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**ST. MARY’S UNIVERSITY**

**SCHOOL OF GRADUATE STUDIES**

**ASSESMENT OF CREDIT RISK MANAGEMENT IN MICRO FINANCE INSTITIUTION** **(IN THE CASE OF AWACH SAVING AND CREDIT COOPERATIVE SOCIETY LTD)**

**BY**

**YONAS TESFAYE**

JUNE **2020**

**ADDIS ABABA, ETHIOPIA**

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**DECLARATION**

First, I declare that this Thesis is my work and that all sources of materials used for this thesis have been fully acknowledged. This thesis has been submitted in partial fulfillment of the requirement for the Degree of Master of Business Administration in accounting and finance

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**Table of Content**

Title page No

Declaration i

Acknowledgements i i

Table of Contents iii

List of Tables vi

Acronyms & Abbreviations vii

Abstract viii

Chapter One: Introduction1

* 1. Background of the study 1

1.2. Statement of the Problem 3

1.3. Objective of the Study 5

1.3.1 General Objective 5

1.3.2 Specific Objectives 5

1.4. Scope and Limitation of the study 6

1.4.1 Delimitation (Scope) of the Study 6

1.4.2 Limitation of the study 6

1.5 Significance of the Study 6

1.6 Organization of the Paper 7

Chapter Two: Literature Review 8

2.1 The concept of risk management 8

2.2 Common Risks Found in Microfinance Institutions 9

2.3 Credit Approval and Implementation 11

2.4 Credit Risk Exposure 12

2.5 Definition of Credit Management 13

2.6 Process of Credit Management 13

2.7 Credit Risk management Indicators 13

2.8 Credit Risk management 14

2.9 Credit Analysis 15

2.10 Default Problems 16

2.11 Credit Collection Techniques 17

2.12 Strategies to Minimize Defaults 18

2.13 Empirical literature 18

Chapter Three: Research Methodology 20

3.1 Research Design 20

3.2 Type and source of data 20

3.3 Method of Data Collection 20

3.4. Sample size and sampling procedure 21

3.5 Data analysis 22

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION 23

4.1 Introduction 23

4.2 Data Analysis 23

4.2.1 General Information 23

4.2.2 Client Appraisal 26

4.2.3 Credit Risk Controls 27

4.2.4 Collection Policy 30

4.2.5 Results of Interview Questions32

CHAPTER FIVE: SUMMARY, CONCLUSTIONS AND RECOMMENDATION 34

5.1 Summary 34

5.2 Conclusion 35

5.3 Recommendation 36

References 37

Appendix 39

**List of Tables**

Tables Page No

 **Table 1** Sample determination for the study 22

**Table 2** Gender 23

**Table 3** Educational level 24

**Table 4** The respondents’ experience 24

**Table 5** Adoption of Credit risk Management Practices 25

**Table 6** Number of loan clients per loan officer ratio of the respective

 branch 25

**Table 7** Extent to which Awach saving and credit cooperative society Ltd

 use client appraisal in Credit risk Management. 26

**Table 8** Level of agreement on client appraisal in MFI 26

**Table 9** Extent to which Awach saving and credit cooperative society Ltd

 use credit risk control in Credit Management 28

**Table 10** Level of agreement on credit risk control in Awach saving and credit

 cooperative society Ltd. 28

**Table 11** Extent to which MFI use collection policy in Credit risk Management 30

**Table 12** Level of agreement on collection policy of MFI 30

**List of Acronym and abbreviations**

MFI MICRO FINANCE INSTITUSTION

ASACCOS AWACH SAVING AND CREDIT COOPERETIVE SOCIETY LTD

NBE NATIONAL BANK OF ETHIOPIA

AMFI ASSOCATION OF MICRO FINANCE INSTITUSTION

LLPR LOAN LOSS PROVISTION RATIO

PAR PORTFOLIO AT RISK

WOR WRITE OF RATIO

ROA RETURN ON ASSET

ROE RETURN ON EQUITY

**Abstract**

Credit risk management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. Sound credit risk management is a prerequisite for a financial institutions stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. The study sought to an assessment of credit risk management in Microfinance Institutions in the case of Awach saving and credit cooperative society ltd. The study adopted a descriptive survey design. The population of study consisted of 10 service delivery posts in Awach saving and credit cooperative society ltd. Primary data was collected using questionnaires where all the issues on the questionnaire were addressed. Descriptive statistics were used to analyze data. Furthermore, descriptions were made based on the results of the tables. The study found that client appraisal; credit risk control and collection policy had effect on credit risk management of MFIs in Awach saving and credit cooperative society ltd. The study established that there was strong relationship between credit risk management of MFIs and client appraisal, credit risk control and collection policy. The study established that client appraisal, credit risk control and collection policy influence on credit risk management of MFIs in Ethiopia . Collection policy was found to have a higher effect on credit risk management and that a stringent policy is more effective in debt recovery than a lenient policy. The study recommends that MFIs should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

**Chapter One**

**Introduction**

* 1. **Background of the study**

The adequate management of credit risk in financial institutions is critical for the survival and growth of financial institutions. In the case of rural banks, the issue of credit risk is of greater concern because of the higher levels of perceived risk resulting from some of the characteristics of clients and business conditions that they find themselves. Credit risk management is a structured approach to managing uncertainties through risk assessment, development of strategies to manage it and mitigation of risk using managerial resources. The strategies include transferring to another party, avoiding the risk, reducing the negative effects of the risk, and accepting some or all of the consequences of a particular risk.

Hull (2007) explains that one of the basic formation of every organization, most importantly a banker is to understand the portfolio of risk it faced currently and the risk it plans to take in future. Oldfield and Santomero (1997) posited that risks facing all financial institutions can be segmented into three separate types from a management perspective. These are (i) risk that can be eliminated or avoided by simple business practices (ii) risk that can be transferred to other participants and (iii) risk that must be actively managed at the firm level.

In the review of Sinkey (2002), modern risk management in the banking industry can be highlighted by five verbs and these are; identify, measure, price, monitor and control. This process of risk management is very much important to the rural banking industry since most of their clients are susceptible to co-variant risk, market risk and credit risk.

Managing financial institutions has never been easy, but in recent years it has become even more difficult because of greater uncertainty in the economic environment. Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. If the microfinance institutions (MFIs) do not manage their credit risks well, they are likely to fail to meet their social and financial objectives. When poorly managed risks begin to result in financial losses, donors, investors, lenders, borrowers and savers tend to lose confidence in the organization and funds begin to dry up. When funds dry up, microfinance institutions (MFIs) are not able to meet their social objective of providing services to the poor and quickly go out of business.

As with any financial institution, the biggest risk in microfinance is default risk. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e., traditional collateral is not often used to secure microloans) Churchill and Coster 2001. The MFIs’ clients are those who cannot get credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed.

Many banks do not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principal amount itself. Therefore, these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities.

Profitability is a suitable mechanism for achieving long term viability and sustainability of the microfinance industry. At the micro level, profitability is a precondition to a competitive microfinance industry and the cheapest source of capital, without which no firm would draw external capital. MFIs profits are also an important source of equity, if profits are reinvested this may promote financial stability. By minimizing the probability of financial crisis, remarkable profits are vital in reassuring MFIs’ stakeholders, including investors, borrowers, suppliers and regulators. At the macro level, a profitable microfinance industry is better placed to overcome negative shocks and contribute meaningfully to the stability of the overall financial system (Muriu, 2011 )

Currently, Ethiopian microfinance institutions are playing crucial roles in improving the life of poor societies and economic development of the country as a whole. The National bank of Ethiopia (NBE) inaugurated the micro finance institutions. Awach Saving and Credit Cooperative Society Ltd (ASACCOS) is legally registered public organization by Federal Cooperative Agency (FCA), associate member of African Confederation of Co-operative Savings and Credit Association (ACCOSCA) and member of International Cooperative Alliance /ICA/. Awach SACCOS has a vision to be a ‘ World Class Saving and Credit Cooperative Society in 2030’ with mission of ‘Improve socio-economic conditions of members & other people through mobilizing saving and creating access of credit & asset building using relevant technology and highly motivated staffs in consideration of social governance aspects’. At this time, it works in Addis Ababa and FinfinneLiyu Zone of Oromia Region, around Addis Ababa; it is serving more than 20,000 members through quality and fast service products of saving, loan, and training of business development skills using in ten branch offices.

**1.2. Statement of the Problem**

Credit risk management challenges are implicit in financial institutions (including micro finance institutions) activities because credit risk events are typically uncertain (Laurentis 2009). Therefore, as Nancy (2001) noted an effective credit risk management process is required to help institution’s top leadership establish rules to prevent operating losses due to human error, employee carelessness, technological malfunction or fraud. To illustrate, a micro finance's management may put into place internal controls and procedures as well as periodic internal audit reviews to ensure that employees comply with rules when performing duties in credit risk management. A credit risk management policy also may cover financial risks of financial institutions.

Al-Tamimi and Al-Mazrooei (2007) also noted that financial institutions including micro finance institutions are a business mostly associated with credit risk because of their high exposure to uncertainty. They also noted that credit risk management is one of MFI liabilities of the operations and procedures being followed. In today’s dynamic environment, all micro finance institutions are exposed to potential credit risks. Due to such exposure to credit risks, efficient credit risk management is required.

Chua et al. (2000) also found that managing credit risk is one of the basic tasks to be done in micro financial institutions, once it has been identified and known. As a result, effective and sound credit risk management is a foundation for the safe and sound operation of a micro finance institution to improve their performance. In connection with this issue, different empirical studies are conducted internationally.

The following are some of them. The studies by Michael (2006) and Samuel (2006) tries to touch the issue of credit risk management in some micro finance institutions in Ethiopia but they did not assess exhaustively the performance of micro finance institutions in credit risk management. For example the study by Samuel (2006) only focuses on one micro finance institution.

Laurentis and Mattei (2009) in their study of Lessons’ recovery risk management capability shows that the development of modern reliable systems of risk management like credit scoring can enhance even more those management capabilities.

In Ethiopia, the studies by Wolday (2001), Befkadu (2007), Zigju (2008), and Michael (2006) focus on progress of micro finance institutions in terms of number of clients, loan amount and number of branches the institutions have throughout the country.

Fernando (undated) conducted research study on managing microfinance risks; some observations and suggestions stated that risk management has become more important now and its importance will continue to grow in the future.

Factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of microfinance risk management. The growing interest of MFIs further reinforces the importance of risk management in MFIs. However, it is disturbing to note that systematic risk management is still not as widespread as it should be.

The empirical studies that have been reviewed in the preceding section focused on the different micro finance institutions issues that affect the performance and in effect profitability of micro finance institutions. In addition, most prior studies regarding credit risk management tried to examine the possible methods to manage credit risk including the use of credit score rating, and the impact of borrower’s financial positions on credit risk management and the impact of relation of borrower and lender on credit risk management .However, it is possible to concluded that although there have been a number of studies on credit risk management and related issues both in developed and developing countries, Ethiopia in particular, the association between Credit Risk management and profitability has not been examined in this manner before. For instance, Andinet (2011) studied Institutional Viability and Performance in Ethiopia. Sara (2014) investigated the determinants of quality of MFIs loan portfolio. Gebrehiwot (2002) studied, Microfinance Institutions in Ethiopia: Issues of Portfolio Risk, Institutional Arrangements and Governance, in Microfinance Theory, Policy and Experience. Wolday (2000) investigated, Networking Microfinance Activities in Ethiopia: Challenges and Prospects, Association of Ethiopian Microfinance Institutions. Hence, it is difficult to believe that these studies exhaustively examined the credit risk management practice of micro finance institutions especially in our country Ethiopia.

As a result, this study is designed to fill the aforementioned gaps (particularly in Awach saving and credit cooperative society Ltd) having the main objective of Credit Risk management and Profitability. Therefore, the purpose of this study is to assess credit risk management in Awach saving and credit cooperative society Ltd From the above point of view there is a specific problem as indicated as follows

1. What characters of credit risks that are most commonly faced by in Awach saving and credit cooperative society Ltd?

2. What techniques are used by Awach saving and credit cooperative society Ltd. to manage the credit risk it’s facing?

**1.3. Objective of the Study**

**1.3.1 General Objective**

The principal aim of this study is to assess the credit risk management on Awach Saving and Credit Cooperative Society Ltd (ASACCOS)and to determine the character of credit risk for the purpose of to find out the ways to manage that credit risk, with particular reference to borrowers in the selected 5 Awach saving and credit cooperative society Ltd branches offices.

 **1.3.2 Specific Objectives**

1 To identify the effect of credit risk on Awach saving and credit cooperative society Ltd

1. To determine the characteristics of credit risk that implies the negative impact on the institution.
2. To identify the challenge that faced by the Awach saving and credit cooperative societyLt in credit risk management.
3. To find out the ways to manage credit risk on the institution.
4. To assess the relationship between the theories, concepts and models of credit risk management and what goes on practically

**1.4. Scope and Limitation of the study**

**1.4.1 Delimitation (Scope) of the Study**

Micro finance institutions have different branches. However, because of time, place, and cost constraint, the study is concerned on Awach saving and credit cooperative society Ltd. In addition to this, the study focuses on their selected five branch office like, Beler, Salitemiret, AddisuGebaya, Lideta and Aware branches.

**1.4.2 Limitation of the study**

The institution and the supervisory body were not willing to disclose information to the researcher due to fear of break of Promise of Privacy (Duty of confidentiality). This constraint was dealt with by relying on the published reports and responses of the participants’ of the study through questionnaire and interview.

**1.5 Significance of the Study**

This study makes several contributions to both knowledge building and practice improvement in credit risk management. It is expected that it was aid to policy makers in their effort to revamp the sector. It shall also be of great relevance to the organizations under study as well as other financial institutions. The non -financial business firms, whether manufacturing or service oriented shall also benefit from the research findings. This is because the result of the study shall enable the users especially MFIs to appraise its credit policies and to review its operations critically for more result oriented approach in dealing with its credit facilities.

* It shows an assessment of credit risk management.
* It shows the challenges faced by the financial institution with regard to credit Risk management
* It shows the major tools or techniques used by financial institution to manage their credit risk.
* It uses as an input for further studies.
* It is useful for financial institution by providing information in credit Risk management.

**1.6 Organization of the Paper**

The study outlined and/or organized in five chapters. Chapter one presents introduction, which is the main skeleton of the study Chapter two contains a review of the related literature including theoretical framework of the study, extensive review of empirical evidence on the subject matter of microfinance institution together with the circumstance of Ethiopia and knowledge gap and conclusion. The research design and methodology are will be presented in Chapter three. Chapter four presents results and discussion with the help of both descriptive statistics and econometrics analysis Finally, chapter five presents summary, conclusions and recommendation.

**Chapter Two**

**Literature Review**

**2.1 The concept of risk management**

Risk management introduces the modern theory of planning or decision making under uncertainty that is contingency planning (Schwartz, 2001) managers in the past have always used financial ratios are quantifying risks. In this light, decisions in the future may turn out to have a negative effect on actual result or vice-versa or actual results can prone to be very different from expected results. Risk management is therefore concerned with the identification of potential problems and eliminating or reducing the damage which they may result in if the problem materializes. Risk management is a central part of any organization’s strategic management activities. It is the process whereby organizations methodically address the risks attaching to their activities with the goal of achieving sustained benefits within each activity and across the portfolio of all activities. The focus of good risk management is the identification and treatment of these risks. It increases the probability of success, and reduces both the probability of failure and the uncertainty of achieving the organization’s overall objectives. (Schwartz, 2001)

Cielens (2010) stresses the discipline aspect of risk management. Risk management is a discipline for dealing with the possibility that some future event will cause harm. It provides strategies, techniques, and an approach to recognizing and confronting any threat faced by an organization in fulfilling its mission. Also lingered that risk management information is used along with other corporate information, such as feasibility, to arrive at a risk management decision, transferring risk to another party, lessening the negative effect of risk and avoiding risk altogether are considered risk management strategies. Examples of risk management practices include: purchasing insurance; installing security systems; maintaining cash reserves; and diversification.

Jorion(1995) adapted this concept of risk management. The actual definition of risk management is the process of analyzing the exposure to risk and finding the means of handling this exposure properly. Every company weighs the pros and cons before starting out; this is done to avoid any future calamities that may lead to losses and insolvencies.

Jorion (1995) also drew the curtail line by defining risk management as “the process by which managers satisfy these needs by identifying key risks, obtaining consistent, operational risk measures, choosing which risks to reduce and which to increase and by what means, and establishing procedures to monitor the resulting risk position” he explained the need to identify risk and finding ways to mitigate the risk.

Management, like risk, can have many meanings, each valid in the appropriate context. For risk management of potential accidental losses, it is best to define management Stoner (1985) did defined management as a process: the process of planning, leading organizing, directing, and controlling organizational resources to achieve given objectives.

Putting this definition of management together with our earlier definition of risk gives us a precise, quite concise, definition of risk management Kloman (2005) gave a comprehensive risk management by bringing out the management aspect of risk. He said Risk management is the process of planning, leading organizing, directing, and controlling organizational resources to achieve given objectives when Surprisingly good or bad events are possible. Churchill (2001) explained that risk taken by the microfinance institutions must be calculated and later merged (2005) concept of systemic approach of it. Risk management is the process of taking calculated risks, a systematic approach that identifies and prioritizes the risks and implements strategies to mitigate the risks. This approach includes both the prevention of potential problems and the early detection of actual problems. It is a continuous process that involves staff at all levels of the organization. However, it is observed that most definitions and explanations as well as the concepts by the experts simply got to do with identifying, measuring, monitoring and controlling the exposure of risk as the definition of management goes.

**2.2 Common Risks Found in Microfinance Institutions**

Financial intermediation involves some risks, with one major challenge facing financial institutions being to identify such risks and to hedge a against them. The risks vary in type and intensity for different financial institutions, whether or not they operate in the same business environment. Each microfinance, therefore, has to identify its own unique set of risks and to manage it in its own way if it wishes to continue to sustain its operations.

According to Fernando (2008), risk management, in relation to an MFI is the process of controlling the likelihood and potential severity of an adverse event; it is about systematically identifying, measuring, limiting, and monitoring risks faced by an institution. Services are relatively small and simple when a new microfinance bank commences Operations. During the setting up of a new microfinance bank, it tends to be very aware of the financial risks that it faces, causing it to make a conscious effort to mitigate them. However, as microfinance bank grows in size and diversifies its loan portfolios, different types of risks, other than the obvious financial ones, tend to begin to manifest themselves Generally, the following three categories of risks that might face microfinance business have been identified.

* + **Liquidity risks**

According to Craig and Dan (2011), liquidity risk arises when a microfinance is unable to meet its cash requirements or payment obligations timely and in a cost-efficient manner. Microfinance have to plan the volume of loans to be approved and disbursed, the withdrawal pattern of their saving clients (where MFI is allowed to mobilize deposits), and other fund requirements for operational purposes, and should be able to match available funds against such requirements.

According to Kolari et al, in order to reduce liquidity risk, each microfinance branch needs to prepare a daily fund plan that guides the matching of cash inflows from loan repayment and saving deposits (that usually take place in the afternoon) with cash outflows (from draw-downs, customer withdrawals and operational expenses) for the branch on a daily basis. Any positive balance or surplus fund should be deposited with a correspondent bank daily, while any anticipated shortfall should be covered by withdrawing cash from the bank early in the day. No overnight cash should be held by the branch, in order to eliminate the risk of fraud or theft. As in the case of the daily fund plan, each branch should also prepare a monthly fund plan that should outline the amount of loans to be granted, the volume of saving withdrawals from customers, and the anticipated operational expenses. The preparation of the plan assists the finance department to anticipate the funding requirements of the various branches, there by allowing the determination in advance of any potential cash shortfall or surplus facing the branches concerned. The funds should then be moved to a position where they can address the situation, while any arising idle funds are invested appropriately.

* + **Credit Risk**

Credit risk is defined as the probability that some of a MFI‘s assets, especially its loans, will decline in value and possibly become worthless. Because MFIs hold little owners‘ capital relative to the aggregate value of their assets, only a small percentage of total loans need to go bad to push a bank to the brink of failure. Thus, management of credit risk is very important and central to the health of a MFI and indeed the entire financial system. As MFI s makes loans, they need to make provisions for loan losses in their books. The higher this provision becomes, relative to the size of total loans, the riskier a bank becomes. An increase in the value of the provision for loan losses relative to total loans is an indication that the bank‘s assets are becoming more difficult to collect . Credit risk is the risk of a loss resulting from the debtor's failure to meet its obligations to the MFI in full when due under the terms agreed (R.S. Raghavan 2003).

* + **Operational risk**

Operational risks arise because of possible system or human errors in service or product delivery. Potentially, unexpected financial losses might occur as a result of a variety of issues, such as inadequate or deficient information systems, operational challenges, incompetent personnel, inadequate skill, deliberate breaches, or fraudulent tendencies. The management of such risks requires that the internal control framework is effective, the information technology (IT) used is adequate, the integrity of the employees is guaranteed, and the operating processes are streamlined. Given the various sources of operational risk, the most obvious is the interaction of loans and clients involving financial transactions. In the case of normal traditional banks, the staff undertaking credit assessment is usually well trained, with multiple levels of crosschecking put in place. Unfortunately, in the case of MFIs, there are usually numerous short-term loans of small amounts, making elaborate crosschecking not cost - effective. As a result, the possibility of both error of assessment and deliberate fraud is relatively high (Mersland and Strom 2007)

**2.3 Credit Approval and Implementation**

The individual steps in the credit approval process and their implementation have a considerable impact on the risks associated with credit approval. The quality of credit approval processes depends on two factors, i.e. a transparent and comprehensive presentation of the risks when granting the loan on the one hand, and an adequate assessment of these risks on the other. Furthermore, the level of efficiency of the credit approval processes is an important rating element. Due to the considerable differences in the nature of various borrowers and the assets to be financed as well as the large number of products and their complexity, there cannot be a uniform process to assess credit risks. The quality of the credit approval process from a risk perspective is determined by the best possible identification and evaluation of the credit risk resulting from a possible exposure.

According to Oesterreichische National bank Credit Approval Process and Credit Risk Management (2000), the credit risk can be distributed among four risk components.

a. Probability of Default (PD)

b. Loss Given Default (LGD)

c. Exposure at Default (EAD)

d. Maturity (M)

The most important components in credit approval processes are PD, LGD, and EAD. While maturity (M) is required to calculate the required capital, it plays a minor role in exposure review.

**2.4 Credit Risk Exposure**

The credit risk exposure (CR) is measured by the sum of the level of loans past due 30 days or more and still accruing interest namely Portfolio at Risk (PAR-30). In robustness tests it is included further measures of credit risk by estimating various econometric specifications for three additional different explanatory variables; the write-off ratio (WOR) which is the value of loans written off during the year as uncollectible, as a percentage of average gross loan portfolio over the year. An additional measure of credit risk is the Risk Coverage Ratio (RC) which is measured as the Adjusted Impairment Loss Allowance/PAR>30 Days and finally Loan Loss Reserve Ratio (LLR). This is measured as the ratio of loan loss reserves to gross loans or simply put as Loan loss reserve/Value of loans outstanding. It is an indicator of how much of the gross loan portfolio has been provided for but not charged off. (Amoah-Binfoh et. al., 2005)

**2.5 Definition of Credit Management**

There are many definitions given for credit management by different scholars. Among these some are here cited as follows Credit management is implementing and maintaining a set of policies and procedures to minimize the amount of capital tied up in debtors and to minimize the exposure of the business to bad debts(http://www.smallbusiness.wa.gov.au/assets/ SmallBusiness-Briefs/small-business-brief-credit-management.pdf).

**2.6 Process of Credit Management**

The process of credit management begins with accurately assessing the credit-worthiness of the customer base and his/her business viability. This is particularly important if the company chooses to extend some type of credit line or revolving credit to certain customers. Hence, proper credit management is setting specific criteria that a customer must meet before receiving the proposed credit arrangement. As part of the evaluation process, credit management also calls for determining the total credit line that will be extended to a given customer. Several factors are used as part of the credit management process to evaluate and qualify a customer for the receipt of some form of commercial credit. This includes gathering data on the potential customer’s current financial condition, including the current credit track record that discloses the character of a customer in meeting obligations as well as collateral value. The current ratio between income and outstanding financial obligations will also be taken into consideration. (http://www.wisegeek.com/what-iscreditmanagement.htm).

**2.7 Credit Risk management Indicators**

Risk and liquidity are other words for the quality of portfolio. According to Ayayi, AyiGavrielet. al., (2010) there are several risk management methods are used by MFI‟s, such as sequential loans, credit scoring etc. E.g. when a borrower stops making payments on a loan, on MFI has two options. First, it can keep the loan on its books and try to collect the outstanding payments, thereby keeping the loan registered in the portfolio. Delinquent loans are tracked in the portfolio -at-risk ratios, depending on how long they have been in non-payment status. The other option for the MFI is to decide that it cannot collect the loan and write the loan off its books. In this case the loan registers in the write off ratio, thereby reducing the loan portfolio by the remaining balance of the loan. Due to the critics on the issue of repayment, these variables are considered less valid, since many MFIs are suspected of misreporting this issue. Yet the hypothesis on the quality of portfolio is that good quality, i.e. low portfolio at risk and low write off ratio, means high profitability since the MFI s get high repayment (Ayayi, AyiGavriel et. al., 2010).

Portfolio quality is a crucial area of performance analysis, since the largest source of risk for any financial institution resides in its loan portfolio (Wolday et. al. 2014) The loan portfolio is, by far, the largest asset and, in addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For microfinance institutions, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial (Wolday et. al 2014).

Loan portfolio is the most important asset of an MFI. Portfolio quality reflects the risk of loan delinquency and determines future revenues and an institution’s ability to increase outreach and serve potential and existing clients. Many MFIs have learned how to maintain loan portfolios of very high quality. In fact, leading MFIs are typically better at maintaining a higher portfolio quality than commercial banks in many countries ( Wolday et. al., 2014)

**2.8 Credit Risk management**

Credit risk management in financial institutions has become crucial for the survival and growth of these institutions (Afriyie&Akotey, 2012, p. 3). It is a structured approach of uncertainty management through risk assessment, development of strategies to manage it and mitigation of risk using managerial resources. The strategies of credit risk management involves transferring risk to other parties, avoiding risks, reducing the negative influence of risk and accepting some or all of the consequences of a particular risk (Afriyie&Akotey, 2012, p. 3). According to Van Gestel and Baesens, credit risk is managed in various ways. The most important method starts with appropriate selection of the counterparts and products (Gestel&Baesens, 2008, p.43). And good risk assessment model and qualified credit officers are key requirements for selection strategy (Gestel&Baesens, 2008, p.43).

For counterparts with higher default risk, banks may need more collateral to reduce risk. And the pricing of product should be in line with the estimated risk. Secondly, limitation rule of credit risk management restricts the exposure of bank to a given counterpart (Gestel&Baesens, 2008, p.43). It avoids the situation that one loss or Limited number of losses endangers the bank’s solvency (Gestel&Baesens, 2008, p.43).

Bank’s determinants on how much credit a counterpart with a given risk profile can take need to be limited. Thirdly, the allocation process of banks provides a good diversification of the risks across different borrowers of different types, industry, and geographies (Gestel&Baesens, 2008, p.43). As a result, diversification strategy spreads the credit risk thus avoids a concentration on credit risk problems. These techniques are translated in the daily organization by written procedures and policies which determine how counterparts are selected, risk profile loans are granted and above which level an expert evaluation is required (Gestel&Baesens, 2008, p.43).

In summary, a strong credit risk management avoids significant drawbacks like credit concentrations, lack of credit discipline, aggressive underwriting to high-risk counterparts and products at inadequate prices (Gestel&Baesens, 2008, p.44). And an effective credit risk management is verified by internal risk control and audit which monitor credit discipline, loan policies, approval policies, facility risk exposure and portfolio level risk .VanGestel&Baesens, 2008, p. 44).

**2.9 Credit Analysis**

Credit analysis is the primary method in reducing the credit risk on a loan request. This includes determining the financial strength of the borrowers, estimating the probability of default and reducing the risk of non-repayment to an acceptable level. In general, credit evaluations are based on the loan officer's subjective assessment (or judgmental assessment technique).Once a customer requests a loan; bank officers analyze all available information to determine whether the loan meets the bank’s risk-return objectives. Credit analysis is essentially default risk analysis, in which a loan officer attempts to evaluate a borrower’s ability and willingness to repay. Similarly Compton (1985) identified three distinct areas of commercial risk analysis related to the following questions:

1. What risks are inherent in the operations of the business?

2. What have managers done or failed to do in mitigating those risks?

3. How can a lender structure and control its own risks in supplying funds?

The first question forces the credit analyst to generate a list of factors that indicate what could harm a borrower’s ability to repay. The second recognizes that repayment is largely a function of decisions made by a borrower. Is management aware of the important risks, and has it responded? As Tomothy (1995:665) quoted, the last question forces the analyst to specify how risks can be controlled so the bank can structure to an acceptable loan agreement. A MFI’s credit analysts often use the five C’s of credit to focus their analysis on the key Dimensions of an applicant’s credit worthiness identified five C’s of credit. Lawrence (1997:776-777)

They include; Character, Capacity, Capital, Collateral, and Conditions.

**2.10 Default Problems**

Non-payment of loans has several undesirable consequences. It gradually destabilizes the credit system. Costs of loan administration of overdue loans are high. And defaults push up lending costs without any corresponding increase in loan turnover. Defaults reduce the resource base for further lending, weaken staff morale, and affect the borrower’s confidence. after a comprehensive survey of defaults in Sri Lanka, identified six factors which contributed to defaults: Sanderatne, (1978)

a. Variability in incomes caused by fortuitous, seasonal, or unforeseen factors;

b. Defects and inadequacies in the organization disbursing credit;

c. Attitudinal conditions not conducive to repayment;

d. Misallocation of borrowed funds;

e. Miscellaneous reasons such as illness, death. Etc.

According to Pandmanabhan (1986: 26-31), causes of delinquencies and defaults are classified as relating to three levels: borrower level, financing institution level, and economy level.

**2.11 Credit Collection Techniques**

Effective credit collection techniques are one of the necessities for financial institutions in any economic climate. Knowing how to encourage customers to pay their outstanding debts to financial institutions like banks on time can increase the cash flow of MFI. Therefore a number of collection techniques are employed. Under normal circumstances loan clients are expected to pay in cash or deposit or keep their installment repayment as per the agreement made. As the loan account becomes past due or overdue the collection effort becomes more personal and strict.

The basic techniques are:

* Telephone Calls

If the loan client passes the due date, a telephone call may be made to the customer to request immediate repayment and up to date his or her account.

* Personal visits

 If the telephone call made is not resulted positive response vesting his business and discussing the issue with the customer can be a very effective collection procedure.

* Letters

If the efforts made so far is unsuccessful and not resulted positive response a polite letter is to be served reminding the customer of its obligation followed by warning letters for the action to be taken in future and its consequence.

* Using Collection Agencies

Firms can turn uncollectible accounts over to a collection agency or an attorney for collection. The fees for this service are typically quite high; the firm may receive less than fifty percent on accounts collected in this way.

* Legal Action

Legal action is the most stringent step in the collection process. It is an alternative to the use of a collection agency not only is direct legal action expensive, but is may force the debtor in to bankruptcy, thereby reducing the possibility of future business without guarantying the ultimate receipt of overdue amount.

**2.12 Strategies to Minimize Defaults**

Because of the vulnerability of the microcredit sub-sector, lending institutions continue to adopt different techniques to improve repayment frequency and grant more credit access to borrowers who pay their credits on time (Christoph 2002). The Kenya, Women Finance Trust believes that small credits are expensive to administer and that the institution can survive only by charging competitive interest rates, lending to women, and keeping defaults to a bare minimum. Women are targeted as clients by this trust because they have been found to have a high propensity to repay (Ibid). According to Mann (1993), some lenders prefer known clients to avoid default. People on a loan committee will give preference to an applicant with whom they have dealt previously. Hence; lending institutions will give money based on previous banking experience with the client. The same study also showed that institutions lend to profitable businesses that have cash flow available to pay back the credit.

**2.13 Empirical literature**

As Nagarajan (2001) in his study of risk management 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. It requires careful planning and commitment on part of all stakeholders. It is encouraging to note that it is possible 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.

Achou and Tenguh (2008) also conducted research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (in terms of loan performance). Better credit risk management results in better performance. Thus, it is of crucial importance that financial institutions practice prudent credit risk management and safeguarding the assets of the institutions and protect the investors interests. This is also true for micro finance institutions. Method used by the researchers is mixed research method. 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.

**Chapter Three**

**Research Methodology**

This chapter describes in detail, how the study has beencarried out, what activities to be done, research design, Subjects or data sources, sample size, sample method, the instruments for data collection, and the analysis particular procedures.

**3.1. Research Design**

Based on the statements of the problem and the purpose of the research, it is decided that the descriptive studyis the most suitable for this topic. Because the study will intends to describe the existing facts about credit risk management on Awach saving and credit cooperative society Ltd. The research approach employed in this study is quantitative and qualitative approaches that would much for the research to address the objectives. Even though the research starts with the description about credit risk management of Awach saving and credit cooperative society Ltd, and the ultimate goal is to test an assessment of credit risk management and how it exists in microfinance institution.

**3.2. Type and source of data**

Generally, the study used to Primary data through questions. The primary data was obtained through both open and close ended questionnaire and interview questions distributed to respondents that involve Branch Managers and operation managers working on loan processing and also Loan Officers.

**3.3 Method of Data Collection**

Primary data have been gathered through both questionnaire and interview. The questionnaire includes both close-ended and open-ended questions, and distributed to sample respondents involving branch managers, operation managers and credit officers working on loan processing were targeted for the data collection where all the issues on the questionnaire were properly addressed. The closed ended questions were used to test the rating of various attributes and this helped in reducing the number of related responses in order to obtain more varied responses. The open-ended questions provided additional information that may not have been captured in the close-ended questions

Semi structured interview refers to the use of already prepared questions during the study Interview schedule has been held based on the pre-defined schedule. Before proceeding to any interview session, interviewees have been made to get additional information on the purpose of the session as well as confidentiality matters. The interview sessions were held with 5 branch managers of Beler, Salitemiret, AddisuGebaya, Lideta and Aware branchesand the analysis of the interview was made based on the information obtained from these branch managers.

**3.4. Sample size and sampling procedure**

Currently in AwachSaving and Credit Cooperative Society Ltd operating in 10 different branches of operation. From the totals service delivery posts out of that the researcher selected five branches based on seniority, credit default, size and status of the share company namely Beler, Salitemiret, AddisuGebaya, Lidetaand Aware branches were considered using purposive sampling technique. Purposive sampling targets a particular group of people. From those selected branch office the total respondents are considered 50 (fifty) number of loan officers and 5 (five) number of operation managers and the rest 5 (five) numbers are branch managers..

When the desired population for the study is rare or very difficult to locate and recruit for a study, purposive sampling may be the only option. In this research context, considering the time constraints, the cost allocated for the research and availability of data, key informant staffs of the branch who are directly engaged in operation of the study concerned have been selected purposively. The following table shows the sample taken by the researcher under Branch by Managers, operation managers and loan officers

**Table 3.1**

Sample determination for the study

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| List of sample branch | Branch Mangers | Operation managers | Loan officers | Sample size |
| Beler | 1 | 1 | 7 | 9 |
| Salitemiret | 1 | 1 | 7 | 9 |
| AddisuGebaya | 1 | 1 | 10 | 12 |
| Lideta | 1 | 1 | 9 | 11 |
| Aware | 1 | 1 | 17 | 19 |
| **Total** | **5** | **5** | **50** | **60** |

**3.5 Data analysis**

The primary data that have been collected through questionnaire were edited, codded, tabulated and finally analyzed using the Statistical Package for the EViews software. Descriptive statistics were used to analyze data like table and percentages. Furthermore, descriptions were made based on the results of the tables.

**CHAPTER FOUR**

**DATA ANALYSIS, RESULTS AND DISCUSSION**

**4.1 Introduction**

This chapter discusses the interpretation and presentation of the findings obtained from the field survey on the effect of credit risk management on the Microfinance Institutions in the case of Awach saving and credit cooperative society Ltd . Descriptive and inferential statistics were used to discuss the findings of the study. The study targeted a population size of 60 respondents from which 54 filled in and returned the questionnaires making a response rate of 90%. This response rate was satisfactory to make conclusions for the study

**4.2 Data Analysis**

**4.2.1 General Information**

**Table 4.1** Gender Male ( ) Female ( )

|  |  |  |
| --- | --- | --- |
| Gender  |  Frequency  | Percentage |
| Male | 21 | 38.9% |
| Female | 33 | 61.1% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the gender which the MFIs had been in existence in the organization, from the findings 61 % of the respondents indicated females and the remaining are 39 % of the respondents are males.

**Table 4.2**

Educational level

|  |  |  |
| --- | --- | --- |
| Educational level |  Frequency | Percentage |
| Diploma | 13 | 24.1% |
| Degree | 38 | 70.4% |
| MA and above | 3 | 5.5% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

With respect to the educational qualification of sample respondents, the result revealed that 24.1% of the respondents were having College Diploma. On the other hand, 70.4% of the respondents were degree holders and the rest 5.5% are MA degree holders this indicates that most of the MFIs had been in educational levels are degree holders .

**Table 4.3:**

 The respondents’ experience

|  |  |  |
| --- | --- | --- |
| Period of time | Frequency | Percentage |
| Less than 2 years | 12 | 22.2% |
| Between 2 to 6 years | 26 | 48.1% |
| Between 6 to 10 years | 13 | 24.1% |
| 10 years and above | 3 | 5.6% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to establish the length of time which the MFIs employer had been in existence in the organization, from the findings 48.1 % of the respondents indicated 2 to 6 years 24.1 % of the respondents indicated 6 to 10 years 22.2% of the respondents indicated less than 2 years whereas 5.6% of the respondents indicated for more than 10 years this implies that most of the MFI employers had been in existence for Between 2 to 6 years.

**Table 4.4**

Adoption of Credit risk Management Practices

|  |  |  |
| --- | --- | --- |
|  | Frequency | Percentage |
| Yes | 49 | 90.7% |
| No | 5 | 9.3% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the organizations that had adopted Credit risk Management practices. From the findings 90.7% of the respondents indicated that their organizations had adopted Credit risk Management practices, where as 9.3 % indicated that their organizations had not, this implies that a significant number of organizations had adopted the use of Credit Management practices is a factor of credit risk management .

**Table 4.5:**

Number of loan clients per loan officer ratio of the respective branch

|  |  |  |
| --- | --- | --- |
| Number of clients | Frequency | Percentage |
| Less than 200 clients | 21 | 38.9% |
| Between 200 to 500 Client | 31 | 57.4% |
| Above 500 client | 2 | 3.7% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the number of clients the organization had, from the findings 38.9 % of the respondents indicated that their organization had Been less than 200 clients 57.4% of the respondents indicated that their organization had Between 200 to 500 Clients whereas 3.7% of the respondents indicated that their organization above 500 clients this implies that one of the reason for default loan is size of the client so majority of the organizations featured in this study had Between 200 to 500 clients.

**4.2.2 Client Appraisal**

**Table 4.6:**

Extent to which Awach saving and credit cooperative society Ltd use client appraisal in Credit risk Management.

|  |  |  |
| --- | --- | --- |
| Number of clients | Frequency | Percentage |
| Very great extent | 9 | 16.7% |
| Great extent | 19 | 35.2% |
| Moderate extent | 26 | 48.1% |
| Total | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the extent to which MFIs used client appraisal in Credit risk Management, from the findings 16.7% of the respondents indicated to a great extent, 35.2% of the respondents indicated to a very great extent whereas 48.1 % of the respondents indicated to a moderate extent, this implies that most MFIs used client appraisal in Credit risk Management to a moderate extent.

**Table 4.7:**

Level of agreement on client appraisal in MFI

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Item | strongly agree % | Agree %  | Neutral % | Disagree % | Strongly disagree % |
| 1. Client appraisal is a viable strategy for credit risk management | 38.9% | 59.3% | 0 | 1.8% | 0 |
| 2. The MFI has competent personnel for carrying out client appraisal. | 38.9% | 40.7% | 0 | 13% | 7.4% |
| 3. Client appraisal considers the character of the customers seeking credit facilities..  | 44.4% | 51.9% | 0 | 3.7% | 0 |
| 4. Aspects of collateral are considered while appraising clients.  | 37% | 50% | 0 | 7.4% | 5.6% |
| 5. Failure to assess customers capacity to repay results in loan defaults | 44.4% | 55.6% | 0 | 0 | 0 |

Source: Eviews Output from Survey Data

As can be seen from table 4.7 item 1 to 5 respondents were asked to indicate their level of agreement \disagreement on the importance of the practice listed as (strongly agree (5) , Agree(4),Neutral(3), Disagree (2) and Strongly Disagree (1). accordingly overall then great majority of the respondents agreed on the importance of the items listed as far as clear appraisal is concerned . specifically speaking respondents showed their agreements on failure to assess customer repayment capacity result in default . likewise item 1, shows that 98.2% of the respondents agreed on the fact that client appraisal as a credit risk management strategy .still item 2, shows that 79.6% of the respondents agreed on the importance of competent personnel as a key to Cary out clients appraisal . Item 3,also shows that 96.3% great majority response agreement on character assessment of Clients as a key for consideration . Item 4,shows that 87% of the respondents agreement on considering physical collateral while client appraisal as a key for MFIs. Item 5,also shows that 100% great majority response agreement on Overall ,the respondents agreed up on the key importance of considering the five Cs i.e. capacity , character ,collateral ,condition and competence of personnel while client appraisal .

**4.2.3 Credit Risk Controls**

**Table 4.8:**

 Extent to which Awach saving and credit cooperative society Ltd use credit risk control in Credit Management

|  |  |  |
| --- | --- | --- |
| Number of clients | Frequency | Percentage |
| Very great extent | 7 | 12.96% |
| Great extent | 33 | 61.11% |
| Moderate extent | 14 | 25.93% |
| Total  | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the extent to which Awach saving and credit cooperative society Ltd used credit risk control in Credit Management, from the findings 12.96 % of the respondents indicated to a very great extent, 61.11 % of the respondents indicated to a great extent where as 25.93 % of the respondents indicated to a moderate extent, this implies that Awachsaving and credit cooperative society Ltd used credit risk control in Credit Management to a great extent.

**Table 4.9:**

Level of agreement on credit risk control in Awach saving and credit cooperative society Ltd.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Item | Strongly agree %  |  Agree %  | Neutral % |  Disagree %  | Strongly disagree %  |
| 1. Imposing loan size limits is a viable strategy in credit management
 | 40.74% | 53.7% | 1.85% | 3.7% | 0 |
| 1. The use of credit checks on regular basis enhances credit management
 | 38.89% | 57.4% | 1.85% | 1.85% | 0 |
| 1. Flexible repayment periods improve loan repayment.
 | 46.3% | 48.15% | 1.85% | 3.7% | 0 |
| 1. Penalty for late payment enhances customer’s commitment to loan Repayment
 | 44.45% | 53.7% | 1.85% | 0 | 0 |
| 1. The use of customer credit application forms improves monitoring and credit management as well
 | 48.15% | 51.85% | 0 | 0 | 0 |
| 1. Credit committee’s involvement in making decisions regarding loans are essential in reducing default/credit risk
 | 53.7% | 46.3% | 0 | 0 | 0 |
| 1. Interest rates charged affect performance of loans in the MFI
 | 50% | 47.15% | 48.15% | 1.85% | 0 |

Source: Eviews Output from Survey Data

As can be seen from table 4.9 item 1 to 7 respondents were asked to indicate their level of agreement \disagreement on the importance of the practice listed as strongly agree (5) , Agree(4),Neutral(3), Disagree (2) and Strongly Disagree (1). Accordingly overall then great majority of the respondents agreed on the importance of the items listed as far as credit risk control is concerned. Specifically speaking respondents showed their agreements on the methods to use credit risk control in Credit risk Management. likewise Item 1, shows that 94.44 % of the respondents agreed on the fact that Imposing loan size limits is a viable strategy in credit risk management . stillItem 2, shows that 96.29 % of the respondents agreed on the importance of credit checks on regular basis enhances credit risk management as a key to carry out credit risk control . Item 3, also shows that 94.45 % of the respondents agreed on Flexible repayment periods improve loan repayment as a key for consideration in credit risk control. Finally Item 4, Penalty for late payment.Item 5, customer credit application forms.Item 6, Credit committees’ involvement in making decisions.and Item 7 Interest rates charged on performance of loans shows that the respondents greatly Agreed on considering credit risk control as a key for MFIs.

Generally the overall respondents agreed up on the key importance of considering Credit risk Management is risk control methods.

**4.2.4 Collection Policy**

**Table 4.10:**

Extent to which MFI use collection policy in Credit risk Management

|  |  |  |
| --- | --- | --- |
| Number of clients | Frequency | Percentage |
| Very great extent | 18 | 33.33% |
| Great extent | 33 | 61.11% |
| Moderate extent | 3 | 5.56% |
| Total  | 54 | 100% |

Source: Eviews Output from Survey Data

The study sought to determine the extent to which MFI use collection policy in Credit risk Management, from the findings 61.11 % of the respondents indicated to a great extent, 33.33% of the respondents indicated to a very great extent whereas 5.56 % of the respondents indicated to a moderate extent, this implies that MFI use collection policy in Credit risk Management to a great extent.

**Table 4.11**:

Level of agreement on collection policy of MFI

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Statement  | Strongly agree % | Agree %  | Neutral %  | Disagree % | Strongly disagree %  |
| 1. Available collection policies have assisted towards effective credit management.
 | 40.74% | 59.26% | 0 | 0 | 0 |
| 1. Formulation of collection policies have been a challenge in credit management.
 | 50% | 44.44% | 1.85% | 3.71% | 0 |
| 1. Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults
 | 55.56% | 44.44% | 0 | 0 | 0 |
| 1. Staff incentives are effective in improving recovery of delinquent loans.
 | 46.3% | 51.85% | 0 | 1.85% | 0 |
| 1. Regular reviews have been done on collection policies to improve state of credit management.
 | 46.3% | 53.7% | 0 | 0 | 0 |
| 1. A stringent policy is more effective in debt recovery than a lenient policy
 | 50% | 48.15% | 0 | 1.85% | 0 |

Source: Eviews Output from Survey Data

The study sought to establish the level at which respondents agreed or disagreed on the importance of the practice listed as strongly agree (5) , Agree(4), Neutral(3), Disagree (2) and Strongly Disagree (1). with the above items relating to collection policy of MFI. From the findings majority of the respondents strongly agreed that Available collection policies, Enforcement of guarantee policies , Regular reviews on collection policies and using A stringent policy than a lenient policy have assisted MFIs collection policy towards effective credit risk management.

Additionally Item 2 also shows that 94.44 % of the respondents agreed on Formulation of collection policies have been a challenge in credit risk management repayment as collection policies for the institution and also Item 4 also shows that 98.15 % of the respondents agreed on Staff incentives are effective in improving recovery of delinquent loans this also a key indicator on collection policy of MFI. Generally speaking from the respondents finding agreed that well organized collection policy is a key factor for managing credit risk

**4.2.5 Results of Interview Questions**

The following section summarized and presented the result of interview sessions with 5 Branch managers of Beler, Salitemiret, AddisuGebaya, Lideta and Aware branches . Since the responses of the participants of the interview session was more or less alike, the researcher has preferred to summarize and present the result of the session in one set.

1 Model or technique to manage credit risk

Responding to this question the interviewees have come up with various factors that affect loan repayment. Among the factors raised are; give training to the staff, Designed or implemented clear policy, Use different measurement technique like PAR, Arrears rate and write off policy etc.

2 Reason of NPLs ratio were increasing

Responding to this question the respondents said that there are different reasons are happened in the case micro finance of NPL were increasing poor screening of borrowers, weak appraisal of loans, lack of immediate follow up, corruption at field staff level such as taking bribe for loans or frauds that can result in delinquencies and De motivated employees.

3 Do you think the current credit procedures; reviewing and approval culture is helping the MFI to achieve its objectives?

When answering to this question, the respondents said yes , it has not a doubt that poor analysis of the borrowers’ project feasibility contributes its effect to the loan repayment. Because the borrowers invested the loan on this project, so that if this project is not profitable the borrowers will fail his business and the loan repayment of the MFIs. So to achieve the goal of MFIs the primary message is procedures like recruitment/selection/ of the customers and approval of the business .

4 Reasons for violating covenants of loan by customers

 Responding to this question the respondents said in the case of group loan problems are happened between the members of the group regarding to duties and responsible in their work place, unexpected happening is occurred in the business from internally or externally.

5 Some comment or suggestions regarding the credit risk management system of the MFI.

Regarding to this question the respondents said, that Establishing an Appropriate Credit Risk management The board of directors should have responsibility for approving periodically (at least annually), Operating under a Sound Credit Granting Process the institution must operate within sound and well-defined credit granting criteria, Maintaining an Appropriate Credit Administration, Measurement and Monitoring Process.

**CHAPTER FIVE**

**SUMMARY, CONCLUSTIONS AND RECOMMENDATION**

**5.1 Summary**

The study revealed that Awach saving and credit cooperative society Ltd use client appraisal in Credit Management to a great extent. Further it established that client appraisal is a viable strategy for credit, Aspects of collateral are considered while appraising clients, failure to assess customer’s capacity to repay results in loan defaults, client appraisal considers the character of the customers seeking credit facilities and that Awach saving and credit cooperative society Ltd have competent personnel for carrying out client appraisal.

The study established that Awach saving and credit cooperative society Ltd use credit risk control in Credit Management to a great extent. The study further established that interest rates charged affects performance of loans in the Awach saving and credit cooperative society Ltd, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk, the use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers commitment to loan repayment, the use of customer credit application forms improves monitoring and credit management, flexible repayment periods improve loan repayment and finally that the use of credit checks on regular basis enhances credit management.

The study revealed that Awach saving and credit cooperative society Ltd use collection policy in Credit risk Management to a great extent. Formulation of collection policies have been a challenge in credit management , enforcement of guarantee policies provides chances for loan recovery in case of loan defaults, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more effective in debt recovery than a lenient policy, regular reviews have been done on collection policies to improve state of credit management, and finally that available collection policies have assisted towards effective credit management.

Regarding the major factors which contributes for the increase in the level of NPLs in the microfinance institutions, respondents strongly claimed that absence of proper group formation, employees lack of motivation and commitment, poor screening of borrowers, weak appraisal of loans, lack of immediate follow up, corruption at field staff level such as taking bribe for loans or frauds result in delinquencies.

The Challenges of Awach saving and credit cooperative society Ltd to reduce credit risks are proper client screening ,designed clear policy and also strong follow up of customers especially after loan disbursed and also follow some ways to check up the level of credit risk like PAR, arrears rate ,loan loss provision.

 **5.2 Conclusion**

From the findings, the study found that client appraisal, credit risk control and collection policy had effect on credit management of Awach saving and credit cooperative society Ltd. The study established that there was strong relationship between credit risk management of Awach saving and credit cooperative society Ltd and client appraisal, credit risk control and collection policy.

The study revealed that a unit increase in client appraisal would lead to increase in credit risk management of Awach saving and credit cooperative society Ltd; this is an indication that there was positive association between client appraisal and credit risk management of Awach saving and credit cooperative society Ltd,

An increase in credit risk control would lead to increase in credit risk management of Awach saving and credit cooperative society Ltd , which shows that there was positive relationship between credit risk management of Awach saving and credit cooperative society Ltd and credit risk control and a unit increase in collection policy would lead to increase in credit risk management this is an indication that there was a positive relationship between credit risk management of Awach saving and credit cooperative society Ltd and collection policy.

Client appraisal, credit risk control and collection policy influence credit risk management of Awach saving and credit cooperative society Ltd.

**5.3 Recommendation**

The study recommends that Awach saving and credit cooperative society Ltd should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

* The research aimed to fill a gap in the previous studies of testing an assessment of credit risk management of Awach saving and credit cooperative society Ltd. And the result of the study provides managers further understanding by how the measures of profitability are affected by the measures of credit risk management. All of these contribute valuable information for MFI managers, financial analysts, investors and supervisors when they make relevant decisions.
* The study also recommends that there is need for Awach saving and credit cooperative society Ltd to enhance their client appraisal techniques so as to improve their financial performance. Through client appraisal techniques, the Awach saving and credit cooperative society Ltd will be able to know credit worth clients and thus reduce their non-performing loans.
* There is also need for Awach saving and credit cooperative society Ltd to enhance their credit risk control this will help in decreasing default levels as well as their non-performing loans. This will help in improving their financial performance.
* Increase the number of employee in the operation department where there is a need for credit risk management so that the case will be minimized and that will give opportunity for every credit officer to do the job efficiently.
* Improve the collateral registration process and obtain cash equivalent collateral for each loan made to the customers.
* Developing and maintaining credit approval authority structure and granting approval authority to qualified and experienced individuals.

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SAINT MARY University

School of graduate studies

Department of MBA IN Accounting & Finance

YONAS TESFAYE

Date:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

I am graduate student in SMU carrying out a research under the topic “Assessment of Credit Risk Management on Micro Finance Institution (in the case of Awach Saving and Credit Cooperative Society LTD)

Therefore, your precise and clear answers to these questionnaire & interviews will ended be critical for the success of this study.

All Information provided would be kept entirely confidential and the interviewee can’t be identified and will remain anonymous. This research is undertaken as part of fulfillment for the program

Thank you for taking some minutes of your precious time.

 Part A: General Information

**1**. Gender Male ( ) Female ( )

**2**. Educational level diploma ( ) degree ( ) MA and above ( )

**3**. For how long the respondents experience in the MFI?

 Less than 2 years [ ] between 2 to 6 years [ ]

 Between 6 to 10 years [ ] above 10 years [ ]

**4.** Has your organization adopted Credit risk Management Practices?

 Yes [ ] No [ ]

**5**. How many clients per loan officer ratio does your organization have?

 Less than 200 clients [ ] between 200 to 500 Client [ ]

above 500 client [ ]

**Part B: Credit Risk Management Practices**

**CLIENT APPRAISAL**

**6**. To what extent does the MFI use client appraisal in Credit Management?

 Very great extent [ ] Great extent [ ]

 Moderate extent [ ] Low extent [ ]

 Not at all [ ]

**7**. What is your level of agreement on the following statements relating to client appraisal in

MFI

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Item  | strongly agree  | Agree  | Neutral | Disagree | Strongly disagree  |
| Client appraisal is a viable strategy for credit management |  |  |  |  |  |
| The MFI has competent personnel for carrying out client  |  |  |  |  |  |
| Aspects of collateral are considered while appraising clients.  |  |  |  |  |  |
| Failure to assess customer’s capacity to repay results in loan defaults  |  |  |  |  |  |

**CREDIT RISK CONTROL**

**8**. To what extent does the MFI use credit risk control in Credit Management?

Very great extent [ ] Great extent [ ]

Moderate extent [ ] Low extent [ ]

Not at all [ ]

 **9**. What is your level of agreement on the following statements relating to credit risk control in MFI?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| item | Strongly agree  |  agree  | Neutral |  Disagree  | Strongly disagree  |
| Imposing loan size limits is a viable strategy in credit management  |  |  |  |  |  |
| The use of credit checks on regular basis enhances credit management |  |  |  |  |  |
| Flexible repayment periods improve loan repayment.  |  |  |  |  |  |
| Penalty for late payment enhances customer’s commitment to loan Repayment  |  |  |  |  |  |
| The use of customer credit application forms improves monitoring and credit management as well  |  |  |  |  |  |
| Credit committee’s involvement in making decisions regarding loans are essential in reducing default/credit risk  |  |  |  |  |  |
| Interest rates charged affect performance of loans in the MFI  |  |  |  |  |  |

**COLLECTION POLICY**

**10**. To what extent does the MFI use collection policy in Credit Management?

 Very great extent [ ] Great extent [ ]

 Moderate extent [ ] Low extent [ ]

 Not at all [ ]

11. What is your level of agreement on the following statements relating to collection policy of MFI?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Statement  | Strongly agree | Agree  | Neutral  | Disagree | Strongly disagree  |
| Available collection policies have assisted towards effective credit management. |  |  |  |  |  |
| Formulation of collection policies have been a challenge in credit management.  |  |  |  |  |  |
| Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults  |  |  |  |  |  |
| Staff incentives are effective in improving recovery of delinquent loans.  |  |  |  |  |  |
| Regular reviews have been done on collection policies to improve state of credit management.  |  |  |  |  |  |
| A stringent policy is more effective in debt recovery than a lenient policy  |  |  |  |  |  |

Thank you

**For interview**

1. Do you have any model or technique through which you manage your credit risk?

2. If the trend of NPLS ratio was increasing, what might be the reason (s)?

3. Do you think the current credit procedures; reviewing and approval culture is helping the MFI to achieve its objectives?

4. In your opinion what are the main reasons for violating covenants of loan by customers?

5. Give your comment or suggestions regarding the credit risk management system of the MFI.