ST.MARY'S UNIVERSITY

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Assessment of Credit Management practices in micro finance institutions a case study of Addis Credit and Saving S.C.

By: Zewude Samuel

July, 2016

Addis Ababa

Assessment of Credit Management Practices in Micro Finance institutions a case study of Addis credit and saving Institution (ADCSI).

Submitted By: Zewude Samuel

A Thesis Submitted to St, Mary's University School of Graduates Studies to Partial Fulfillment of the Requirements for degree of MBA in accounting and finance

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Approved By Board of Examiners

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External Examiner	Signature
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Internal Examiner	Signature
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ACRONYMS USED

- **ADCSI - ADISS CREDIT & SAVING INSTITUTION S.C**
- **AEMFI -ASSOCIATION OF ETHIOPIAN MICRO FINANCE INSTITUTION**
- **CR - CREDIT REPORT**
- **DBE - DEVELOPMENT BANK OF ETHIOPIA**
- **GB - GRAMEEN BANK**
- **NBE - NATIONAL BANK OF ETHIOPIA**
- **MFIs - MICRO FINANCE INSTITUTIONS**

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ABSTRACT

This study was aimed at assessing the effectiveness of credit management systems on loan performance of microfinance institutions a Case Study of Addis credit and saving S.C. and is an attempt to indicate the importance of credit management in financial institutions such as micro finances and others. Thus, the rationale behind for undertaking this study is to deeply investigate the causes of credit management practical problems and to suggest the possible solutions that enable the micro finances to run its operation in a safe way as credit is known to be the main stay of all micro finances. The main objective of the study is to evaluate the performance of credit management practical problem of Addis credit and saving S.C. For the purpose of the study both primary and secondary data are used. Primary data is collected using structured questionnaires. The secondary data is collected from annual reports, directives, and bulletins of the micro finance. Descriptive statistical tools are used in analyzing the data collected. Hence, the nature of the Study is descriptive. Finally, based on the findings possible recommendations are given. These include the issues of rising loan clients complaint on the micro finance regarding the valuing of properties offered for collateral, lengthy of loan processing, amount of loan processed and approved, Frequent follow-up and supervision, loan period, giving them a discount, Increasing the penalty rate and discretionary limits affecting the performance of credit management.

Key Words: *Credit management system, Loan Performance, and Collection Policy.*

CHAPTER ONE

INTRODUCTION

1.1. BACKGROUND OF THE STUDY

The concept of credit can be traced back in history and it was not appreciated until and after the Second World War when it was largely appreciated in Europe and later to Africa (Kiiru, 2004). Banks in USA gave credit to customers with high interest rates which sometimes discouraged borrowers hence the concept of credit didn't become popular until the economic boom in USA in 1885 when the banks had excess liquidity and wanted to lend the excess cash (Ditcher, 2003). In Africa the concept of credit was largely appreciated in the 50's when most banks started opening the credit sections and departments to give loans to white settlers. In Kenya credit was initially given to the rich people and big companies and was not popular to the poor. In 1990s loans given to customers did not perform which called for an intervention. Most suggestions were for the evaluation of customer's ability to repay the loan, but this didn't work as loan defaults continued (Modurch, 1999). The concept of credit management became widely appreciated by Microfinance Institutions (MFI's) in the late 90s, but again this did not stop loan defaults to this date (Modurch, 1999).

A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It may be difficult to establish an optimal credit policy as the best combination of the variables of credit policy is quite difficult to obtain. A firm will change one or two variables at a time and observe the effect. It should be noted that the firm's credit policy is greatly influenced by economic conditions (Pandey, 2008). As economic conditions change, the credit policy of the firm may also change.

Microfinance Institutions and other finance institutions must develop a credit policy to govern their credit management operations (Pandey, 2008) and since microfinance institutions generate their revenue from credit extended to low income individuals in the form of interest charged on the funds granted (Central Bank Annual Report, 2010) the loan repayments may be uncertain. The success of lending out credit depends on the methodology applied to evaluate and to award the credit (Ditcher, 2003) and therefore the credit decision should be based on a thorough evaluation of the risk conditions of the lending and the characteristics of the borrower. Numerous approaches have been developed in client appraisal process by financial institutions. They range from relatively simple methods, such as the use of subjective or informal approaches, to fairly complex ones, such as the use of computerized simulation models (Horne, 2007). Many lending decisions by Microfinance institutions are frequently based on their subjective feelings about the risk in relation to expected repayment by the borrower. Microfinance institutions commonly use this approach because it is both simple and inexpensive.

According to proclamation (No. 40/1996) of the Federal Government of Ethiopia, Micro Finance business means an activity of extending credit, in cash or in kind, to peasant, farmers or urban small entrepreneurs, of loan size of what shall be fixed by the National Bank. Micro Finance institution was first started in 1980's by professor Mohammed Yenus in Bangladesh. He led the way with pilot group lending scheme for the landless people. Finally this becomes a Grameen Bank which is now used as a model for many countries in the world.

When we back to our Mother Land Ethiopia Government appreciate and support micro finance Institutions at their start-up stage. The country's five years action plan starting from the year 1992 E.C has included Micro Finance services as one component part of agricultural extension package, to facilitate poverty alleviation and rural development in the country. As a result government issued a proclamation (No. 40/1996) and a number of directives for licensing and supervising these institutions.

According to Professor Mohammed Yenus in 1983, the major cause of low economic growth and poverty is:

- Lack of income, High volume of unemployment, Lack of skill & education, and Lack of health and Lack of infrastructure etc…

Currently there are many licensed Micro finance institutions in Ethiopia working in both rural and urban areas. So my research focuses on Addis credit and saving institution which is established in January 2000 G.C. Addis credit and saving institution gives credit and saving services for all types of businesses, individuals and social welfares like "edir". It creates job opportunity for thousands of unemployed persons and contributes its part in reduction of unemployment rate and poverty. The researcher wants to choose Addis Micro finance institution because it is the elder one.

Ledger Wood J, (1999). which is a micro-finance hand book, cited that, credit is borrowed funds with specified terms for repayment .When there is no sufficient accumulated savings to finance a business and when the return on borrowed funds exceeds the interest rate charges on the loan, that makes sense to borrow rather than not doing the business activity until sufficient savings can be accumulated, assuming the capacity to service the debt exists.

As Ledger wood, explains that loans are generally made for productive purposes that is, to generate revenue within a business. Some micro-finance institutions give loans for consumption housing or special occasions. So in order to use the credit properly there should be appropriate credit management, control system & continuous follow up procedure. According to Ledger wood methods of credit delivery in the micro–enterprise lending program generally can be divided into two broad categories. These are individual & group based lending approaches based on the program delivers & guarantees its loans. Among the above two credit delivery methods group based lending is assumed to be a better credit management system for micro-enterprises lending program.

1.2. STATEMENT OF THE PROBLEM

From the trend of developed countries in addition to banking services micro- finance institutions play a great role to fight poverty as a means of building financial system that serves the society especially the poor. Relying on the above facts, micro finance institutions have many merits even if their development is restricted due to various problems. That means social political, economical, level of education and etc. (Shekhar, 1985). Generally, MFI in Ethiopia is giving available credit service targeting to ensure sustainable life and development to the rural and some urban areas. By searching the general performance of Addis credit & saving institution I try to indicate the practices of credit management in Addis credit & saving institution. Credit management is one of the major functions which financial institutions undertake for proper mobilization of funds. (Shekhar, 1985). Some of the hindrance factors to accomplish their goals.

- Therefore:-

1.3. Basic Research Question

- ❖ Is the credit given to customers collected within the specified time period?
- ❖ Are the credit provision criteria & standards effective?
- ❖ Do interest on loan & terms of payment are reasonable to customers?
- ❖ Is the group lending methodology effective for the repayments of loan?

1.4. OBJECTIVES OF THE STUDY

Microfinance institution can contribute to the enhancement of standard of living and economic development as a whole. To improving the living standard of rural, urban and poor people by using the instrument called microfinance institution. The objectives of the study are divided into two which is general & specific objectives.

1.4.1. General Objectives

- ✓ The major objective of the study is assessing practices of credit management of Addis credit & saving institution represent and sample other credit & saving institutions.

1.4.2. Specific objective

1. To assess the quality of services given by Addis credit and saving institution to its customer.
2. To assess how provision of loan, collection and procedure is managed in Addis credit & saving institution.
3. To assess the cause and effects of credit management Practical problems in Micro finance institutions case of Addis credit & saving institution on interest rate, group lending methodology, credit collection.

1.5. SIGNIFICANCE OF THE STUDY

The result of this study is expected to have a great importance to evaluate Micro finance institutions in providing efficient and effective services for those who are in trouble of working capital and also expected to have the following importance.

It will give constructive suggestions based on the findings in order to deliver best quality Micro finance service to Addis credit & saving institution and stake holders.

The findings of this paper also will serve as a base for other researches by providing the findings who want.

It enables current & potential credit manager's to evaluate credit Management.

It enhances the knowledge of the readers on Credit managing.

It would enable managers to be aware of what is expected of them in managing credit.

It would enable current & potential customers, employees, & others to have understanding about the organizational credit status. Finally it gives a way to design a new credit management system or practices.

1.6. Scope of the study

The findings of the researcher would be more fruitful if it were conducted by including the other similar firms. But due to time, and many constraints it would be too tedious and out of the reach of me to include other firms. Thus the study is delimited to Addis Micro finance S.C.

1.7. Limitations of the study

In addition to the scope of the study the expected limitations would be the following.

During interview the higher officials' willingness is not well to allow me some important information that strongly supports the study, Lack of co-operation to the literature, Due to

Financial and time Limitation, There is some carelessness of responses by both customer and employees and other limitations would be indicated while conducting the actual research paper.

1.8. ORGANIZATION OF THE STUDY

In the remaining part of the paper the following information’s are included. The Second chapter explains about the review of the related literatures, the third chapter shows Research design and methodology, the forth chapter shows the analysis of the data's collected, and finally the last chapter brings the study to an end with Findings, Conclusion and Recommendation.

CHAPTER TWO

LITERATURE REVIEW

2.1. Theoretical Literature review

Micro finance has evolved as an economic development approach intended to benefit low-income women and men. The term refers to the provision of financial services generally include savings and credit; however, some micro finance organizations also provide insurance and payment services. In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group. Thus the definition of Micro finance often includes both financial inter mediation and social inter mediation. Micro finance is not simply banking it is a development tool.

Micro finance activities usually involve some loans, typically for working capital, collateral substitutes, such as group guarantees of compulsory-savings, access to repeat and larger loans based on repayment performance, streamlined loan disbursement and monitoring secure saving products. As Ledger wood stated it, Micro-finance institutions (MFls) can be non governmental organizations (NGOs) savings and loan cooperatives, credit unions, governmental banks, or non bank financial institutions. Micro-finance clients are typically self-employed, low income entrepreneurs in both urban and rural areas, Clients are often traders, street vendors, small farmers, service providers (hairdressers), artisans and small producers. Usually their activities provide a stable source of income (often from more than one activity). Although they are poor, they are generally not considered to be the “poorest of the poor”.

2. 2. THE EMERGENCE OF MICRO FINANCE

In many of the developing countries lack of capital for credit availability has been a great constraint to development. In order to avoid poverty and to expand economic activities it is very essential to have available credit services for the poor society. Even if the poor gets credit services from traditional lenders, the high payment of interest has hindered the activities of the poor on which they get income. Those who took credit even if they have worked hard they were unable to invest due to payment of high interest to the traditional lenders.

Therefore, in order to enable them to work on small trading activities or other works, to produce products for markets and to give many maintenance services they involved in the field of Micro enterprises by the help of small micro finances. These small micro finances given credit to support the rural and urban poor. For this a very good example of micro finance project is the GB project in. Bangladesh introduced by professor Mohammed Yenus in 1983. It has been a successful project and has been raised whenever the problem of the informal sector is mentioned. In addition, small micro finance project set up in Uganda in 1984 and BKKB in Indonesia was started. Their objective was to provide credit facilities to the poor section of the society especially for women.

According to micro finance development review, vol. 1, No. 2, 2000, the operation of micro finance activities in Ethiopia was came in to existence in earlier times by NGOs, and they were delivering relief and development services such as emergency food, water, health and education facilities, etc. Later on, its operation is carried on by government and non-government institution and extending their services by providing micro credit to the informal sector (small and micro-enterprise) activities for the rural and urban poor in order to improve their lives and to create employment opportunities.

2. 3. OBJECTIVES OF MICRO FINANCE INSTITUTION

The micro-finance lending program has many objectives. Among these, some of the objectives are as follows: - to provide credit facilities for those Urban and Rural Poor's who are in lack of capital to engage in productive economic activity, protecting urban and rural poor from paying high interest rates to the informal money lender, improve the economic capacity of women and the saving habit of the people, utilize and use the local material effectively and efficiently and enhance investment and income of the society.

2. 4. MICRO FINANCE SERVICE BEING PROVIDED

Micro Financial Services generally include savings and credit; however some micro finance organizations provide insurance and payment services. In addition to financial intermediation many MFls provide social intermediation services such as group formation, development of group confidence, and training in financial literacy and management capabilities among members of a group. So we can say microfinance is not simply banking; it is also a development tool. Some types of services provided by MFls such as:- small loan, typically for working capital, informal appraisal borrowers and investment, collateral substitutes; such as group guarantee or compulsory savings, financial administration of third party, stream lined loan disbursement an monitoring and secure savings products.

2.5. ROLE & CONTRIBUTIONS OF MICRO-ENTERPRISES

An important role of micro-enterprise activities of ordinary people primarily concerned wit satisfying the basic consumer needs. They also meet general market demands for cheap products and services. Informal sector (micro-enterprise activities are at least in the sense that they generate income for a large number of people. Micro-enterprises are also the most adopted in exploiting local materials. A great portion of informal sector employment is in the form of self employed proprietorship. These people are quick at grasping new opportunities and are free to be extremely flexible. Those who are not able to self employed and lack skills or back ground of formal training, need only to be ready for manual labor and gradually acquire skills-on-the-job-training. The other contribution of micro-enterprises that are well suited to high labor absorptive capacity and easy entry, non requirement of sophisticated skills, the labor intensive nature of technologies that are usually involved in this sector's economic activities .

2.6. CREDIT & ITS ROLE IN FINANCING MICRO-ENTERPRISES

2.6.1. DEFINITION OF CREDIT

The root meaning of credit is assumed to be the Latine word " credo " which means " I believe " or " I put my faith in" . Hence the practical understanding of credit seems to be derived from people's act of putting faith in person willingly to entrust their money to him / her.

In business the word credit means the act of making loan either by ways of direct lending or by post payment for transactions carried at present with transfer of goods / money.

More formally credit is defined as an immediate acquisition of fund or something in return for premise to make an appropriate payment in the future. These days credit becomes “the business of financial institutions & the primary basis on which lenders quality & performance judged.” Credit enables people to obtain goods or services even if they do not have enough money to pay for them right away.

Credit, transaction between two parties in which one (the creditor or lender) supplies money, goods, services, or securities in return for a promised future payment by the other (the debtor or borrower, such transaction normally include the payment of interest to the lender. Credit may be extended by public or private institution to finance business activities, agricultural operations consumer expenditures, or government projects.

Credit is borrowed funds with specified terms for repayment. (*Ledger wood*, 1999). As ledger wood further stated it when there are insufficient accumulated savings to finance a business and when the return on borrowed funds exceeds to interest rate charged on the loan, it makes sense to borrow rather than post pone the business activity until sufficient savings can be accumulated, assuming the capacity to service the debit exists.

Credit, in reality plays a more powerful economic, social and political role than the economists have admitted. Credit is a powerful weapon. Any body possessing this weapon is certainly better equipped to maneuver the forces around him to his best advantage. With appropriate credit institutions and credit policies one can lead a society towards a desired shape. Credit creates entitlement to resources. The more credit one can receive the more resources he can command, the more powerful he is. In a given society if one can find out who is enjoying how much credit facility today, it would be easy to predict the socio-economic configuration for tomorrow. (Mohammed Yunus, 1987). A credit expansion, to be successful, must be moderate and must generate productions, and savings, via investments. (Ostlend, 1969)

In urban areas micro-enterprise need working capital to start production. The main problem in micro-enterprises is shortage of capital and promotional services (Hailu Wondafrash, 1994). To achieve this it may be necessary to try a different type of financial and promotional institution to be established to address the need of the poor informal operator.

According to Hailu Wondafrash (1994), the provision of credit for informal sector (micro-enterprises) promotes the socio-economic development of Ethiopia and its special importance in relation to the issue of employment creation and poverty alleviation. Credit stimulates mass employment at the grass root level. And the financial and promotional institution to micro-enterprises contributes:- create opportunities for self-employment for the vast unutilized manpower resources; bring people together in a sort of group to work together, eliminate or reduce exploitation by informal moneylenders and improve the productive base of the economy and raise employment opportunities and income at the grass root level.

It has been also explained the role of credit in financing micro-enterprises by Gebrehiowot Ageba (2000), “the lack of capital is a major constraint on activities in the informal sector. The provision of credit would therefore, permit these enterprises to expand, produce more projects and hence generate more income and employment.”

2.7. MICRO-FINANCE IN ETHIOPIA

Banking service started in Ethiopia since 1905 and a lot of development has taken place in the sector since then. However, none of these financial institutions has provided services to majority of the Ethiopian poor. The main reasons for such inaccessibility to these formal banks are: - the terms and conditions of the banks particularly the issues of collateral and equity contribution are way beyond the reach of the poor and small loans are often characterized by high transaction costs making difficult to the banks to make profits.

Despite the above situation, lots of efforts are underway to serve the financial needs of the poor through the government and non-government organizations. It is even interesting to see number of cases where micro financing activity becoming a strategic component in the overall poverty alleviation programs of many government offices, national and international NGOs.

According to micro finances development review, vol. No. 2, 2000, the operation of micro finance activities in Ethiopia was came into existence in earlier times by NGOs, and they were delivering relief and development services such as emergency food, water, health and education facilities, etc. Latter on, its operation is carried on by government and non-government institutions and extending their services by providing micro credit to the informal sector (small and micro enterprise) activities for the rural and urban poor in order to improve their lives and to create employment opportunities.

2.7.1. THE POLICY AND REGULATORY PRACTICES OF MICRO-FINANCE IN ETHIOPIA

The steadily growing demand of the poor for credit services has resulted in the emergence of number of micro-finance organizations in the country. The government has recognized the situation ad issued a micro-financing policy that went into effect on July 5, 1995 under proclamation No. 40/1996. The policy, which is known as the Licensing and supervision of micro-financing institutions, establishes a close partnership between micro-finance institutions and the National Bank of Ethiopia (NBE). It states the purpose and objectives of such institutions should be in delivering credit and saving services to rural and urban poor.

2.7.2. CHARACTERISTICS OF MICRO-ENTERPRISES

It has been suggested by Gebrehowt Ageba (2002) "The micro enterprise is characterized by small scale production and service activities that are individually or family owned and use labor intensive and simple technology. They usually self employed workers, have little formal education (generally unskilled,) and lack access to financial capital." Most members of micro-finance are lack of minimal public services such as electricity, water, transportation, educational and health services. Micro enterprises require not a large sum of start up capital and usually involve the marketing of home made food stuffs and handicrafts.

According to Rainbow Development Consult and Training services (2000), micro-enterprises have the following characteristics: - the working capital is individual or house hold; knowledge and skill are required through enterprises, mainly use local inputs and local market for their product and have very low educational background.

2.7.3. TERMS AND CONDITIONS FOR MICRO-ENTERPRISE LOAN

So far concerning the terms and conditions for micro-enterprise loan, there is no available material and information on it. According to DBE report (June, 1997), there are some major and common terms and conditions entered into micro-enterprises loan agreement. These are presented below: - the loan shall be extended to very poor household for income generation activities, at least 50 percent of the loan should be extended for women entrepreneurs, since the beneficiaries are very poor they are not required to pledge collateral. In stead, in case of default, the group will be responsible to settle the debt, the maximum credit limit is birr 5000 per head. The payment period could be from one to three years, the loan will be repaid within a week for one year loan term and within a month for the three year loan term, the interest rate has been waived and MFls are now free to set their own interest rates ceiling and the loan is tied with a compulsory saving scheme that is 10 percent of the total amount of the loan should be deducted and saved in the bank account.

2.8. CREDIT MANAGEMENT AND CONTROL SYSTEM

Ledger Wood j, (1999), cited that, credit is borrowed funds with specified terms for repayment. When there is no sufficient accumulated savings to finance a business and when the return on borrowed funds exceeds the interest rate charges on the loan, it makes sense to borrow rather than not doing the business activity until sufficient savings can be accumulated; assuming the capacity to service the debt exists. Action Aid (1992), also explains that credit is provided for an activity which involves and needs proper selection of activity, source of funding, detailed planning, implementation of saving components and evaluation.

As Ledger Wood (1999), explains that loans are generally made for productive purposes that is, to generate revenue within a business. Some micro finance also make loans for consumption housing or special occasions. So, in order to use the credit properly there should be appropriate credit management, control system and continuous follow up procedure. According to him methods of credit delivery in the micro-enterprise lending program generally can be divided into two broad categories. These are individual and group based lending approaches based on the program delivers and guarantees its loans. Among the above two credit delivery methods group based lending is assumed to be a better credit management system for micro-enterprises lending program (ledger Wood, 1999).

2.8.1. GROUP BASED LENDING

The well-known microfinance schemes in Bangladesh, such as those of BRAC and the Grameen Bank, tend to work through groups. Indeed, such schemes are often, referred to as group-based finance or 'Solidarity-group lending schemes'. Because group members are jointly liable for each individual's loans, this represents a form of "social collateral". This contrasts to the physical collateral land or assets which poor people are unable to offer. The rationale of group-based lending is that if a member is having difficult with repayments, others in the group will put pressure on that member to repay. Further, that if this pressure fails and the member defaults on the loan, the whole group will repay the loan on behalf of the member.

Despite the popularity of group-based lending as a design feature the function which groups in the scheme can vary: as we have seen, women may find meeting, time-wasting, or an important social event, depending of their circumstances. Recent research shows the way in which group solidarity operates in practices illuminating in this respect. First, it is worth clarifying what is meat by 'group'. Some microfinance schemes have small groups of five or six members, called 'solidarity group'. A number of these small groups may then come together as "development centers" or village organizations. (ledger Wood, 1999).

2.9. INTRODUCTION TO CREDIT MANAGEMENT

Credit management is one of the major functions which financial institutions undertake for proper mobilization of funds. The credit management function includes loans & advances .It also involves a large number of activities ranging from credit investigation to contract with borrowers, appraisal, review, follow up, documentation, nursing, recovery & write- offs.

Safety of a financial institutions loan or advance is directly related to the basis on which the decision to lend is taken, the type and quantum of credit to be provided and the terms and conditions on which the loan will be made available .Consequently, a two- pronged approach is required to be followed to ensure the safety of each loan. (*Arun Chatterji (2004), Credit Management a practical approach*,)

- ***Pre-sanction appraisal*** to determine the acceptability of each loan proposal and
- ***Post-sanction control*** to ensure proper documentation, follow up and supervision.

Pre-sanction appraisal: - Is concerned with the measurement of the riskiness of a loan proposal. Not only financial data relating to the past and projected working results are required, but a detailed credit report is compiled on the borrower, if any, based on information collected from the borrower, market reports, final audited accounts, income –tax and wealth tax returns/assessments or orders and confidential information called for from other lenders and financial institutions with whom the parties have dealings. The credit report has to be updated periodically. It is an important source of reliable information for preparing the risk profile of the borrower and for finalizing the credit rating of the borrower.

The CR reveals the personal details of the proprietor, partner or directors of the firm as well as his/their assets and liabilities including indebtedness to other parties including lenders and financial institutions. The CR as a personal profile of the borrower, if kept up to date is particularly useful when the borrower /surety is financially embarrassed and the bank makes efforts to have his personal assets attached..

***Post-sanction control*: -** To a large extent it depends up on the findings of the pre-sanction appraisal. The post-sanction control involve proper documentation of the facility and the after care or follow up and supervision through monitoring of transactions in the loan amount, scrutiny of periodical statements submitted by the borrower ,physical inspection of the securities and books of account of the borrower ,periodical reviews and renewals etc. Successful lending thus depends up on careful selection of the customer, proper appraisal of his credit needs and adequate control to ensure that his dealings with the lender are above –board and that he is complying with the terms and conditions on which credit has been sanctioned to him.

2.10. SECURITIES FOR LENDING

Securities taken by lenders can be classified as primary security and collateral security .While a lender doesn't lend against security, security is taken as an insurance against untoward happenings such as the failure of the business due to reasons beyond its control or defaults in payment arising from mala fide intension .A lender will take only primary security from a professionally managed and viable business enterprise .If a business is unincorporated or exhibits signals that it has or likely to become less than a first class risk, the need for additional or collateral security does arise.

The expression collateral means running parallel or together .Collateral security is an additional and separate security taken to secure the due repayment of money borrowed: common forms of collateral include third –party secured or unsecured guarantees, pledge of share and other securities deposit of title deeds with intent to create a mortgage etc .taken in addition to the primary security for working capital finance or a term loan. (*Arun Chatterji (2004), Credit Management a practical approach*,)

A security loan or advance is defined as a loan or advance made on the security of assets the market value of which is not at any time less than the amount of the loan or advance and an unsecured loan or advance means a loan or advance not so secured.

Primary security may be personal or impersonal or both. Personal security is created by a duly executed promissory note, acceptance or endorsement on a bill of exchange and the personal covenant in loan agreement and mortgage deeds. The personal security gives the lender aright of action to proceed against the borrower personally in the event of his default. Impersonal security is created by way of a charge on the borrower's assets such as stocks, shares, book debts, fixed assets etc...In case of default the lender can, depending up on the nature of its charge proceed directly or through the intervention of the court tribunal to dispose of the security and realize its dues.

Impersonal security may be a specific or continuing security where a demand loan or term loan is sanctioned to a borrower; the impersonal security is a specific security covering the specified loan or debt alone.

The specific security does not extend to cover the other indebtedness of the borrower to the company unless otherwise contracted by the operation of the companies general lien Where an advance (cash credit ,overdraft e t c) is sanctioned .the security documents are so worded as to constitute a continuing security in terms of which the impersonal security continues to secure all sums due now or in the future from the borrower until the ultimate balance is determined regardless of whether the borrower account is in debit or occasionally in credit (*Arun Chatterji (2004), Credit Management a practical approach*,)

Collateral security may be a direct or indirect security. As stated earlier, collateral security is obtained by lenders to reinforce the primary security in cases where such security is not deemed adequate to cover the loan or advance. Where the borrower is not in a position to offer additional security on his own to the lender, the lender may accept collateral security given by a third party on his behalf. Collateral security taken from third parties with the borrower knowledge and consent is known as indirect collateral security. indirect collateral security may embody merely a personal covenant of the third party or may include impersonal security .lodged by the third party together with his personal covenant .A guarantee is an example of indirect collateral security .It can be a clean guarantee .In direct collateral security ,depending upon its nature can be retained apart in the event of the borrowers insolvency or liquidation and may be enforced by the company meet the short fall after sale or realization of the primary and direct collateral security and if need be after receipt of dividend from the receiver or liquidator .Property of a borrower coming in the hands of a banker in the normal course of banking business is subject to this general lien . Specific property remaining in the hands of the company after repayment of the loan unless subject to any contract to the contrary ,is also covered by the bankers general lien for the ultimate balance of account of the borrower .In addition ,the banker has the right of set account of the borrower . In addition the banker has the right of set off on the surplus sale proceeds and credit balances of a borrower (*Arun Chatterji (2004), Credit Management a practical approach*,).

2.11. FUNCTIONS OF A CREDIT MANAGER

- Assessing of credit standing of both new & existing customers.

- Establishment of terms having regard to the risk involved & the potential profit
- Maintaining of the sales ledger
- Monitoring & controlling of customers balance
- Collection of payment as close to terms as possible without jeopardizing future business.

2.12. Empirical Review

Several studies have been done in regard to credit management on loan management. Pyle (1997) in his study on credit management held that financial institutions needed to meet forthcoming regulatory requirements for risk measurement and capital. However, it is a serious error to think that meeting regulatory requirements is the sole or even the most important reason for establishing a sound, scientific risk management system. Managers need reliable risk measures to direct capital to activities with the best risk/reward ratios. They need the estimate of the size of potential losses to stay within limits imposed by readily available liquidity, by creditors, customers and regulators. Mechanisms are needed to monitor positions and create incentives for prudent risk taking by divisions and individuals. Sindani (2012) in her study on Effectiveness of Credit Management System on Loan Performance: Empirical Evidence from Micro Finance Sector in Kenya found out that Credit terms formulated by the microfinance institutions do affect loan performance; the involvement of credit officers and customers in formulating credit terms affects loan performance. Interest rates charged had a negative effect on the performance of the loans, the higher the interest rates the lower the loan performance.

Nagarajan (2011) in his study of credit management practices for microfinance institutions in Mozambique found that risk management is a dynamic process that could ideally be developed during normal times and tested at the wake of risk. The study concluded that financial institutions needed to minimize risks related losses through diligent management of portfolio and cash-flow by building robust institutional infrastructure with skilled human resources and inculcating client discipline, through effective coordination of stakeholders.

Matu (2008) carried out a study on sustainability and profitability of microfinance institutions and noted that efficiency and effectiveness were the main challenges facing Kenya on service delivery. Soke and Yusoff (2009), in their study on credit risk management strategies of selected financial institutions in Malaysia found that majority of financial institutions losses stem from outright default due to inability of customers to meet obligations in relation to borrowing. This study will establish whether MFIs borrowers in Baringo do meet their loan obligation or not.

Orua (2009) conducted a study on the relationship between loan applicant appraisal and loan performance of microfinance institutions in Kenya. The study revealed that short-term debt significantly impacted MFI outreach positively. Long term debt however showed positive relationship with outreach but was not significant with regard to default rates. This study is different since the focus is exclusively on short term debts.

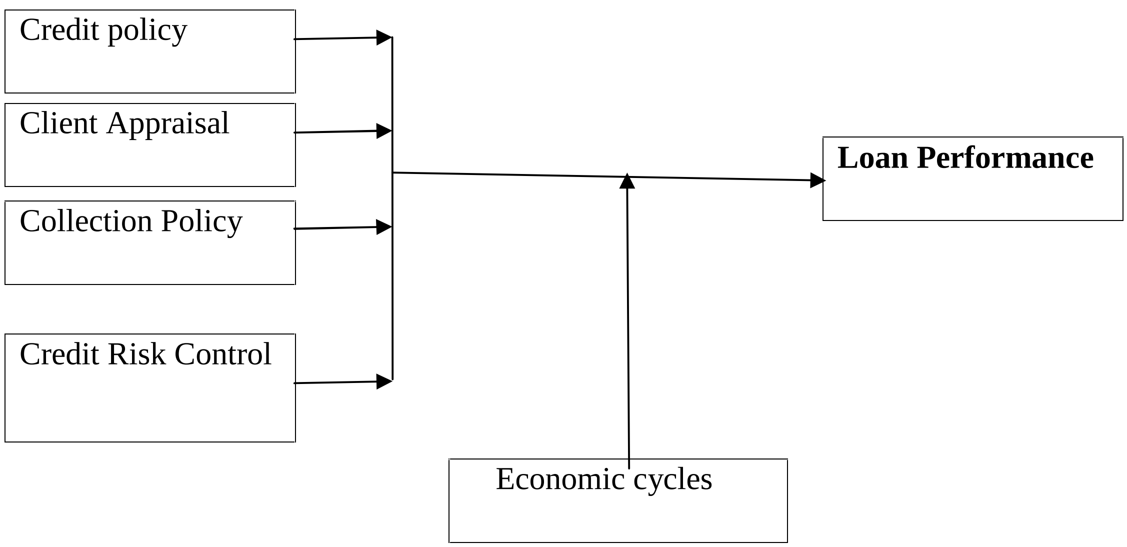
Sindani (2012) in her study on effectiveness of credit management system on loan performance based on empirical review established that credit terms formulated by microfinance institutions affected loan performance. The study recommended that both credit officers and customers should be involved in formulating credit terms. This study is expected to find out if this recommendation was applicable in the case of MFIs in Baringo County.

A key requirement for effective credit management Practice is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It may be difficult to establish an optimal credit policy as the best combination of the variables of credit policy is quite difficult to obtain. A firm will change one or two variables at a time and observe the effect. It should be noted that the firm’s credit policy is greatly influenced by economic conditions (Pandey, 2008). As economic conditions change, the credit policy of the firm may also change. Microfinance Institutions and other finance institutions must develop a credit policy to govern their credit management operations (Pandey, 2008).

2.13. Theoretical Framework

The conceptual base for this study was drawn from the theory of self-efficacy postulated by Bandura (1995). It "refers to beliefs in one's capabilities to organize and execute the courses of action required to manage prospective situations". Self-efficacy affects people's thoughts, feelings, actions, motivations, efforts, and determinations to confront the obstacles faced in life. High self-efficacy means that people are more likely to participate in activities in which they believe they can succeed. It promotes the premise that individuals have the potential to mitigate and improve their situations. Finally, the theory identifies factors that affect the success or failure of individuals, including their collective or group actions.

2.13.1. Credit Management Practice and Loan Performance Framework



(Source Secondary data; Bandura (1995)).

2.14. FRAMEWORK OF A LOAN POLICY

The lender specific parameters according to the lenders internal policies, which would determine the entry, exit, reduce or increase exposure decisions in various industries/sectors can be described as follows:

- vision and mission, business plans, strategies, operational plans and regulatory compliances which include:-

- Risk-taking capacity of the lender as determined by the loan policy. Existing risk exposure of the lender, Capital adequacy- existing and projected – capital allocation policy, Provisioning norms, Sector/industry exposure as per policy framework, group exposure, preferred industry / sectors, risk pricing policy, Borrower exposure and Risk-based internal control system.

❖ **Vision & Mission Statement**

A lenders loan policy should orchestrate its vision and mission statements. The vision and mission statements are the focal points which provide the direction goals and objectives of the lenders pursuit for excellence in its chosen field of enterprise. They reflect a long term commitment of the top management to the growth and survival of the bank in an intensively competitive environment and should provide concrete guideposts with the business plans and strategies providing the milestones for converting aspirations into results the vision and mission should address the following issues:

- Where does the lender see itself 3-5 years hence in terms of market share product development national and international presence?
- What is the technology plan as a driver to achieve operational efficiency; cost efficiency and market reach and realize the aspirations of the vision and mission statements?
- What is the quality of human resources at various levels in the organizational hierarchy to put into shape the business and operational plans?
- Does the organizational hierarchy have the required culture flexibility and safeguards to facilitate two-way communications quick decision making and risk-reward trade-offs?
- How does the lender differentiate itself in a highly competitive financial market?

❖ **Business plans**

Market existing / projected

The loan policy should spell out the sector-wise details of the deposit, credit and investment markets in which it has existing exposures. it should indicate which sectors have shown good performance representing good quality exposures of the lender sectors which have not been performing well would have shown some deterioration in credit and / or investment quality the policy should highlight the slippages in credit ratings of the industries /sectors and individual borrowers in such sectors with particular reference to the causative factors as well as how the situation is proposed to be contained

A review of sectors in which the lender has exposure may indicate that there is some overexposure in say steel, textile, rubber, medium/light engineering sectors the lender may decide to limit its exposure to these sectors at the existing levels. the thrust for the credit growth in the current year could be in newer sectors such as retail fast moving consumer durables, hospitality, healthcare, gems/jeweler., electronics industries etc.

The loan policy should also lay down not only the preferred sectors in which lender would attempt to increase the size of its investments ad credit portfolios, but also the market share the lender would strive to capture in terms of the management’s vision and mission statement. The growth of the loans portfolio should be segmented into priority sector lending, working capital loans, term/ project loans and deferred payment guarantees, off-balance sheet exposure and exposure and exposure to the infrastructure sector. Further fine tuning may be required to determine the credit exposure to the retail, corporate and non-corporate sectors.

If a lender has developed new products and/ or entered into retailing of other services products such as insurance products, the loan policy should spell out how these new factors would be employed for higher growth and profitability.

The Policy should focus and stress on the need for the orderly growth of deposits on the liabilities side of the lenders balance sheet. The growth rate of retail and wholesale deposits on a fortnightly basis should be estimated. Annual growth figures should be announced ensuring that the fortnightly growth rates are maintained.

The business plan should at the end of the day lead to a higher return on assets (ROA) and return on equity (ROE). Also, if the lender’s shares are listed, the bank will have to comply with listing requirements such as public announcement of quarterly results etc. The policy should, therefore, indicate market indicators of its performance and estimate its ROA and Roe for the current year.

Risk based Pricing

The lender should indicate in the loan policy brief details of the credit scoring model it has adopted, how the operating staff would compile the credit rating of each industry/sector in which the bank has an exposure and the credit scoring model for individual borrowers.

The policy should be specific with regard to credit rating of (i) borrowers migrating from other banks, (ii) borrowers who are not having credit arrangements with any other lender but re now seeking credit for business growth and (iii) new borrowers/entrepreneurs who have recently set up their business and require credit facilities from the bank. The risk based interest rate to be charged on borrowers accounts could be either a mark up or mark down on the benchmark prime lending rate of the lender.

Specialization

In the event the bank management has taken the view of targeting market segments, the loan policy should indicate the areas of focus, channels and business potential as well as business share.

Asset-Liability mismatches

The loan policy must state the lenders asset-liability mismatches and how these mismatches are proposed to be rectified during the current year in compliance with regulatory requirements.

Discretionary Powers

Decision making powers in the institution inter alias, are governed by the financial powers that are by Board approved policy granted to various functionaries in the Institution including the Chairman and Managing Director and the committee of Directors for sanctioning loans and advances both funded and non-funded. The policy also spells out how these powers are to be exercised and the accountability that is associated with the exercise of such powers. The loan policy should indicate whether the financial powers that have so far been granted are adequate, whether they are being exercised properly in letter and spirit and whether any major abuse of such powers was noticed in the previous year and, if so. What corrective measures have been adopted?

- **Strategies**

Business Strategies

Business strategies have to be designed for the implementation of the business plan. The lender has to keep the rapidly changing business profiles of the industry and the ways of doing business. Some of the strategies would revolve around (i) branch computerization and networking – LAN/WAN, (ii) product development and sale of related services products (fee based services), (iii) Business process outsourcing (iv) identification of critical branches in terms of business potential, recoveries etc, (v) market segmentation with identified branches being transformed into, branches for servicing corporate clients, The lender if it has tied all arrangements can launch branded/ co-branded.

Human resources strategies

The HR strategies should relate to development of manpower skills, particularly in technical skills, HRD and marketing. The bank should have a policy of risk-reward trade-offs, performance appraisals and placements and accountability in place to motivate and encourage the human resources to give a practical shape to the vision and mission statements of the lenders.

- **Operational plans**

The operational plans for implementation plans of the business plans could be incorporated in the loan policy in general terms. Details of the business budgeting exercise at the branch level are worked out by the branch controllers before the beginning of each year. The operational plans can be considered in nine heads:

A) Appraisal standards

- Determining viability of the business, Deviations from benchmarks, Methods of lending applicability of various methods, cut-off limits etc, Working capital assessment, Creation of bills culture, Project lending and term loans and Time-frame for decision marking

B) Credit rating and risk pricing

- Setting credit rating as per bank's credit scoring model for industry/sector
- Setting credit rating as per credit scoring model for individual borrower
- Loan pricing based on credit rating

C) Sanction and disbursement

- Value chain system of credit decision making
- Temporary/ad hoc/over limit facilities
- Sub-limits/interchangeability of limits/ceilings
- Post sales facility: stipulation with regard to corporate borrowers

D) Documentation standards

Each lender has printed loan documents together with printed letters/memoranda etc. For execution once the loan sanction letter is received at the origination branch. The loan policy needs to stress only on the fact that documentation work should be carried out strictly as per the external internal guidelines of the lender.

E) Processing fees, other charges, penal interest, commitment fees etc.

Fees and other charges are bank-specific. What the loan policy should stipulate are the standard charges that are to be recovered, circumstances under which such charges are to be levied, and which authority I the bank has the powers to reduce or waive all or any of these charges when warranted by market environment.

F) Nature of security and security cove

A preferred situation is when the security interest (realizable value of primary and collateral security is provided and withdrawals I the loan accounts allowed. The loan policy should stipulate the minimum security cover acceptable to the lender.

G) Loan review mechanism

- Credit Audit, Risk-based internal control system
- Physical control through
  - Physical verification using the ABC inventory classification system
  - Stock audit
- Financial Control through
  - Periodical statements such as stock statements, book debt's statements, creditor's statements, quarterly information system statements, etc.
  - Regular reviews and renewals
  - Review of credit rating of the borrower and his industry/sector and Special Audit

H) Recovery of non-performing assets

- Improving, upgrading and maintaining the quality of standard assets, Identification of realizable NPAs and Compromises and settlements.

THE CREDIT PERIOD: **-** The credit period is the basic length of time that credit is granted. The credit period varies widely from industry to industry.

Length of the credit period: - A number of factors influence the length of the credit period one of the most important is the buyer's inventory period and operating cycle. All other things being equal the shorter these are the shorter the credit period will normally.

The operating cycle has two components the inventory period and the receivables period the inventory.

There are a number of other factors that influence the credit period. Many of these also influence our customers' operating cycles so once again these are related subjects among the most important are:

1. ***Perishablility and collateral value***. Perishable items have relatively rapid turnover and relatively low collateral value. Credit periods are thus shorter for such goods. For example, a food wholesaler selling fresh fruit and produce might use net seven days. Alternatively, jewelry might be sold for 5/30 net four months.

2. ***Consumer demand.*** Products that are well established generally have more rapid turnover. newer or slow-moving products will often have longer credit periods associated with them to entice buyers, also as we have seen, sellers may choose to extend much longer credit periods for off-season sales (when customer demand is low).

3. ***Cost profitability and standardization***. Relatively inexpensive goods tend to have shorter credit periods. The same is true for relatively standardized goods and raw materials. These all tend to have lower markups and higher turnover rates, both of which lead to shorter credit periods. There are exceptions auto dealers, for example generally pay for cars as they are received.

4. ***Credit risk*** the greater the credit risk of the buyer, the shorter the credit period is likely to be (assuming that credit is granted at all).

5. ***The size of the account***. If the account is small, the credit period may be shorter because small accounts are more costly to manage and the customers are less important.

6. ***Competition*** when the seller is in a highly competitive market, longer credit periods may be offered as a way of attracting customers.

7. ***Customer type*** a single seller might offer different credit terms to different buyers a food wholesaler, for example might supply groceries, bakeries, and restaurants, each group would probably have different credit terms. More generally, sellers often have both wholesale and retail customers and they frequently quote different terms to the two types.

2.15. RISKS IN LENDING

Lenders face many risks which impact on their balance sheet, transactions, operations and liquidity. While risks are inherent in financial institute, it is essential that lenders quantify the risks faced by them and set up prudential norms to limit their effects.

Balance sheet risks arise out of mismatches between the interest rate structure, maturity and currency of assets and liabilities which results in –

- Credit Risks, Market Risks and Operational Risks

2.16. COMMON SOURCES OF MAJOR CREDIT PROBLEMS

- ✓ Most major Lending problems have been either explicitly or indirectly caused by weaknesses in credit risk management in supervisors' experience certain key problems tend to recur severe credit losses in a banking system usually reflect simultaneous problems in several areas such as concentrations failures of due diligence and inadequate monitoring **.**

Concentrations

- ✓ Concentrations are probably the single most important cause of major credit problems. Credit concentrations are viewed as any exposure where the potential losses are large relative to the lenders capital, its total assets or where adequate measures exist, the lender's overall risk level. Relatively large losses may reflect not only large exposures, but also the potential for unusually high percentage losses given default. Many credit problems reveal basic weaknesses in the credit granting and monitoring processes while shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process.

Credit process issues

- ✓ Many credit problems reveal basic weaknesses in the credit granting & monitoring processes. While shortcomings in underwriting & management of market related credit exposures represent important sources of losses at financial institutions, many credit problems would have been avoided or mitigated by strong internal credit process. Many lenders find carrying out a thorough credit assessment (or basic due diligence) a substantial challenge for traditional lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence landing may need new types of information, such as risk measurements, and more frequent financial information, such as risk measurements, and more frequent financial information to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions.

- ✓ The absence of testing and validation of new lending techniques is another important problem. Adoption of untested lending techniques in new or innovative areas of the market especially techniques that dispense with sound principles of due diligence or traditional benchmarks for leverage have led to serious problems at many lenders sound practice calls for the application of basic principles to new types of credit activity. Any new technique involves uncertainty about its effectiveness. That uncertainty should be reflected in somewhat greater conservatism and corroboration indicators of credit quality an example of the problem.

- ✓ Some credit problems arise from subjective decision making by senior management of the lender this includes extending credits to companies they own or with which they are affiliated to personal friends to persons with a reputation for financial acumen or to meet a persons with a reputation for financial acumen or to meet a personal agenda, such as cultivating special relationships with celebrities.

- ✓ Many lender’s that experienced asset quality problems lacked an effective credit review process (and indeed many lender’s had no credit review function) credit review at larger financial institutions usually is a department made up of analysts independent of the lending officers who make an independent assessment of the quality of a credit or a credit relationship based on documentation such as financial statements credit analysis provided by the account officer and collateral appraisals. at smaller banks this function may be more limited and performed by internal or external auditors the purpose of credit review is to provide appropriate checks and balances to ensure that credits are made in accordance with lend policy and to provide an independent judgment of asset quality uninfluenced by relationships with the borrower effective credit review not only helps to detect poorly underwritten credits it also helps prevent weak credits from being granted since credit officers are likely to be more diligent if they know their work will be subject to review.
- ✓ A common and very important problem a failure to monitor borrowers or collateral values many lenders neglected to obtain periodic financial information from borrowers in order to evaluate the quality of loans on their books and the adequacy of collateral as a result many lenders to recognize early signs that asset quality was deteriorating and missed opportunities to work with borrowers to stem their financial deterioration and to protect the bank’s position. This lack of monitoring led to a costly process by senior management to determine the dimension and severity of the problem leans and resulted in large losses.
- ✓ Many lenders credit activities involve lending against non-financial assets in such lending many banks have failed to make an adequate assessment of the correlation between the financial condition of the borrower and the price changes and liquidity of the market for the collateral assets. Much asset-based business lending (i.e. commercial finance, equipment leasing and factoring) and commercial real estate lending appear to involve a relatively high correlation between borrower creditworthiness and asset values.

- ✓ Market and liquidity – sensitive instruments change in riskiness with changes in the underlying distribution of price changes and market conditions. For market-sensitive instruments, for example increases in the volatility of price changes effectively increases potential exposures. Consequently banks should conduct stress testing of volatility assumptions. Market and liquidity sensitive exposures because they are probabilistic can be correlated with the creditworthiness of the borrower. Changes in the value of a market or liquidity sensitive instrument can also influence the borrower's financial health and future prospects lenders need to analyze the relationship between market and liquidity sensitive exposures and the default risk of the borrower. Stress testing shock the market or liquidity factors is a key element of the analysis.

Lending is an important function of financial institution interest earned on loans and loan related products offsets the interest paid on deposits and contributes to their operating expenses and profits. A healthy, interest-earning loan portfolio is, therefore, a prerequisite for sound lending. These institutions are operating a rapidly changing and highly competitive credit market. Borrowers, particularly large borrowers, have become more demanding in terms of cost of credit (i.e. loan pricing), loan products and quality of service. From a captive walk-in business, lending has become a strategic marketing function based on innovative products, loan pricing and service quality (*Churchill in handbook 2000:42)*.

Sound, informed lending requires taking timely, risk-based credit decisions on loan proposals, documenting the loan decision on the basis of terms of sanction and legal requirements and closely monitoring the loan utilization till the loan is repaid or renewed.

Credit decision making can be defined as the process of taking risk based decisions for lending after analyzing the required information collected from various sources within a stipulated time frame. The definition implies that the decision maker understands i) why, how and from which sources, relevant information should be collected ii) how the available information should be appraised, iii) how the risk factors affecting a loan proposal should be evaluated, and iv) how to take timely decisions whether to accept or reject the loan proposal or, recommend its acceptance or rejection to the competent authority.

Several risks affect credit decisions, the main risks are credit risk, market risk (comprising basically liquidity risk and interest rate risk) and operational risk. Also, the risk tolerance policy of the bank plays an important role in decision taking.

Credit decision takers have to be guided by the loan policy framed by management and approved by its Board of Directors. The policy should have in-built flexibility to meet changing situations during the course of the year. It needs to be reviewed periodically to align it with emerging conditions in the market.

At the operating level, the major risk factor is the credit risk. Credit risk taking is the process of determining the credit-worthiness of borrowers d financing them at a price (risk price) which matches their risk profile (risk rating). Credit risk designed on “the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms”.

Credit Risk is defined as the possibility of losses associated with diminution the credit quality of borrowers or counterparties. In a bank’s portfolio, losses stem from outright default due to inability or unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, settlement and other financial transactions, or alternatively, losses resulting from reduction in portfolio value arising from actual or perceived deterioration I credit quality. Credit risk emanates from lenders dealings with an individual, corporate, bank, financial institution or a sovereign (*Arun Chatterji (2004), Credit Management a practical approach*,).

Lenders have suggested several measures for management of credit risk. The measures which require top management’s attention include:

1. Measurement of risk through credit rating/scoring;
2. Quantifying the risk through estimating loan losses i.e. the amount of loan losses that the lender would experience over a chosen time horizon (through tracking portfolio behavior over 5 or more years) and unexpected loan losses i.e. the amount by which the actual losses exceed the expected the losses (determined through statistical tools of standard deviation of losses or the difference between expected loan losses and some selected target credit loss quartile);

3. Risk pricing e.g. Prime lending rate which also accounts for risk, on a scientific basis; and

4. Risk control through effective Loan review mechanism and portfolio management.

Managing Internal Factors Affecting credit risk

The internal factors determining the quality of the loan portfolio can be taken care of by adopting a proactive loan policy, good quality credit analysis and loan monitoring and development of a sound credit culture. *(CORPORATE FINANCE ,1995).*

Managing External Factors

The lender can manage the external factors affecting credit risk by adopting a loan policy with in-built flexibility to meet the needs of the changing times. The loan policy requires to be reviewed annually. The policy should, inter alias, spell out guidelines on key issues relating to (a) creation of a well diversified loan portfolio, (b) norms for scientific commercial viability of a loan proposal, (c) norms for exposure to individual borrower as well as to a group of borrowers, (d) norms for sectoral deployment of funds, (e) a strong monitoring and internal control system and (f) delegation and accountability.

Principles of Lending

The principles for the Assessment of lenders management of Credit risk have been divided into 4 main groups of sound practices, addressing the following areas:

1. Establishing an appropriate credit risk environment;

2. Operating under a sound credit-granting process;

3. Maintaining an appropriate credit administration, measurement and monitoring process;

4. Ensuring adequate controls over credit risk and role of supervisors.

2.17. CREDIT INFORMATION

The process of lending enables the lender to develop a healthy business relationship with the borrower. The relationship is based partly on mutual faith and trust and partly on mutual business commitments. The borrower expects timely availability of credit and good quality service. The lender expects the borrower to comply with the terms of sanction, service the loan as per agreement/ loan document and repay the loan on schedule.

Developing a business relationship implies that the lender and the borrower have to build bridges of information as a confidence building measure.

2.17.1. KNOWING THE CUSTOMER WELL

The first step towards sound lending is gathering information relevant to credit decision making about the existing or potential borrower, the business he is engaged in or the industry to which his unit belongs, and the means he possesses to finance his contribution towards the funds requirements of his business.

The information so collected, after proper analysis, should clearly indicate that the borrower is credit worthy, that his business or unit is viable and will continue to remain so that he has the required means (or, has the ability to raise his own resources as per his commitment accepted by the lender) to finance the margin money and that the income generated by him would be adequate to service the loan proposal deserves to be rejected.

2.17.2. SOURCE OF CREDIT INFORMATION

Source of information that can be directly collected from the customer include:

❖ Information collected during the visit to the customer’s factory, business premises etc.

- Information obtained during the interview with the customer.
- Information available from the documents submitted by the customer, such as partnership deeds, memorandum and articles of association, certified/audited accounts, etc...
- Information available I the duly completed loan proposal tendered by the borrower.
- Sources of information that can be collected independently of the customer include.
- Market research and market surveys/information. As an example, discussions with selected transport operators or auto ancillaries/components suppliers/manufacturers could reveal long waiting periods for delivery of commercial vehicles (CVs) or larger orders, which in turn can lead to the reasonable inference that the market demand for CVs has gone up. Other/ institutions with which he maintains accounts. Specialized journals, magazines and newspapers. And

Other agencies such as credit rating agencies Like S&P or Moods, government departments, local bodies etc (*Arun Chatterji (2004), Credit Management a practical approach*,).

2.17.3. OTHER SOURCES OF CREDIT INFORMATION

Financial newspapers, economic journals, daily newspaper, government departments, registering authorities, local authorities/bodies and credit rating agencies are other sources of information which branches can tap. If a firm does want credit information on customers there are a number sources. Information commonly used to assess creditworthiness includes the following:

1. Financial statements a firm can ask a customer to supply financial statement information such as balance sheets and income statements. Minimum standards and rules of thumb based on financial ratios then used as a basis for extending or refusing credit.

2. Credit reports on the customer’s payment history with other firms. Quite a few organizations sell information on the credit strength and credit history of businesses firms the best known and largest firm of this type is dun & Bradstreet, which

provides subscribers with a credit reference book and credit reports on individual firms. TRW is another well-known credit reporting firm. Ratings and information are available for a huge number of firms, including very small ones. Equifax, transition, and TRW are the major suppliers of consumer credit information.

3. Banks bands will generally provide some assistance to their business customers in acquiring information on the credit worthiness of other firms.

4. The customer's payment history with the firm. The most obvious way to obtain information about the likelihood of a customer not paying is to examine whether they have settled past obligations and how quickly they have met these obligations.

2.17.4. CREDIT EVALUATION

There are no magical formulas for assessing the probability that a customer will not pay. In very general terms, the classic five Cs of credit are the basic factors to be evaluated: */ (Churchill and Dan coster handbook (1999:38)).*

1. Character the customer's willingness to meet credit obligations.
2. Capacity the customer's ability to meet credit obligations out of operating cash flows.
3. Capital the customer's financial reserves.
4. collateral a pledged asset in the case of default
5. Conditions general economic conditions in the customer's line of business.

CHAPTER THREE

3.1. RESEARCH DESIGN AND METHODOLOGY

The research design adopted for the study is descriptive research. Descriptive research is selected do to its ability to properly document and describe the existing nature of performance appraisal practice. This further enables the study of analyze the existing practice by comparing it with the theoretical aspects.

Both qualitative and quantitative approaches are used in this paper. Questionnaires and interviews are used for quantitative and qualitative approaches respectively. The quantitative approach is aimed for creating a relationship among the sample and the wider population of the study, whereas the qualitative approach will used for explaining the actual practice of performance appraisal.

3.2. DATA SOURCE

Descriptive research can be done relying on both primary & secondary data's are used in this paper to achieve both objectives.

3.3. PRIMARY DATA

- The primary data's are collected using Formal and Informal interviews. The interviews was assist by questionnaires.
- The primary data will be collected on the current situation of the institution and opinion of customers and employees. To this end survey method of making use of questionnaires, interviews and personal observations are going to be employed as needed.
- The question will be given to sample members of customers and it would chosen by non-probability sampling techniques.
- The sample will be develop on area bases and the geographic areas to be considered are Kolfe, Arada, Lideta, Kirkos and Gulele Kifle ketemas with the sample size of 22 customers for each the institution's credit given areas .This allows the data obtained from the sample to be used in making inferences about a larger population.

- The question include more of closer –ended and less open-ended type and be designed in such way that they should generate important information in looking into the opinion of the employees on the institutions credit management system.
- In addition to this the researcher or I try to gather information through personal sight, visits (personal observation) to the head quarter especially to Business development department (which is a concerned department about the credit management of the institution)

3.4. SECONDARY DATA

- Documents (like Financial reports, balance sheet), Books, Manuals and different reports which are related to credit Management are going to be used to investigate problems and recommend what ought to be done in the future.

3.5. DATA ANALYSIS METHED

As the researcher has mentioned earlier in this study, findings which were magnitude of the practices will be excavated from interview, observation and questionnaires. Thus, the raw data was presented, analyzed and interpreted to give solutions for the research which mentioned as limitation.

In doing so, the appropriate responses of questionnaires are cleaned, coded, categorized, tabulated, analyzed and summarized. Whereas interviews and observations be organized and summarized.

Finally, based on the analyzed and summarized data to create triangulation between the released information through literature review, questionnaire and interview by the help of the Statistical Program for Social Sciences, version 16.0, (SPSS, 2005).

3.6. ORGANIZATIONAL INFORMATION

Addis credit and saving Institution (ADCSI) was established in accordance with the "Licensing and supervision of Microfinance institutions Proclamation No 40/96" on January, 2000 as a share company with a capital of 1,017,000.00 to undertake its activity, in order to facilitate the economic development of the country by increasing the speedy flow of money and encourage small investments by giving some financing opportunities and giving credit facility to the lower income society. Currently the institutions capital raise to 810,509,000.00 & the institution give it's service in 10 branches and Many sub-braches in Addis Ababa.

Addis Credit and saving institution is established to give full support to micro and small scale business operators in Addis Ababa & Oromia region surrounding Addis Ababa, Burayu & Sululta. As per the revised proclamation No. 626/2009, ADCSI has an objective to collect deposits and extend credit to rural and urban farmers, and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs.

Addis Credit & Saving Institution has delighted to announce that it moved its head office which is located near to abune Petros Avenue to the new constructed new building which is located at Churchil Avenue next to electric world building. Currently the institution has 10 branch offices, 116 service delivery posts and opening & micro bank.

3.7. VISION OF THE INSTITUTE

Addis credit and saving institution wants to be independent, to give a service which has strong based financial capacity and to have a contribution in poverty alleviation and reduction of unemployment in Addis, as a result to see the city free from social and economical problems.

3.8. MISSION STATEMENT

ADCSI's mission is to promote micro and small enterprises to alleviate poverty and unemployment prevailing in Addis Ababa city administration territory through provision of sustainable financial and other related service with particular attention to women.

3.9. GOAL

- To give continuous and wide credit and saving services, To give loan for employees which have low income, To support the spreading of small businesses, To facilitate self confidence and the creation of the culture of job creation in the youth and To upgrade the societies saving capacity.

SERVICES GIVEN BY THE INSTITUTION

- ❖ Lending Service, Saving Service, Third party financial administrative service and Consultation service.

THE TYPE OF LENDING SERVICE

- ❖ A loan which is paid by the interval of 15 days, a loan which is paid once after some period of time and Machineries lease loan.

TYPES OF ACTIVITIES WHICH THE LOAN IS GIVEN

- ❖ Weaving, For Metal Work, For leather Products, For Building Material, For Dry Foods, For sanitary products, For City Farming, For Construction and Others like retail services

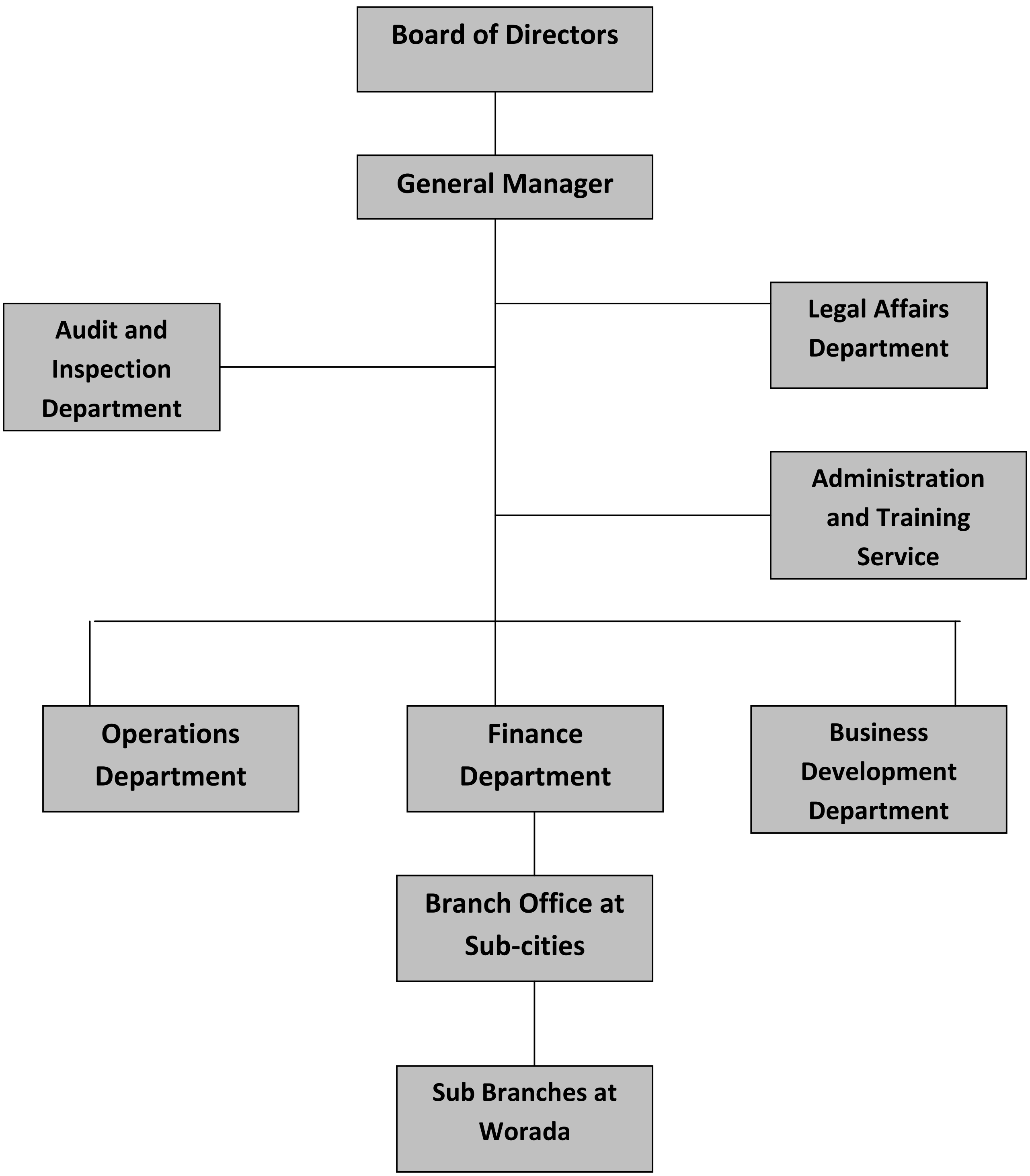
QUALIFICATION FOR GETTING LOAN

1) For an individual who live in Addis and wants to involved in small business & whose is age 18 and above, For “Edirs" organized in Addis, For Group associations in Addis and For Share companies.

BALANCE SHEET OF THE INSTITUTION (MAY 24, 2016)

Addis Credit and Saving Institution(S.C)					
Current Balance Sheet					
(May 24, 2016)					
Asset			**Liability and Capital**		
	Dr	**Cr**		**Dr**	**Cr**
Cash on hand		6,232,000.00	Voluntary savings	822,893,000	
Cash at banks		359,560,000.00	Compulsory Saving	583,459,000	
Cash at NBE			Time Deposit	173,664,000	
Short term investment		15,629,000.00	Loan Financing Debit-Commercial	353,269,000	
Gross Outstanding loans	2,407,142,000				
Less:-loan loss reserve	(30,387,000)	2,376,755,000.00			
Less:- reserve for interest			Interest Payable on deposits	27,206,000	
Other receivable		20,220,000.00	Deferred Grants		
Prepayment		1,880,000.00	Other Short term Liabilities	91,741,000	
Long term investment in allied activates		49,104,000.00	Other Long term Liabilities	50,000,000	
Long term investment in non allied activities			**Total Liabilities**		2,102,232,000.00
Fixed Assets	105,507,000		Paid up Capital	231,017,000	
Accumulated Dep.& Amortization	(23,527,000)		restricted for loan	62,193,000	
Net Fixed Assets		81,980,000.00			
Other Assets		1,381,000.00	Granted Equity: Prior period	21,668,000	
			Retained Earnings	342,460,000	
			Profit/Loss	65,063,000	
			Legal Reserves	88,108,000	
			Total Capital		810,509,000.00
Total Assets		**2,912,741,000.00**	**Total Liability and Capital**		**2,912,741,000.00**

3.10. ORGANIZATIONAL STRUCTURE OF THE INSTITUTION



3.11. CREDIT POLICY OF THE INSTITUTION

So far concerning the credit policy for the institution there is no sufficient material & information. But I have found that the major & common ones regarding the loan are:

- The loan shall be extended to very poor households for income generating activities.
- At least 50% of the loan should be extended for woman entrepreneurs (Female group borrowers).Since these borrowers are poor they are not required to pledge collateral. Instead in case of default, the group will be responsible to settle the debt.
- The minimum credit limit is birr 500 per head.
- The payment period could be from one to three years.
- The loan will be repaid within a week for one year loan & within a month for the three year loan.
- Since MFI's are now free to set own interest rates ceiling, ADCSI has its own interest rate which is relatively smaller than other MFI's.
- The loan given by the institution is tied with a compulsory saving, that is 10% of the total amount of the loan which is deducted & saved in a Bank.
- Even if it has practicality problem, the institution penalize those customers which are not paying on time.

INTEREST RATES & SERVICE CHARGES ON LENDING

Description	Annual Lending interest Rates	Charge
Loan installments paid within 15 days or 1 month	10 %	3 %
Loans which is paid totally after some time	12 %	3 %
For Machinery lease	15 %	3 %

LOAN SIZE

Description	New Customers	For Existing Customer
For Individuals	up to 20,000	up to 30,000
For Shares	up to 40,000	up to 60,000
For Group Associations	up to 70,000	up to 100,000
For Edirs	Based on agreement	Based on agreement

CREDIT PERIOD (LOAN REIMBURSEMENT PERIOD)

LOAN SIZE	A MAXIMUM TIME TO REFUND THE LOAN
For Any type of Loan up to 2,000	up to 22 month
For Br 2001-5000	24 month
Above 5,000 Br	36 month

COLLATERAL TYPE

- Group guarantee, Permanent employee salary, Fixed Asset, Existing customers guarantee and Edirs, Shares, Association

TYPES OF SAVING

- Saving based on the willingness of individual

	Rate
o Book, saving	4 %
o saving based on time limit	5 %
o Forced saving: for those who take a loan only	4%

GRACE PERIOD

The institution give a one month grace period for new borrowers but there is no grace period for the existing customers who want to take a loan for more than one times.

PENALITY FOR LOAN PAYMENT

Months passed for payment	Rate
1-3 months	1 %
4-6 months	2 %
7-9 months	3 %
10-12 months	4 %
> 12 months	5 %

Launching Mobile services in Ethiopia

Addis Credit & Saving Institution S.C (ADCSI) has started giving mobile money Services M-birr in collaboration with M.O.S.S ICT plc. With M-BIRR you can use your phone to pay for goods in shops or pay bills like DSTV. No more wasting time travelling and queuing. It s fast, efficient, easy.

M-BIRR the fastest, convenient and reliable way of sending money to anywhere in Ethiopia. And it can be done any time day or night from your mobile phone.

How it works - just dial *818#

M-BIRR is a mobile wallet account accessed from your phone. Once you have registered, simply dial *818# and a menu appears on your screen like the one below. You can then start transacting from your phone.

Deposit, withdraw, and help!

M-BIRR has a network of agents all over the country that take in cash deposits and give out cash withdrawals from your mobile wallet account. It also provides you with some assistance and support.

CHAPTER FOUR

4.1. DATA ANALYSIS & INTERPRETATION

Micro finance Institutions play a great role in creation of job opportunities and alleviation of poverty for both urban & rural areas. Even if their contribution is high for developing the economy, there are some problems regarding to their credit management aspect. So my survey tries to find out credit management practical problem of Micro finance institutions particularly that of Addis Credit & Saving Institution.

The sample size determined using the following formula from Israel (1992).It stated the sample size determination formula as follows

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

Where,

N= Size of population

n = Size of sample

x= sampling error

Thus

$$n = \frac{108}{1 + 108(0.05^2)}$$

n = <u>85</u>

The sample survey includes 85 respondents which are selected proportionally from randomly selected 5 sub cities. Thus from, the sampled 55 beneficiaries 5 of them are non respondents & from 30 employees 2 of them are non respondents. So based on the findings I tried to analyze and interpret the data’s as follows.

4.2. COLLECTION OF CREDIT WITH THE SPECIFIED TIME

Micro finance institutions are institutions that provide suitable financial and other services using innovative methodologies & systems at low cost to meet the need of low income sections of the society and act as financial intermediaries in genuine sense. Since most of the customers of Micro finance institutions are old aged and illiterate individuals they do not have enough knowledge regarding timely reimbursement of loan and time value of money .So I try to examine the following questions to know any problem regarding timely collection of the loan & related aspects.

- **Questions-1**

No.	Item	Response by customers	
		Yes	No
1.	Does the institute collect the credit given to customers within the specified time?	41%	59%

(SOURCE-PRIMARY DATA)

From the above table , the case of timely collection of credits given to customers , 59% of responders clearly state that credit is not collected within the specified time , even though 41% of them agree that credit given to customers are collected as per the time limit .

MAJOR REASONS GIVEN BY CUSTOMERS FOR NOT PAYING WITH THE SPECIFIED TIME

1) Since the credit period is small, customers will face a problem in running their business and generating income and reimbursing the loan .So because of these customers will not finish their loan as per the specified time.

2) In group lending if conflict is created between the group members, the group members shut down the business and no one will pay the loan.

3) Mostly some of the customers use the money their borrowed for consumption use. If they do not use the money they borrowed to generate money, so they become unable to pay the loan.

4) Sometimes, customers may face loss; as a result they will loss the capacity to repay the loan.

5) The most serious one is the case of group Co-operatives which are organized by government to produce “Blockets” for condominium houses, these Co-operatives take a loan from ADCSI, to buy machineries, and run their activity. The problem is that they force to sale their product for Addis Ababa housing agency with unfair price. From my survey, I observed that more than 85 % of these Co-operatives shut their business and the individuals get lost. Currently this problem is a great headache for ADCSI.

- **<u>Questions-2</u>**

No.	Item	Response by customers	
		Yes	No
2.	Do you think that the grace period given to repay the credit is enough?	23.04 %	76.96 %

(SOURCE-PRIMARY DATA)

From the above table I understand that 76.96% of the respondents disagree on the fairness of the grace period, and the rest 23.04% (Most of them are employees) believe the grace period were enough for the repayment of the loan. The major reason for the disagreement of customers is difficulty of getting sufficient customers with one-month Grace period.

- **<u>Questions-3</u>**

No.	Item	Response by customers	
		Yes	No
3.	Did you face a problem in repaying the loan?	52.8 %	47.2 %

(SOURCE-PRIMARY DATA)

From the survey 52.8 % of the customers inform me that, they faced a problem in repaying the loan.

PROBLEMS THEY FACED TO REPAY THIER LOAN

1) The interest rate on loan is highest than their income.

2) In group borrowing, if one of the group members unable to pay because of different reasons or problems the others group members must forced to cover his loan payable share.

3) At the beginning since the beneficiaries are new to run their business properly.

4) The smallness of the amount of loan given to them. As a result they are not running their business as per their dream. So they face a problem to repay the loan.

5) Mostly they sale their products on credit basis, so this makes beneficiaries not to pay their loan on time.

VERIFICATION OF LATE PAYMENT BASED ON CUSTOMERS LEDJER

From each sub branch of the institution which I gathered data, and randomly select 10 customers ledger to check timely collection of the loan. From the sample I have taken more than 55% of customers finish their loan from 1 up to 19 months later after the due date. The following table shows late finished customers among the sample taken from each sub-branches.

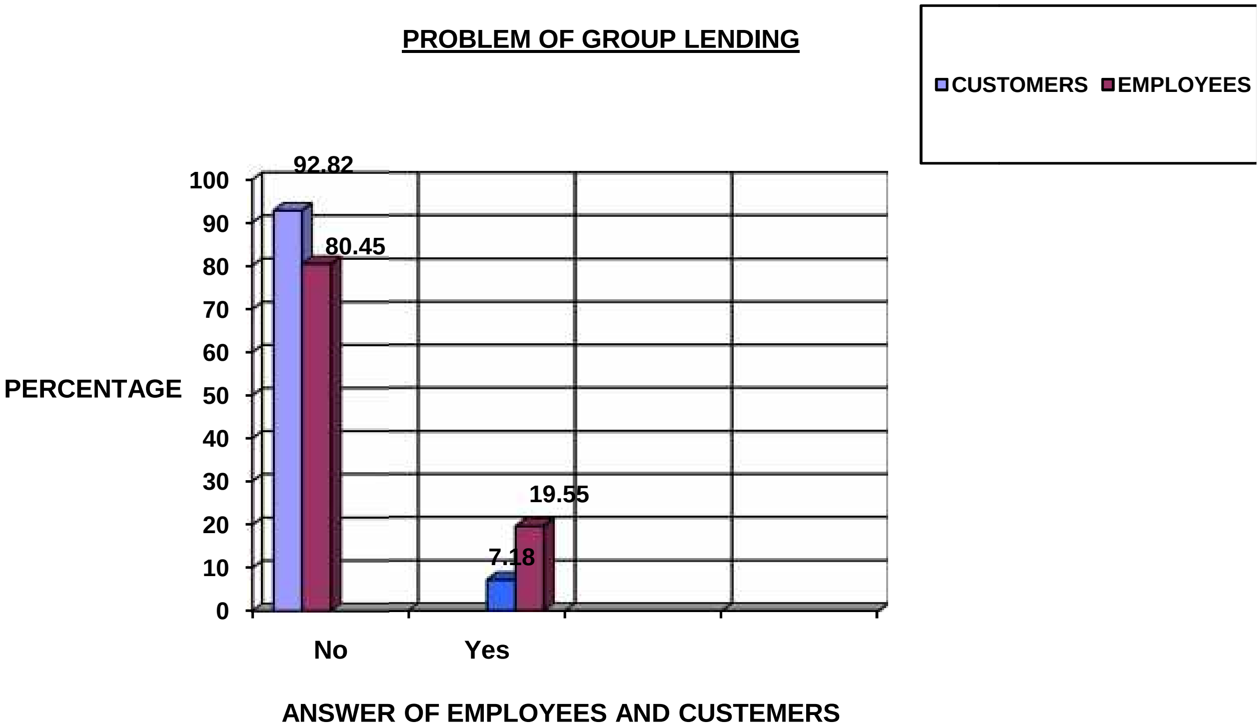
No	Sub branch	Customers ID	Customer type	Borrowed Date	Finishing Date	Finished Date	Month after due date
1	Lideta 02/03	C-97020222	Individual	29/06/06	27/08/07	15/01/08	5
2	Lideta 02/03	C-96020037	//	10/04/05	10/03/06	15/02/08	21
3	Kolfe 02/05	C -296/kol/0093	//	15/01/07	15/01/08	26/03/08	2
4	Kolfe 02/05	C -197/kol/0340	//	01/09/2007	01/09/07	13/03/08	6
5	Kolfe 01/03	I-94/ko2/0024	Group	01/01/06	01/01/08	not paid	19
6	Kolfe 01/03	I-96/ko3/0027	Individual	02/03/07	02/03/08	02/04/08	1
7	Lideta 04/06	C -96040/09	//	18/08/05	12/12/06	12/01/08	13
	//	C -96040186	//	01/02/07	01/06/08	15/12/08	6
8	Lideta keb 11	C -97/20/78	//	24/04/06	24/03/07	20/03/08	12
9	//	C -97/202/7	//	18/07/06	18/06/07	02/02/08	8
10	Arada/ l/ Keb7/8	96090043	//	17/02/96	17/02/98	05/12/98	10
11	Arada/l/ keb 11	H-96/ko9/0130	//	06/02/06	06/02/08	04/08/08	6
12	Arada l/keb11	96-110/15	//	12/06/05	12/06/07	06/02/08	8
13	Arada/ l/ Keb7/8	96116/92	//	23/04/06	23/02/08	22/03/08	13
14	Gulele 09/05	I96/1006/0169	//	10/02/06	10/12/07	16/01/08	1
15	Gulele 09/05	I96/k06/01/96	//	10/02/06	10/12/07	16/01/08	1
16	Gulele 06/08	I95/k03/40003	//	10/02/06	10/10/07	03/07/08	9
17	Gulele 06/08	I96/K03/B114	//	16/04/06	16/02/08	06/03/08	9

4.3. EFFECTIVENESS OF GROUP LENDING METHODOLOGY ON REPAYMENT OF LOAN

This method is used in providing credit facility to the ultimate need of financial support to poor women and youth in the form of loan. This effort gives relief for those who tries to create Job for themselves as a bridge for the development of entrepreneur's ability of small business in the area, which leads people to raise money from their business activity for their substantial need, loan repayment and the saving habit for the expansion of their business. Micro financial institutions use different lending methodology to disburse the loan. Among the methodologies, my survey focuses on the effectiveness of group based lending methodology. Group based lending methodology is a method beneficiaries associate to work through groups. This methodology are often, referred to as group-based finance or 'Solidarity-group lending schemes'. Because group members are jointly liable for each individual's loans, this represents a form of "social collateral". This contrasts to the physical collateral land or assets which poor people are unable to offer. The rationale of group-based lending is that if a member is having difficult with repayments, others in the group will put pressure on that member to repay. Further, that if this pressure fails and the member defaults on the loan, the whole group will repay the loan on behalf of the member.

- Question 4

Do you think that there is a problem in group lending methodology? (Is it effective?) (Source primary data)



As indicated in the above bar graph the group based lending method shows, 92.82% of customers face a problem on repayment of loan. On the other hand 7.18% of them replay that the group based collateral method did not create any problem on repayment of loan. Where as staff members response indicate that 80.45 % of them argue that group based collateral method create problem on the repayment of loan, the rest 19.55 % of the staff members disagree with this idea . Since the group members were organized by micro small enterprise, the members did not know each other behaviorally, which cause default in repayment of the loan. As a result repetitive wastage of time in court for the settlement of the loan will happen. On the other hard other group members will be forced to cover the share of the defaulted individual.

REASONS FOR THE NON EFFECTIVENESS OF GROUP LENDING

1. The group members were not known well each other behaviorally.
2. They are stay together for short time.
3. The money they borrowed and the type of work they want to do, do not match.
4. The conflict created between the group members.
5. Even if they took the loan in-group but they work individually .This will create a problem on the re-imbursement of a loan.
6. In the case of co-operatives, because of lack of freedom to sale their products for their own customers. They are forced to sale their product for Governmental institutions only.
7. The institution does not gather enough credit information about the group members.
8. Some times the group members use the loan for their personal consumption.
9. The different living place of the group members.

4.4. FOLLOW UP OF THE CUSTOMERS

Micro finance institutions are institutions that provide suitable financial and other services using innovative methodology and systems at low cost to meet the need of low income sections of the population and acts as financial intermediaries in genuine sense and most development interventions incorporate micro finance as a catalyst means to stimulate peoples to create their own job opportunity that help them productive citizens. Therefore to facilitate them to use the money they borrowed for the proper purpose there must be strict follow up. But from the data I gathered I have observed the following information.

- Question 5

Is there any follow up of customers in using the Money they borrowed for the required purpose?

No	Questions	Type of respondents	Responses	
			Yes	**No**
1	Is there any follow up of customers?	Customers	29%	71%
2	Is there any follow up of customers?	Employees	45%	55%

(Source primary data)

From the above graph and table in case of follow up and supervision of beneficiaries activity, 71% of customers clearly state that there is no follow up and supervision on their business activities, even though 29 % of them agree that the a availability of follow up & supervision. On the other hand 55% of the employees disagree that on the availability of follow up and supervision of customers activity the rest 45 % of them agree on it

4.4.1. REASON FOR NO FOLLOW UP OF CUSTOMERS

1. The institution should give priority for new customers, because of this there is no follow up for existing customers how to expand their business and how to use the money they borrowed effectively, as a result some customers use the money for consumption purpose.
2. Sometimes the fairness of the customer's house has a problem for follow up.
3. The employees in the sub – branch do not have detail information the way how to consult customers.

CHAPTER FIVE

FINDINGS, CONCLUSION AND RECOMMENDATION

5.1. FINDINGS

In this part, the researcher put the major weakness of the institution. Since the major aim of this research is to identify the practical problems related to ADCSIs credit management practices, the major findings are as the following...

5.2. Strengths

- ❖ The institution has strong advertising method.
- ❖ Since most of the employees in sub-branches are younger, they are eager to serve customers in a better way.
- ❖ It is supported that the institution has many sub-branches to give service to customers at their near place.
- ❖ It is supported that the institution gives continuous training to employees to upgrade their work performance.
- ❖ Each sub-branch has its own bank account to accumulate the daily collection. This help manager's to follow up daily cash collection.
- ❖ Monthly bank reconciliation report & cash flow statements prepared by sub-branches are another controlling mechanism for managers.
- ❖ The institution attracts customers by the following methods.
    1. By advertising through mass media
    2. By advertising through brochures, notice boards.
    3. By going to customer's house and telling them about the Institution.
- ❖ The following methods help the institution to manage its credit.

- Using customer’s ledger and identifying customers who are not paying their loan & by telling them to pay,
- For those customers who are defaulted, by taking them to court and using annual auditing.

5.3. Weakness

- The institution face a problem to collect it’s loan as per the specified time.
- The beneficiaries face different problems to disburse their loan.
- The grace period is too short for the beneficiaries to repay their loan.
- Group lending methodology is not effective.
- There is no adequate follow-up & supervision of beneficiary’s activity in order to check the use of the money they borrowed for the proper purpose.

5.4. Conclusion

The informal sector (small micro enterprise) activities have a significant importance in the economy of developing countries. The sector contributes a lot in minimizing unemployment by providing job opportunities for those who are actively seeking work.

It also plays an important role in the income of the poor and proper utilization of local resources. To address this importance to the poor section of the society, the NBE has set the credit management system for the lending program of microfinance institutions. Even if it has implementation problems, using the rules and regulations which are set down by NBE, the activity of the lending program is implemented by ADCSI in all sub cities of Addis Ababa. Based on the above idea, my study presents the following conclusion.

1. From the survey , I observe that due to different reasons the institution face a great problem in collecting its loan with in the specified time .In the case of group lending and group associations due to different problem the group members close their business , as a result they become unable to repay their loan. If this problem continues like this, it pushes the institution to go to court to discharge customers. On the other hand the grace period is too short some business activities require longer period to produce a given product and to sale.

2. The survey indicates group base lending methodology is not effective in achievement of ADCSI's objective. Due to this case default payment is made by the group members. In addition beneficiaries who use the method also face problem in the repayment of loan, the rest who repay regularly were enforced to pay the default amount.

3. From my study I observed that there is no adequate follow-up and supervision of beneficiaries activity how they utilize their loan. The institute provides training about how to use the loan to staff members and sometimes to beneficiaries however the out come from training brings lower attitudinal change as the result some beneficiaries use the loan for other purpose like for consumption.

5.5. Recommendations

Based on the above findings & conclusions drawn from the analysis I would like to suggest the following recommendations that would help ADCSI to achieve its goal and resolve its short comings. Some of the recommendations may be implemented within short period of time while others may take longer period.

1. Even if the credit is not collected with the specified period, the institution must be ready to make changes like.

   - ✓ Increasing the grace period for those activities which require longer period to produce and sale the product e.g. cement products, metal works.
   - ✓ Appreciating customers which pay on time, i.e. by giving them a discount.
   - ✓ Increasing the penalty rate.
   - ✓ By having strict follow-up for those customers which do not pay on time.

2. Since the group based collateral method is not effective .The institute shall focuses on other collateral methods like ,permanent employees salary, and fixed asset as collateral to guarantee the repayment of the loan.

3. Frequent follow-up and supervision on beneficiaries activities should be done as much as possible ,such follow up and supervision will enable credit beneficiaries to utilize the loan on productive activities .The institute should try to fill in areas where skilled man power is required which will prove the delay of loan processing period and effective service delivery.

4. Before giving loan it is better if the institution has enough credit information about the beneficiaries and evaluates the customers by considering the following 5 Cs.

   A. ***Character*** the customer's willingness to meet credit obligations.

   B. ***Capacity*** the customer's ability to meet credit obligations out of operating cash flows.

   C. ***Capital*** the customer's financial reserves.

   D. ***Collateral*** a pledged asset in the case of default

   E. ***Conditions*** general economic conditions in the customer's line of business.

5. Creating awareness to customers how to use the money they borrowed and giving consultation service for their business.

6. Increasing the man power at sub–branches.

7. Changing the manual system to computerized system.

8. Fulfilling the communication facilities at sub-branches.

9. Currently credit management function is handled by Business development department.

In the future it is better if it has its own department.

5.6. Scope for Further Research

This research indicated that there is a relationship between effective credit management systems and loan performance within microfinance institutions. The researchers therefore suggests further researcher on the following:

1) Reasons for loan defaults from clients' perspective in microfinance institutions.
2) The effect of Credit Referencing of customers on loan performance in microfinance institutions.
3) The findings would be more fruitful if it were conducted by including the other similar firms.

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ENDORSEMENT

Thesis has been submitted to ST.MARY`S UNIVERSITY, School of Graduate Studies School of Business, for examination with my approval as a University advisor.

-- -------------------------

Advisor Signature

ST.MARY`S University

July, 2016

Addis Ababa

DECLARATION

I, Zewude Samuel, hereby declare that the thesis entitled "Assessment of Credit Management practices in micro finance institutions a case study of Addis Credit and Saving S.C.", submitted by me.

Zewude Samuel Signature……………

ST.MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

MBA IN ACCOUNTING AND FINANCE

QUESTIONNAIRE

Dear respondents,

This questionnaire has been prepared in view of assessing the practices in credit management of Addis credit & saving institution. The primary objective of the questionnaire is to collect data, information & opinion for the conduct of a senior essay for partial fulfillment of the requirement for award of MBA in accounting and finance.

Your valuable responds would help the researcher to find out the credit management practices & thus highlight the alternative solutions to problems.

Thank you in advance for your valued time & cooperation, the researcher believes that your genuine response, opinions & views are used only for academic purpose & also kept confidential.

N.B please give your answer on the space provided & put tick mark in the box corresponding to your response. ☑

PART I

1. PERSONAL INFORMATION

A. Sex Male ☐ Female ☐

B. Age____________________

C. Educational background _________________

D. Your Position in your institution____________

E. Experience in your Current position _______________

PART II

2. Questioners to assess the credit management practices

A. Nature of Questions

1	2	3	4
Yes	No	Neutral	Explanatory

S.N	Parameters	Yes	No	Neutral
2.1.	Do you think that the loan given to you is enough to handle the business you are running? (Filled by customers only)			
2.2.	Is the institution collects its credit given to customers within the specified time period?			
2.3	Do you think that the grace period to repay the loan is enough?			
2.4	Is the group lending methodology effective for the repayments of the loan?			
2.5	Is there any follow up of customers in using the money they borrowed properly?			
2.6	Is there any unspecified problem about the institutions Credit service given to customers?			
2.7	Do you think current credit management process needs revision?			
2.8	Do you think your institution credit assessment practice and loan policy are made and reviewed on annually. (Filled by employees only)			
2.9	Do you think credit risk is adequately measured, monitored and controlled by the employee and others?			
2.10	Is Credit risk operations are reviewed by independent reviewers to asses' policies and procedures are being properly followed on ongoing basis?			
2.11	Is the Institution ensures compliance with all relevant laws, regulations and directives of national bank of Ethiopia?			
2.12	Is the Management develops take measures that will facilitate the measurement, monitoring and control of credit risk?			
2.13	Do you think manager ensures that internal audit review of credit management system is made on ongoing basis?			
2.14	Is the credit risk management strategy and policies are effectively communicated to all relevant personals?			

2.15	Is the institution consider and documented in credit granting ,the borrowers' repayment history and current capacity to repay based on historical financial trends and future cash flow projections under various scenarios.?			
2.16	Is Every credit proposal or Credit business plan in the institution is subject to careful analysis by qualified credit analysts?			
2.17	Is the Institution establishes accountability on the personnel who pass a credit decision?			
2.18	Is the Institution manage the amount of credit granted by customer are suitably monitored?			
2.19	Is the Credit limit for individual, counter parties and groups of connected counterparties are established in the institution?			
2.20	Is all credit file of the borrowers includes all the information necessary to ascertain the current financial condition of counterparties?			
2.21	Is the institution uses stress testing by identifying possible events of future changes in economic conditions that could have uncomfortable effects on institution credit exposures?			
2.22	Is the institution properly maintaining the credit file after credits granted to borrowers?			
2.23	Is the credit file of all customers is always updated?			

PART III

B. Nature of Questions

- ➢ Explanatory

1. What are the main challenges do you think your credit and saving organization will face in implementing any necessary change to your current credit management process? (Filled by employees only)

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2. What are the methods used by the institution to attract customers? (Filled by employees only)____

3. What are cause and effects of credit management problems in the institution? ____

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4. What is your advice for the institution in order to solve the credit management practices problems?____

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5. What extra elements do you think could be incorporated into your credit management process to make it more robust? ____

Interview Questions

1. When the Addis Credit & Saving Institution S.C MFI as the institution start Work?
2. How you organize the clients?
3. How you control the loan repayment?
4. How you control default?
5. How to evaluate the operational efficiencies and other related activities related to credit and its impact?