ST. MARY'S UNIVERSITY COLLEGE
FACULTY OF BUSINESS
DEPARTMENT OF MANAGEMENT

AN ASSESSMENT OF LOAN MANAGEMENT PRACTICES: *THE CASE OF ADDIS CREDIT AND SAVING INSTITUTION*

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SMUC
ADDIS ABABA, ETHIOPIA

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SUMC
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Acronyms

NBE-national Bank of Ethiopia

MFIs-Micro Finance Institutions

ADSCI- Addis Saving and Credit

GOs- Governmental organizations

NGOs-Non- Governmental organizations

CHAPTER ONE
INTRODUCTION

1.1. Background of the Study

Currently there are 28 microfinance institutions in Ethiopia supervised by the National Bank of Ethiopia (NBE), where 5 of them work in Addis Ababa region. The existence of policy and guidelines has created conducive environment for the growth and development of Microfinance Institutions (MFIs). The availability of such institutions helps to simplify the existing loan processing procedures in commercial banks and access small loans to households. MFIs play the major role in improving society's income generation activities in informal sectors by giving credits (www.lifeinafrica.com/microfinace/).

Even though it has created a road map to success in encouraging the society to participate in economic activities, there are several factors which limit the fast growing cooperation that exist between MFIs and the society in relation to loan management. In this study, an attempt will be made to review the existing loan management problems in **Addis Credit and Saving Institution (ADCSI)**.

ADCSI is one of the most popular MFIs in Ethiopia which operates which operates within the boundary of Addis Ababa City Administration. It was established and registered at the National Bank of Ethiopia on January 2000. Its vision is to become active contributor towards poverty reduction efforts and would like to see improvement in the life of low income section of the society with duties to promote micro and small enterprises to alleviate poverty and reduce unemployment prevailing in Addis Ababa City Administration territory through the provision of Sustainable financial and other related services with particular attention to women.

The organization is growing since its establishment. Currently, the number of customers has reached to 30,000. In the study area, Addis Ketema sub city, Kebele 01/02, the number of customers is 676. *(Interview with officials)*

1.2. Statement of the Problem

As we know Ethiopia is one of the least developing countries in the world. The per capita income of the nation is very low and unemployment is high. However, to change this situation the government is trying to achieve the millennium development goals and make Ethiopia one of those countries with middle income earning category after 20 years. So the first lion role in loan management from financial sector is micro finance institutions like Addis Credit and Saving Institution. MFI's efforts involve enabling measures that increase the capacity of active poor to engage in gainful activities to enhance their earnings and reduce variability of earning. Those micro and small enterprises are increasingly recognized as effective instrument of poverty alleviation, job creation and economic growth due to low requirement of capital, training, technology and labor intensive nature.

However, the loan management problems encountered by Micro finance institutions limits their accessibility by customers. Consequently, their contribution to the development and expansion of micro and small business enterprises is very limited. Most of the micro finance institutions are suffering from poor loan management practices. The researcher makes an observation and interview staffs of the institution and learned that some of the problems encountered by MFIs are poor follow up, attitudes of customers and their failure to repay the amount borrowed on time. One of these institutions facing these problems is ADCSI. Therefore, the paper will try to investigate the loan management practices, problems and procedures of ADCSI.

1.3. Research Questions

Generally, the paper tried to give answers to the following basic questions:

- What are the loan management practices of ADCSI?
- What are the loan management procedures of the institution?
- What are major problems in loan management in ADCSI?

1.4. Objective of the Study

General Objective:

The general objective of this study is to explore the loan management practices, procedures, problems and role of loan management.

Specific Objectives:

The specific objectives of this study are:

1. *To assess the loan management practice of ADCSI*
2. *To identify loan management problems of ADCSI*
3. *To assess the loan management procedures of the Institution*

1.5. Significance of the Study

The significance of the study is to provide information for further study in improving the loan management practices. The result of the study can also be used by other interested researchers for further study in the area.

1.6. Scope of the Study

It is possible to assess the loan management practices of all Micro Financial Institutions in the country. However, this research assessed only the loan management practices of one branch of **Addis Credit and Saving Institution (ADCSI)** that is, Merkato Branch, Addis Ketema Sub cit, Kebele 01/02. In other words the specific area of focus is on the loan management practices of the institution in Merkato area from 2005 to 2010.

The area was selected because there are a large number of customers of the institution in this area and also it is a business area where large numbers of clients are operating.

1.7. Research Design and Methodology

1.7.1. Research Design

The student researcher used descriptive type of research. The loan management practices, procedures and problems encountered by ADCSI is described in detail.

The data collected from staffs of ADCSI such as loan department head, auditors and other staffs who are engaged in approving the loan, collecting the loan and those who follow up the clients/customers of the institution.

1.7.2. Population and Sampling Technique

i. Population

Sample is drawn from the customers of the Institution who are operating around Merkato. The total numbers of customers (population of the study) currently in this area are 653.

ii. Sample Unit

The sampling unit for the study is list of current customers of the institution in the study area.

iii. Sample Size

For the study a sample of **75** clients of the branch were used and their response was collected using a questionnaire.

iv. Sampling Technique

The sample clients are selected using *convenient sampling technique*. The student researcher selected clients that are convenient, close at hand, and willing to give information and easy to reach. In addition to this in the study area there are large numbers of customers concentrated in Merkato since it is a business area.

1.7.3. Types of data Used

The paper used both *primary* and *secondary* data. The primary data required for the study is collected using interview and questionnaire. The secondary data is collected from reports, financial statements and other documents.

1.7.4. Methods of Data Analysis

The data obtained is analyzed using tables, graphs, charts and qualitative description of the information.

1.8. Limitation of the Study

The main limiting factor during the research work was time and lack of cooperation from the concerned parties in providing relevant information for the research work particularly the respondents was not willing to fill give their responses.

1.9. Organization of the Study

The paper is organized in to four chapters. The first chapter covers background, statement of the problem, research methodology; objective of the study, significance of the study, and scope of the study. The second chapter presents the summary of related literatures. In chapter 3 the data collected is presented and analyzed. The last chapter (chapter 4) covers the conclusion and recommendation of the study.

CHAPTER TWO
LITERATURE REVIEW

2.1. Definition of terms

The following are the definitions of key terms;

1. **Loan** is a form of accommodation provided by the banker to its customer who is in need of money. **Loan** is an arrangement of advancing a sum of money on interest for a pre-agreed period and for a particular purpose. *(N.Kumar,2002)*
2. **Loan** can be defined as an arrangement in which a lender gives money or property to a borrower, and the borrower agrees to return the property or repay the money, usually along with interest, at some future point(s) in time. Usually, there is a predetermined time for repaying a loan, and generally the lender has to bear the risk that the borrower may not repay a loan (though modern capital markets have developed many ways of managing this risk *(http://www.investorwords.com/2858/loan.html).*

3. **Loan management** is the process by which risks that are inherent in the credit process are managed and controlled. . *(Comptroller's Handbook of Loan management, April 1998, pp: 2)*

From these definitions, we can learn that loan is sum of money lend to borrowers for pre-arranged period at an agreed rate of interest.

2.2. Types of loans

There are different types of loan provided by commercial banks to these customers. They may include: *(http://en.wikipedia.org/wiki/Loan")*

1. Term Loans

Term Loans are one type of credit facility, which provided for specific duration and this term loans are physical money lent to borrowers in expectation of period repayments. This kind of financing is characterized by periodic repayments that can be monthly, quarterly, and semi-annually. The duration of the loan can be classified as: A) Short term loans, B) Medium term loans and C) Long term loans.

2. Overdraft facilities

Overdraft facilities: When a current account holder is permitted by the banker to draw more than stands to his credit, such as advance is called an over draft facility. It is usually made to customers of satisfactory records as supplement of working capital.

Overdrafts are very convenient for borrowers to deposit funds not required and there by get reduction in interest.

This arrangement of overdraft facility may be extended to the current account holders either on giving some collateral security or on the personal security of the borrowers. The customer may with draw as and when they needs funds and repay it by means of deposits. Interest is charged on the exact amount over drawn and for the exact period of its actual utilization, overdraft is not granted as regularly as cash credit. It is granted only occasionally and for shorter periods. *(Annual Report, Year ended June 30, 2006, National Bank of Ethiopia)*

3. Letter of Credit Facilities

Trade between countries is mainly through letter of credit. Letter of credit is a document or order by a bank in one place, authorizing some other bank in some other place, to honor the drafts or cheques of a person named in the document up to the amount stated in the letter and the issuing banker him self binds to pay the money paid up on careful study of the financial position of the applicant, a letter of credit facility limit inclusive of the margin or a one time letter of credit limit at specific margin paid can be approved. *(Comptroller's Handbook of Loan management, 1998, pp: 5)*

4. Merchandise Loans

Merchandise Loans are loans to be granted against merchandise held as pledge or collateral to assist customers facing shortage of working capital.

This credit facility is granted for a very short duration, usually for three months. Merchandise loan will be approved as advance at a certain percentage proportion of the value of the merchandise to be pledged. Merchandise Loans is a type of credit facility that are not readily available to all types of customers due to the administrative problem involved while valuing the Merchandise pledged banks verity the existence and value of stored goods.

5. Advance against export hills

Advance against export bills made on documentary export bills and are made available to customers against presentation complete set of export documents. The complete ship documents are handed over to the bank property endorsed. The bank finds it convenient to advance portion of the value of shipping documents, if the documents are found to be in order. Documents required include bills exchange in duplicate, commercial invoices, insurance policy and bill of lending.

6. Advance against import bills

Advance on import bills are actually advances made under import letter of credit by way of customer's liability under letter of credit. Such advances are also made under acceptance credits. And it is a written promise that the bank gives to foreign banks on behalf of its clients.

The system is designed to accommodate the non-withdrawal of import documents by the importer. Import usually request letter of credit facility when they face financial constraints to cover the credit to be opened or when they do not want to tie up their funds until the arrival of the documents.

The account "Advance 01, import bills" is debited and correspondent's account is credited to counter balance the debit entry made by correspondent banks. Balances debited to this account are settled with interest when documents are taken up or drafts mature.

7. Letter of Guarantee

Letter of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the "Surety" or "guarantee" the person for whom the guarantee is given is called the "principal debtor," and the person to whom the guarantee is given is called "creditor"

In the contract of guarantee the surety is liable only when the "principal debtor" commits default. When *a* customer is not in a position to other any collateral security for an advance, the banker can lend on a guarantee. It is easy to obtain a guarantee the than to insist for a tangible security.

The bank should take in to account and prior considerations and conditions attached by the surely in signing the contract guarantee. Some of them are:-

- The guarantor should be lightly credit worthy
- Periodical reports on the borrower as well as the guarantor should be obtained.
- The letter of guarantee should be signed in the presence of an officer of the bank.
- The banker should not approach any person to give a guarantee for an advance to borrower.

- The guarantee should be taken on the bank's approved form only.

8. Credit creation

Banks play a leading role in the economic development of a country through the Mechanisms of credit creation. Fluctuations in the credit created by the PR banks have an important impact on the level of economic activities in a country. Expansion of credit results in increased investment, production and employment.

Credit creation is one of the most important functions of commercial banks and other financial institutions. They aim at earning profit. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day to day transactions. When a bank advances a loan, it opens an account in the same of the custom and does not pay him in cash but it rather allows him 0 to draw the money by check according to his need. *(Dashen Bank Credit policies and procedure manual)*

2.3. Loan Management

1. Introduction

Lending is the principal business activity for most commercial banks and Credit and Saving Institutions. The loan portfolio is typically the largest asset and the predominate source of revenue. As such, it is one of the greatest sources of risk to the institutions' safety and soundness. Whether due to careless credit standards, poor loan portfolio risk management, or weakness in the economy, loan portfolio problems have historically been the major cause of bank and Credit and Saving Institutions losses and failures.

Effective management of the loan portfolio and the credit function is fundamental to lenders' safety and soundness. **Loan management** is the process by which risks that are inherent in the credit process are managed and controlled. Because review of the loan management process is so important, it is a primary supervisory activity. Assessing loan management involves evaluating the steps lending institutions management takes to identify and control risk throughout the credit process. The assessment focuses on what management does to identify issues before they become problems. *(Comptroller's Handbook of Loan management, April 1998, pp: 2)*

For decades, good loan portfolio managers have concentrated most of their effort on prudently approving loans and carefully monitoring loan performance.

To manage their portfolios, bankers must understand not only the risk posed by each credit but also how the risks of individual loans and portfolios are interrelated. These interrelationships can multiply risk many times beyond what it would be if the risks were not related. Until recently, few banks used modern portfolio management concepts to control credit risk. Now, many banks view the loan portfolio in its segments and as a whole and consider the relationships among portfolio segments as well as among loans. These practices provide management with a more complete picture of the bank's credit risk profile and with more tools to analyze and control the risk.

The following nine elements are part of a loan portfolio management process. These elements complement such other fundamental credit risk management principles as sound underwriting, comprehensive financial analysis, adequate appraisal techniques and loan documentation practices, and sound internal controls. The nine elements are: (*Comptroller's Handbook of Loan management, April 1998, pp: 2)*

1. Assessment of the credit culture,
2. Portfolio objectives and risk tolerance limits,
3. Management information systems,
4. Portfolio segmentation and risk diversification objectives,
5. Analysis of loans originated by other lenders,
6. Aggregate policy and underwriting exception systems,

7. Stress testing portfolios,
8. Independent and effective control functions,
9. Analysis of portfolio risk/reward tradeoffs.

Each of these elements is important to effective loan management. To a greater or lesser degree, each indicates the importance of the interrelationships among loans within the portfolio. Their focus is not on individual transactions, but on a group of similar transactions and on verifying the integrity of the process. *Each practice, by itself, adds a dimension to loan portfolio management, but their value is amplified when they are used together; moreover, the absence of any one of these elements will diminish the effectiveness of the others.*

2. Risks Associated with Lending

Risk is the potential that events, expected or unexpected, may have an adverse impact on the bank's earnings or capital. Scholars in the field have defined nine categories of risk for bank supervision purposes. These risks are ***credit***, ***interest rate***, ***liquidity***, ***price***, ***foreign exchange***, ***transaction***, ***compliance***, ***strategic***, and ***reputation***.

A key challenge in managing risk is, understanding the interrelationships of the nine risk factors. Often, risks will be either positively or negatively correlated to one another. Actions or events will affect correlated risks similarly. For example, reducing the level of problem assets should reduce not only credit risk but also liquidity and reputation risk. When two risks are negatively correlated, reducing one type of risk may increase the other. For example, a bank may reduce overall credit risk by expanding its holdings of one- to four-family residential mortgages instead of commercial loans, only to see its interest rate risk soar because of the interest rate sensitivity and optionality of the mortgages.

Lending can expose a bank's earnings and capital to all of the risks. Therefore, it is important that the examiner assigned LPM understands all the risks embedded in the loan portfolio and their potential impact on the institution. How each of these categories relates to a bank's lending function is detailed in the following sections. *(Comptroller's Handbook of Loan management, 1998, pp: 5-10)*

1. Credit Risk

For most financial institutions, loans are the largest and most obvious source of credit risk. However, there are other pockets of credit risk both on and off the balance sheet, such as the investment portfolio, overdrafts, and letters of credit. Many products, activities, and services, such as derivatives, foreign exchange, and cash management services, also expose banks and other MFIs to credit risk.

The risk of repayment, i.e., the possibility that an obligor will fail to perform as agreed, is either lessened or increased by a bank's credit risk management practices. A bank's first defense against excessive credit risk is the initial credit-granting process S sound underwriting standards, an efficient, balanced approval process, and a competent lending staff. Because a bank cannot easily overcome borrowers with questionable capacity or character, these factors exert a strong influence on credit quality. Borrowers whose financial performance is poor or marginal, or whose repayment ability is dependent upon unproven projections can quickly become impaired by personal or external economic stress. Management of credit risk, however, must continue after a loan has been made, for sound initial credit decisions can be undermined by improper loan structuring or inadequate monitoring.

Effective management of the loan portfolio's credit risk requires that the board and management understand and control the bank's risk profile and its credit culture. To accomplish this, they must have a thorough knowledge of the portfolio's composition and its inherent risks. They must understand the portfolio's product mix, industry and geographic concentrations, average risk ratings, and other aggregate characteristics. They must be sure that the policies, processes, and practices implemented to control the risks of individual loans and portfolio segments are sound and that lending personnel adhere to them.

2. Interest Rate Risk

The level of interest rate risk attributed to the MFI's and bank's lending activities depends on the composition of its loan portfolio and the degree to which the terms of its loans (e.g., maturity, rate structure, embedded options) expose the MFI's and bank's revenue stream to changes in rates.

Banks and MFIs frequently shift interest rate risk to their borrowers by structuring loans with variable interest rates. Borrowers with marginal repayment capacity may experience financial difficulty if the interest rates on these loans increase. As part of the risk management process, MFIs and banks should identify borrowers whose loans have heightened sensitivity to interest rate changes and develop strategies to mitigate the risk. One method is to require vulnerable borrowers to purchase interest rate protection or otherwise hedge the risk.

3. Liquidity Risk

Effective management of liquidity risk requires that there be close ties to, and good information flow from, the lending function. Obviously, loans are a primary use of funds. And while controlling loan growth has always been a large part of liquidity management.

In fact, banks are taking a more active role in managing their loan portfolios. While these activities are often initiated to manage credit risk, they have also improved liquidity. Banks increasingly are originating loans "for sale" or securitization. Consumer loans (mortgages, installment loans, and credit cards) are routinely originated for immediate securitization. Many larger banks have been expanding their underwriting for the syndicated loan market. Additionally, banks are also expanding the packaging and sale of distressed credits and otherwise undesirable loans.

4. Price Risk

Most of the developments that improve the loan portfolio's liquidity have implications for price risk. Traditionally, the lending activities of most banks were not affected by price risk. Because loans were customarily held to maturity, accounting doctrine required book value accounting treatment.

5. Foreign Exchange Risk

Foreign exchange risk is present when a loan or portfolio of loans is denominated in a foreign currency or is funded by borrowings in another currency. In some cases, banks will enter into multi-currency credit commitments that permit borrowers to select the currency they prefer to use in each rollover period. Foreign exchange risk can be intensified by political, social, or economic developments. The consequences can be unfavorable if one of the currencies involved becomes subject to stringent exchange controls or is subject to wide exchange-rate fluctuations.

6. Transaction Risk

In the lending area, transaction risk is present primarily in the loan disbursement and credit administration processes. The level of transaction risk depends on the adequacy of information systems and controls, the quality of operating procedures, and the capability and integrity of employees. Significant losses in loan and lease portfolios have resulted from inadequate information systems, procedures, and controls. For example, banks have incurred increased credit risk when information systems failed to provide adequate information to identify concentrations, expired facilities, or stale financial statements. At times, banks have incurred losses because they failed to perfect or renew collateral liens; to obtain proper signatures on loan documents; or to disburse loan proceeds as required by the loan documents.

7. Compliance Risk

Lending activities encompass a broad range of compliance responsibilities and risks. By law, a bank must observe limits on its loans to a single borrower, to insiders, and to affiliates; limits on interest rates; and the array of consumer protection and regulations. A bank's lending activities may expose it to liability for the cleanup of environmental hazards. A bank may also become the subject of borrower-initiated "lender liability" lawsuits for damages attributed to its lending or collection practices. Supervisory activities should include the review of the bank's internal compliance process to ensure that examiners identify and investigate compliance issues.

8. Strategic Risk

A primary objective of loan management is to control the strategic risk associated with the financial institution's lending activities. Inappropriate strategic or tactical decisions about underwriting standards, loan portfolio growth, new loan products, or geographic and demographic markets can compromise a bank's future. Examiners should be particularly attentive to new business and product ventures. During their evaluation of the loan management process, examiners should ensure that bankers are realistically assessing strategic risk.

9. Reputation Risk

When a bank and MFI experiences credit problems, their reputation with investors, the community, and even individual customers usually suffers. Inefficient loan delivery systems, failure to adequately meet the credit needs of the community, and lender-liability lawsuits are also examples of how a bank's and MFI's reputation can be tarnished because of problems within its lending division.

3. Loan Management Objectives

Loan management objectives establish specific, measurable goals for the loan. Top level management must ensure that loans are made with the following three basic objectives in mind:

- To grant loans on a sound and collectible basis.
- To invest the bank's funds profitably for the benefit of shareholders and the protection of depositors.
- To serve the legitimate credit needs of their communities.

4. The Loan Policy

The loan policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it also is a statement of the bank's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the bank's lending activities in a manner consistent with the bank's strategic direction. Loan policy sets standards for portfolio composition, individual credit decisions, fair lending, and compliance management. *(Comptroller's Handbook of Loan management, April 1998, pp: 17-21)*

Loan policies vary in length, organization, degree of detail, and breadth of topics S there is no ideal format. Frequently, the bank's general lending policy will be supplemented by more detailed underwriting standards, guidelines, and procedures. [*N.B.* Hereafter, references to loan policy should be interpreted to include these supplements.] Within the same banking company, certain aspects of the policy may vary because of factors such as geographic location, economic conditions, personnel, or portfolio objectives.

The format should be tailored to fit the needs of a particular bank, and the scope and detail should be commensurate with the complexity of the bank's lending activities. In all but very small community banks, the loan policy will be written. The policy should provide a realistic description of where the bank wants to position itself on the risk/reward spectrum. It needs to provide sufficient latitude for a bank to respond to good business opportunities while concurrently controlling credit risk. In normal circumstances, a bank should be able to achieve portfolio objectives and respond to changing market conditions without triggering a limit. Limits should not be so conservative that insignificant changes breach them, nor should they be so liberal that they have no practical effect.

For the policy to be an effective risk management tool, it must clearly establish the responsibilities of those involved in the lending process.

Loan Policy Topics

While the form and contents of loan policies and procedures will vary from bank to bank, there are some topics that should be covered in all cases. These are: *(Comptroller's Handbook of Loan management, 1998, pp: 17-21)*

- Loan authorities.
- Limits on aggregate loans and commitments.
- Portfolio distribution by loan category and product.
- Geographic limits.
- Desirable types of loans.
- Underwriting criteria.
- Financial information and analysis requirements.
- Collateral and structure requirements.
- Margin requirements.
- Pricing guidelines.
- Documentation standards.
- Collections and charge-offs.
- Reporting requirements.
- Guidelines for loan participations.
- Off-balance-sheet exposure.

The policy may also address insider transactions, affiliate transactions, conflicts of interest, the code of ethics, community support, appraisal requirements, environmental assessment requirements, relevant accounting issues (such as charge-off loans, nonperforming loans, and debt restructuring), and the allowance for loan and lease losses. Any administrative requirements for granting loans should be covered in the policy. Policies and procedures should also ensure compliance with laws and regulations.

5. Loan Approval Process

The loan approval process is the first step towards good portfolio quality. When individual credits are underwritten with sound credit principles, the credit quality of the portfolio is much more likely to be sound. Although good loans sometimes go bad, a loan that starts out bad is likely to stay that way. The foremost means to control loan quality is a solid loan approval process.

There is no one single system of loan approval. However, every loan approval process should introduce sufficient controls to ensure acceptable credit quality at origination. The process should be compatible with the bank's credit culture, its risk profile, and the capabilities of its lenders. Further, the system for loan approvals needs to establish accountability. *(Ayle T. 2009)*

An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides guidance on the documents needed to approve new credit, renew credit, increase credit to existing borrowers, and change terms in previously approved credits. It will also designate who has the authority to approve credit or changes in credit terms. Loan authorities should be commensurate with the experience of the lender/credit officer and take into consideration the type of credit, the amount of credit, and the level of risk involved.

Generally, underwriting document standards should include: *(Comptroller's Handbook of Loan management, April 1998, pp: 5-10)*

- Financial information including:
- current and historical balance sheet and income data,

- balance sheet, income, and cash flow projections, when appropriate, and
- Comparative industry data when appropriate.
- Financial analysis, including repayment capacity.
- Collateral identification and valuation.
- Guarantor support and related financial information.
- Summary of borrower and affiliated credit relationships.
- Loan terms, including tenor and repayment structure.
- Pricing information, including relationship profitability data.
- Covenants and requirements for future submission of financial data.
- Exceptions to policy and underwriting guidelines and mitigants.
- Information fields to capture data for concentration reporting, identifying shared national credits etc.
- Risk rating or recommended risk rating.

The approval process for consumer loans may be more streamlined, but should still include sufficient information to support the credit granting decision, including, when applicable, scorecard data.

2.4. Evolution of Microfinance

The paper tries to assess the loan management practices of MFIs, particularly the case of Addis Saving and Credit Institution. Therefore, in this part the researcher is interested to review literatures related to Micro finance focusing on their evolution/development in Ethiopia, services and performance measures.

Traditional banking sector cannot reach millions of poor for whom small loans could make huge differences. There are several reasons for this. Most of the poor are rural, and they are much dispersed. They have low education levels, if at all. As a result, administrative cost of supplying loans to the poor population is extremely high. Another issue that makes it difficult to serve these customers through traditional banking is that the poor does not have any assets to use as collateral. As a result, the poor had access to loans only through local moneylenders at exorbitantly high interest rates.

Micro-credit financing starts with the assumption that the poor is willing to pay high interest rates to have access to finance. In general, the system uses the social trust as the collateral.

Micro-credit institutions report that their repayment rates are above the commercial repayment rates, sometimes as high as 97%. Today, there are millions of poor people around the world who turn to be entrepreneurs through the micro-credit sector.

Micro credit and microfinance are relatively new terms in the field of development, first coming to prominence in the 1970s, according to Robinson (2001) and Otero (1999). Prior to then, from the 1950s through to the 1970s, the provision of financial services by donors or governments was mainly in the form of subsidized rural credit programs. These often resulted in high loan defaults, high lose and an inability to reach poor rural households (Robinson, 2001). Robinson states that the 1980s represented a turning point in the history of microfinance in that MFIs such as Grameen Bank and BRI2 began to show that they could provide small loans and savings services profitably on a large scale. They received no continuing subsidies, were commercially funded and fully sustainable, and could attain wide outreach to clients (Robinson, 2001).

The 1990s "saw accelerated growth in the number of microfinance institutions created and an increased emphasis on reaching scale" (Robinson, 2001: 54). Dichter (1999:12) refers to the 1990s as "the microfinance decade". Microfinance had now turned into an industry according to Robinson (2001). Along with the growth in micro credit institutions, attention changed from just the provision of credit to the poor to the provision of other financial services such as **savings** and **pensions**.

2.5. The History of Financial Services and the Emergence of Micro-Finance in Ethiopia

Formal financial institutions in Ethiopia do not have very long history. In addition to their very little experience they are going through different systems. The literature on the history of financial services in the 1950-70 tells that credit delivered by governments and donors were the one to provide credit to marginalized farmers aimed at increasing productivity. However, it was unsuccessful. It was delivered without the assessment of the repayment capacity of farmers. Credit was abused by government officials and used if for rent-seeking and other objectives. The financial institutions were unable to sustain the program.

Later 1970s onwards, women were included in the credit program, which was aimed at income generations with the objective to supplementing household income. Since the intervention was a Welfare approach, it was unable to recognize women as development stakeholders. As a result sustainable development was not attainable. The failure of subsidized credit to poor farmers including women paved the way to the emergence of non-government organizations (NGOs) with the objective of humanitarian aid. Credit was a component in their programs. Lack of regulatory framework for the service of credit by NGOs and the need for expansion of financial service created the emergence of micro-finance with varied services. (GetachewTeaka,Yishak Mengesha 2005).

The failure of the formal banks to provide banking facilities, on the one hand, led the unsustainability of the NGO's credit scheme on the other hand, led the government to issue out a legal framework for the establishment and operation of micro finance institutions. Currently there are 28 microfinance institutions in Ethiopia, licensed and registered by NBE, following the issuance of **Proclamation No. 40/1994**.

2.6. What Is Microfinance?

Micro-finance is defined elaborately by Marguerite Robinson (2000) as follows:

> *"Microfinance refers to financial service primarily credit and saving provided to people who operate small enterprises or micro-enterprises' where goods are produced, recycled, repaired, or sold; who provide services: who work for wages or commissions; who gain income from renting out small amounts of land, or machinery and tools: and other individuals and groups at the local levels of developing countries, both rural and urban. Many such house holds have multiple sources of income". (Rutherford 1999)*

The fact that microfinance addresses the social and economic needs of the poor; it has been kept high in the global agenda. Summits were held which acknowledge its expansion and development.

2.7. Services of micro finance institutions

Microfinance services may be seen in terms of four main mechanisms:

1. **Loans**: allow a lump sum to be enjoyed now in exchange for a series of savings to be made in the future in the form of repayment installments.
2. **Savings**: this allows a lump sum to be enjoyed in future in exchange for a series of savings made now.
3. **Insurance**: allows a lump sum to be received at some unspecified future time if needed in exchange for a series of savings made both now and in the future. Insurance also involves income pooling in order to spread risk between individuals on the assumption that not all those who contribute will necessarily receive the equivalent of their contribution.
4. **Pensions**: allow a lump sum to be enjoyed as a specified and generally distant date in future in exchange for a series of savings made now.

CHAPTER 3

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

3.1. Introduction

In this chapter of the paper the primary data collected from customers of ADCSI through questionnaire and interview of officials of the institute; and secondary data obtained from brochures, reports and other documents are presented, analyzed and interpreted.

3.2. Data Presentation and Analysis

In this section of the paper, the data obtained through the questionnaire are presented using tables and graphs and analyzed qualitatively. Out of the total 85 questionnaires distributed, 75 were collected and 10 of them are either incomplete or not filled by the respondents.

3.2.1. Respondents by their Demographic Factors

The respondents' age, sex and educational background is analyzed in the following section. Because it is believed that their background has an implication on the outcome of the research.

Table 1: Respondents age, sex and educational background

Item	Description	Number	Percentage
1. Age	18-25	15	20
	26-35	24	32
	36-45	21	28
	46-55	6	8
	Above 55	9	12
Total		**75**	**100**
2. Sex	Male	33	44
	Female	42	56
Total		**75**	**100**
3. Education	Illiterate	23	31
	1-8 grade	18	24
	9-12 grade	9	12
	Diploma	16	21
	Degree and above	9	12
Total		**75**	**100**

As it is shown in the ***Table 1***, respondents have the following demographic characteristics. Out of the total number of respondents (75), 15(20%), 24 (32 %), 21(28%), 6(8%) and 9 (12%) falls within the age range of 18-25, 26-35, 36-45, 46-55 and above 55 respectively.

From this we can conclude that 80% of the clients of the Institution are below the age of 45 and 52 % of them are below the age of 35. Therefore, the majority of the customers are young. In addition to this, the majority of the customers (56%) are females.

With regard to the educational background of the respondents out of the total respondents 23(31%) are illiterate, 18(24%) are 1-8 grade complete, 9(12%) are 9-12 grade complete, 16(21%) are Diploma holders and 9(12%) have Degree and above qualification. From this we can conclude that the majority of the respondents are illiterate and only the small percentage of them have Degree and above qualifications. This implies that the major customers of the institution are less educated section of the society.

3.2.2. The Types of Business Activities of Respondents

Table 2: Types of business activities

Types of activities	**Number**	**Percentage**
1. Retail business (butter, coffee, sugar, etc)	12	16.0
2. Selling ready made clothes	7	9.3
3. Tailoring	5	6.7
4. Entertainment services such as pool, play station	11	14.7
5. Baking and selling Injera	16	21.3
6. Small restaurant	4	5.3
7. Design works	2	2.7
8. Laundry services	3	4.0
9. Production and sell of Traditional artifacts	6	8.0
10. Cleaning services (washing cloths using a washing machine and ironing	4	5.3
11. Guilt etc	5	6.7
Total	**75**	**100**

Respondents were asked to mention the types of business activities they are currently engaged in. As it is shown in **Table 2** above the clients of ADCSI are engaged in the following business activities

- ✓ Retail business (butter, coffee, sugar, etc)
- ✓ Selling ready made clothes
- ✓ Tailoring
- ✓ Entertainment services such as pool, play station
- ✓ Baking and selling Injera
- ✓ Design works
- ✓ Small restaurant
- ✓ Laundry services
- ✓ Production and sell of Traditional artifacts
- ✓ Cleaning services (washing cloths using a washing machine and ironing)
- ✓ Guilt etc

From their response the majority of them (21.3%) and 16% are engaged in selling of Injera and in retail businesses respectively.

3.2.3. Source of Information and Number of Years as a Customer

Table 3: Number of years as a consumer of the institution

Factors		**Number**	**Percentage**
Years of membership	**1-3**	39	52
	4-6	27	36
	7-10	9	12
	Above 10	0	0
Total		**75**	**100%**

As it is shown in ***Table 3***, 52% of the respondents are clients of the of the institution for 1-3 years; 36% are clients for 4-6 years and only 12% of the respondent who have long years of relationship with the institution, that is, from 7-10 years.

From this we can say that the majority of the respondents have shorter years of relationship with the institution. This also shows that recently the number of people who are interested in using credits to start business is growing. This is a very good culture that should develop because it will contribute to ward the expansion of small and micro enterprises which are considered as an engine for economic development.

Table 4: Source of information

No	**Items**	**Number**	**Percentage**
1.	Neighbors	21	28
2.	Friend	6	8
3.	Family members	5	7
4.	Media/radio advertisement	25	33
5.	Forums	14	19
6.	*Kebele* officers	4	5
	Total	**75**	**100**

With regard to source of information *(as it is shown in table 4 above)* the majority of the clients *(33 %)* get information from media advertisement and 28% of the respondents also get information from neighbors.

This indicates that media and social system has an important impact in changing the attitudes of the society towards using credit. So the organization should use creative and attractive advertisement packages.

3.2.4. The Impact of Borrowing Loan from ADCSI on Your Personal Life

Respondents were asked to mention whether there is an improvement in their personal life or not.

Consequently, the majority of respondents said that after they have borrowed money from ADCSI they have got a lot of benefits. Some of these benefits are:

- ✓ Increase their profitability of their business because they manage to have large scale of operation than before
- ✓ Increase their confidence which enables them to assume calculated risk
- ✓ Help them to diversify their business and minimize risk
- ✓ Help them to construct their own house
- ✓ Increase their competitiveness and so on

Of course some respondents said that there is no change at all in their life after taking loan from the institution.

3.2.5. Credit Service Practices of the Institution

Since its establishment, ADCSI has been using different types of lending methodology. Starting from the mid E.C year 1995 attends changes in the policies, procedure and methodology of the institution. Particularly, in addition to group lending it provides individual and group loan on personal guarantee and or collateral basis. Cooperatives and joint ventures are also entertained on the same line ***(Policy manual of ADCSI).***

i. Target groups

According the **interview** with the officials of the institution, the major target groups of the institution are micro and mall enterprise operators and potential operators, low income persons who are capable to engage in income generating activities/small business. In another words, women, disabled people, HIV/AIDS victims etc are the major customers of the institution. The main purpose of extending loan to these customers is to encourage the development of micro and small scale businesses, which are found important instrument for economic development in many countries.

ii. Requirements for loan application

From the **interview with Ato Daniel** (the official in the institute) it can learnet that the clients of the institute are required to fulfill the following requirements:

1. Letter of approval from Kebelles' which proves that they are residents of Addis Ababa
2. Certification letter for cooperatives and Edirs
3. License and registration of joint ventures and other business associations from Addis Ababa City Administration or Trade and Industry Bureau
4. License, for business activities requiring loan sizes exceeding ETB 5000.
5. The activities should be implemented in Addis Ababa only.
6. Loan taken form the institution or similar institutions should be settled before hand.
7. The loanees should respect and abide to the regulation and procedures of the institution.
8. Loanees can be physical persons who resided in Addis Ababa City and attained 18 years old and above.
9. Loanees can be legal persons such as Edirs (legally registered). Cooperatives, Joint ventures and other business associations.

iii. Credit service Processes

According to the **interview** with the officials of the Merkato Branch, ADCSI gives credit to customers who fulfill the above criteria at different levels in its structure depending on the amount of loan.

Loan requests up to 30,000 birr can be handled by loan centers (*kebeles*) whereas, loans amounts from 31,000 to 50,000 birr is evaluated by branches of ADCSI. A loan amount from 51, 000 to 250,000 Birr is evaluated and approved by the Head office and for such type of loans the customer has to prepare a business plan.

AdCSI reaches its target groups through the ten branch offices established at sub-city level and service delivery posts established in every 88 *kebeles*. Added to this, there are credit & saving committees to select clients.

On the other hand, AdCSI has networked with the City Administrations Micro and Small Enterprise (MSE) Development Agency to link the credit service with BDS and disseminate information to operations.

Borrowers can apply for the loan either to MSE Development agents & or directly to the institution through the service delivery posts with in their respective *kebele*, then to branches and Head office.

iv. Majors types of guarantees

Ato Daniel told us in order to get the services of the Institution, clients should have a guarantee. The following are eligible for this purpose:

- Group guarantee
- Salary of permanent employees working in GOs, NGOs and private sectors
- Collateral/a house or a vehicle/
- Clients of the institution/their savings or business enterprise can be used a guarantee/
- Joint individual and machines guarantee/
- Joint individual and machineries guarantee.
- Edris, cooperatives, governmental and non-governmental organizations and public enterprises.

In this regard clients complained that they finding a guarantee are a real problem that they encounter while they want to borrow from the institution.

3.2.6. Problems Encountered During Loan Processing

According to the **responses** of the **respondents**, the following are the major problems faced by the clients of the institution:

- ✓ Collateral requirements
- ✓ Getting guarantees and
- ✓ The service is given only in the nearby branch

From the organization's point of view the officials said that the following are the major problems usually faced by the Institute which can be seen in terms of: ***(interview with the officials)***

A. Granting loans

Cooperatives that have members of 10 or more and enterprises (3-5 members) apply for group loan after getting work permit or license. The main problems with these groups are.

1. lack of adequate space to carry out their business
2. Lack of Guarantee for the loan.
3. Conflict among the members which might lead toward failure of the business and consequently default the repayment of the loan

B. Problems Related to collecting loans

1. Cooperatives and business partnership try to change their place of work with the objectives of not to pay their installment payment on time or the loan balance.
2. Individual borrower's try to extend their loan payment common reason they give is poor market performance of their business.

C. Measures usually taken by the institute

From the **interview** with the officials the researcher learned that, When ASCI face the above problems, i.e. failure to repay the loan, it takes the following actions:

1. Gives notice to these customers every month
2. Creates social pressure using tactics like posting their name in different places and make it clear that the organization has the right to take legal action
3. Conduct a meeting with the credit and saving committee in order to decide on taking legal action or not. Taking legal action in the last measure considered by ADCSI

During the **interview** session the officials were also asked to mention the major causes of credit default. They said that usually credit default happens because of one of the following reasons or factors, i.e.,

1. *Poor Business plan not supporter by sufficient information*
2. *work character problems of the borrower*
3. *Poor location selection.*

3.2.7. What makes the services of ADSCI different from Commercial banks?

Officials were asked to mention the unique characteristics of the services of the institution. They said that the credit services of ADCSI are different from those of commercial banks with regard to:

- *the ceiling of the loan amount which is limited to Br. 250,000*
- *the loan period-usually shorter with max period of 60 months*
- *Follow up of customers which, is house to- house in case of ADCSI.*
- *The purpose of the loan is given to creditors with the objective of support and encouraging small business activities and reduces poverty.*

- *Interest rate-* ADCSI charges high interest rate)as compared to commercial banks because of the high risk involved with the loan and in intensive follow up services provided by the organization.

According to the branch manager, however, the interest rate that the institution charges is lower than other similar institutions.

3.2.8. Suitability of credit system

Table 5: Suitability of credit system and periodic repayment of the loan

Items		***Number***	***Percentage (%)***
Do you pay your debt on time?	Yes	63	84
	No	12	16
Total		75	100
Is the credit system suitable?	Yes	68	91
	No	7	9
Total		75	100

The majority of the clients (91%) claim that the credit system is suitable and 84 % of the same respondents said that they pay their loan on time. Those respondents who said they do not pay their loan (84%) on time gave the following reasons:

- Poor follow up from the organization
- Lack of permanent work place. When the lease contract expires the land lords either increase price or cancel the contract any time when they observe the business profitable
- Poor location which in turn affect the profitability of the business and
- Lack of adequate market

As shown in Table 5, Out of the total respondents, 7% said that the Institute's credit system is not suitable for them. This is because the process is so lengthy and it requires taking the maximum care to avoid taking unnecessary risk.

CHAPTER 4

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter paper presents summary, conclusion and recommendation based on the information presented in the previous chapters.

Summary

ADSCI is growing since its establishment. Currently, the number of customers of the institution has reached to 30,000. In the study area, Addis Ketema sub city, Kebele 01/02, the numbers of customers are 676. Out of which the total 85 questionnaires distributed, 75 were collected and 10 of them are either incomplete or not filled by the respondents.

The general objective of this study is to explore the loan management practices, procedures, problems and role of loan management in ADSCI.

The major target groups of the institution are Micro and small enterprise operators and potential operators, low income persons who are capable to engage in income generating activities/small business. In another words, women, disabled people, HIV/AIDS victims etc are the major customers of the institution.

Women, disabled people, HIV/AIDS victims and other low income population are the major customers of the institution. This can help these groups to declare their financial freedom. In addition, it contributes to the economic development in the country.

The institution provides ***seven types*** of loan products to achieve its objectives. These are micro business loan sometimes called general loan, small business loan, micro lease, short term loan, Agricultural loan, consumption loan a housing loan. The institution charges different interest rates and service charge and requires 1-2 % insurance charge for housing and construction loans. The loan term ranges from 6 months to 60 months.

AdCSI has networked with the City Administrations Micro and Small Enterprise (MSE) Development Agency and borrowers can apply for the loan either to MSE Development agents & or directly to the institution through the service delivery posts with in their respective *kebele*, then to branches and Head office. This gives clients flexibility in accessing the services of the institution.

From the survey, we can conclude 80% of the clients of the Institution are below the age of 45 and 52 % of them are below the age of 35. Therefore, the majority of the customers are young. In addition to this, the majority of the customers are female (56%).

The study shows that 52 % of the respondents have shorter years of relationship with the institution. This also shows that recently the number of people who are interested in using credits to start business is growing. This is a very good culture that should develop because it will contribute to ward the expansion of small and micro enterprises which are considered as an engine for economic development.

The majority of respondents said that after they have borrowed money from ADCSI, they have got a lot of benefits. Some of these benefits are: Increase their profitability of their business, Increase their confidence, Help them to diversify their business and minimize risk, Help them to construct their own house and Increase their competitiveness and so on. But some respondents said that there is change at on in their life after taking loan from the institution.

Conclusions

From the study we can draw the following conclusions:

With regard to source of information the majority of the clients (33%) get information from media and 28 % from neighbors. This indicates that media and social system has an important impact in changing the attitudes of the society towards using credit.

The major problems faced by the clients of the institution are collateral and guarantee requirements of the institution. Majority of the respondents said it was difficult for them to fulfill these requirements. In addition to this, the services are given only in the nearby branch which limits the flexibility of customers in getting the service in any branch.

ADCSI charges high interest rate as compared to commercial banks because of the high risk involved with the loan and in intensive follow up services provided by the organization. As a result, the respondents said that it is difficult in many cases to pay the interest and periodic installment.

The survey and interview result showed that there are credit defaults which usually happen because of poor business plan, poor work character, poor location and lack of permanent place of work.

4.3. Recommendations

Based on the findings the following recommendations are forwarded:

1. ADSCI should use intensive advertisement on TV, Radio and news papers and other mechanisms such as seminars, workshops and other social gatherings to encourage and attract potential customers to use loan and expand businesses.
2. The institute should reduce the guarantee requirements in order to achieve its purpose of contributing to the growth of small and micro businesses.
3. The institute should also reduce the interest rate and other service charges to help the poor engaged in business activities and contribute to the economic development of the country.
4. The institute should carryout a strict follow up of clients and provides some technical assistance including training on financial management, bookkeeping, and business plan preparation so that they can run their business successful without facing any failure.

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