ST.MARY'S UNIVERSITY

FACULTY OF BUSINESS
DEPARTEMENT OF ACCOUNTING

# ASSESSEMENT OF CREDIT RISK MANAGEMENT THE CASE OF WEGAGEN BANK

**BY**

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SEPTEMBER, 2014
ADDIS ABABA

**ASSESSEMENT OF CREDIT RISK MANAGEMENT**
**THE CASE OF WEGAGEN BANK**

**A senior Essay Submitted to the Department of Accounting Business Faculty**

**ST.MARY'S UNIVERSITY**

**In partial fulfillment of the requirements for the Degree of Bachelor of Arts in Accounting**

**BY**

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## Approved by the committee of Examiners

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# ACRONYMS

| | |
|---|---|
| ATM | ATOMATIC TELLER MECHINE |
| FIS | FINANCIAL INSTITUTION |
| NBE | NATIONAL BANK OF ETHIOPIA |
| WB | WEGAGEN BANK |

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# CHAPTER ONE
# INTRODUCTION
## 1.1. Back ground of the study

A commercial bank is a type of financial intermediary and a type of bank. After the Great Depression, the US Congress required banks only engage in banking activities, whereas investment banks were limited to capital market activities. Since the two no longer have to be under separate ownership, some use the term "commercial bank" to refer to a bank or a division of a bank primarily dealing with deposits and loans from corporations or large businesses. Commercial bank is the term used for a normal bank to distinguish it from an investment bank(Khambata, (1996).

Bank credit is a scarce resource; hence it should be optimally utilized under all circumstances. For industrial unit, it has become scarcer. Now there are more contenders, for bank credit: Agriculture, small scale industry, farmers, small man and many others. Public enterprises also approach commercial bank for their working capital requirements. The share of bank credit to large scale industry has diminished. On the other hand; the share of small industry and public enterprise is steadily increasing.

In view of the growing demand on bank funds from all sectors; industrial companies have no option but to use bank funds in the most efficient way. In the past they misused or mismanaged the bank funds. Bank credit primarily meant for working capital finance was found to be used for long term purpose and to finance subsidiaries and associated companies. Not only this; cheap credit available from banks have been used to build up disproportionate stocks of materials to realize trading profits. (Pandey, 1999)

In fact; the misuse of bank funds was made possible by the existing system of bank lending; based on cash credit system. The practice was to lend generally to the extent of 75% of the value of inventory and receivables; the remaining 25% being the margin. The value of inventory included purchases of materials on credit. Thus, amount to double financing from creditors as well as banks. Bank lending; under the cash credit system; was directly related to security in the forms of inventory and receivables; irrespective of borrower's operations. So, as long as the borrowers continued to provide the required margin; the banker considered his advance to be safe and liquid and did not bother about the way in which advance was being utilize. The borrower's limit was generally

increased without much questioning about his operation when ever inventory and receivable level went up. The banker never took a closer look in to the affairs of the customer (Khambata, (1996).

One important drawback of the system was that the banker sanctioned maximum limit within which the borrower could draw at his will. Under this procedure the level of advance in a bank is determined not by how much a banker can lend at a particular point of time, but the borrower's decision to borrow at that time under a fight situation such a system would put banks to considerable strain. The cash credit system marks credit planning by bankers very difficult.

The existing practice in fixing limit was to value inventory at the market prices for fixing limit. For this reason and because of the availability of credit from creditors borrower was able to borrow more than his current assets requirements. Accordingly; it was possible for the borrower to divert banks` funds to acquire fixed assets; including investments and make advances to subsidiaries and associated concerns.

Credit is also pervasive that the world's economic system is often characterized as a credit economy. Credit touches the lives of everyone often in several different roles.

An understanding of the nature, uses, and general function of credit is, therefore essential for business, economists and customers alike. A much more thorough knowledge of credit in all its phase, however, is necessary for those charged with its management. (Beckman,(1955).

Adequately managing credit risk in financial institutions (FIs) is critical for the survival and growth of the FIs. In the case of banks, the issue of credit risk is of even of greater concern because of the higher levels of perceived risks resulting from some of the characteristics of clients and business conditions that they find themselves in.

Banks are in the business of safeguarding money and other valuables for their clients. They also provide loans, credit and payment services such as checking accounts, money orders and cashier's checks. Banks also may offer investment and insurance products and a wide whole range of other financial services. (in accordance with the 1999 Financial Services Modernization Act by the US)

**Back ground of the Organization**

Wegagen Bank is privately owned Share Company which started operations on June 11, 1997 with a subscribed capital of birr 60 million and a paid up-capital of birr 30 million.The number of shareholders reached 2,130 while the total capital (including paid-up capital, share premium and legal reserves) reached over birr 1.6 billion. Its vision is to become the most preferred Bank in Ethiopia. Accordingly, its mission is to provide a wide range of quality banking services through a dynamic workforce and up-to-date IT solutions to satisfy the desires of all stakeholders. Hence, Wegagen Bank has a network of 90 branches of which 43 are in Addis Ababa and the remaining 47 are located in other cities and towns of the country. The board of directors consisting of a chairperson, a vice chairperson and seven Directors governs Wegagen Bank. The overall management is entrusted to the management team, which comprises the President/ chief Executive officer, who is appointed by the Board of Directors, two vice- presidents and twelve Departments Managers. The number of permanent employees of the bank stood at 2158, of which 1377 were clerical, professionals and semi professionals, holding diploma and first and second degrees (Annual Report, 2011-2014).

The main objectives of the bank are:

A. maximizing profitability through increased efficiency;
B. enhance growing market share;
C. expanding the bank's capital base;
D. ensuring excellence in customer services; and
E. provides differentiated, varied and value added banking services

To achieve these objectives the bank provides the following major services.

* It accepts different type of deposits;
* It grants varieties of loan facilities;
* It offers full-fledged international banking services;
* It renders local and international money transfer services; and
* Payment card services through ATM and POS network (Annual Report, 2011-2014)

## 1.2. Statement of the problem

Loans are the most important resources held by banks. Lending activity requires banks to make judgment related to credit worthiness of a borrower. However, the judgments do not always prove to be accurate and the credit worthiness of a borrower may decline due to various factors. Consequently, banks face credit risk. Credit risk is the risk that obligations will not be repaid on time and fully as expected, resulting in financial loss or Non performing Loan (NPL). The borrower may fail to meet the terms of the understanding loan agreement (Teferi, 2002).

Credit management is the most sensitive part of the banking system and where most problems arise. More than 85 % of their liability is deposits from depositors (saunders, cornett, 2005). Bank use these deposits to generate credit for their borrowers, which in fact is a revenue generating activity for most banks. Because of this reason credit management should be given due care to safeguard and improve the banking industry, if something went wrong in managing credit improper way; the banking industry and the general economy will collapse (financial distress including bankruptcy). The main reason for studying is to determine and find how efficiently and effectively Wegagen Bank is managing the credit process.

## 1.3 Basic Research Question

- What are major kinds of method or process used by the in management of credit risk?
- Who has the authority to establish credit risk management in policy or procedure in Wegagen Bank?
- What are the challenges faced by the bank with regards to credit risk management?
- How does the bank effectively communicate to reduce credit risk?
- What is expectation from effective credit risk management in Wegagen Bank?

## 1.4. Objective of the study

### 1.4.1 General objective of the study

The general objective of the study is to assess the credit management in Wegagen Bank.

### 1.4.2. Specific objective of the study

The specific objective will only concern about the banking industry especially private commercial banks and in our case Wegagen Bank and its credit management system.

- To identify the authority to establish credit risk management in policy or procedure.
- To identify the method or process used by the in management of credit risk.
- To assess the effective credit risk management in Wegagen Bank
- To identify the challenge that faced by the financial institution in credit risk management.
- To assess the effectively communicate to reduce credit risk in WB.

### 1.5. Significance of the study

The output of the study is expected to create a clear picture about the credit management process of WB. It is believed that the paper is contributed important ground for those who are interested in a detailed study; regarding credit management. Furthermore, the paper is expected to show the input for further studies.

## 1.6 Research Deign METHODOLOGY

### 1.6.1 Research Design

For this study, descriptive type of research technique is going to be used. Because, the aim of the study is to describe the credit risk management practice of Wegagen Bank.

### 1.6.2 - Population and Sampling

The study subjected to the fact that population used to represent the target population. The respondent is selected with non-probability sampling particularly purposive sampling to gather relevant data more concerned and those who are deemed knowledge about the topic are selected. At present in Wegagen Bank the researcher used five branches they have high loan facility from other branches and questionnaire is distributed to 42 Employees (branch Managers, Loan clerks and loan officers) as a sample from the total population (personal Bankers, accountants, customer service supervisors,… etc) , because they are concerned bodies to the topic.

### 1.6.3. Type of Data used

The researcher has also used both primary and secondary data.

**Primary data**

Primary data is collected by using questionnaire. The questionnaire is distributed to employees of the bank who are believed to have knowledge on credit.

**Secondary data**

The secondary data is collected from annual reports of Wegagen Bank for the year of (2011 up to 2013).

### 1.6.4. Method of Data Collection

Primary data is collected by using questionnaires. A questionnaire, which is composed of 18 questions, was disseminated into five branches (Head Office, Bole, Stadium, Merkato; and Megenagna Branches). The questionnaires is distributed to 42 employees of the bank who are believed to have knowledge on credit like loan clerks, loan officers; and branch managers selected for non-probability sampling particularly purposive sampling used. From the Head Office 10 employees and for the rest of selected four branches eight employees were chosen to fill out the questionnaire. . Each chosen branches' managers are also part of the respondents i.e. 5 of the 42 respondents are branch managers.

Secondary data is gathered from the bank. Has been given Annual Report (2011 up to 2013), which show the overall picture of WB.

### 1.6.5 Data Analysis method

After the needed data was collected; data analysis was conducted. After all data reduction was made; which is the process of transcribing data from individual data sheet to a summary form and then coding and edition of data was followed. This process helps the researcher to discover invalid data; missing data and outliners; after checking all data and make correction; if it is needed; then the researcher was passed to a descriptive analysis in using different tools; like.

- Quantitative and table
- Percentages

Using the tools helps to manipulate the information gathered and Make them easy to analyses. To facilitate comparison and to avoid an unnecessary descriptive statement that helps the researcher to conduct the research simply within a given time. Finally; the researcher conducted data interpretation.

## 1.7 Scope of the study

This research will be carried out in Wegagen Bank. Due to shortage of time the student researchers concerned on Head office and four branches (Bole, Megenagna, Merkato and stadium) because high transaction loans. The study is mainly emphasized on credit risk management system that mostly used by the Bank.

## 1. 8 Limitation of the study

The study covers the recent years of the bank's credit management process of WB. In the course of the data collection the researcher faced some problems from the side of the respondents who were not willing to give information needed for the study. But the researcher convinced them to give necessary information and the branch managers who was requested to kindly pass the questionnaires to the targeted employees.

## 1.9. Organizational of study

The study has four chapters. The first chapter deals with the problems and its approach which include background of the study, statement of the problem, objectives of the study, significance of the study, scope, limitation of the study and research methodology. The second chapter is concerned with presenting review of related literatures. Third chapter shows the analysis and presentation of the collected data. The fourth chapter brings to an end this study with summary of major findings, conclusions and recommendations.

# CHAPTER TWO
# REVIEW OF RELATED LITERATURE

## 2.1. Introduction

This chapter will provide the readers with an explanation of the theoretical rational about credit management. Not only this but also how banks manage the credit process from start to end, and other related subjects like classification of credit terms used in credit management process. The credit department set-up will be briefly discussed.

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

## 2.2. What's credit management?

Credit management and financial analysis they try to describe credit management is more challenging as it offers relatively greater scope to bankers for judgment and discretion in selecting their loan portfolios. But this higher degree of freedom in the field of credit management is also accompanied by greater risk. Particularly during recent years; the credit years, the credit function has become more complex. It cannot be handled properly without recovers to modern tools of financial analysis. More experience and conventional Wisdom is just not sufficient to meet the new challenges that are arising today in the area of bank lending.Credit management function includes loans and advances. It involves a large number of activities ranging from credit investigation to contact with borrowers appraisal review, follow-up, documentation, Inspection, nursing recovery and write off. These activities require decision making skills; which can partly be developed through experience, but partly it has to be learned externally. (SINGH, 1983)

## 2.3 The Basic function of credit management

According to (Beckman, 1955) bank credit management generally involves three principal functions:

- Investigation of the credit standing of applicants.
- Constant revision of bank credit records; so as to keep the bank officers informed the states of their accounts.
- Furnishing credit information correspondent to banks and other creditors who seek it.

## 2.4 Overview of credit policy and loan characteristics

In commercial banking lending represent the heart of the industry. Loan dominates asset at most bank and generate the larger share of operating income. Loan officers are among the most visible bank employees; while loan polices typically determine how fast a community grows and what types of business develops. (Timothy and Scott, 2000)

The increased competition among commercial banks; saving banks, credit unions; finance companies and investment banks has load to changes in lending policies and loan portfolios. Different management teams pursue different lending strategies. Many banks concentrate on niches in which they restrict new loans to well defined markets; where they have specialized experience. They consciously limit growth in hopes of building future expansion. (Koch, 1999)

### 2.4.1. The credit process

The fundamental objectives of commercial and consumer lending is to make profitable loans with minimal risk. Management should forget specific industries or markets in which lending officers have expertise. The same what competing goals of loan volume and loan quality must be balanced with the banks liquidity requirements capital constraints and rate of return objectives. The credit process relies on each bank’s systems and controls that alone management and credit officer to evaluate risk and return trade-offs. The credit process includes three functions, credit execution, administration; and credit review. ( Cmpton, 1985)

### 2.4.2 Credit analysis

Credit standards influence the quality of the firm's customers. There are two aspects of the quality of customers.

- The time taken by customers to repay credit obligation, and

- The default rate. The average collection period (ACP) determines the speed of payment by customers. It measures the number of days for which credit sales remain outstanding. The longer the average collection period; the higher the firm's investment in accounts receivable. Default rate can be measured of bad-debt losses ratio, the proportion of uncollected receivable. Bad debt losses ratio indicates default risk. Default risk is the likelihood that a customer will fail to repay the credit obligation. On the basis of past practice and experience. Once a customer requests a loan; bank officers analyze all available information to determine whether the loan meets the bank's risk return objectives. Credit analysis is essentially default risk analysis in which a loan officer attempts to evaluate a borrower's ability and willingness to repay. ( Compton,1985)

Identified two distinct areas of commercial risk analysis related to the flowing questions are:-

- What risks are inherent in the operation of the business?

- What have managers done failed to do in mitigating those risks?

The first equation forces a credit analysis to create a list of factors that indicate what could harm borrower's ability to repay.

The second recognizes that repayment is largely a function forces the analyst to specify how risks can be controlled; so the banks can structure an acceptable loan agreement.

### 2.5 Supervisory Authority of Bank Credit Risk Management

**Sound Credit Risk Assessment and valuation for Loans:**

**Principle 1:** The bank's board of directors and senior management are responsible for ensuring that the banks have appropriate credit risk assessment processes and effective internal controls to consistently determine provisions for loan losses in accordance with the bank's stated policies and procedures, the applicable accounting framework and

supervisory guidance commensurate with the size, nature and complexity of the bank's lending operations.

**Principle 2:** Banks should have a system in place to reliably classify loans on the basis of credit risk.

**Principle 3:** A bank's policies should appropriately address validation of any internal credit risk assessment models.

**Principle 4:** A bank should adopt and document a sound loan loss methodology, which addresses risk assessment policies, procedures and controls, for assessing credit risk, identifying problem loans and determining loan provisions in a timely manner.

**Principle 5:** A bank's aggregate amount of individual and collectively assessed loan provisions should be adequate to absorb estimated credit losses in the loan portfolio.

**Principle 6:** A bank's use of experienced credit judgment and reasonable estimates are an essential part of the recognition and measurement of loan losses.

**Principle 7:** A bank's credit risk assessment process for loans should provide the bank with the necessary tools, procedures and observable data to use for credit risk assessment purposes, account for impairment of loans and the determination of regulatory capital requirements.

**Principle 8:** Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk policies and practices for assessing loan quality.

**Principle 9:** Banking supervisors should be satisfied that the methods employed by a bank to calculate loan loss provisions produce a reasonable and prudent measurement of estimated credit losses in the loan portfolio that are recognized in a timely manner.

**Principle 10:** Banking supervisors should consider credit risk assessment and valuation practices when assessing a bank's capital adequacy.

### 2.5.1. The Basic factors determine the credit risk

The principal factors to be taken into consideration in deciding whether or not to grant credit (loan), in what amount and on what terms and conditions,

The credit manager should be able to form a reasonable judgment regarding the chances of default. To estimate the probability of default, the credit manager should be consider five C`s; ( Pandey, 1999)

**1, Character: -** referrers to the customer's willingness to pay.

**-** The customer's willingness to meet credit obligation.

- Credit management should be judge whether the customers will make honest efforts to honor their credit obligations.

- Is the aggregate of mental and moral qualities which identifies an individual borrower.

2. **Capital**: - refers to the financial strength of a risk as measured by the equity or net worth of the business.

– The customers (borrower's) financial reserve.

3. **Capacity**; refers to the customer's ability to pay can be judged by assessing the customer's capital and assets which he may offer as security.

–The borrower's ability to meet credit obligation out of operating cash flows.

**4. Conditions**; refers to the prevailing economic and other conditions which may affect the customers` ability to pay.

– Adverse economic conditions can affect the ability or willingness of a customer to pay.

- general business, political and economic environment over which individuals do not have control, may alter the ability of even the more cab able risk to meet his/hers obligations.

**5. Collateral;**-a pledge asset in the case of default.

- Includes any assets the owner pledges to the bank as security for repayment of the loan. If the company defaults on the loan, the bank has the right to sell the collateral and use the proceeds to satisfy the loan.

**2.5.2 Credit risk and other related risks**

One reason credit managers overtook operating credit risk is the un intentional smoke screen credited by other risks that surround corporate services definitions low basic types of risk associated with payments and securities follows;

**Credit risk**; is the risk of loss due to the financial weakness of the bank's customer. Generally it is the risk that customer will not be able to provide funds to settle its transactions; usually due to bankruptcy or some other liquidity crisis.

**Operational risk;** is the risk of loss due a failure to perform when executing a customer's transaction. The failure can be the bank's the customer or other parties. Operational risks include errors, system failure and disruptions caused by natural disasters; employees' actions power failure and the like. There is no necessary for credit expertise to manage operational risk.

**Fraud risk;** is the risk of loss due to the illegal additional parties to a transaction or interlopers. Controls of fraud risk are clearly not the responsibility of credit officials.

**Systematic risk**; arises when a bank participates in a payments or securities clearance.

(Paul, 1993)

### 2.6 Credit execution (decision) and Administration

Credit decision can be made individually; by an independent under writing department; or by committee; depending on bank's organization structure. This structure varies with a bank's size, number of employees and the type of loans handled, a bank's board of directors normally has the final say over which loans are approved.

Typically; each lending officer has independent authority to approve loans up to same fixed amount. A committee made up of the bank's senior loan officers often formally reviews larger loans. This committee reviews each step of the credit analysis as presented by the loan officer and supporting analysis and makes a collective decision. Loan committees meet regularly to monitor the credit approval process and asset quality problems when they arise. When required the board of directors or a director's loan committee review this decision and grants final approval. (Koch,2000 )

#### 2.6.1. Credit investigation (appraisal)

Credit appraisal implies consideration of fresh or enhancement proposals on the basic of futuristic data; while appraising proposals; bankers try to find out;

- Financial need of the client
- End use of funds
- Viability of operation and

- Risk in valued.

At the time of appraisal plan in the form of operating statement; balance sheet and funds flow or cash flow statement nursing decision may require a very detailed appraisal of technical feasibility; managerial competence; financial soundness and economic viability.

Appraisal of term loan proposals requires information about the project. In such a cases a complete project repent may be enacted; giving details of technical and other inputs cost of the project, market prospects; element of competition, managerial competence etc. (Koch,2000 )

### 2.6.2. Credit follow-up

Follow-up may be defined as a continuous activity aimed at ensuring observance of stipulation laid down by the bank; picking up signals on the health status of clients position; remedial action and ensuring result of actions on of funds; hoardings; management and inefficiencies at periodical intervals on continuums basis. The ultimate objective of follow-up is to ensure safety of bank funds and the end-use of bank credit on on-going basis.

The concept of follow-up can be explained in yet another way. Generally landing decision is made by the banker after satisfying on the following aspects;

- Proposal is viable and will continue to be; so in the future security object is also alright, fine the canon of safety is fully satisfied.
- Demand for credit is need-based and production based.
- there will not be diversion of funds; and
- Lending conforms to large social interest.

## 2.7. Credit collection policies and practices

Collection policies adapted by various banks will nursery differ; especially with respect to leniency or strictness underlying the collection system. Some of the policies are regarded as general; while others are of a special character. (Koch, 2000)

### 2.7.1. General collection policies

1. **promptness in collection;** the significance of promotes lies not only in the fact that it brings payment soon; it also has psychological effect up on borrowers; showing them the attitude of the bank forward the loan; and leaving no doubt as to how the bank expects the borrower to regard it's; obligation.
2. **Require in collection;** promptness should be combined with regulating in the collection effort. Few borrower's objects to being reminded of their obligations when the reminder (bank) is prompt, ligulae and courteous. Furthermore; regularity keeps borrower in sound and healthy financial condition;
3. **Systematization of collection;** successful collection depends on large measure upon the development of the collection system; such a system is a methodical; preplanned program; Adapted to differing collection needs; yet prodding uniform treatment for all comparable cases.

The system should never differences in customers' personality; past record; financial conditions personality. Past recorded financial conditions; and the value of future patronage.

## 2.8. Lending procedures and processing credit applications

The fundamental objectives of commercial and consumer lending are to make profitable loans with minimum risk management should forget industries or markets in which lending officers have expertise. The credit process relies on each bank's system and controls that allow management and credit officers to evaluate risk and return trade-offs. (Beckman, 1955)

### 2.8.1. Loan application

According to Beckman, the application for loan provides a basic for the analysis of the risk. The executive officer who takes the application files in the necessary information; determines the market value of securities offered as collateral; and secures a new financial statement if necessary. The borrower's previous record with the lending initiation is filled under "**remarks"** all commercial account whose initial deposits are substantial are ordinary marked for investigation.

To identify the four part process;

**Overview of management and operations:-**

Before analyzing financial data the analyst should gather back ground information on the firms operation including specific characteristics of the business and intensity of industry competition; management character and quality; the nature of the loan request and the data quality relevant historical development and recent trends should also be examined.

**Comment size and financial ratio analysis:-**

Most banks motivate the data analysis using financial analysis spreadsheet which arranges the borrower's balance sheet and income statement data into a consistent format for comparison over time and against industry standards**.**

**Cash flow analysis:-**

Bank regulators require banks to support credit decisions with cash flow information for each borrower. This section presents a frame-work for calculating of firm's cash flow from operations that essentially converts a company's income statement to a cash basis. Cash flow estimate are subsequently compared to principal and interest payment and discretionary cash expenditure to assess firms borrowing capacity and financial strength.

**Financial projection:-**

The three stages process described previously enables a credit analyst to evaluate the historical performance of a potential borrower; projections of the borrower's financial condition reveal what the loan proceeds are needed for how much financing is required; how much cash flow can be generated from operations to service now debt and when; if at all a loan can be repaid.(Koch,2000)

The basic cover rents in every term loan agreement should be constructed around four principles; Limitation of other indebtedness.

- Prohibition of secured obligations or ranking ahead of commercial term loan.
- A provision for the maintaining of a certain minimum working capital.
- Furnishing financial statement.
- Credit information
- Credit investigation
- Credit limits; and
- Collection procedures. (Mortorn , 2003)

### 2.8.2. Types of loans

Based on the time of repayment loans are classified in to three bound categories;

- **Short-term loans:** - the time limit to repay is one year or less and is often required for working capital and is repaid out of the proud from sales.

- **medium-term loans:-** the usual repayment paired for such type of loan is from 15 month to five years

- **Long-term loans:** - is used to finance the purchase of property or equipments with the purchase asset serving as collateral for the loan. The normal repayment period ranges from 5to15 years or in a few cases even up to 20 years. (NBE NO.109 (2011).

## 2.9. Foreclosure legal action for loan recovery

If the borrower feed to make the mortgage payments; the bank lender may issue on "Natal of default" (NOD). This is essentially a hot ice that the borrower was late in making the mortgage payment and that legal action may be taken.

This legal preceding is known as a foreclosure; and will result in the loss of the borrower's home; additional foreclosure fees; legal fees and possibly a Deficiency judgment if the outstanding loans exceed the current value of the property.

### 2.9.1. The fore closure process

Unfortunately the borrower may lose Job; fail ill or simply fall baring on the mortgage payment. But these are not valid reason to miss mortgage payment. When originally applied for a loan; the borrower likely verified aspect reserves that Provo to the bank that he/she can differed the loan for an attain amount of months; even it fail to receive any additional income.

Once the borrower miss the first payment; the bank or lender will hit the borrower with a 30-day late.

At this point credit will take a huge hit and a representative from the bank may call or send a notice in the mail regarding failure to pay on time. The bank may also discuss a fort aberrance plan to resolve the misact payment to get back on track. This is basically a special payment to case the repayment of the loan. The bank may also discuss refinancing the loan to terms that make the payments more affordable. But borrower will have to prove to the bank that he/she will be able to handle the new financing terms. But if he/she

fails to take with the bank and continue to avoid paying the mortgage; the borrower will be but ruined and any chance for refinancing or seeking for aberrance place will be most likely loss.

Once the borrower hit the 90-day late mark; the bank will likely hit with NOD. This NOD (natal of default) essentially states that the borrower have 30-days to made the payment correct; appear in court or face the risk of fore closure. If 30-days 90 by and fail to appear in court or make payment current; the court can schedule on auction to sell the prospering within 7 days.

If the auction ends without a buyer; the bank will gain ownership and likely perform maintenance on the property; and clear up any lit to issues; then put it on the market.

After paying legal fees; foreclosure fess; late fees and losing property. The borrower will also get a huge duty on the credit report. A foreclosure will drop the credit score dramatically and prevent from borrowing from a paper banks for as long as 4 years. (A.A.U. unpublished paper, 2008).

## 2.10. - PORTFOLIO APPROACH:

Since the 1980s, banks have successfully applied modern portfolio theory (MPT) to market risk. Many banks are now using earnings at risk (EAR) and value at risk (VAR) models to manage their interest rate and market risk exposures. Unfortunately, however, even though credit risk remains the largest risk facing most banks, the practical of MPT to credit risk has lagged. (William, 2007).

### 2.10.1. Managing Bank's Loan portfolio

More than any other thing it is the bank's lending activities and the management of loan portfolio which determines the degree of success (or the failure) of the bank. This is where the principles of portfolio choice play a critical role.

The principal business of commercial banks is to make loans to qualified borrowers. Loan is among the highest yielding assets a bank can add to its portfolio; and they provide the largest portion of operating revenue.

A substantial portion of bank credit is extended to commercial and industrial customers in the form of direct loans. Historically; commercial banks have preferred to make short term loans to business; principally to support purchases of inventory. In recent years,

however, banks have lengthened the maturity of their business loans to include term loans (which have maturities over one year) to finance the purchase of buildings, machinery and equipments. Because the long term loans carry greater risk due to unexpected changes in interest rates, banks have also required a much greater proportion of new loans to carry variable interest rates that can be changed in response to shifting market conditions. (Rose, 1992)

### 2.10.2 MANAGING CREDIT RISK USING FINANCIAL RATIOS:

Ratio analysis (financial and accounting ratios) is a measurement system to analyze the strength, weakness, opportunity and threats (SWOT Analysis) of an FI. The table below depicts some of the frequently used ratios in credit analysis (Caoutte.et.al, 1998)

**Frequently Used Ratios in Credit Analysis**

| Category | Ratio |
| --- | --- |
| Operating Performance | Earnings before interest, taxes, depreciation and amortization(EBITDA)/Sales<br>Net Income/ Sales<br>Net Income/ Net Worth<br>Sales/ Fixed Assets |
| Debt Service Coverage | EBITDA/ Interest Payment>1.5<br>Free Cash-flow expenditure/ Interest payments<br>Free Cash-flow expenditures-dividend/Interest |
| Financial Leverage | Long-term debt/Capitalization<br>Long-term debt/Tangible net worth Total liabilities/Tangible net worth Current liabilities/Tangible net worth |

| Liquidity | Current ratio (current assets/current liabilities)<br><br>Quick ratio (current assets-inventory/current liabilities)<br>Inventory turnover(inventory/Net sales)<br>Inventory to Net working capital<br><br>Current debt to Inventory<br><br>Raw materials,WIP, and finished goods as a percentage of total Inventory |
|---|---|
| Receivables | Aging of receivables:30,60,90,90+days |

Source; caoutte ,et al, 1998

**2.11. Problem in credit management:-**

Most major problems have been either explicitly or in indirectly caused by weakness in credit risk managements. In supervision's experience certain key problems tend to require; saver credit losses in a banking system usually reflect simultaneous problems in several areas. Some of the problems are;

- The absence of testing and validation of new leading retinues.
- The failure to perform adequate due diligence and financial analysis.
- Subjective decision making by senior management of the bank.
- Lack of effective credit review.
- Failure to monitor borrowers or collateral values.
- Failure to use sufficient caution with attains leveraged credit arrangements.

(Morton, 2003)

# CHAPTER THREE

## DATA PRESENTATION, ANALYSIS AND INTERPRETATION

### 3.1 Introduction

A questioner, which is composed of 18 questions, was disseminated into five branches (Head Office, Bole, Stadium, Merkato; and Megenagna Branches). The questioner was distributed to 42 employees of the bank who are believed to have knowledge on credit like loan clerks, loan officers; and branch managers selected for simple random sampling used. From the Head Office 10 employees and for the rest of selected branches eight employees were chosen to fill out the questioner. Each chosen branches' managers are also part of the respondents i.e. 5 of the 42 respondents are branch managers.

Secondary data is gathered from the bank. Has been given Annual Report (2011 up to 2013), which show the NPL Ratio of WB.

To analyze the questions are divided into four groups namely the general questions (gender, age,…), experience, credit risk management and provided trainings.

**A, General questions**

**Table 3.1.1: distribution of respondents by gender, Age, Educational status and employment basis**

| Item No | Description | Options | No of Respondents | Percentage % |
|---|---|---|---|---|
| 1 | SEX | Male | 29 | 69.05% |
| | | Female | 13 | 30.95% |
| 2 | Age | 18-25 | 2 | 4.76% |
| | | 26-35 | 31 | 73.81% |
| | | Above 35 | 9 | 21.43% |
| 3 | Educational status | Diploma | 7 | 16.67% |
| | | First degree | 33 | 78.57% |
| | | Second degree | 2 | 4.76% |
| 4 | Employment basis | Permanent | 42 | 100% |
| | | Temporary | 0 | 0% |
| 5 | Department | Branch manager | 5 | 11.90% |
| | | Loan officer | 16 | 38.10% |
| | | Loan Clerk | 21 | 50.-% |

*Source: Primary Data*

As it is shown in Item no 1 of Table 3.1.1, the genders of the employees are categorized into two. From which 29(69.05%) of the respondents are males and 13(30.95%) of the respondents are females. This shows that most of the workers in credit departments are male.

Regarding to their age as indicated in Item no 2 of Table 3.1.1, 2(4.76%) of the employee's age fall between 18-25 and 31(73.81%) of the employees are between 26-35, and 9(21.43%) of employees age fall above 35. This shows that most of the respondents are youngest.

When we come to their educational status as shown in Item no 3 of Table 3.1.1,the respondents have second Degree 2(4.76%), diploma 7(16.67%) and degree holder 33(78.57%) most of the respondents are degree holders. This shows that most of respondents are educated employees and they have the required skill and knowledge to perform the assigned tasks.

As it is shown in Item no 4 of Table 3.1.1, the employment basis of the respondents is categorized into two major parts. From which 42(100%) of the employees are permanent.

The last Item no of Tables 3.1.1, 21(50%) of the respondents are from Loan Clerk, 16(38.10%) of the respondents are from the Loan Officer, 5(11.90%) from the Branch Manager. From the percentage shared by looking the number of respondents the researcher decided that, there is segregation of duties and responsible in the Wegagen Bank.

**B. Experience**

**Table 3.1.2:** Working Experience

| ITEM NO | Description | Options | No of Respondents | Percentage % |
|---|---|---|---|---|
| 1 | General bank experience | **Less than 1 year** | **0** | **0%** |
| | | **1-2 years** | **6** | **14.29%** |
| | | **3-5 years** | **24** | **57.14%** |
| | | **More than 5** | **12** | **28.57%** |

| 2 | **Experience on Credit risk management** | **Less than 1 year** | **1** | **2.38%** |
|---|---|---|---|---|
| | | **1-2 years** | **19** | **45.24%** |
| | | **3-5 years** | **16** | **38.10%** |
| | | **More than 5** | **6** | **14.28%** |

*Source: Primary Data*

Respondents in order to investigate the respondents' experience on both general banking systems and specifically on credit risk management.

As we can see Item no 1 of the table 3.1.2, the majority of the respondents i.e.24(57.14%) of them have three up to five years of general banking experience while 6(14.29 %) of them have less than two years working experience and 12(28.57%) have more than five years experience. When we see the respondents experience on the risk management area Item no 2 of the Table 3.1.2, 19(45.24%) of them have one up to two years working experience. 16(38.10%) of them have three up to five years working experience. 6(14.28%) of them have experience more than five years. Only 1(2.38%) of them have experience less than one year.

As stated above the respondents are those who are working with credit. However, when we see the working experience of those respondents who have working experience on risk management area are less than with those who have experience on general banking system. Meaning 85.71%(sum of 57.14% & 28.57%) of the respondents have three and more years experience on general banking system while 52.38% (sum of 38.10% & 14.28%) of them have risk management area experience. The table shows that less experience on the risk management area. This might expose the bank to risk because since the majority of the respondents does not have a detailed experience on the risk management area they might have less knowledge on implementing the risk management guideline and/or policies and might not follow all the procedures before approving the loan request.

**C. Credit Risk Management**

In order to investigate the practice of Wegagen bank's credit risk management practice questions were presented for the respondents.

**Table 3.1.3:** Credit Risk Management Policy

| Response | No. Respondents | Percentage |
|---|---|---|
| Yes | 42 | 100% |
| No | 0 | 0% |
| **Total** | **42** | **100%** |

*Source: Primary Data*

This Table 3.1.3 focused a credit risk management guideline and/or policy. All the respondents stated Wegagen Bank have a guideline and/or policy. This is a good sign because it helps the organization to manage their credit risk. If a bank has a guideline, the employees will work according to the developed guideline or policy. Employees like loan clerks, loan officers; and branch managers must be familiar with the bank's Lending Guidelines in order to minimize the risk. All banks should establish know your customer and money laundering guidelines, which should be adhered at all times. This will help to ensure that borrowers, principals, and guarantors are in fact who they claim to be. Hence, establishing a guideline is one method to manage credit risks.

**Table 3.1.4**: Who have the authority to establish the guideline and/or policy?

| Response | No. Of Respondents | Percentage |
|---|---|---|
| Chief financial officer | 0 | 0% |
| Board of Director | 40 | 95.25% |
| Executive management committee | 2 | 4.75% |
| Internal auditor | 0 | 0 % |
| Staff | 0 | 0 % |
| **TOTAL** | **42** | **100 %** |

*Source: primary Data*

According to the Table 3.1.4 respondents the Board of Directors are the one who established the guideline and/or policy. As stated above the Board of Directors in Wegagen Bank consist a chairperson, a vice chairperson, and seven Directors. Most of the organizations believe that it is the responsibility of the board of Directors or committee & Executive management team to establish credit risk management. Top management decides the objectives and strategies for organizational credit risk management activities, mission, and overall objectives. The guideline and/or policy designed by the Board of Directors supports the goals and objectives of credit risk managements.

**Table 3.1.5:** Do you understand the credit risk management policy and/or guideline?

| Response | NO | Percentage |
|---|---|---|
| Good understanding | 40 | 95.24% |
| Low understanding | 2 | 4.76% |
| **Total** | **42** | **100%** |

*Source: Primary Data*

Then we wanted to examine if they, the respondents, understand the credit risk management policy and/or guideline. As can be seen from table 3.1.5 majority respondents 40(95.24%) stated that they understand the guideline and/or policy very well. However, the rest 2(4.76%) stated that they do low understand the guideline and/or policy. This might be because most of the respondent, even if they are working in the risk management area, do not have long time working experience and limitation of knowledge on risk management area. As identified on question experience (see Table 3.1.2), even though most of the respondents have a working experience more than three years on general banking system the majority have less than three years experience on credit risk management area.

Thus, it might be disadvantageous for the bank if the employees who are working on credit risk management area do low understand the credit risk management guideline and/or policy. Therefore, it is advisable to either appoint those employees who have long

experience to work on risk management area or give deep training on the guideline and/or policy.

**Table 3.1.6**: How often does your organization change it guideline and/or Policy to manage credit risk?

| Response | No. of Respondents | Percentage |
|---|---|---|
| Once per year | 42 | 100% |
| Once per two years | 0 | 0% |
| Once in more than two years | 0 | % |
| Never | 0 | 0% |
| **Total** | **42** | **100%** |

*Source: Primary Data*

As you can see from Table 3.1.6 all of the respondents, 42(100%) of them, replied that their bank changes the guidelines and/or polices which they use to manage credit risks once per year. This means that Wegagen bank is in a good track because the financial world is always fluctuating. However, the bank should be flexible to update the guideline and/or the policy anytime there is change in the financial world or whenever the National bank changes the guiding policies.

**Table 3.1.7:** How does your organization effectively communicate to reduce credit risk?

| Response | No. of Respondents | Percentage |
|---|---|---|
| Creating clear and trustworthy information | 8 | 19.05% |
| Developing understanding between management team and employee | 14 | 33.33% |
| Fast communication between management team and customers | 6 | 14.29% |

| | | |
|---|---|---|
| Regularly communicating among management and staff | 12 | 28.57% |
| Creating and maintaining a clear communication | 2 | 4.76% |
| Total | 42 | 100% |

*Source:* *Primary Data*

We wanted to investigate how the bank effectively communicates with the employees and committees to reduce credit risk. The results show Table 3.1.7 that 14(33.33%) the most common way of communicating effectively to reduce risk in Wegage Bank is by developing understanding between management team and employee. It means that most of the respondents think that developing this understanding is a first priority for the organization. Then 12(28.57%) of the respondents stated that the bank effectively communicate to reduce credit risk by regularly communicating among management and staff. Creating clear and trustworthy information and fast communication between management team and customers were selected by 8(19.05%) and 6(14.29%) respondents respectively. 2(4.76%) of the respondents stated that creating and maintaining a clear communication is another form of effective way to reduce credit risk.

**Table 3.1.8:** What is your expectation from effective risk management in your organization bank?

| **Response** | **No. of Respondents** | **Percentage** |
|---|---|---|
| Reduce financial loss | 24 | 57.14% |
| Improve communication with customers | 4 | 9.53% |
| Improve resource allocation | 14 | 33.33% |
| **Total** | **42** | **100%** |

*Source:* *Primary Data*

We wanted to know the respondents expectation from effective risk management in their bank. 24(57.14%) of them said they expect the effective risk management should reduce financial loss. 14(33.33%) of the respondents stated that it improves resource allocation and 4(9.53%) of stated it helps to improve communication with customers. This is good expectation because the effective credit risk management to reduce risks from loss.

**Table 3.1.9**: What are major kinds of method or process used by the in management of credit risk?

| Method | Portfolio approach | Credit limitation | Credit assessment | Credit analysis |
|---|---|---|---|---|
| Respondents | 42 | 42 | 42 | 42 |
| Percentage | 100% | 100% | 100% | 100% |

*Source: Primary Data*

This Table 3.1.9 focused is major kinds of method or process used by the in management of credit risk. All the respondents stated Wegagen Bank have a tools and method to manage credit risk. This is a good sign because it helps the organization to manage their credit risk.

**D. Training**

**Table 3.1.10:** the bank offer trainings on Credit risk management?

| Response | No. of Respondents | Percentage |
|---|---|---|
| YES | 42 | 100% |
| NO | 0 | 0% |
| **Total** | **42** | **100%** |

*Source: Primary Data*

All 42(100%) respondents stated that Wegagen bank offers training. The purpose of training is to improve knowledge, skills and attitudes. According to Table 3.1.10 organization give training to employees. This is enables employees to understand the credit risk management practices and to do better effort in the behalf of the organization benefit.

3.2 S**econdary Data**

**Table 3.1.11: Non-performing ratio**

| year | 2011 | 2012 | 2013 |
|---|---|---|---|
| | Out standing balance | Out standing balance | Out standing balance |
| Loan & advance | 2,910,048,944.- | 3,565,674,639.- | 4,690,141,602.- |
| NPL | 132,173,359.- | 86,701,684.- | 105,035,959.- |
| Ratio(percentage) | 4.54% | 2.43% | 2.23% |

Source: *secondary Data (Annual Report 2012/2013)*

The table show that the total of loan and advance amount is increased at closed of the fiscal 2011 and 2012 years. Meanwhile, the bank was able to keep the Non-performing loans ratio which, as at end of the fiscal year, dropped from 4.54% to 2.43% by 2.11% & from 2.43% to 2.23% by 0.2% which will below the maximum allowable regulatory requirement of 5%. . This means that Wegagen bank is in a good track because the credit risk decreases from year to year.

Wegagen Bank is managed and monitored in accordance with defined credit polices and procedures. The credit worthiness of each counterpart is evaluated and appropriate credit limits are established. To reduce individual counter party credit risk the Bank ensures, whenever necessary, that all loans are secured by acceptable forms of collateral. The bank has also established credit limits across industries and products, it regularly reviews it credit exposure (Annual Report 2012/2013).

# CHAPTER FOUR

# SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter is the last part of the study which deals with summary of the major findings, conclusion and recommendations.

## 4.1: Summary

The main aim of this study is to investigate the credit risk management in practice. For this reason, five branches of Wegagen Bank were chosen. These branches are the Head Office, Bole, Megenagna, Merkato and Stadium. To analyze the credit risk management practice at Wegagen Bank both primary & secondary data were collected. From this source, one can see that Wegagen Bank has credit risk management Guideline and/or policy establish by Board of Directors. According to respondents this Guideline includes all the objectives and goals of credit risk management.
However, 2(4.76%) of respondents stated that they do low understand the credit risk management guideline and/ or policy. This might be because most of respondents, that is 19(45.24%) of them, stated that they have less than 3 years of experience credit risk management area. But most of them, 24(57.14%) of them, stated that they have more than three years of experience on General banking system.

We wanted to investigate how the bank effectively communicates with the employees and committees to reduce credit risk. The results show that 14(33.33%) the most common way of communicating effectively to reduce risk in Wegage Bank is by developing understanding between management team and employee.

All the respondents stated Wegagen Bank have a guideline and/or policy. According to the respondents the Board of Directors are the one who established the guideline and/or policy. Bank changes the guidelines and/or polices which they use to manage credit risks once per year.

## 4.2: CONCLUSIONS

Based on the findings the following conclusions are drawn:

The banks are in risky business because their income generates from credit creation. However, credit creation by itself is surrounding by so many risks which might lead the bank to default/bankrupt. Moreover, the respondents indicted that their challenges;

- lack of technology to manage the portfolio
- lack of experience
- data miss interpretation of policies,
- not knowing the exact feature of customers especially individual borrower,
- effects of changing in government policy,
- inadequate human capacity,
- poorly organized of industries to evaluate their worthiness,
- problem of collateral registration,
- low level of awareness to ward credit risk management,
- bad attitudes of the staffs towards satisfying the need of their organization,
- unable to get full information about customer from external sources,
- the department is under staffed,
- use of traditional or simple measurement tools, and
- Absence of relevant information on time.

Good practice in Wegagen Bank;

- WB have credit risk management guideline or policy
- Guideline or policy establish by Board of Director
- Guideline or policy updating
- Organization effectively communicated to reduce credit risk between management team and employee
- WB offer training on credit risk management
- NPL decrease from year to year

## 4.3: Recommendation

Based on the finding this research would recommend that the banks could establish a credit risk management team that should be responsible for the following actions that will help in minimizing credit risk;

- Participation in portfolio planning and management
- Working with business groups and individual in creating credit risk awareness within the bank risk taking capacity.
- Creating goal concurrent.
- Developing and maintaining credit approval authority structure and granting approval authority to qualified and experienced individuals.
- Since the credit risk management department providing training for the employee to enhance their capacity and reviewing the adequacy of credit training across..
- Follow up the implementation credit polices and standards that conform to regulatory requirements and the bank over all objectives and improve the miss implementation of credit risk management policies or guidelines. Cope up to the changes of credit risk management policies with the regulatory body or organ.
- Establish external credit rating agencies to obtain the true information of the clients and use modern credit evaluation technique.
- Improve the collateral registration process and obtain cash equivalent collateral for each loan made to the customers.
- Increase the number of employee in the department.
- Change it frequently life once every year because currently the financial fluctuation happens frequently.

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# APPENDICES

St Mary's University
Faculty of Business
Department of Accounting

Dear respondents:
This is a questionnaire designed to collect data on the credit risk management which will be used as an input for a thesis in a partial fulfillment of Degree in Accounting. Your genuine response is solely used for academic purpose. Therefore, your kindly cooperation is appreciated in advance.

1. Gender
   - ☐ Male
   - ☐ Female
2. Age of the respondent
   - ☐ 10 – 25
   - ☐ 26 – 35
   - ☐ Above 35
3. Educational Statu
   - ☐ Diploma
   - ☐ First degree
   - ☐ Second degree
4. Employment
   - ☐ Permanent
   - ☐ Temporary
5. What are your responsibilities in the bank?
   - ☐ Branch Manager
   - ☐ Loan Officer
   - ☐ Loan clerk

6. How many years of experience do you have working with bank and risk management area?

BANK Risk management
Area

☐ Less than 1 year
☐ 1-2 years
☐ 3-5 years
☐ More than five years

7. What is your expectation from effective risk management in your organization (bank)?

☐ Reduce financial loss
☐ Improve communication with the stake holders
☐ Improve resource allocation
☐ Other (please specify)

______________________________________________________________

______________________________________________________________

8. Who has the authority to establish credit risk management policy in your organization (bank)?

☐ Chief financial office (CFO)
☐ Board/ committee
☐Executive management committee
☐ Internal Auditor
☐ Staff
☐ Other (please specify)

______________________________________________________________

______________________________________________________________

9. Does your organization have credit risk management guideline or policy?

☐ Yes
☐ No

10. Does the guideline support the goals and objectives of credit risk management?

☐ Yes
☐ No

11. Do you understand the credit risk management guideline or policy?

☐ Good understanding
☐ Low understanding

12. How often does your organization change it guidelines or policies to manage credit risks?

☐ Once per year
☐ Once per two years
☐ Once in more than two years
☐ Never

13. In the future, does your organization have a policy to support the development of credit risk management?

☐ Yes
☐ No

14. Does your organization offer training for employees?

☐ Yes
☐ No

15. How your organization effectively communicate to reduce credit risk?

☐ Creating clear and trustworthy information
☐ Developing understanding between management team and employee
☐ Fast and sharp communication between management team and stakeholders
☐ Regularly communication among management and staff
☐ Creating and maintaining a clear communication
☐ Other

16. Does your organization provide credit risk management training course?

☐ YES
☐ NO

17. What challenges you face in credit risk management?

______________________________________________________________________
____________________________________________________________________

18. What are major kinds of method or process used by the in management of credit risk?

_________________________________________________________________
_________________________________________________________________
____________________________________________________________

**DECLARATION**

I the undersigned, declare that this senior essay is my original work, prepared under the guidance of Mr. Benyam Argaw. All sources of material used for the manuscript have been duly acknowledged.

| NAME OF ADVISOR | SIGNATURE |
|---|---|
| Mr. Benyam Argaw | ____________________ |

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| AMINA ADEM | ____________________ |
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Place of submission: Addis Ababa

Date of submission: September, 2014