182	.093	-.182	-1.948	.056
	Ineffective Credit approval	.129	.061	.196	2.105	.040
	Wrong timing of Credit delivery	.202	.087	.256	2.319	.024
	Inadequate Monitoring and follow up	.226	.079	.325	2.866	.006
	Credit diversion	.118	.086	.141	1.375	.174
	Inefficient management information system	.197	.086	.238	2.300	.025

a. Dependent Variable: NPLS

$$\gamma = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \epsilon$$

$$\gamma = 1.115 - 0.182X_1 + 0.129X_2 + 0.202X_3 + 0.226X_4 + 0.118X_5 + 0.197X_6 + \epsilon$$

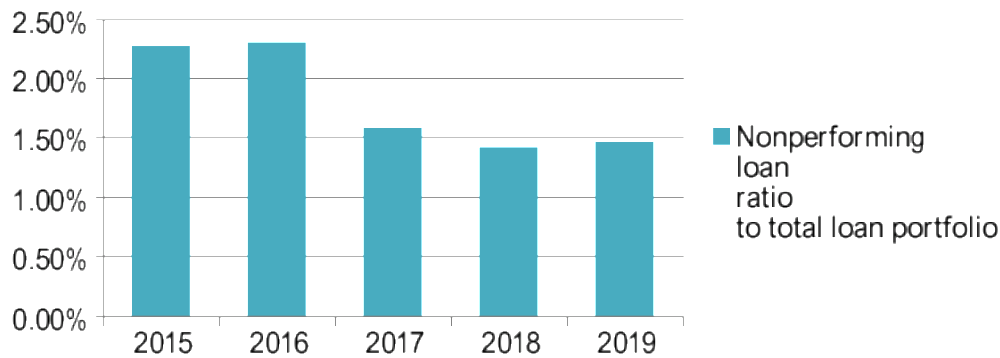
According to the regression equation established, taking all factors into account (ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, Inadequate monitoring and follow up, credit diversion and inefficient management information systems, variables) constant at zero, nonperforming loans of Specialized Financial and Promotional Institution was 1.115. The study also found that a unit increase in ineffective credit appraisal while holding ineffective credit approval, Wrong timing of credit delivery, Inadequate monitoring and follow up, credit diversion and inefficient management information systems will lead to a increase in non-performing loans of SFPI by 0.182; a unit increase in ineffective credit approval while holding ineffective credit appraisal, Wrong timing of credit delivery, Inadequate monitoring and follow up, credit diversion and inefficient management information systems will lead to an increase in nonperforming loans of SFPI by 0.129, a unit increase in wrong timing of credit delivery variables while holding ineffective credit appraisal, ineffective credit approval, Inadequate monitoring and follow up, credit diversion and inefficient management information

systems will lead to an increase in non-performing loans of SFPI by 0.202, a unit increase in inadequate monitoring and follow up variables while holding ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, credit diversion and inefficient management information systems will lead to an increase in non-performing loans of SFPI by 0.226, a unit increase in credit diversion of borrowers variables while holding ineffective credit appraisal, ineffective credit approval, Wrong timing of credit delivery, Inadequate monitoring and follow up and inefficient management information systems will lead to an increase in non-performing loans of SFPI by 0.118 and a unit increase in inefficient management information system variables will lead to an increase in non-performing loans of SFPI by 0.197. At 5% level of significance and 95% level of confidence, Nonperforming loans in Specialized and Financial Institution (SFPI) mostly caused by inadequate monitoring and follow up followed by wrong timing of credit delivery, inefficient management information system, ineffective credit approval, and ineffective credit appraisal variables were influencing nonperforming loans of SFPI.

**4.9 Moving Trends of nonperforming loans in SFPI from (2015-2019)**

Table 20 Moving Trends of nonperforming loans

Description	Year				
	2015	2016	2017	2018	2019
Loan	122,487,624	171,093,922	186,609,181	208,286,374	254,736,797.01
NPLs	2,804,966.58	3,952,269.60	2,922,868	2,982,454	3,762,179.10
Nonperforming loan ratio to total loan portfolio	2.29%	2.31%	1.59%	1.43%	1.48%



**Figure 4 Nonperforming loans ratio to total loan portfolio**

**Source: Annual Reports and Financial Statement 2015 - 2019**

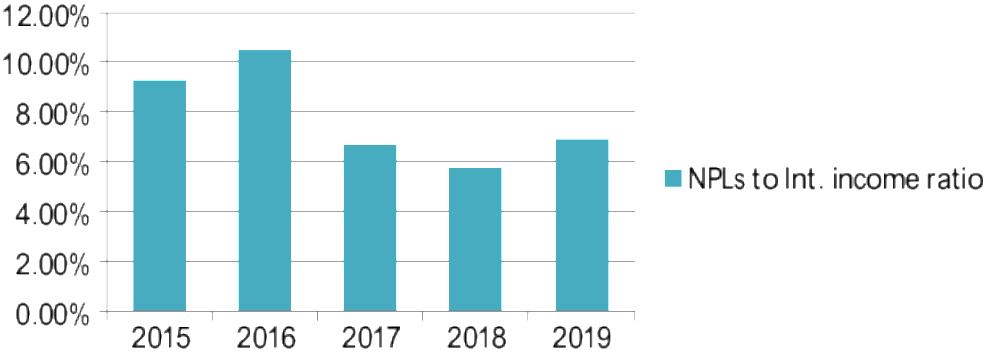
The table above illustrates, provisions were made for credit losses in the four year period of study, and were expressed as a percentage of the total loan portfolio. The percentages values for the period 2015 - 2019 were 2.29%, 2.31%, 1.59% 1.47% and 1.48% respectively. The percentage seen above shows that the ratio of NPLs to total portfolio increased from the percentage of 2.29% in 2015 to 2.31% in 2016 and declined to 1.59% and 1.47% in 2017 and 2018 respectively. In 2019 the percentage also increased to 1.48%. The figure in the five consecutive years indicates as the total portfolio increased by 107.9% from 2015-2019 the amount of nonperforming loans were significantly increased by 34.1%. The percentage increase in nonperforming loan represents there were ineffective credit management in the institutions and the percentage ratio decline in nonperforming loan represents a significant improvement in the quality of loan granted to borrowers. The percentage changes of nonperforming loans within five years shows the huge amount of loan-able funds has been used for provisioned expense. This indicates less attention was given by managements of the organization and loan officers to control the quality of loan portfolio rather than increasing the quantity of loan portfolio.

#### **4.10.1 Effect of nonperforming loans (bad debts) on the interest incomes.**

Interest income is the major financial sources of any financial institution to minimize liquidity problems. The finding of this study is more concerned to indicate the ratio of interest incomes eaten due to the occurrence of nonperforming loans or bad debts in the organization within five consecutive years in the table below.

**Table 21 Effects of nonperforming loans on the interest income.**

Description	Year					Total
	2015	2016	2017	2018	2019	
Interest income	29,977,044.6 2	37,600,798.6 4	43,800,603.4 3	50,683,57 8	54,553,950	216,615, 974.69
NPLs	2,804,966.58	3,952,269.60	2,922,868	2,982,454	3,762,179.1 0	16,424,7 37.28.
NPLs to Int. income ratio	9.3%	10.5%	6.7%	5.8%	6.9%	7.6%



**Figure 5 Nonperforming loan to interest income ratio**

**Source: Annual report and Financial Statements 2015-2019**

According to the findings in table 20 shows that the ratio of nonperforming loans to interest incomes were 9.3%, 10.5%, 6.7%, 5.8%, and 6.9% for 2015, 2016, 2017, 2018, and 2019. The interest incomes of the organization was continuously increased from 2015 - 2019. Besides this the amount of nonperforming loans were increased from 2015-2016 and declined in 2017. Nonperforming loans were again started to increase from 2018-2019 as the interest income generated from loan portfolio increases. From the total interest incomes of the organization was reduced by 7.6% for provision purpose. The table above indicates more credit recovery program were undertaken by the management of the organization and loan officers to control the quality of loan portfolio from 2017 - 2018 which shows declined 6.7% and 5.8% respectively. Nonperforming loans ratio to interest income in 2019 shows increased by 6.9%. The increased

percentage in provisions payment due to bad debts illustrates that; less attentions and inappropriate monitoring and follow up was the main issues for the rose of bad credit. Therefore the increased rates of nonperforming loans were negatively affecting the interest income of the organization as shown in the above table.

#### 4.10.2 Effect of Nonperforming loans (bad debts) on the Operating Profit of SFPI.

The study was conducted to found out the effects of NPLs on the operating profit of SFPI for the five years from 2015-2019 which is illustrated in table below.

**Table 22 Effects of NPLs on the operating profit.**

Item	Year					Total
	2015	2016	2017	2018	2019	
Operating profit	11,435,303	11,799,90	10,648,74	13,011,404	12,509,75	59,405,113
Provision amount for credit loss	1,053,226	548,841	745,125	621,266	1,296,742	4,265,200
Ratio of provision to operating profit	9.2%	4.6%	7%	4.8%	10.4%	7.2%

**Source: SFPI Annual reports and Income statement 2015-2019**

Table 21 illustrates the highest 10.4% of operating profit in 2019 is eaten by the provision for injured loans. 9.2% of provision amount made for credit losses in 2015 from the total operating profit and 7% of the provision amount is eroded from the total amount of operating profit. 4.6% and 4.8% operating profit was eaten as a result of provision losses in 2016 and 2018 respectively.

The huge provision amount for credit losses in 2019 were represents 10.4% of the operating profit and the least amount for credit losses was 4.6% in 2016. This figure indicates the huge portion of operating profits of SFPI was declined as a result of provision for bad debt, and it affects negatively the net operating profit. As the problems seen above there was a gap to control the health of loan portfolio quality before it beyond over the capacity of the institution.

#### 4.10.3 Effect of nonperforming loans (bad debts) on loanable funds.

The capacity of every microfinance institutions on credit is influenced by the amount of deposit mobilization, good recoveries and disbursements of loans. If the disbursed loans are not effectively collected with related interest income, it decline the available amount of funds for lending, sustainability or performance of the institution will be in question, demoralizes the capacity to create fresh loans.

**Table 23 Effect of NPLs on loanable funds**

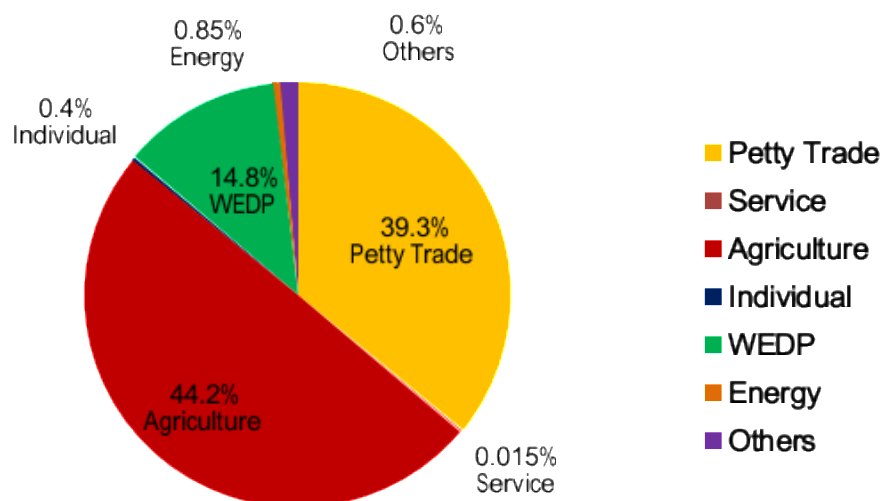
Year	NPLs	Loanable funds	Average interest income lost (21%)	Total lost
2015	2,804,966.58	-	-	-
2016	3,952,269.60	2,804,966.58	589,043.00	3,394,009.58
2017	2,922,868	3,952,269.60	829,976.60	4,782,246.20
2018	2,982,454	2,922,868	613,802.28	3,536,670.28
2019	3,762,179.10	2,982,454	626,315.34	3,608,769.34
2020		3,762,179.10	790,057.6	4,552,236.70
Total	16,424,737.28.	16,424,737.28.	3,449,194.82	19,873,932.10

**Source: SFPI Annual reports and Income statement 2015-2019**

The findings in table 22 indicates that the amount of 2,804,966.58, 3,952,269.60, 2,922,868, 2,982,454, and 3,762,179.10 would have been available for lending in 2015, 2016, 2017, 2018, 2019 and 2020 respectively. These amounts were not collected with related interest income and provision payments for credit losses declines loanable funds for consecutive five years. The study also shows that the total interest income of 3,449,194.82 which should have been earned on those funds for the period 2015-2020 had been used to create new loan at the rate of 21%. This obviously impacted negatively on the financial performance of the organization since the sum of the total lost interest income and the total lost loanable funds comes to 19,873,932.10 in the five-year period. It is important to state again that the incidence of NPLs during the period under discussions seriously impacted negatively on the liquidity of the organization which could result in borrowing from other financial institutions at high cost.

#### 4.16 Burden of NPLs by Sectors

Findings that indicated in the table below was from SFPI annual reports indicates agricultural loan has the lion's share of credit service which has been followed by petty trade sectors, WEDP loan sectors, others activities, Micro energy sectors, Individual loan sectors and service sectors



**Figure 6 Burdens of NPLs by Sectors**

Source: SFPI Annual Reports (2019)

In figure 6 Agricultural loan sector has the first share of NPLs from the others sectors which was represents 44.2%, petty trade is the second share of having 39.3%, Women Enterprise development program has a share of 14.8%, and energy ,others, individual and service has a share of 0.85%, 0.6%, 0.4% and 0.015% respectively. The study indicates that agricultural loan, petty trade loan and WEDP loan sectors has huge amount of nonperforming loans that shows 98.3% from the overall sectors. This analysis shows that the significant increasing of NPLs in three sectors has negative effects on the portfolio quality of the institution. Therefore agricultural loan recovery is very difficult once it is beyond the capacity of the institution. This indicates less attention was given by loan officers who have directly responsible to manage the health of loan portfolio. Hence, the burdens of nonperforming loans in three sectors should be needs diversification strategies and mechanisms to control the quality of loan portfolio.

## **CHAPTER FIVE**

### **5.0 SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

The aim of this finding was to identify the major causes of nonperforming loans on the operations of Specialized Financial and Promotional Institution. In the summary of this research, primary and secondary data were used for the overall findings and summarized under this chapter. In advance to this a conclusion of findings and recommendations of the study were given based on the objectives of the study. Finally proper recommendations were given to MFIs how to reduce the occurrence of NPLs and its effect on the operational activities.

#### **5.2 Summary of Findings and Interpretations**

Many factors were assigned to the causes of nonperforming loans in the microfinance

institutions as studied by different researchers. Accordingly, the study found out that the interest charged on loan by SFPI is fair. SFPI has employed Portfolio at Risk (PAR) techniques to monitor the overall contaminated loan portfolio and ageing analysis techniques to monitor the monthly injured loan portfolio. Additionally, the types of security/collateral mostly offered by borrowers to secure loans from specialized financial and promotional institution were group and property guarantees such as car and building.

The study established that the most common factors accounting for ineffective credit appraisal was ineffective client screening and selection, Customer's collateral before extending a loan, mechanism to check applicant's borrowing history with other financial, Client's characters before extending a loan, customers capacity to pay back in order to qualify for the loan, Lack of cohesiveness of the group, adequate training before credit appraisal and absence of credit reference bureau to check whether client's borrowing from other MFI's.

The study established that the most common factors accounting for poor credit approval was overlapping of loan repayments, ineffective credit appraisal by loan officers, ineffective understanding of customers business activities, customer's inability to meet credit approval requirement, liquidity problems and inflexible credit approval procedures.

The study found out that the most causes for wrong timing of credit delivery were; insufficient loan-able funds, Unscheduled credit delivery program, Ineffective understanding of customer's business activities and ineffective credit approval procedures.

The study established that the most common factors accounting for inadequate monitoring and follow up were; lack of logistic facilities, lack of convincing strategies to recover problem loan, staffing Problem, availability of road networks, lack of legal actions to recover problem loans and write off actions for the quality of loan portfolio.

The study established that the most common factors accounting for credit diversion were; capacity building on business activities before granting loans to customers, the organization considers proper monitoring after loan to insure whether the credit is used for the intended purposes and the organization considers ignorance of lending terms and conditions.

The study found out that the most causes for wrong timing of credit delivery were; management concerns about MIS, insufficient funds to purchase the system and Absence of proper human resources to retrieve data.

The increasing rates of nonperforming loans was highly influencing the interest income collected

from loans within the consecutive five years as illustrated in table 21. The operating profit of Specialized Financial and Promotional Institution was eaten due to provision payment for nonperforming loans (bad debts) in five years period. The figures amount illustrated in table 23 indicates that; the principal and interest income which has not been collected in the five years period was negatively influencing the liquidity performance of the organization.

The sectors analysis of NPLs indicate that agriculture, petty trade and WEDP loan sectors has significant share of 44.2%, 39.30% and 14.8% respectively. This was followed by others sectors, energy, individual and service sectors having NPLs share of 0.85%, 0.6%, 0.4% and 0.015% and this shows the huge amount of nonperforming loans were concentrated only in three sectors.

### **5.3 Conclusion**

The main purpose of this study was to found out the major causes of nonperforming loans on the operations of MFIs particular focusing on Specialized and Financial Institution (SFPI).

The study addressed the following questions; what are the causes of nonperforming loans in Specialized Financial and Promotional Institution (SFPI)? What is the trend of NPLs in the last five years? What effect does the occurrence of NPLs (bad debts) have on interest income, operating profit, and loan able funds? And which sector has the highest burden of Non-Performing Loans? Accordingly, the research study concluded that; Nonperforming loans in Specialized and Financial Institution (SFPI) mostly caused by inadequate monitoring and follow up followed by wrong timing of credit delivery, Management information system, poor credit approval and Credit diversion.

At 5% level of significance and 95% level of confidence, inadequate monitoring and follow up, wrong timing of credit delivery, inefficient management information system, ineffective credit approval, and ineffective credit appraisal variables were found to be significant in influencing nonperforming loans of SFPI.

The study also concluded that lack of convincing strategies, legal actions attorney staff and lack of logistics facilities were mostly the causes of inadequate monitoring and follow up. This indicates a loan officer was not supervising weather the granted loan used for the intended purposes. Adequate monitoring and follow up on loan utilization is more acceptable to check the clients pay back capacity and properly use of their loans or not.

The study established that insufficient loan-able funds, unscheduled credit delivery program,

ineffective understanding of customer's business activities and ineffective credit approval procedures were the factors for the occurrences of wrong timing of credit delivery. This indicates borrowers were secured their loan after the business opportunities is lost. These kinds of lending terms will also encourage the borrowers to use loans for the other purposes rather than the intended purposes.

The study established that ineffective of management concerns, insufficient funds to purchase the system and absence of proper human resources to retrieve data was the most factors hinder to employ management information in specialized financial and promotional institution (SFPI). The institution was using Peachtree soft ware system to retrieve the overall financial data. This kind of management information system has not attractive to simply retrieve the daily past due and nonperforming loans amount to take portfolio management actions.

The study concluded that actions to control credit diversion and approval such as enough capacity building on customers business activities, understanding customers business plan to mitigate under financing and over financing, proper credit appraisal by loan officers, encouraging customers to meet credit appraisal requirement, managing liquidity problems.

Further study established that NPLs or bad debts have significantly influencing the interest income, operating profit and loan-able funds of SFPI.

The study concluded on the sectors analysis of nonperforming loans indicates agriculture sectors has the lion's share of NPLs, petty trade loan sector has the 2<sup>nd</sup> share of NPLs, WEDP loan sector has the 3<sup>rd</sup> share of NPLs and this was followed by others loan sector, energy loan, Individual loan sectors.

#### **5.4 Recommendations**

The findings of the research study show nonperforming loans were significantly affecting the operational and financial performance of in terms of reduction in interest incomes, operating profit and available funds. Therefore it is important that to overcome the issues of NPLs; different recommended strategies and measurements are discussed below to control the health of loan portfolio.

- Inadequate monitoring and follow up is the causes for the occurrence of nonperforming

loans. Therefore considering adequate monitoring and follow up is better to control the quality of loan portfolio by advising the borrowers how to use and repay loan in their schedules. Additionally it helps to know borrowers capacity to pay back and credit worthiness of the borrowers. In order to effectively supervise the health of loan portfolio, the arrangement of logistic facilities and different supportive activities for loan officers is more acceptable.

- Under taking an effective credit management is better to control under and over financing and encourages clients to use the granted loans for intended purposes.
- Management information system implementation is more acceptable for microfinance institutions to simply retrieve the contaminated loans from the overall loan portfolio.
- Wrong timing of credit delivery is the causes for the occurrence of nonperforming loans. The borrowers were secured their loans after the business opportunities are lost, and it also leads to credit diversion problems. So to mitigate wrong timing of credit delivery, it is recommended to make continuous supervision of branches to ensure weather the credit delivery is conducted effectively or not.
- Sometimes, borrowers were secure credit without pre loan training, understanding customer's capacity to pay back, effective screening and selection are conducted by loan officers. So these kinds of ineffective credit approval and appraisal will open the door for the incidence of nonperforming loans. To minimize these problems, it is better to think about the mechanisms to check the overall background of the borrowers to conduct the effective credit appraisal and credit approval procedures.
- It is highly recommended that relevant training programs are organized for loan officers particularly in the area of risk management and mechanisms to control the health of loan portfolio. This helps to improve the knowledge and analytical skills of the credit officers. The training program will assist the loan/credit officers to appreciate the importance of prompt credit delivery in loan default prevention. These types of measurement actions are help to think further direction how to manage the quality of loan portfolio.
- The analysis conducted on the burdens of nonperforming loans by sectors were indicates agricultural and petty trade loan sectors has high burdens of NPLs in SFPI. To minimize the burdens of NPLs on agriculture and Petty trade sectors, it is better to employ diversification strategies and mechanisms to control the quality of loan portfolio.

### **5.5 Directions for further research**

This study examined causes and impacts of nonperforming loans on the operations of MFIs specifically focusing on Specialized and Financial Institution using selected variables. However, there are so many variables that were not included in this study. Thus, future researchers provide supplementary results for this study by including other variables like Poor credit culture, branch expansion (outreach), loan size, weather conditions, business failures and unexpected events/natural occurrences.

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## **APPENDIX I: QUESTIONNAIRES**

### **QUESTIONNAIRES FOR SAVING AND CREDIT STAFF, AND BRANCH MANAGERS**

Dear Respondents;

The following questionnaires are meant for data collection for academic study. Your response to these questions will be treated with utmost confidentiality. Your honesty and objective answers to the following questions will be highly appreciated and acknowledged.

- Do not need to write your name

- Mark  and circle for close end questions and
- Do not select more than one answer(s) in one row for scale questions.

**Section 1: Socioeconomic Characteristics**

1. Gender    Male     Female
2. Age    18-25     26-33     34 and above
3. Indicate the highest educational level attained
  - (a) Primary school
  - (b) Secondary school
  - (c) Diploma
  - (d) Degree
  - (e) Masters

**Section 2: Causes of NPLs in Specialized Financial and Promotional Institution.**

**2.1: To investigate the appropriateness of credit appraisal process of SFPI.**

4. Does SFPI have a credit policy for loan applicants?
  - (a) Yes    (b) No
5. Do you have any formal training in credit appraisal?
  - (a) Yes    (b) No
6. How do you describe the interest rate charged by SFPI?
  - (a) Strongly agree    (b) Agree    (c) Neutral    (d) Disagree    (e) Strongly disagree

7. Please indicate your level of agreement with the following statements concerning with the causes of loan appraisal?

Causes	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The organization considers effective client screening and selection					
The organization considers Customer's collateral before extending a loan.					
Considering mechanism to check					

applicant's borrowing history with other financial institutions.					
The organization considers Client's characters before extending a loan.					
The organization assesses customers capacity to pay back in order to qualify for the loan					
Lack of cohesiveness of the group					
Lack of adequate training before credit appraisal					
Absence of credit reference bureau to check whether client's borrowing from other MFI's					

8. In your opinion, which types of security / collateral offered by borrowers is better to secure loans from SFPI?

- (a) Landed property certificate
- (b) Cash (fixed deposit, S/A)
- (c) Property guarantee (building or Car)
- (d) group guarantee

**2.2: To investigate the appropriateness of credit approval process of SFPI.**

9. Do you sometimes delay in approving loans?

- (a) Yes
- (b) No

10. In your opinion, which of the following factors hinder the credit approval process of SFPI?

<b>Factors</b>	<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>
Inflexible credit approval procedures.					
Ineffective credit appraisal by loan officers					

Ineffective understanding of customers business activities					
Customer's inability to meet credit approval requirement.					
The organization considering overlapping of loan repayments					
liquidity problems					

**2.3: To investigate the factors influencing timely credit delivery of SFPI.**

11. In your opinion, which of the following factors influencing effective credit delivery?

<b>Factors</b>	<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>
Ineffective understanding of customer's business activities.					
Liquidity problems.					
The organization considers effective credit approval procedures.					
Unscheduled credit delivery Program					

**2.4: To investigate effective credit monitoring and follow up the health of loan portfolio.**

12. In your opinion, what factors hinder effective monitoring and follow up the health of loan portfolio?

<b>Factors</b>	<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Agree</b>

	e				
Staffing problem.					
Availabilities of road network.					
Logistic facilities.					
Write off actions for the quality of loan portfolio.					
Legal actions to recover problem loans.					
Convincing strategies to recover problem loan.					

13. In your opinion, what techniques employed to monitor the health of loan portfolio?

- (a) Aging analysis
- (b) Portfolio at risk (PAR)

**2.5: To Identify the causes for loan diversion.**

14. Do loan officers make follow up to ensure that loan facilities are used or not used for the purposes for which they were granted.

- (a) Strongly agree
- (b) Agree
- (c) Neutral
- (d) Disagree
- (e) Strongly disagree

15. Please indicate your level of agreement with the following statements concerning with the factors account for credit diversion.

	<b>Strongly Disagre e</b>	<b>Disagre e</b>	<b>Neutral</b>	<b>Agre e</b>	<b>Strongly Agree</b>
The organization considers ignorance of lending terms and conditions					
The organization considers under and over financing.					
The organization considers enough capacity building on business activities before granting loans to customers.					
The organization considers proper monitoring after loan to insure whether the credit is used for the intended purposes.					

16. In your opinion, is inadequate management information the causes for the increase NPLs in SFPI?

<b>Causes of MIS</b>	<b>Strongly Disagre</b>	<b>Neutral</b>	<b>Agre</b>	<b>Strongly</b>

	Disagree			Agree
Management concerns about MIS				
Insufficient funds to purchase the system				
Absence of proper human resources to retrieve data				

**2.6 To identify the causes for the occurrence of nonperforming loans.**

17. Please indicate your level of agreement with the following statements concerning with the causes for the Occurrence of nonperforming loans.

Causes	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
The organization considers the wrong timing of credit delivery					
The organization considers ineffective credit appraisal procedures					
The organization considers ineffective client screening and selection					
Recovery of loans is influenced by business failure					
Recovery of loans is influenced by high interest rate charged on loans					
Recovery of loans is influenced by delay approval of loans					

**THANK YOU FOR YOUR COOPERSTION!**

## APPENDIX II: List of Microfinance Institution in Ethiopia

1	Amhara credit and Saving Institution S.C	20	Harbu Microfinance S.C
2	Addis Credit and Saving Institution S.C	21	Kendil Microfinance S.C
3	Adeday Microfinance Institution S.C	22	Lefayeda Credit and Saving S.C
4	Afar Microfinance Institution S.C	23	Letta Microfinance S.C
5	Aggar Microfinance Institution S.C	24	Lideta Microfinance S.C
6	Africa Village Financial Service S.C	25	Meklit Microfinance S.C
7	Awachi Microfinance S.c	26	Metemamen Microfinance S.C
8	Benishangul Gumuz Microfinance S.C	27	Nisir Microfinance S.C
9	Bussa Gonofa Microfinance S.C	28	Oromia Credit and Saving S.C
10	Microfinance Institution S.C	29	Omo Microfinance S.C
11	Dedebit Credit and Saving Institution S.C	30	Rays Microfinance S.C
12	Dere Dawa Microfinance S.C	31	PEACE Microfinance Institution S.C
13	Digaf Microfinance S.C	32	SFPI Microfinance S.C
14	Dynamic Microfinance Institution S.C	33	Sidama Microfinance S.C
15	Eshet Microfinance S.C	34	Somali Microfinance Institution S.c
16	Gambela Microfinance S.C	35	Tesfa Microfinance
17	Gasha Microfinance S.C	36	Wasasa Microfinance S.C
18	Ghion Microfinance S.C	37	Vision Fund Microfinance S.C
19	Harar Microfinance S.C		

**Source: Association of Ethiopian Microfinance Institution - 2019**