ST. MARY'S UNIVERSITY

SCHOOL OF BUSINESS GRADUATE STUDIES

ASSESSMENT OF CREDIT RISK MANAGEMENT IN BANKING BUSINESS: THE CASE OF BANK OF ABYSSINIA S.C

By

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JULY, 2024

ADDIS ABABA, ETHIOPIA

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TO UNDERTAKE A REASERCH IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR AWARD IN THE PROGRAM OF MASTERS OF BUSSINESS ADMINISTRATION (MBA)

JULY, 2024

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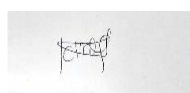
Kiros Habtu (Ass. Prof)	 July, 16, 2024
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AKNOWLWDGEMENT

First of all, I would like to give my glory and praise to the Almighty God for his priceless concerns and supports all the way through my life.

I would like to express my gratitude to my Advisor Dr. Kiros Habtu for her valuable and Expeditious advice, her tolerance guide and useful criticism all through the course in preparing the paper, her constructive corrections and insightful comments and encouragement are highly appreciable.

Finally, I would like to give my greatest appreciation to my parents because they have supported me in diverse ways and they contribute to the success of my education. Last but not least I also thank my respondents without their input this work would not have been possible.

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ACRONYMS

NBE: National Bank of Ethiopia

CRM: Credit Risk Management

BOA: Bank of Abyssinia

FI: Financial Institution

NPL: Non-Performing Loan

BoD: Board of Directors

S.C. Share Company

RM: Relation Manager

ABSTRACT

The objective of this research is to assess the credit risk management of Bank of Abyssinia S.C which is great concern for most banks because unable to control credit risk can easily and most likely facilitate bank failure. So Managing credit risk is complicated task so it needs comprehensive consideration and practices for identifying, measuring, controlling and minimizing credit risk. In this study, the researcher utilized purposive sampling technique in order to select participants of the study. For the purpose of this study, both primary and secondary data were used. Primary data were collected through questionnaires distributed to respondents that involve professionals working in the banks such as Department Managers and Senior Officers working on loan processing. Descriptive statistics such as average, percentages, frequencies and tables were used to analyze and present the data. The study found that factors such as information asymmetry on credit policy, weak credit analysis and poor credit monitoring are influence towards the attainment of successful credit risk management in BOA. Based on the findings, the paper recommends that the bank's credit policies should be designed and implemented with consideration for internal and external factors that enable the bank to maintain sound credit granting standards; monitor and control credit risk; to properly evaluate new business opportunities; and identify and administer problems of credits.

Key words: Credit, Credit Risk, Credit Risk Management

CHAPTER ONE

INTRODUCTION

This section contains the research introductory material. It comprises research question, statement of the problem, background, aims, significance, limitations, scope and organization of the study.

1.1 Background of the study

Credit creation is the main income generating activity for the banks. Bank loans are the largest and most obvious source of credit risk. Since exposure to credit risk continues to be the leading source of problems in the banks and can greatly put at risk the smooth functioning of a bank's business. In essence, Banks serve as intermediaries between individuals who deposit money and those who borrow money. While other financial institutions, like stockbrokers also act as intermediaries between buyers and sellers of shares, it is the ability to accept deposits and provide loans that sets banks apart, even though many banks offer additional financial services. (P.Suresh & J Paul, 2010).

Credit management means the total process of lending starting from inquiring potential borrowers up to recovering the amount granted. In the sense of banking sector credit management is concerned with activities such as accepting application, loan appraisal, loan approval, monitoring and recovery of non-performing loans. Businesses in the corporate sector often require funds to finance their investment projects. These projects may have a longer time horizon, and the expected returns may not be realized for several years. Banks address this by lending funds to businesses, allowing them to borrow the required capital and repay it in line with the expected returns of their investment projects. (K. R.Upadhaya, 2009).

Credit risk management is an important part of any business that is because the company assesses the investments and loans that it is committed to Banks in Ethiopia play a vital role in offering liquidity by providing depositors with easy access to their funds and facilitating borrowing for businesses with Credit management encompasses the entire lending process, starting from evaluating prospective borrowers to recovering the granted amount. In the context of the banking sector, credit management involves various activities such as accepting loan applications, appraising loans, approving them, monitoring their progress, and recovering any non-performing loans. (K. R.Upadhaya, 2009).

Longer-term investment projects. They act as intermediaries, connecting savers and borrowers to ensure the efficient allocation of financial resources in the economy. Credit risk management is a crucial aspect of business operations. It involves evaluating the investments and loans that a company is involved in. The manager responsible for credit risk must take a long-term perspective and carefully assess the viability of each investment and loan, as the financial well-being of the company relies on making safe and profitable choices. In addition to analyzing the company's loans, these credit risk managers also need to review and evaluate the creditworthiness of customers to whom the company extends credit. (K. R.Upadhaya, 2009).

1.2 Background of the Organization

1.2.1 History of Banking in Ethiopia

In 1931 the Ethiopian government established nationally owned bank called State Bank of Ethiopia, which changed the foreign dominated structure of the banking industry. The banking activities were expanded by the involvement of Italian private banks during the five years of the Italian occupation (1936-1941). Until 1974 there were eight private foreign owned banks, three states owned, and one foreign and private owned banks operating in Ethiopia. In 1974, all private banks were nationalized and the national bank of Ethiopia was set up at the peak of the banking structure to manage all the functions of a central bank. At the time, the three banks: Commercial Bank of Ethiopia (CBE), Development Bank of Ethiopia (DBE) and Construction and Business Bank (CBB) were the only banks in operation. CBE followed by the DBE were the most important banks in the country both before and after reform mainly to implement the economic plans outlined by the state. On average the CBE alone contains more than 90% of total deposit mobilization and 71% of the total lending, (Alemayehu Geda, 2009). Subsequent to the downfall of the Derge’s administration in 1991, the economic policy of Ethiopia was changed from socialist command economic policy to market-oriented economic policy. This new change in the political system and policy of the new government brought a significant change in the functioning of the banking industry. A new banking proclamation was introduced in 1995, which allowed Ethiopian private Banks to engage on the sector. And thus, the financial sector was allowed to serve the private sector (AlemayehuGeda,2009).Source;www.nbe.gov.et/History/history.htmwww.nbe.gov.et/History/history.htm As a result, new private banks were established. These banks started operation with more or less the same type of human capital, working culture and operational systems used by the existing dominant and experienced government banks, which have their impact in the operation of these new private Banks. The new banks provided retail banking (saving, transfers and payment instruments), lending (short, medium and long term loans) and international banking (import, export, guarantees, forex, treasury and transfer) services to the public.

1.2.2 **History of Bank of Abyssinia**

Bank of Abyssinia was established on February 15, 1996 (90 years to the day after the first but defunct private bank was established in 1906 during Emperor MenelikII in accordance with 1960 Ethiopian commercial code and the Licensing and Supervision of Banking Business Proclamation No. 84/1994.BOA started its operation with an authorized and paid up capital of Birr 50 million, and Birr 17.8 million respectively, and with only 131 shareholders and 32 staff. In two decades since its establishment Bank of Abyssinia has registered a significant growth in paid up capital and total asset. It also attracted many professional staff members, valuable shareholders and large customers from all walks of life. This performance indicates public confidence in the Bank and reliability and satisfaction in its services. Nowadays, employing the state-of-art banking technology, the Bank provides excellence domestic, international and special banking services to its esteemed and valuable customers. It also strives to serve all economic and services sectors via its ever-increasing branch networks throughout the country. The description of the logo icon consists of a diamond shaped six petals yellow colored flower (endemic) called “adeyabeba”, surrounded by a square with black color in the background. The flower: the logo is taken from an endemic six petals flower, locally known as “adeyabeba its botanic name is Bidensmacroptera (sch. Bip ex chiov). The color connotes hope and peace, signifying bright future for the Boa in a growing and peaceful economic environment. http://www.bankofabyssinia.com

Bank of Abyssinia has more than 11,283 staffs and more than 9.3 million account holders at March 30, 2023 and works with known money transfer agents such as Western Union, Express Money, Ria International, Transfast, Dahabshiil, MoneyGram, Kaha and Eezreemit. Following a strong demand for better service and products from all directions on the one hand, and a ground-breaking development in ICT, on the other, BOA has replaced its in-house IT system with the state-of-the art technology called T24 and started ATM and POS services and mobile banking services. BOA also provides Internet banking services .following great demand for better service and products from all directions on the one hand and a ground breaking development in ICT. On the other hand Boa’s well-structured financial service system is connected through the T-24 core banking system. This coupled with 1271 ATM machines, 18 virtual banking centers and more than 1256 POS placed in different locations to afford customers to access their accounts from anywhere at any time. Portal.bankofabyssinia.com

Bank of Abyssinia maintained its remarkable growth trends in the fiscal year 2022/23 and total incremental deposits mobilized throughout the reporting period reached 36.49 billion, a 29.89% growth from last fiscal year. Accordingly the Bank’s total outstanding deposits stood at birr 158.54 billion as at June 30, 2023. Deposits showed increase across all deposit types with saving deposits leading the way followed by IFB and demand deposits .The deposits stock was composed of 68.22% savings, 15.99% demand, 11.40% IFB, and 4.39 fixed time deposits. The banks total outstanding loans and advances and also IFB financing reached birr 33.18 billion, or by 29.27% from the previous period. The bank’s assets have risen significantly in size over the year, total assets increased from birr 149.45 billion of June 30,2022, to birr 189.51 billion as at June 30,2023, a growth of birr 40.06 billion(26.81%) Portal.bankofabyssinia.com

BOA has 2,424 shareholders who are successful businessmen, intellectuals, celebrities, etc. Which started banking services with only one branch in 1996, has more than 900 branch networks, of which more than 271 branches are in Addis Ababa and more than

553 branches are established in bankable towns all over the country. Most branches work 10 hours a day 6 days a week (starting from 08:00 up to 06:00pm). All city and outlying branches are interconnected with state-of-the art ICT. Portal.bankofabyssinia.com

. **1.3 Statement of the problem**

Banks primarily provided loans to enterprises that could offer immovable assets as collateral. However, many banks have now expanded their lending scope to include individuals, corporate bodies, and enterprises without requiring collateral for instance recently Abyssinia has introduced new digital application which is called Apollo which gives microloans and salary advance without requiring collateral. Therefore establishing a robust credit risk management system is crucial for ensuring the stability and suitability of a financial institution's operations. Therefore, it is the responsibility of the institution's management to take the lead in developing and implementing such a system. . (P.Suresh & J Paul, 2010).

The gap in order to be fulfilled is that Banks rely on customer deposits to generate credit for borrowers, which serve as a significant source of revenue for most banks. However, this credit creation process exposes banks to the risk of defaults, potentially leading to financial difficulties. This research is about to fill the gap of the flexibility of it Credit assessment and control policy as we are living in a dynamic world the policy needs to be more flexible this plays a crucial role in helping bankers select the right type of borrower. It is the responsibility of bankers to thoroughly investigate clients from various angles, considering their strengths and weaknesses, to ensure that they can repay the bank loan along with the associated profits. To prevent future financial crises, it is important to enhance borrowers' financial literacy, improve transparency in the lending process, and assess the affordability and sustainability of loan products more effectively. . (P.Suresh & J Paul, 2010).

1.4 Research questions

The basic research questions of this study that require possible solutions will be listed below.

- ✓ To what extent does the bank implement efficient policies and procedures to manage credit risk adequately?
- ✓ What methods does the bank utilize to measure and monitor credit risk?
- ✓ What methods or mechanisms does the bank employ to regulate or control loans?

1.5 Research objective

1.5.1General objective

The primary aim of the study is to assess the effectiveness of Bank of Abyssinia in implementing credit risk management across its activities.

1.5.2 Specific objectives

The specific objectives are:

- ✓ To examine to what extent does the bank implement efficient policies and procedures to manage credit risk adequately.
- ✓ To evaluate the methods that the bank utilize to measure and monitor credit risk.
- ✓ To evaluate the mechanisms the bank employs to regulate or control loans?

1.6 Significance of the research

The research aimed to assist Bank of Abyssinia in gaining a better understanding of its credit risk exposure. This, in turn, enables the bank to establish appropriate policies and practices to effectively manage these risks. Additionally, the study provide valuable insights for those interested in conducting further research on credit risk management practices and can serve as a reliable source of secondary information.

1.7 Scope and limitation of the study

1.7.1 Scope/delimitation of the study

It is important to note that this research focused on the credit risk management practices of Abyssinia Bank. The study specifically targets respondents from the Head Office, particularly those in the credit and risk department, as well as selected branches in specific cities. Since the bank operates with a centralized integrated system, the researcher believed that the practices observed at the Head Office are indicative of the bank's operations as a whole. As a result, the primary data collection for this study relies solely on questionnaires, as it is a convenient and time-saving method

1.7.2 Limitation of the study

This conducted specifically at the Bank of Abyssinia's Head Office and selected branches. Due to the challenges of reaching all employees in these locations, the study focused on a sample of respondents. Furthermore, the study specifically examines credit risk management and does not address other areas of risk within the bank. While credit risk management is a concern for all banks operating in the country, this paper is limited to analyzing the credit risk management practices of Bank of Abyssinia.

1.8 Organization of the study

This study is categorized in to five chapters. Chapter one of the research comprises the background, statement of the problem, objective of the study, research questions, Significance, scope and limitation of the study. The literature related and relevant to the research topic is reviewed in the second chapter. In Chapter three of this study, the research will present methods and design, including how the research will be carried out and deliberated on the methodology used for the study. Chapter four presents and discusses the empirical results of the study. The last chapter is chapter five, in this chapter the researcher summarizes the entire work, makes the summary, conclusions and recommendations.

CHAPTEER TWO

LITERATURE REVIEW

2.1.Theoretical literatures

This section mostly covers related literatures generated by various writers and researchers in response to the research's basic questions and objectives. Furthermore, different empirical research on motivation will be conducted, and the conceptual framework will also display.

2.1.1. Definitions and Concepts of credit risk

Currently, the concept of risk is gaining significant attention from researchers across various disciplines. It involves studying the likelihood of an event happening and the potential outcomes it may have. These studies help guide decisions about how to protect the health and safety of communities and the environment. As a result, a crucial question emerges regarding how humans perceive and understand risks. The Renaissance period, along with its advancements in exploration and long-distance trade, is widely recognized as a significant turning point in the development of risk analysis. (Jorge Rocha, Sandra Oliveira and César Capinha, 2020)

Financial institutions have encountered various challenges over time, but the primary reason for significant banking issues remains the relaxed criteria for lending money and doing business with borrowers and partners. Additionally, inadequate management of portfolio risks and a failure to monitor economic or other factors that can negatively impact the creditworthiness of a bank's partners contribute to these problems. This is a widespread occurrence in both G-10 and non-G-10 countries. (Jorge Rocha, Sandra Oliveira and César Capinha, 2020)

Credit risk refers to the possibility that a borrower or business partner of a bank may fail to fulfil their obligations as per the agreed terms. The objective of credit risk management is to optimize a bank's return on investment by keeping credit risk exposure within acceptable limits. Banks are responsible for managing the credit risk associated with their entire portfolio as well as the risk associated with individual loans or transactions. It is also important for banks to consider the interplay between credit risk and other types of risks. Effective credit risk management is a crucial aspect of a comprehensive risk management approach and is vital for the sustained success of any banking institution. (Jorge Rocha, Sandra Oliveira and César Capinha, 2020)

2.1.2 Sources of credit risk

In order to assess credit risk, someone needs to identify the transactions and products that involve credit risk

2.1.2.1Accounts receivable

Refers to the money that a company expects to receive from its customers for the products or services it has provided. However, there is a risk involved in extending credit to customers. This risk is known as credit risk. When a seller or service provider sends an invoice to the customer, they expect to be paid within a specific time frame. However, there is a chance that the buyer may not pay or make a late payment. In such cases, the creditor may have the option to charge late fees or interest if the payment is not made by the due date. Depending on the industry and the customer, the payment for accounts receivable can be received up to 10-20 days after the due date. (Panayiota Koulafetis, 2017)

Businesses understand that not all invoices they send out will be paid on time or at all. To account for this, they estimate and record an allowance for doubtful accounts. They also analyze the extent to which payments are overdue, categorizing them as 30-60 days overdue or 90+ days overdue. When accounts receivable remain unpaid, some businesses enlist the help of third-party collection agencies. These agencies work to recover the owed amount by negotiating payment plans, settlement offers, or even resorting to legal action. Accounts receivable represent the money that is owed to the business for the sale of products or services and are classified as current assets. (Panayiota Koulafetis, 2017)

2.1.2.2 Loans

A loan is when a lender provides cash to a borrower, with the agreement that it will be repaid on a specific future date. The borrower is required to pay interest on the loan amount at scheduled payment dates, which is the cost of the loan. The loan agreement outlines all the terms and conditions, including the borrower's obligations, restrictions, and covenants. *(*Panayiota Koulafetis, 2017*)*

2.1.2.3 Leases

Financial leases, to a certain extent, resemble medium-term secured loans since the lessor can repossess the leased asset upon the lessee's (obligor's) default. However, in a financial lease the lessee is the owner of the asset rather than holding security over the asset as in a secured loan. The lessor usually borrows the funds to finance the acquisition of the asset it leases and requires from the lessee future scheduled payments in order to service the debt. The lessee enjoys the use of the asset by paying a number of scheduled periodic payments. Many firms may prefer leasing assets rather than actually owing them through debt financing, because it allows them—in most cases—to show an improvement of their return on assets and to have a lower depreciation since the asset is not shown on the balance sheet but is providing income, and because of tax deduction advantages. (Panayiota Koulafetis, 2017)

2.1.2.4 Bonds

A bond carries the risk of credit default. This means that the issuer of the bond may fail to make timely payments, make reduced payments, or completely default on the scheduled coupon and principal payments. The inability to make payments can be due to poor cash flows from the issuer's operations. If the bond has a floating interest rate, an increase in interest rates would require higher interest payments, further increasing the credit risk. Other factors that can affect the bond issuer's ability to make payments include overall market conditions, competition, regulatory changes, and technological advancements. The credit risk associated with a bond can be evaluated by referring to the ratings provided by Nationally Recognized Statistical Rating Organizations (NRSROs) designated by the Securities and Exchange Commission (SEC). (Panayiota Koulafetis, 2017)

2.1.2.5 Derivatives

Derivatives are financial instruments that derive their value from the price of an underlying asset or benchmark, such as stocks, bonds, commodities, currencies, or precious metals. These instruments involve a contractual relationship between two parties, where one party has the right to claim the underlying asset in the future, while the other party is obligated to fulfill that liability. The derivative contract can either bind both parties equally or provide one party with the option to exercise specific rights. It may also involve the swapping of assets or obligations. The maturity period of a derivative contract can vary, ranging from a few weeks or months, as seen in futures contracts, to several years, like long-term swaps. If the value of the underlying asset or benchmark moves unfavorably, it can impact the value of the derivative. (Panayiota Koulafetis, 2017)

2.1.3 Who is exposed to credit risk?

Organizations and individuals face the possibility of credit risk, whether they willingly accept it or not. However, not all exposure to credit risk is necessarily harmful. Banks and hedge funds, for example, thrive by taking on and effectively managing credit risk. Similarly, individuals opt to invest in fixed income bond funds to gain additional returns compared to holding U.S. Treasury bonds. For industrial corporations or service companies, credit risk arises due to their sales of goods or services. (Sylvain Bouteillé and Diane Coogan-Pushner, 2013)

2.1.4 Why manage credit risk?

A crucial factor in credit risk is its manageability. It is not a sudden occurrence that befalls a company and its credit risk managers without any warning. If the fundamental sources of credit risk are comprehended and can be predicted, it would be unacceptable to neglect its management. Credit risk is not solely a result of external factors, but also influenced by human behavior and decision-making. When obligors face financial difficulties, it is often due to decisions made by the company's managers. These decisions are influenced by the incentives of both the managers and the shareholders they represent. It is crucial to understand the motivations of shareholders and managers in order to assess the credit risk profile of counterparty. (Sylvain Bouteillé and Diane Coogan-Pushner, 2013)

All firms should devote significant attention and resources to credit risk management for their own survival, profitability, and return on equity: Survival. It's a concern primarily for financial institutions for which large losses can lead to bankruptcy, but even a nonfinancial corporation can have credit losses that can cause bankruptcy. It sounds trivial to state that the less money one loses, the more money one makes, but the statement pretty much summarizes the key to profitability, especially of low-margin businesses. Return on equity. Companies cannot run their business at a sufficient return on equity if they hold too much equity capital. Holding large amounts of debt capital is not the solution either, because debt does not absorb losses and can introduce more risk into the equation. The key to long-term survival is a sufficiently high amount of equity capital complemented by prudent risk management. (Sylvain Bouteillé and Diane Coogan-Pushner, 2013)

2.1.5 Credit Risks in banking

As (Shelagh Heffernan ,2005) stated every business in order to maximize its profits, including banks, must navigate through various macroeconomic risks, such as the impact of inflation or recession, as well as microeconomic risks. Credit risk is the biggest risk for banks. It occurs when borrowers or counterparties fail to meet contractual obligations. The defaults on failing to meet the obligation can occur on mortgages, credit cards and fixed income securities.

While banks cannot be fully protected from credit risk due to nature of their business model, they can lower their exposure in several ways. Since deterioration in an industry or issuer is often unpredictable. The major risks for banks include credits, operational, markets; and liquidity risk The objective of this chapter is to outline the key financial risks and their implications. (Shelagh Heffernan, 2005)

2.1.6 Duration Analysis

In simpler terms, when considering the impact on shareholders' equity due to changes in the risk-free interest rate, duration analysis goes beyond just looking at the maturity of assets and liabilities. It takes into account the possibility that the average life or duration of an asset or liability may differ from its maturity. Let's take an example of a loan with a maturity of six months that the bank decides to match with a six-month Certificate of Deposit (CD). If a portion of the loan is repaid each month, the duration of the loan will be different from its maturity. On the other hand, for the CD, the duration will be the same as the maturity if depositors receive a lump sum at the end of the six months. (Shelagh Heffernan, 2005)

However, if only part of the loan is repaid each month and depositors are still paid a lump sum, it creates a duration gap. This exposes the bank to interest rate risk. Duration is a measure that calculates the average term to repricing, taking into account the present value of cash flows. Initially, it was primarily used for bonds with coupons to adjust for the impurity of a bond. The true duration is typically shorter than the bond's term to maturity. (Shelagh Heffernan, 2005)

$$\text{Duration} = T\,\{1 - [\text{coupon size}/\ (MV \times r)]\} + [(1 + r)/r][1 - (DPVR/MV)] \quad (3.1)$$

Where: T: time to redemption

r: market (nominal) interest rate

MV: market value DPVR: discounted present value of redemption

2.1.7 Management of risks in banking

As (Shelagh Heffernan ,2005) stated Every business that aims to maximize its profits, including banks, must navigate through various macroeconomic risks, such as the impact of inflation or recession, as well as microeconomic risks like emerging competition. Additionally, all businesses face potential risks such as technological failures, supplier or customer issues, political interference, or natural disasters. However, banks in Ethiopia also encounter certain unique risks that are not typically faced by non-financial companies. (Shelagh Heffernan, 2005)

Credit risk, which refers to the possibility of borrowers defaulting on bank loans, is the primary risk associated with banks due to their role as intermediaries in lending. Managing credit risk effectively is crucial because a significant number of bank failures are linked to a high proportion of non-performing loans compared to the total loans. However, as banks in Ethiopia evolve into more complex organizations, offering a wider range of fee-based financial services and utilizing newer financial instruments, other types of financial risks have been identified and made more transparent. The objective of this chapter is to outline the key financial risks and their implications. (Shelagh Heffernan ,2005)

Risk management in a bank involves identifying, measuring, planning, controlling, and monitoring the risks that may occur in the bank's business. It is an ongoing process that aims to increase transparency and effectively manage risks. Every bank needs to have a long-term vision and strategy for integrated risk management, tailored to its size, focus, position, and available resources. This requires the full commitment of senior management and specialized skills and expertise. (Shelagh Heffernan, 2005)

2.1.7.1 Identification of credit risk

According to Ketan R. (2009), Identifying credit risk is the first step in managing the risks associated with lending money. Credit risk can be categorized into three types: default risk, exposure risk, and recovery risk. Default risk refers to the likelihood that a borrower will fail to make the promised payments leading to a default. Exposure risk arises from the uncertainty surrounding the future amounts that are at risk. This risk may not be present for all lines of credit, especially if there is a repayment schedule in place. However, project financing, which involves uncertain cash flows and repayments, can create exposure risks. Recovery risk comes into play when default is unpredictable. This risk can take the form of collateral risk, third-party guarantee risk, and legal risk. Overall, identifying these different types of credit risk is crucial for effective credit risk management in order to mitigate potential losses. (Ketan R.2009), Collateral risk means the uncertainty surrounding the ability to access and sell the collateral that has been used to secure a loan. This risk also includes the costs associated with selling the collateral. When collateral is used to mitigate credit risk, it introduces the risk of recovering the loan amount and the risk of changes in the value of the collateral. Third-party guarantee risk arises when a third party fails to fulfil their commitment to repay the loan on behalf of the borrower. In this case, there is a joint default risk if both the borrower and the guarantor fail to meet their obligations simultaneously. Legal risk comes into play when legal procedures are initiated in the event of default. This risk involves the uncertainties and potential complications that can arise during the legal process. Understanding these risks is important for effective credit risk management and to take appropriate measures to mitigate potential losses. Ketan R. (2009),

2.1.7.2 Measurement of credit risk

Measurement of credit risk has been an important function of credit risk management, as if risk cannot be measured properly, it cannot be managed properly. Chaubal R.P. in his article “Measuring credit risk” has explained that measurement of credit risk involves quantification of

Expected loss (EL) and ii) unexpected loss (UL) Expected loss is denoted by the formula:

EL = PD x LGD x EAD UL = $EAD\sqrt{CPD} \times \delta$ 2LGD+LGD2$\times$ $\delta 2PD$3 Thus, for the measurement of credit risk, quantification of the following components is necessary probability of default, expected exposure at default, loss given default, maturity or tenor of the exposure and degree of diversification in a bank credit portfolio. Some of the known models that are being used by banks include

Saunders and Cornett explained Altman Z Score Model – A model developed by Altman, which measures the default risk. Z score model is a combination of key financial indicators measuring profitability, liquidity, asset utilization and solvency. The purpose of credit rating for loan accounts is to assess whether the account will continue to be a performing asset and not default in the future. The National Bank of Ethiopia (NBE) has provided guidelines for banks to conduct credit rating for their borrowers and categorize them accordingly. The NBE also advises banks to collect and maintain data on loan defaults based on the rating categories. This data is important for managing the credit portfolio effectively, as it allows banks to estimate expected defaults, contributions, and the capital required to maintain the portfolio. By analyzing this information, banks can make informed decisions about their lending practices and mitigate potential risks. (Padmalatha S. & Justin P., 2010).

2.1.7.3 Control and Monitoring of Credit Risk

Many credit losses occur because credit risk is not properly monitored. One common way of monitoring credit risk is by gathering information from customers and analyzing it using basic ratio analysis. Effective credit risk monitoring involves actively managing credit risk before serious problems arise. This requires a thorough understanding of both operating risks and financial risks so that any negative changes in these factors can be identified early on. The underlying principle of credit risk monitoring is that deteriorating economic and business conditions will eventually impact the performance of borrowers. Frontline credit risk management officers should be vigilant in identifying early warning signs of adverse developments. By doing so, they can take proactive measures to mitigate risks and prevent potential credit losses. (CibyJoseph, 2005).

2.2 Empirical literature

Sahlemichael M. (2015) has investigated credit management on Ethiopian Commercial Banks. The main objective of the study is to assess how banks manage their credit risk. He raised the following recommendations. Some of the recommendations is that in order to maintain credit discipline and to enunciate credit risk management and control process, the banks are advised to establish a separate department unit independent of the loan origination function, in order to be effective, credit policies must be communicated throughout the organization, implemented through appropriate procedures, monitored and periodically revised to take into account changing internal and external circumstance and banks should diversify their credit portfolios by avoiding huge credit concentration on one or two sectors and/or on individuals or companies.

Ur Rehman, Zia Muhammad, Noor Sarwar, Bilal raz Muhammad Asif (2019) the study aims to identify risk management strategies undertaken by the commercial banks of Balochistan, Pakistan, to mitigate or eliminate credit risk. The findings of the study are significant as commercial banks will understand the effectiveness of various risk management strategies and may supply them for minimizing credit risk. The study analyzes the opinions of employees of selected commercial banks. The study aims to provide guidance for the commercial banks of Balochistan to adapt long term performance improving risk management strategies.

Solomon (2013) in his paper entitled "credit risk management techniques and practice of NIB International Bank" has conclude that credit risk management system of commercial banks should incorporate a check and balance for the extension of credit that integrate separation of 28 credit risk management from credit sanction, credit processing/approval from credit administration and finally establishment of an independent credit audit and risk review function

Frederick L. (2012) in his paper entitled "Evaluation of Credit Risk Management Practices in Ghana Commercial Bank Ltd." Emphasized that credit risk monitoring and supervision efforts should be intensified by the bank. The bank should ensure that credit officers perform periodic follow-ups on borrowers to ensure that loans are used for the intended purpose and the bank should adhere strictly to the loan policies and discourage any human intervention if necessary requirements are not met.

Michael Donso Junior (2015), in his research “An assessment of credit risk management process of credit unions” emphasized on the credit unions will change the voluntary nature of the credit committee and get people with appreciable academic qualification who will be on salary, since the credit committee members are part of the team which is managing he greatest assets of the credit unions.

Onyango Jason Ochola (2010), conducted a research on “Assessment of the credit risk management practice of commercial banks in Kenya “and he recommended that banks should have an awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risk and that they are adequately compensated for risks incurred.

CHAPTER THREE

Research Design and Methodology

3.1 Introduction

This section of the study constitutes the study design and methodology. The methodology of a study involves the types of data used in undertaking the study as well as the process and procedures used in data collection. The chapter is categorized into the following sub-headings; research design, target population, sampling size and sampling techniques, data collection.

3.2 Research Design

There are different types of research design like descriptive, explanatory, correlational and so on based on the purpose of the study. In this case the study adopted a descriptive survey in trying to establish the extent to which Abyssinia Bank undertakes credit risk management. The aim is to describe and explain the phenomenon of interest. Since the study is interested in assessing credit risk management of Bank of Abyssinia.

3.3 Research Approach

There are three types of research approaches: such as quantitative, qualitative and mixed. the study used quantitative research methods to evaluate the credit risk management strategies being used by Abyssinia Bank. In order to achieve the objectives of the study the research used qualitative data. In doing so, the study intends to describe, and interpret the existing facts about credit risk management. A survey study approach was adopted to assess credit risk management of Abyssinia Bank S.C. The choice of survey aimed to describe the responses. The tools used to gather data by distributing a questionnaire to respondents that work on credit at Abyssinia bank especially Department Managers and Senior Officers. The data source was primary & secondary data from the following source: Primary data was collected through questionnaires distributed to respondents that involve professional working in the banks such as Department Managers and Senior Officers working on loan processing this is to elicit a wide range of baseline information about credit risk management. The secondary data will be collected from annual reports, directives, and bulletins of National Bank as well as different books. Secondary data will be obtained from publications of banks and reference books. The advantage of gathering data through questionnaire is that it allows for easy and economical way of collecting data especially when using questionnaires highly effective especially where large amounts of data is to be collected from a sizable population.

3.4 Target Population

The focus of this study is to evaluate credit risk management policy and practice of BoA; it has huge staff strength of more than 11,000 staffs. To this effect all employees of the bank constitute the population of the study. The target population for this study is 186 employees of the bank found in higher position, including directors, senior staffs at head office organs, managers, loan officers of the selected branches these branches are found in city and perform loans well as relation managers of district found in Addis Ababa. The selection criterion for the target population on the basis of employees more involving in credit processing and granting. Therefore, the study provides questionnaire for the above selected staffs of BoA to extract responses for analysis.

3.5 Sampling techniques and sampling size

3.5.1 Sampling technique

In this study, the researcher utilized purposive sampling technique in order to select participants of the study. The idea behind purposive sampling is to concentrate on people who are directly involved in credit processing and administering because they would better be able to assist with the relevant research data.

3.5.2 Sample size

With regards to the sample size of this study, staff of credit and risk departments, some selected branches and managers found at head office and district of Boa used as a representative of the entire BoA. The purposive sampling technique is most appropriate for personnel of the bank who has in-depth knowledge of the credit risk management practices of the bank and can therefore provide adequate information useful for research analysis purposes. Sample Size selected from professionals working in the credit and risk department, city districts and some selected city branches, related to credit and credit related operations as a whole will be taken as participants of the study.

Out of the target population, Slovin‘s formula is used to calculate the sample size. Then, 186 employees selected from the target population 350 using simple random sampling technique. At 95% confidence level, and e = ±5% n = N/1+ (e) 2 = 350/1+350(0.05)2

Where:- n = the sample size=186

N = the target population size=350

e = the level of confidence (Sampling error) = ±5%

Hence, based on the above formula; the sample size is calculated as 186. The study limited to the Branch Managers, Department Managers and Credit Officers. For this reason 3 Relation Manager, 40 Branch Managers and 143 Credit Officers were selected for the research. It is expected that the sample size represented the whole population.

3.6 Data Analysis & Presentation

The data analyzed by using descriptive statistics. In this study descriptive analysis is chosen because of its simplicity & clarity to draw inferences by using descriptive. The data measured in percentages, frequencies and tables used for analysis of the data and interpretations. Analysis measures the bank’s performance as well as judge the effectiveness of its credit risk management.

3.7 Validity & Reliability

3.7.1 Validity

Validity refers to the credibility of the research. It is concerned with the findings use really about what appears to be about. Validity defines as the extent of which data collection methods are accurately measured and what they were intended to measure (sounders, 2003). In order to achieve the objectives, the researcher has taken the survey question were prepared based on literature and empirical review and data were collected from reliable source from staffs of BoA who were working with credit administration.

3.7.2 Reliability

Reliability estimates the consistency of the measurement or simply the degree to which an instrument measure the same way this time it is used under the same condition with the same subject. Thus, the reliability of data tested using the statistical methods of describing the data average, percentages frequencies and tables used for the analysis of the data and assisted for interpretations. Reliability is essential about consistency if we measure, something many times and the result is always the same. Then, we can say that our measure is reliable (William G. 2016)

CHAPTER FOUR

Data presentation, Analysis and Interpretation

Introduction

This chapter of the research describes how data collected from the respondents are analyzed and presented. The data are analyzed by using table, pie charts and bar charts are used to represent the data collected from respondents. The data collected are analyzed based on the objectives of the research with inferences drawn from the analysis of the data. The reason is to present the results of the research from structured questionnaires were sent to the selected departments, branches and districts. This chapter presents the data gathered as follows; the position of the respondents, qualification of credit administrators, experience, credit identification and assessment, measurement and monitoring and credit control process. Questionnaires were sent out to 186 staffs at BoA. A total of 110 questionnaires were received and analyzed. These questionnaires represented 59% of what was targeted which is considered to be a reasonably medium response rate. Characteristics of the respondents are described in the ensuing sections.

I. Demographic Characteristics of Respondents

The demographic nature of the employee has a great contribution in the credit management of loans in understanding the credit policies and procedures as well as exercising and improving it when demanded. Thus, in this work process the demographic characteristics of respondents like gender, marital status, and educational level are assessed.

Table 4.1 Gender of Respondents		
	Frequency	Percent
Male	65	59.09
Female	45	40.91
Total	110	100.00

The mix of gender of the employee in the loan area is, 59.09 percent dominated by the male parts and 40.91 percent is female as it is shown in table 4.1. This is due to the education and experiences required to work in the loan area as loan officers or analysts is almost proportionally assigned to both male and female employees. Employees with high experience and qualification are needed to work in the loan area, as they have to understand the responsibility and accountability for prudent credit management and minimizing credit risks to the required level. Hence, in this regard the banks should considered gender distribution smartly.

Table 4.2 Current Position of Respondents		
NO	POSITION	QUANTITY
1	Directors	1
2	Relation managers	4
3	Branch managers	40
4	Credit officers	65
TOTAL		110

In this regard, the respondents were directors, relation managers, branch managers and credit officers. Most of the respondents have an educational background of accounting, economics and business management with BA and above and have five to 18 years of work experience. The selected respondents are listed below,

Table 4.3 Educational Level of Respondents		
	Frequency	percent
BA/BSc	78	70.91
MA/MSc	32	29.09
Total	110	100.00

Source: Primary Data, 2024

Educational background of employee is an important factor to be considered with regard to making business decision. Education improves the skill, capacity, communication, and access to development endeavors. As it can be revealed from table 4.3, on average 70.91% of the respondents have undergraduate degree and the remaining 29.09% possess a master's degree qualification. Hence, with respects to qualifications the findings implied that most of the employees working in the credit department are well qualified, this contributed a lot to the effectives, and efficiency in credit management practices of the banks.

Table 4.4 year of experience

No	Year of experience	Work experience	percent
1	1 - 5 years	15	13.64
2	6 - 10 years	60	54.54
3	11 - 15 years	25	22.73
4	More than 15 years	10	9.09
Total		110	100.00

Source: Primary Data, 2024

According to chart 4.4 the longest serving credit officers on average have 6-10 years working experience across all the participating staff. This group constitutes 54.54% of the total respondents. Most of the credit administrators with the experience credit officers are credit department. This fact support the believe that a high experience level of credit management staff is a key factor to the success of the credit unions in terms of credit management. Out of the total respondents 13.64% of them have 1-5 years working experience. According to the data presented in this chapter, it is obvious that the second least number of working experience among the credit department staff are the officers who have one year to five years' experience. Commenting on the relevance of experience of credit management staff, respondents acknowledge that experience brings efficiency. According to chart 4.4 out of the total respondents 9.09% of them have more than 15 years of experience which is a very small number. Some respondents state that for effective and efficient credit management, the credit unions need experienced credit management staff.

II. Credit Risk Assessment & Identification

The first question in the survey asks banks whether they have a credit risk management department. 100% of the respondents said that there was a credit risk management department. There must be a risk management department in banks in order to achieve their objectives properly. It is also the requirement of NBE to establish this department.

Table 4.5 Loan proposal approval persons

	Frequency	Percent
Board	2	1.82
Loan Committee	40	36.36
Credit Department	68	61.82
Branch Manager	0	0
Total	110	100.00

Source: Primary Data 2024

As the above table 4.5 depicts, 36.36 percent of employees agreed that loans and advances of the bank is recommended or approved by the loan committee at all levels. That is, both at branch and at head office as per the discretions provided. While very few number of respondents, 1.82%, and 0%, agreed that loan approval were made by Board and branch respectively. Thus, with respects to loan recommendation and approval, the bank did not follow uniform system in all branches although loan committee at level dominantly participated in the system.

Table 4.6 CRM Department independent of loan origination		
	Frequency	Percent
Yes	85	77.27
No	25	22.73
Total	110	100.00

Source: Primary Data, 2024

Separation of duties and responsibilities with respects to credit risk management and loan origination function minimizes the information asymmetry and moral hazard problem before approving loan and collecting the loan provided to various classes of clients. To assess this, respondents were asked questions and their responses presented in table 4.6 accordingly, 77.27 percent replied that the function of credit risk management department independent of loan origination function while 22.73 percent agreed that both functions are overlapping and hence no need to assign them to different concerned departments and this might accepting default loan clients or rejecting innocent and prudent clients which adversely affects the banks credit risk management practices.

Table 4.7 Credit risk policy, guidelines and procedures that explain objectives		
	Frequency	Percent
Yes	110	100
No	0	0
Total	110	100.00

Source: Primary Data, 2024

Producing and developing credit policy and procedures as well as other pertinent manuals and guidelines help to create common understanding and uniformity among all employees. Lending is the core product line, which contributes the biggest share to the profitability of a banking organization. In the table 4.7, 100 percent of the bank employee replied positively for having credit policy and procedure manuals. This implies, the bank have credit policy document to protect it against over exposure, mal-administration of credit arresting the creation of nonperforming loans, and arrive at a trade-off between returns and risks if effectively implemented.

Table 4.8 Credit Manual Revision		
	Frequency	Percent
Yes	90	81.82
No	20	18.18
Total	110	100.00

Source: Primary Data, 2024

It is clear that, banking industry is highly affected by the changing social, economic, and technological environment. To adopt with these changing environment, the existing manual or policy requires periodical revision or change. Accordingly, in table 4.8, more than three quarters (81.82%) of the respondents replied that their banks revised the existing credit manual or policy.

Table 4.9 Policy & Procedures approved by the BoD		
	Frequency	Percent
Yes	77	70
No	33	30
Total	110	100.00

It is the overall responsibility of board of directors to approve bank’s credit risk strategy and significant policies relating to credit risk and its management, which should be based on the bank’s overall business strategy. Therefore, as seen in the above table 4.9, 70% of the respondents said that their bank’s credit policy and procedures are approved by their board of directors. The remaining 30% said no, simply as they didn’t know the responsible person who approves policy and procedures.

70% of the banks, which confirmed approval of their credit risk policy and procedures by BoD, have stated that bank's BoD have the following responsibilities: Defining the bank's overall risk tolerance in relation to credit risk, Ensuring the bank's overall credit risk exposure is maintained at prudent levels and consistent with the available capital, ensuring that top management as well as individuals responsible for credit risk management possesses sound expertise and knowledge to accomplish the risk management function, ensuring that the bank implement sound fundamental principles that facilitate the identification, measurement, monitoring and control of credit risk and ensuring that appropriate plans and procedures for credit risk management are in place.

As per the risk management guidelines of the Basel committee for banks supervisions which are mentioned in the literature reviews, senior management of banks should develop and establish credit policies and credit administration procedures as part of the overall credit risk management framework and get approved from board. Besides, such policies and procedures should provide guidance to the staff and aim to obtain an in-depth understanding of the bank's clients, their credentials and their businesses in order to fully know their customers on various types of lending.

Table 4.10 Credit risk strategies and policies are effectively communicated thorough out the organization

	Frequency	Percent
Yes	60	45.45
No	50	54.55
Total	110	100.00

Source: Primary Data, 2024

Effectively communicated credit policy and procedures as well as other pertinent manuals and guidelines help to create common understanding and uniformity among all employees. According to table 4.10, more than half percent of the respondents donot agree for effective communication of the strategies among the staffs, this contributes for subjective decision making and bias to the uniformity of the implementation. This implies, the bank is in danger for credit policy document to protect it against default, mal-administration of credit leads to the creation of non-performing loans. Lending limit refers to the period of time, which is given to borrowers to repay the loan. To ascertain the lending limit of BoA, a question is designed in the questionnaire, which intended to determine the maximum repayment is given to the customers of the bank.

Table 4.11 Loan repayment period

	Frequency	Percent
2 – 5 years	80	72.73
6 – 10 years	20	18.18
11 -25 years	10	9.09
Total	110	100.00

Source: Primary Data, 2024

Table 4.11 depicts the response of the respondents regarding the credit limit, it is clearly shown that about 72.73% of the respondents have a maximum loan repayment of 2 – 5 years, 18.18% of the respondents have a maximum loan repayment of 6 – 10 years and only 9.09% of the respondents said that 11 - 25 years of repayment period.

III. Credit Measurement, Monitoring and Control

It is advisable for all banks to measure the credit risk of each loan requests made by clients before approval at least to minimize the risk of adverse selection. Theoretically, there are different tools can be used for this purpose.

Table 4.12 Tools used to measure credit risk

	Frequency	Percent
Internal Rating	55	50
Through the five C's of credit	35	31.82
Through financial statement ratio	20	18.18
Human judgments through experience	0	0
Total	110	100.00

Source: Primary Data, 2024

In this regard, the findings showed in table 4.12, 50 percent of the respondents said that the bank's internal credit rating is used as a primary tool while 31.82 percent stated that the five C's of credit rating are used as a sound method. The remaining 18.18% agreed that various financial statement ratios of the loan applicants are used as a tool to measure their credit risk. This implies that each person are using their own best method of credit risk measurement although it recommended in various literatures that combination of various methods can be used to minimize the credit risks.

Table 4.13 Probability of default of customers

	Frequency	Percent
We calculate	99	90
We don't calculate	11	10
Total	110	100.00

Source: Primary Data, 2024

As far as the uncertainty of the future or loss contingency from default customers is concerned, estimation of probability of default of customers before approving loan to applicants can minimize the risk of adverse selection. The results of the survey findings in this respect are presented in table 4.13 and interpreted as 90 percent of respondents collectively agreed that their banks calculate probability of default of customers and only 10% replied that probability of default of customers are not calculated. Therefore, majority of the banks have used the probability theories and estimate the chance of existence of default of customers before loan approval. After the credit assessment and disbursement is done, the credit customer is expected to payback the instalment as per agreed schedule. Each bank has a different repayment mechanism. In order to ensure good repayment, Banks have to ensure proper monitoring and follow up actions. According to majority of the banks' credit policy manual, credit is transferred to the legal service when it fails to regularize or settle the loans in default and when all efforts used to kindly repay the loans fail and it is ascertained that legal action is to be the last alternative.

Table 4.14 Recovery rate of a loan

	Frequency	Percent
Yes	80	72.73
No	30	27.27
Total	110	100

Source: Primary Data, 2024

In table 4.14, respondents were asked to state whether their banks calculate recovery rate of a loan or not. Accordingly, more than half (72.73%) said that their banks calculate recovery rate of a loan and this enable them to know performing and non-performing loan clients. However, still few respondents were negligent to calculate this rate as supported by 27.27% of the respondents and this implies that those administrators faced difficulties of determining performing and nonperforming loan clients for a specific period.

Table 4.15 Methods used by bank to mitigate credit risk

Methods	Total	Frequency
Credit Limit	15	13.64
Taking Collateral	60	54.54
Diversification	20	18.18
Credit Insurance	10	9.09
Loan selling	5	4.55
Total	110	100.00

Source: Primary Data, 2024

There are different ways of mitigating credit risk used by banks and each of them have their own cons and pros. As indicated in table 4.15, credit limit, taking collaterals, diversification, credit insurance and loan selling, are used as a means of alleviating or at least minimizing the risks associated with providing loan to clients as agreed by 13.64%, 54.54%, 18.18%, 9.09%, and 4.55% of respondents respectively. Hence, the findings imply that credit limit, taking collaterals, and diversifications are the three most popular methods used to mitigate credit risk.

Table 4.16 Procedures/policies in regard to credit exposure limits

	Frequency	Percent
Single borrowers	25	22.73
Groups of connected counter parties	30	27.27
For particular industries or economic sectors	30	27.27
Geographic regions	15	13.64
Specific loan type	10	9.09
Total	110	100.00

Source: Primary Data, 2024

Setting different or diversified credit limits for different kinds of loan applicants is essential for each bank to include all categories of borrowers, diversify its credit risk and to increase the outstanding loans, which later on increase the expected interest income on the loan. Thus, as depicted in table 4.16, most of the respondents, agreed that their banks have procedures /polices concerning credit exposure limits, which is set for single borrower and groups of connected counter or economic parties. The remaining respondents replied that their banks have procedures /polices concerning credit exposure limits, which is set for particular industries or economic sectors, geographic regions, specific loan type, and all the above mentioned loan clusters.

Table 4.17 Maintain credit files by the bank of all borrowers

	Frequency	Percent
Yes	110	100
No	0	0
Total	110	100.00

Source: Primary Data, 2024

Maintaining credit files all borrowers visa-vis credit information, purpose of loan, loan approval document, insurance coverage, financial statement are necessary for banks to get access these information when needed and to make the agreement legally binding. In this regard, the findings presented in table 4.17 clearly shows that all respondents (100%) said that their banks adequately keep credit files of all borrowers of all information and hence no problem of information which can be used as supporting evidences of why, to whom, when and for what purposes the loan was provided.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

Finally from the above study, I have given a proper conclusion and recommendations drawn based on the research findings that has been discussed and analyzed. These are as follows:

5.1 Summary of findings

Based on the study results from a questionnaire distributed to 186 credit and risk employees of the bank, findings were summarized to evaluate the bank's credit risk management policies and practices. The demographic characteristics of the bank indicated that it has well-educated and experienced staff, with all credit and risk employees holding at least a BA degree and having over two years of work experience. The qualifications of the employees suggest that the majority of those working in the credit department are highly qualified, which greatly enhances the effectiveness and efficiency of the bank's credit management practices.

In terms of work experience, the majority of staff members have between six to ten years of experience, indicating that experience leads to increased efficiency and effectiveness. Regarding awareness of credit strategies and policies, over fifty percent of the respondents do not agree that the strategies are effectively communicated among the staff. This lack of effective communication contributes to subjective decision-making and bias, which hinders the uniform implementation of the policies.

The research assessed Bank of Abyssinia S.Co's credit risk management practices to investigate how the bank identifies credit risks, how credit risks are classified and monitored by the Bank of Abyssinia, and to analyze the bank's methods for controlling credit risks by evaluating the adopted policies and procedures. The study's results suggest that the bank monitors the management of credit risks throughout the loan duration.

The literature review showed that banks are aware of the risks associated with concentrating credit risks and how it can impact their financial performance. As a result, banks have implemented strategies to address this issue. These strategies include regularly assessing the credit quality of loans and other credit exposures, measuring credit risks, and combining the findings of this analysis to determine the expected losses of a portfolio.

To address the research objectives, a survey study approach was used, involving a questionnaire administered to gather the perspectives of a senior credit officer at BoA regarding credit risk management. The study findings indicated that BoA has a well-defined written policy on credit risk management, with the board of directors overseeing its implementation. While having a written guideline on credit risk management is important, the effectiveness of its implementation will ultimately determine the bank's success in mitigating credit risk.

Credit risk management involves evaluating, identifying, classifying, analyzing, and monitoring the risk associated with granting loans to efficiently and effectively manage it. Despite many studies on the topic, none have specifically looked at the credit risk management of Bank of Abyssinia. This study aims to assess how Bank of Abyssinia manages credit risk.

5.2 Conclusions

Credit risk poses a significant challenge for banks, making credit risk assessment a key area of research for bank management. Managing credit risk is crucial in the banking sector, with ample opportunities for growth. Banking professionals must strike a balance between risks and returns, as lending can be precarious and other risks can arise from securities and investments. Credit risk management is essential for mitigating risks in securities and derivatives, but further advancements are needed to analyze credit, predict default probabilities, and assess loss risks. Therefore, credit risk management is a vital tool for ensuring the survival of banks.

Improved credit risk management leads to enhanced bank performance. Therefore, it is crucial for banks to adopt careful credit risk management practices to protect the bank's assets and investors' interests. Majority of employees of the bank working in credit department are 1st degree holders followed by 2ndDegree holders and highly experienced which might this enables the bank to accelerate its service delivery and become effective in the growing stiff competitive banking industry as qualified and experienced work force enhances competence and increase in operating results.

The study findings suggest that Bank of Abyssinia (BoA) has established policies for identifying credit risk, demonstrating clear methods for identification. However, the research also indicates insufficient communication with loan personnel, impacting the bank's portfolios significantly. In conclusion, the bank utilizes various credit risk management tools, techniques, and assessment models with the primary aim of minimizing loan defaults, which are a key factor in bank failures.

Many employees acknowledge a lack of consistent understanding of credit risk management procedures, highlighting weaknesses in credit creation processes. This underscores the need for the bank to educate its staff on credit manuals and policies to avoid subjective decision-making by credit personnel. Such weaknesses in credit risk management could negatively impact loan growth and damage client reputation. Furthermore, the study indicates that banks with robust credit risk management policies tend to have lower loan default rates

The study results point to a lack of coordination among lending staff, failure to conduct due diligence, and inadequate independent monitoring as the primary reasons cited by the bank for the high frequency of credit risk incidents. Consequently, the research findings suggest that the utilization of credit risk monitoring methods is relatively limited.

5.3 Recommendations

Based on the findings and conclusions of the study, the following recommendations are forwarded which are aimed at improving the credit management of the bank.

- ❖ For credit policies to be successful, they need to be effectively communicated across the organization, implemented using suitable procedures, monitored regularly, and adjusted periodically to adapt to evolving internal and external circumstances.
- ❖ The bank ensures that credit officers conduct regular follow-ups with borrowers to verify that loans are being utilized for their intended purposes.

- Building strong relationships with borrowers emerged as the most effective strategy adopted by banks to minimize non-performing loans. This involves offering guidance to borrowers on problem-solving, attending their business meetings, and delivering excellent services. The study indicates that banks must innovate new approaches to engaging with borrowers, providing ongoing support, and aiding in the growth of their businesses to enhance loan recovery efforts.
- Hence, as banks transition into a more complex financial landscape with heightened risks, there is a growing demand for advanced and adaptable instruments or models for assessing, monitoring, and managing risk exposure. Consequently, Bank of Abyssinia (BoA) is well-prepared to meet the challenges by developing tools and systems capable of evaluating, monitoring, and controlling risk exposures in a more systematic manner.

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Bank of Abyssinia annual report of the year 2022/2

ST. MARY'S UNIVERSITY

MBA Program

The purpose of this questionnaire is to carry out a research for the partial fulfilment of master's degree in MBA. The paper focuses on the topic of "Assessment of Credit Risk Management of Abyssinia Bank S.C." The outcome of the study will be used to suggest possible solutions for problems identified on the captioned topic. Thus, your free will and cooperation in giving the reliable information is very important. Any information provided by you will only be used for academic purpose. As a result it will be kept confidential and utmost anonymity.

Thank you in advance for taking your time to fill out this questionnaire

If you need any further assistance, please do not hesitate to contact me in the following address. Tewodros G/hawaryat Tel. 0922-82 47 99 Email address tedrosgh98@gmail.com

Please use a ( ) mark and put the answer on the space provided.

I. Demographic information:

1. Gender: Male ☐ Female ☐

2. Years of service

3. Marital status: Married ☐ Single ☐

4. What is your current position in BOA

5. Educational level: Diploma ☐ BSc/BA ☐ MSc/MA ☐ PhD ☐ Other

II. Credit Risk Identification and Assessment

In this section provide a great understanding of the nature of the issue with regards to lending practices, procedures, and qualifications.

1. Do you have credit risk management department? Yes ☐ No ☐

2. Who approves procedures of credit proposal of client?

Board of Directors ☐ Branch Manager ☐

Loan Committee ☐

Credit Department ☐

3. Does function of your credit risk management department independent of the loan origination function? Yes ☐ No ☐

4. Do you have credit risk policy, guidelines and procedures that explain objectives and principles of credit risk management process? Yes ☐ No ☐

If yes, has it been reviewed periodically and is it helpful for processing credit request? ---

5. If your answer for question no. 4 is yes, is the policy and procedures approved by the Board of Directors? Yes ☐ No ☐

6. If your answer for question no. 4 is yes, what are the responsibilities of the board of directors?

☐ Defining the bank's overall risk tolerance in relation to credit risk

☐ Ensuring the bank's overall credit risk exposure is maintained at prudent levels and consistent with the available capital

☐ Ensuring that top management as well as individuals responsible for credit risk management possesses sound expertise and knowledge to accomplish the risk management function

☐ Ensuring that the bank implement sound fundamental principles that facilitate the identification, measurement, monitoring and control of credit risk

Ensuring that appropriate plans and procedures for credit risk management are in place

Others, please specify,---

7. Does the credit risk strategy and policies be effectively communicated throughout the organization? Yes ☐ No ☐

8. Rank the top three types of loans, which are mostly given out?

Type

Business loan ☐

Housing loan ☐

Educational loan ☐

Car loan ☐

Personal loan ☐

Refinancing loan ☐

Other (please state)…………………………………………………………………………………………………

9. What is the longest duration given for repayment of your loans?

…………………………………………………………

10. What method of payment is mostly use to repay loans? (Rank 1 to 3)

Cash over the counter ☐ Standing order ☐ Direct debit ☐

III. Credit risk measuring and monitoring

In this section gather the nature of the issues with regards to credit administration, measuring and monitoring

1. What are the tools used by the bank to measure credit risk?
   - ☐ Internal rating
   - ☐ Through the five C's of credit (i.e. Character, Capacity, Capital, Conditions and Collateral) through financial statement ratios
   - ☐ Human judgments through experience

   Others, please specify………
2. Do you calculate probability of default of customers?

   We calculate ☐ We don't calculate ☐ Other ……………………………………

3. Do you calculate recovery rate of a loan?

   Yes ☐ No ☐

If yes, when do you calculate this (Hint: at the time loan is pass, special mention, or at all time)…………………………………………………………………………………
………………………………………………………………………………………
………………………………………………………………………………………
………………………………………………………………………………………
……………………………………………………………………………………

4. In credit risk management banks use various methods to mitigate risks: from those methods which method does your bank use

☐ Credit limit

☐ Taking collateral

☐ Diversification

☐ Credit insurance

☐ Loan selling

5. Does your bank has procedures/polices in regard to credit exposure limits, which is set for

☐ Single borrowers

☐ Groups of connected counter parties

☐ For particular industries or economic sectors

☐ Geographic regions

☐ Specific loan type

6. Does the bank maintain up-dated list of problem loans & list of loans reviewed indicating the date of the review & the credit rating (hint pass, special mention etc)

   Yes ☐ No ☐

IV. Control over credit risk In this section gather the nature of the issues with regards to credit control

1. Do you have internal credit review and reporting systems, which are conducted by individual's independent from the credit function to evaluate the overall credit administration process?

Yes ☐ No ☐

2. If your answer for question no. 1 is yes to whom does the report addressed

☐ Board of director

☐ Senior management with no lending authority

☐ Control department

Others, please specify,………………………………………………………………………………………

3. Is internal review conducted at least semi-annually for problem loans and/or for loans of huge amount & at least annually for all lending areas?

Yes ☐ No ☐

If no, please specify the bank's trend……………………………………………………………………………………

4. Does your bank maintain credit files of all borrowers, which contain information on?

Description	Yes	No
Determines loan approvals to be in line with credit policy & procedures		
Determines loan approvals are within the limits of the bank's lending authority		
Determines documentation is satisfactory prior to disbursing loan proceeds		
Determines new loan have been posted accurately		
Examines entries & checks interest posting to various loan account		
Confirms collateral on a test basis		

5. Finally, please share any other issues or ideas that you may have in regard to bank's credit risk management policy and practice.

Thank you again for your patience in responding the question