ASSESSMENT OF LOAN RISK AND ITS MANAGEMENT IN ADDIS CREDIT AND SAVING INSTITUTION (S.C): THE CASE OF AKAKI KALITY BRANCH

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Declaration

I hereby declare that this thesis entitled “Assessment of Loan Risk and its Management in Addis Credit and Saving Institution (S.C): The Case of Akaki kality Branch” was composed by myself, with the guidance of my advisor, that the work contained here is my own except where explicitly stated otherwise in the text, and that this work has not been submitted, in whole or in part, for any other degree or professional qualification.

Name                     Signature                     Date
Getahun Sitotaw           ___________________________  June 2018
Certificate
This is to certify that, the thesis prepared by Mr. Getahun Sitotaw Alemu entitled “Assessment of Loan Risk and its Management in Addis Credit and Saving Institution (S.C): The case of Akaki kality Branch” and submitted in fulfillment of the requirements for the Degree of Master of Business Administration in Industrial Management complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

Signed by Examining Board:

Internal Examiner  Signature  Date

External Examiner  Signature  Date

Thesis Advisor  Signature  Date

Thesis Co-Advisor  Signature  Date
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Abstract

The adequate management of credit risk in financial institutions is critical for the survival and growth of financial institutions. In the case of rural banks, the issue of credit risk is of greater concern because of the higher levels of perceived risk resulting from some of the characteristics of clients and business conditions that they find themselves in. Credit risk management is a structured approach to managing uncertainties through risk assessment, development of strategies to manage it and mitigation of risk using managerial resources. Therefore, the management of the risk related to credit affects the profitability of MFIs. The study analyzes the loan risk and its management in Addis Credit and Saving Institution (S.C): The case of Akaki Kality branch. There have been complains by the microfinance institutions regarding high rate of default/delinquency by their clients there are a number of reasons which is included in the problem, such as, measures that the institution perform for late repayment before taking legal action. Methods that can be employed to control loan delinquency/default. All fifty five employees of a branch were selected for the study. Questionnaire and interview guide were used to collect data for the study. The study found the cause of loan default to include; lack of credit risk assessment, employee credit risk awareness, poor appraisal, lack of monitoring, and improper client selection. Measures to control risk were found to include training to employees, reasonable interest rate, monitoring of clients and proper loan appraisal. It was recommended among others that the institution should have clear and effective credit policies and procedures and must be regularly reviewed. It was concluded that the National Bank of Ethiopia should regularly monitor and supervise the institution so as to insure safety of clients’ deposit and customers’ deposit. Sound credit management is a prerequisite for a financial institution’s stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. The probability of bad debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective. Such delays on collecting cash from debtors as they fall due has serious financial problems, increased bad debts and affects customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good businesses to put credit management at the front end by managing it strategically.

Key words: Disbursement, Arrears, default, Micro finance institution, Addis credit & saving institution
List of Tables

<table>
<thead>
<tr>
<th>Tables</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table: 4.3.1  Micro credit activity</td>
<td>42</td>
</tr>
<tr>
<td>Table: 4.3.2  Establishing credit control</td>
<td>42</td>
</tr>
<tr>
<td>policy</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.3  Review interval of credit</td>
<td>43</td>
</tr>
<tr>
<td>policy</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.4  Credit appraisal process</td>
<td>43</td>
</tr>
<tr>
<td>Table: 4.3.5  Employee awareness of credit</td>
<td>44</td>
</tr>
<tr>
<td>risk</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.6  Credit assessment of the</td>
<td>45</td>
</tr>
<tr>
<td>institution</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.7  Credit risk assessors of the</td>
<td>46</td>
</tr>
<tr>
<td>institution</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.8  Loan default identification</td>
<td>47</td>
</tr>
<tr>
<td>period</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.9  Measures taken difficult to</td>
<td>47</td>
</tr>
<tr>
<td>repay on time</td>
<td></td>
</tr>
<tr>
<td>Table: 4.3.10 Important of risk identification</td>
<td>48</td>
</tr>
<tr>
<td>Table: 4.4.1  Impact on financial performance</td>
<td>49</td>
</tr>
<tr>
<td>of AdCSI</td>
<td></td>
</tr>
</tbody>
</table>
## List of Figures

<table>
<thead>
<tr>
<th>Figures</th>
<th>Description</th>
<th>Page No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Figure: 2.4</td>
<td>Conceptual Framework</td>
<td>33</td>
</tr>
<tr>
<td>Figure: 4.1</td>
<td>Data collected and analyzed</td>
<td>39</td>
</tr>
<tr>
<td>Figure: 4.2.1</td>
<td>Sex of respondents</td>
<td>40</td>
</tr>
<tr>
<td>Figure: 4.2.2</td>
<td>Education of respondents</td>
<td>41</td>
</tr>
<tr>
<td>Figure: 4.2.3</td>
<td>Age of respondents</td>
<td>41</td>
</tr>
</tbody>
</table>
List of Abbreviations

AdCSI: Addis Credit and Saving Institution
CGAP: Consultative Group to Assist the Poor
GOU: Government of Uganda
GTZ: Gesellschaft fur Technische Zusam. (German Technical Cooperative Agency)
IRDP: Integrated Rural Development Program
MFIs: Micro Finance Institutions
MSMEs: Micro, Small and Medium scale Enterprises
NBE: National Bank of Ethiopia
SHGs: Self Help Groups
SACA: Smallholder Agricultural Credit Adminstration
SPSS: Statistical Package for Social Sciences
CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The adequate management of credit risk in financial institutions is critical for the survival and growth of financial institutions. In the case of rural banks, the issue of credit risk is of greater concern because of the higher levels of perceived risk resulting from some of the characteristics of clients and business conditions that they find themselves in. Credit risk management is a structured approach to managing uncertainties through risk assessment, development of strategies to manage it and mitigation of risk using managerial resources. The strategies include transferring to another party, avoiding the risk, reducing the negative effects of the risk, and accepting some or all of the consequences of a particular risk, Amanuel Regassa (2015).

Reducing arrears is crucial if Micro Finance Institutions (MFIs) are to achieve self-sufficiency. MFI staff must understand the causes of arrears, whether from clients’ testing the MFI’s determination to collect, crises in clients’ lives, loans that are too large, or loans given on the basis of favoritism. Analytical tools for assessing and preventing arrears include key measures for analyzing arrears (e.g., portfolio quality ratios and performance ratios by credit officer) and financial ratio tests for determining appropriate loan size. The key to reducing arrears is to follow up late loans quickly, form strong solidarity groups, update and enforce credit policies, focus credit officers’ services in a specific geographic scope, special selection of clients, and provide financial incentives for credit officers. In critical arrears situations, MFIs should suspend lending to new clients until portfolio quality improves, as well as ascertain clients’ ability and willingness to repay in order to design appropriate strategies to pursue, Dan Norell (volume III).

As with any financial institution, the biggest risk in microfinance is default risk. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e., traditional collateral is not often used to secure microloans). The MFIs’ clients are those who cannot get credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do
not extend credit to these kinds of people due to the high default risk for repayment of interest and in some cases the principal amount itself. Therefore, these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities, Churchill and Coster (2001).

A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit lines. In order to minimize exposure to bad debt, and bankruptcies, companies must have greater insight into customer financial strength, credit score history, and changing payment patterns. The ability to penetrate new markets and customers hinges on the ability to quickly and easily make well-informed credit decisions and set appropriate lines of credit. Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected, Peterson Mbaya Kisala (2011).

The chance that a microfinance institution (MFI) may not receive its money back from borrowers (plus interest) is the most common and often the most serious vulnerability in a microfinance institution (Warue, 2012). According to her since most microloans are unsecured, delinquency/default can quickly spread from a handful of loans to a significant portion of the portfolio. This contagious effect is worsened by the fact that microfinance portfolios often have a high concentration in certain business sectors. Consequently, many clients may be exposed to the same external threats such as lack of demand for clients’ products, livestock disease outbreak, bad weather and many others. These factors create volatility in microloan portfolio quality, heightening importance of controlling credit risk. In this regard, MFIs need a monitoring system that highlights repayment problems clearly and quickly, so that loan officers and their supervisors can focus on delinquency (repayment rate) before it gets out of hand. In lending services, a default is the failure to pay back a loan.
1.2. Overview of the company on literature

Addis credit and saving institution is one of the major micro finance institutions in Ethiopia, its Operation started on the year 2000 according to proclamation no. 40/96 under the control of National Bank of Ethiopia. The institution Head quarter located at Addis Ababa. The company owned by 5 major shareholders, named, Addis Ababa city administration, Addis Ababa city female association, Addis Ababa teachers association, Addis Ababa Youth Association & Karalo Area Farmers Association, currently its capital more than 2.1 billion birr, according to annual magazine of the institution (2016) and the institution have 16 micro banks in Addis Ababa and Oromia region, 10 branches and 116 sub branches in Addis Ababa.

As to the revised proclamation No. 626/2009, AdCSI has an objective to collect deposits and extend credit to rural and urban farmers, and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs, the maximum amount of which may be determined by the national bank.

1.3. Statement of the Problem

The sustainability of microfinance institutions depends largely on their ability to collect their loans as efficiently and effectively as possible. In other words to be financially viable or sustainable, microfinance institutions must ensure high portfolio quality based on 100% repayment, or at worst low delinquency/default, cost recovery and efficient lending. (American International Journal of Contemporary Research Vol. 4, No. 12; (December 2014)

There have been complains by the microfinance institutions regarding high rate of default/delinquency by their clients; which presupposes that most microfinance institutions are not achieving the internationally accepted standard portfolio at risk of 3%, which is a cause for concern because of its consequences on businesses, individuals, and the economy of a country at large. (American International Journal of Contemporary Research Vol. 4, No. 12; (December 2014))
Governments (at both national and local levels) can create a legal and regulatory environment that encourages market entry and competition in microfinance. To do this, finance ministries, central banks, and other government bodies should recognize microfinance as a legitimate financial activity within the financial system, rather than a marginal sector or a resource transfer mechanism. The most important contribution governments can make to microfinance is to maintain macroeconomic stability through appropriate monetary and fiscal policies. In the 1990s, volatile inflation often reached three digits. The resulting need for frequent price changes disrupted microfinance institutions (MFIs) and confused their clients, (CGAP, May 2000).

Governments can involve the private sector in formulating poverty reduction strategies, and explicitly recognize its leading role in financial sector development, including microfinance. The active participation of the private sector should help to embed microfinance firmly within financial systems, with private and non-governmental actors taking the lead (as opposed to government bodies, such as ministries of agriculture and health, and local authorities), (CGAP, May 2000).

If and when needed, governments should adjust regulatory frameworks to permit all types of financial institutions to offer services to poor people. Premature or restrictive regulations can stifle innovation. This limits poor people’s choices and access to services. The introduction of prudential regulation is generally only warranted when a critical mass exists of institutions that are strong enough to obtain licenses to mobilize deposits from the public. Governments should invest in supervisory capacity. In many developing countries, bank supervision capacity is limited. There is no point in licensing institutions that cannot be effectively supervised.

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

Al-Tamimi and Al-Mazrooei (2007) also noted that financial institutions including micro finance institutions are a business mostly associated with credit risk because of their high exposure to uncertainty. They also noted that credit risk management is one of MFI liabilities of the operations and procedures being followed. In today’s dynamic environment, all micro finance institutions are exposed to potential credit risks. Due to such exposure to credit risks, efficient credit risk management is required. Chua et al. (2000) also found that managing credit risk is one of the basic tasks to be done in micro financial institutions, once it has been identified and known.

However of late, there have been complains by the microfinance institutions regarding high rate of default/delinquency by their clients; which presupposes that most microfinance institutions are not achieving the internationally accepted standard portfolio at risk of 3%, which is a cause for concern because of its consequences on businesses, individuals, and the institution liquidity risk at large. Delinquency and hence default have started creeping deeply into the operations of the branch as well as the institution.(American International Journal of Contemporary Research Vol. 4, No. 12; (December 2014))

As a result, this study is designed to fill the aforementioned gaps (particularly in the institution) having the main objective of loan risk and its management of Addis Credit and saving institution Akaki Kality Branch. Therefore, the purpose of this thesis is to look at the Assessment of loan risk and its management.

1.4 . Basic Research Question

The study attempted to address the following basic research questions:

- What are the causes of loan default/delinquency in Addis Credit and Saving Institution Akaki Kality branch?
What measures can be employed to control loan default and delinquency in Addis credit and saving institution Akaki kality branch?

1.5. Objective of the study

The study generally investigated loan risk and its management in Addis Credit and Saving Institution S.C. Akaki Kality Branch. The specific objectives of the study included the following:

- To examine the causes of loan default/delinquency in Addis Credit and Saving Institution Akaki Kality Branch.
- To recommend measures to control the default/delinquency in Addis credit & saving institution (S.C) Akaki Kality branch.

1.6. Significance of the study

This study makes several contributions to:

**The institution:** practice of capacity building improvement in credit risk management and boosting profitability. It is expected that to reduce outstanding loans at risk. It shall also be of great relevance to other branches of the institution. This is because the result of the study shall enable the user especially AdCSI to appraise its credit policies and to review its operations critically for more result oriented approach in dealing with its credit facilities.

**Future researchers and scholars:** The study will help in facilitating an increase in the general knowledge of the subject and will act as a reference material to future researchers who may wish to embark on related studies. Research in the various components of the sector will help to unearth hitherto unknown information that will go a long way in facilitating further understanding of the micro finance sector.
1.7. **Scope of the study**

This research is delimited only to the study of loan risk and its management of sample sub branches of the institution from Akaki Kality Branch. The study seeks to analyze the credit risk management of the institutions and to determine the level of the institution credit risk exposure. Specifically, establishing the empirical association between the services provided to the clients’ on one hand and credit risk management as well.

1.8. **Organization of the study**

This research is organized in to five chapters. The first chapters holds the introductory part of the study which consists of back ground of the research, statement of the problem, significance of the study, scope and limitation of the study. The second chapter deals with review of related literature to the research. The third chapter discussed about methodology. The collected data from the subject of the study are carefully analyzed and interpreted under the fourth chapter. The fifth chapter forward conclusion and recommendation of the finding of the study. Reference and Appendix, which includes questioner and interview format, were part of the research document.
CHAPTER TWO: REVIEW OF THE RELATED LITERATURE

2.1 Theoretical Review

2.1.1. Brief Review on the theory of Loan Delinquency and Loan Default

A loan is delinquent when a payment is late (CGAP, 1999). A delinquent loan becomes a defaulted loan when the chance of recovery becomes minimal. Delinquency is measured because it indicates an increased risk of loss, warnings of operational problems, and may help to predict how much of the portfolio will eventually be lost because it never gets repaid.

There are three broad types of delinquency indicators: collection rates, which measures amounts actually paid against amounts that have fallen due; arrears rates measures overdue amounts against total loan amounts; and portfolio at risk rates, which measures the outstanding balance of loans that are not being paid on time against the outstanding balance of total loans (CGAP, 1999).

Default occurs when a debtor has not met his or her legal obligations according to the debt contract. For example, a debtor has not made a scheduled payment, or has violated a loan covenant (condition) of the debt contract (Ameyaw-Amankwah, 2011). A default is the failure to pay back a loan. Default may occur if the debtor is either unwilling or unable to pay their debt. A loan default occurs when the borrower does not make required payments or in some other way does not comply with the terms of a loan. (Murray, 2011).

Moreover, Pearson and Greeff (2006) defined default as a risk threshold that describes the point in the borrower’s repayment history where he or she missed at least three installments within a 24 month period. This represents a point in time and indicator of behavior, wherein there is a demonstrable increase in the risk that the borrower eventually will truly default, by ceasing all repayments. The definition is consistent with international standards, and was necessary because consistent analysis required a common definition. This definition does not mean that the borrower had entirely stopped paying the loan and therefore been referred to collection or legal processes; or from an
accounting perspective that the loan had been classified as bad or doubtful, or actually written-off. Loan default can be defined as the inability of a borrower to fulfill his or her loan obligation as at when due (Balogun and Alimi, 1990).

2.1.2 Causes of Loan Delinquency/Default
According to Ahmad, (1997), causes of loan default include; lack of willingness to pay loans coupled with diversion of funds by borrowers, willful negligence and improper appraisal by credit officers.

In addition, cited by Kwakwa, (2009) found that, corporate loan default increases as real gross domestic product decline, and that the exchange rate depreciation directly affects the repayment ability of borrowers.

Balogun and Alimi (1990) also identified the major causes of loan default as loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes.

Moreover, Akinwumi and Ajayi (1990) found out that farm size, family size, scale of operation, family living expenses and exposure to sound management techniques were some of the factors that can influence the repayment capacity of farmers.

According to Olomola (1999), loan disbursement lag and high interest rate can significantly increase borrowing transaction cost and can adversely affect repayment performance. After surveying different banks in India, Berger and De Young (1995) identified the main causes of default of loans from industrial sector as improper selection of an entrepreneur, deficient analysis of project viability, inadequacy of collateral security/equitable mortgage against loans, unrealistic terms and schedule of repayment, lack of follow up measures and default due to natural calamities.

The early stages of the downturn saw MFIs experience significant liquidity shortages, but as the capital markets recovered, concerns turned from funding to asset quality (CGAP, 1999). This scenario points to links between external factors and loan delinquency. The
relationship between the macroeconomic environment and loan quality has been investigated in the literature linking the phase of the business cycle with lending institutions stability. For instance, Fofack (2005) studied causal analyses and macroeconomic implication on loan default in Sub-Saharan countries. Fofack showed that, macroeconomic stability and economic growth are associated with a declining level of default; whereas adverse macroeconomic shocks coupled with higher cost of capital and lower interest margins are associated with a rising scope of nonperforming loans.

2.1.3 Measures to Control Loan Delinquency/Default
Kohansal and Mansoori (2009) were of the view that, lenders devise various institutional mechanisms aimed at reducing the risk of loan default. These include pledging of collateral, third-party credit guarantee, use of credit rating and collection agencies, etc.).

Loan repayments should be monitored and whenever a customer defaults action should be taken. Thus, banks should avoid loans to risky customers, monitor loan repayments, and renegotiate loans when customers get into difficulties (Ameyaw-Amankwah, 2011). MFIs need a monitoring system that highlights repayment problems clearly and quickly, so that loan officers and their supervisors can focus on delinquency before it gets out of hand (Warue, 2012).

Sheila, (2011) is of the view that proper and adequate appraisal is key to controlling or minimizing default. This is the basic stage in the lending process. According to Anjichi (1994), the appraisal stage is the heart of a high quality portfolio. This includes diagnosing of the business as well as the borrower. Before beginning the process of collecting information on the client for determining credit limits, the loan officer should have specific information available which will guarantee that the data and figures provided by the client will have a pro-margin error (Sheila, 2011).

The majority of the information is obtained by the loan officer through direct interaction with the client in such a way that each loan analysis provides valuable insights for evaluating the application for the future client.
However, most clients withhold a great deal of information making the evaluation a difficult and unreliable exercise. Furthermore, the loan officer should visit the home or the work place of the client with the main objective of determining whether the client needs the loan programmes or not. This information will help the loan officer to assess the ability to effectively utilise the loan. Hunte (1996) observed that the time to assess the applicant’s credit worthiness also matters. He argues that the longer it takes to assess the applicant, the better.

This is because he believes that a shorter time is not enough to fully assess the applicant. This is in agreement with Bigambah (1997) who contends that it is necessary to analyse the client before a loan is issued; the applicant has to be screened to assess his or her credit worthiness. That is the ability to repay the loan, the business, and the guarantee to secure the repayment of the loan. Bigambah (1997) observed that the loan default in Uganda has identified loan appraisal as the key factor. In a number of cases, the information received is not verified; in some cases, the information received is doctored or falsified. It must therefore be emphasized that credit risk analysis is another important element in loan appraisal. When lending out money, the lender should consider the borrowing proposition and subsequent repayment in isolation from security. It should be noted that, the borrower should be screened basing on the future and the past. Lending should be based on capital, character, capability, purpose, amount, repayment, term, and security. Basing on the knowledge above, the lender should investigate on the customer’s record, ability, and experience. Security tends to come towards the end and is considered only after the borrowing proposition has met the criteria. This process of appraising the client will help the officer to assess the ability of the borrower to utilize the loan effectively. Furthermore, the loan officer will be able to predict the likely changes or effect on the business for which the money is being lent out. Another stage in the lending process, which is critical to minimizing default, is the disbursement stage according to Sheila (2011). This stage is regarded as the most demanding to borrowers, which often times leads to failure to meet their loan obligations.

This is because most of the financial institutions take long to disburse funds to successful applicants. This affects the borrowers in that they take long to buy inputs needed to carry
out their activities hence end up spending it unnecessarily. The most affected are those involved in the agricultural sector because their activities are usually in line with the prevailing weather conditions. If the people involved in the agricultural sector receive the loan late, this will delay the planting season hence they end up not making any profit in time or may yield less as a result they are not able to pay their loans in time.

To control default MFIs should also carefully examine the monitoring and control stage in the lending process (Sheila, 2011). Anjichi (1994) lamented that, many of the agonies and frustrations of slow and distressed credits can be avoided by good loan supervision which helps in keeping a good loan good. This is done by visiting the borrowers’ premises to investigate the general state of affairs, checking on the state of borrowers’ morale and physical stock of finished goods. The general business policy and advice are considered. If the MFI is sensitive to business development, it can revise its own credit policies and loan procedures as well as advising its customers. It can also monitor the disbursed loans by the use of loan tracking sheets, checking the amount deposited and the remaining balance of the borrowers. He further says that early recognition of the loan default is crucial, and therefore tries to give guidelines on managing loan losses.

These guidelines include immediate recognition of non-performing loans, re-appraising the borrowers’ financial positions in respect to the market share and extending of payment period where necessary.

Saywer (1998) noted that it is essential for the lender to take an active interest in the borrower and monitor his continuing ability to repay the debt. On monitoring, the lender should focus on the actual sales per month and compare with the monthly budget and reasons for any variance. This regular touch with the borrower will enable the lender to receive early warning of any problem. Bigambah (1997) observed that the frequent visits help to ensure that the client is maintaining the business and intend to repay the loan. The frequent visits allow the loan officer to understand the clients business and appropriateness of the loan term (amounts, frequency of repayments and repayment period) otherwise; the chances of loan default to occur are high. Mugisha (1995) asserts
that non-performing loans in Uganda are usually because of weak banking systems. He says that lending institutions in Uganda lack enough skilled loan personnel which become hard to make a follow up of the loan applicants hence they end up defaulting.

According to Warue (2012) Microfinance institutions regulators, credit referencing bureau and MFIs policy makers have to be wary about increasing loan delinquency in the industry and put in place appropriate management strategies to mitigate portfolio at risks. In addition, MFIs management should regularly review credit risk techniques used and expand loan-monitoring framework among Self Help Group (SHGs) for effective credit portfolio assessment. Further SHGs management should strengthen group solidarity to facilitate prompt loan repayment by the group members.

In the view of Saloner (2007), group lending will also minimize loan default. Many microfinance institutions borrow in groups and choose to lend to groups of borrowers rather than on an individual basis. As opposed, the microfinance institutions provide the loans so that the borrowers are not limited to the money that they themselves can contribute. The general organization of group lending consists of a group of borrowers who work together, support, and mentor one another to maximize the impact that the loan can have on each individual. Additionally, in many group-lending situations, the members of the group are responsible for selecting new members and for the timely repayment by other members, known as joint liability. As a result, group lending tends to lead to superior performance by the borrowers in operating their businesses and better rates of loan repayment.

However, while this social effect can produce positive outcomes for the microfinance institutions, some researchers believe that it can lead to an unhealthy social environment. Islam (1995) examines the effect of lending groups from the perspective of the microfinance institutions. His study finds that group lending provides a strong system of peer monitoring, which in turn provides the institutions with the ability to be more flexible with their finances, either charging lower rates than other lenders or charging the same rate and receiving higher rates of repayment with lower risks. Although most of the research on joint lending finds positive effects, an empirical study of microfinance
institutions and borrowers in Thailand concluded that, contrary to conventional understanding, joint lending does not have a significant effect, either positive or negative, on the repayment of loans (Kaboski and Townsend 2005).

The consensus in the literature on group lending and group liability is that group lending benefits both the borrowers and the institutions. The borrowers receive the additional support and assistance from a group of individuals dealing with the same types of issues. Furthermore, the institutions are able to lower costs by relying on the lending groups to provide these services that otherwise would be required from the institution itself. Group lending also works to move institutions into a more client-led realm, which has proven to be more effective in creating sustainable development programmers.

2.1.4. Common Risks Found in Microfinance Institutions

Many risks are common to all financial institutions. From banks to unregulated MFIs, these include credit risk, liquidity risk, market or pricing risk, operational risk, compliance and legal risk, and strategic risk. Most risks can be grouped into three general categories: financial risks, operational risks and strategic risks.

2.1.4.1. Financial Risks

The business of a financial institution is to manage financial risks, which include credit risks, liquidity risks, interest rate risks, foreign exchange risks and investment portfolio risks. Most microfinance institutions have put most of their resources into developing a methodology that reduces individual credit risks and maintaining quality portfolios. Microfinance institutions that use savings deposits as a source of loan funds must have sufficient cash to fund loans and withdrawals from savings. Those MFIs that rely on depositors and other borrowed sources of funds are also vulnerable to changes in interest rates. Financial risk management requires a sophisticated treasury function, usually centralized at the head office, which manages liquidity risk, interest rate risk, and investment portfolio risk. As MFIs face more choices in funding sources and more product differentiation among loan assets, it becomes increasingly important to manage these risks well. (Liquidity Management: A Tool Kit for Microfinance Institutions, page 11-22 published by GTZ, January 2000.)
**Credit risk:** Credit risk, the most frequently addressed risk for MFIs, is the risk to earnings or capital due to borrowers’ late and non-payment of loan obligations. Credit risk encompasses both the loss of income resulting from the MFI’s inability to collect anticipated interest earnings as well as the loss of principle resulting from loan defaults. Credit risk includes both transaction risk and portfolio risk.

**Transaction risk:** Transaction risk refers to the risk within individual loans. MFIs mitigate transaction risk through borrower screening techniques, underwriting criteria, and quality procedures for loan disbursement, monitoring, and collection.

**Portfolio risk:** Portfolio risk refers to the risk inherent in the composition of the overall loan portfolio. Policies on diversification (avoiding concentration in a particular sector or area), maximum loan size, types of loans, and loan structures lessen portfolio risk.

**Liquidity risk:** Liquidity risk is the possibility of negative effects on the interests of owners, customers and other stakeholders of the financial institution resulting from the inability to meet current cash obligations in a timely and cost-efficient manner.

Liquidity risk usually arises from management’s inability to adequately anticipate and plan for changes in funding sources and cash needs. Efficient liquidity management requires maintaining sufficient cash reserves on hand (to meet client withdrawals, disburse loans and fund unexpected cash shortages) while also investing as many funds as possible to maximize earnings (putting cash to work in loans or market investments).

**Market risk:** Market risk includes interest rate risk, foreign currency risk, and investment portfolio risk.

**Interest rate risk:** Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. Also known as, asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets). In MFIs, the
greatest interest rate risk occurs when the cost of funds goes up faster than the institution can or is willing to adjust its lending rates. The cost of funds can sometimes exceed the interest earned on loans and investments, resulting in a loss to the MFI. Interest rate changes can also affect fee income, since most fee income is associated with loan products that are interest rate sensitive.

**Foreign exchange risk:** Foreign exchange risk is the potential for loss of earnings or capital resulting from fluctuations in currency values. Microfinance institutions most often experience foreign exchange risk when they borrow or mobilize savings in one currency and lend in another. For example, MFIs that offer dollar savings accounts and lend in the local currency risk financial loss if the value of the local currency weakens against the dollar. Alternatively, if the local currency strengthens against the dollar, the MFI experiences a financial gain.

### 2.1.4.2. Operational Risks

Operational risk arises from human or computer error within daily product delivery and services. It transcends all divisions and products of a financial institution. This risk includes the potential that inadequate technology and information systems, operational problems, insufficient human resources, or breaches of integrity (i.e. fraud) will result in unexpected losses. This risk is a function of internal controls, information systems, employee integrity, and operating processes. For simplicity, this section focuses on just two types of operational risk: transaction risk and fraud risk.

**Transaction risk:** Transaction risk exists in all products and services. It is a risk that arises on a daily basis in the MFI as transactions are processed. Transaction risk is particularly high for MFIs that handle a high volume of small transactions daily. When traditional banks make loans, the staff person responsible is usually a highly trained professional and there is a very high level of cross checking. Since MFIs make many small, short-term loans, this same degree of cross-checking is not cost effective, so there are more opportunities for error and fraud.
The loan portfolio usually accounts for the bulk of the MFI’s assets and is thus the main source of operational risk. As more MFIs offer additional financial products, including savings and insurance, the operational risks multiply and should be carefully analyzed as MFIs expand those activities.

**Fraud risk:** Until recently, fraud risk has been one of the least addressed risks in microfinance to date. Also referred to as integrity risk, fraud risk is the risk of loss of earnings or capital as a result of intentional deception by an employee or client. The most common type of fraud in an MFI is the direct theft of funds by loan officers or other branch staff. Other forms of fraudulent activities include the creation of misleading financial statements, bribes, kickbacks, and phantom loans.

Effective internal controls play a key role in protecting against fraud at the branch level, since line staff handles large amounts of client and MFI funds.

### 2.1.4.3 Strategic Risks

Strategic risks include internal risks like those from adverse business decisions or improper implementation of those decisions, poor leadership, or ineffective governance and oversight, as well as external risks, such as changes in the business or competitive environment. This section focuses on three critical strategic risks:

**Governance risk:** One of the most understated and underestimated risks within any organization are the risk associated with inadequate governance or a poor governance structure.

The dangers of poor governance that nearly resulted in the failure of that institution. Direction and accountability come from the board of directors, who increasingly include representatives of various stakeholders in the MFI (investors, borrowers, and institutional partners). The social mission of MFIs attracts many high profile bankers and business people to serve on their boards. Unfortunately, these directors are often reluctant to apply the same commercial tools that led to their success when dealing with MFIs. As MFIs face the challenges of management succession and the need to recruit managers that can balance social and commercial objectives, the role of directors becomes more important to ensure the institution’s continuity and focus.
**Reputation Risk**: Reputation risk refers to the risk to earnings or capital arising from negative public opinion, which may affect an MFI’s ability to sell products and services or its access to capital or cash funds. Reputations are much easier to lose than to rebuild, and should be valued as an intangible asset for any organization.

Most successful MFIs cultivate their reputations carefully with specific audiences, such as with customers (their market), their funders, and investors (sources of capital), and regulators or officials. A comprehensive risk management approach and good management information reporting helps an MFI speak the “language” of financial institutions and can strengthen an MFI’s reputation with regulators or sources of funding. (A Tool Kit for Microfinance Institutions, page 11-22 published by GTZ, January 2000.)

### 2.1.5. Practical Approach to Avert Loan Default Risk
According to Oguntoyinbo (2011), a pragmatic microfinance approach to dealing with such a serious challenge involves engaging in group lending, character referencing, and continuous building up of customers’ credit history, in order to establish realistic and workable loan arrangements. In this regard, the following measures, among others, have been found to be most effective.

#### 2.1.5.1 Building Relationships
A microfinance bank should emphasize the need to build and to maintain a strong and cordial relationship with its customers. Loan officers should visit their clients regularly, not only to collect installments, but also to relate closely to them in order to understand the challenges of their businesses and to assist them with their most pressing concerns. The experience of MFIs over the years has indicated that, in a lending situation. Without collateral, a critical success factor for timely loan repayment is to build strong ties with the clients involved.

#### 2.1.5.2. Engaging in Group Lending
While Microfinance Banks normally grant credit to individual businesses and persons, clients are frequently required to form themselves into groups of about 5 to 10 members (e.g. cooperatives) that nominate specific members for loan awards. Ultimately, the group
members are expected to act as enforcers of the repayments of the loans by the individual members, by means of group sanction, if a member defaults in making repayments. In terms of such an arrangement, the failure of a single member is likely to affect the credit rating of the whole group, so that social pressure forces the non-performing member to make amends in terms

2.1.6. Risk Ameliorating Models

According to Ogunjpyinbo (2011), the following are further models adopted by Microfinance Banks to meliorate risks inherent to their mode of operations.

2.1.6.1. Use of a ‘Daily Collection Board’
The ‘daily collection board’ is a large board on which is written up the amount of money due for collection each day, including both loan installments and savings collection, with the names of the respective loan officers written against the collections to ensure transparency. The maintenance of such a board enables details regarding the daily collection targets for the various loan officers to be available at a glance and also helps to prevent the possibility of misappropriation of money by the officers concerned.

2.1.6.2. Collections in Group Meetings
The system requires that all savings and loan installments are collected during group meetings and in full view of the members concerned. In terms of such an arrangement, the clients are able to witness all financial transactions and, thereby, to increase their level of confidence in the organization. The possibility of fraud is also minimized.

2.1.6.3. Rotation of Loan Accounts
Rotating the clients’ accounts within the same branch among loan officers every six months helps to ensure transparency, as no particular officer has a monopoly of knowledge of client accounts. In addition, such rotation helps to ensure accuracy in record keeping, as well as compelling a six-monthly review of accounts, helping with the detection of error, and cutting down on the possibility of fraud
2.1.6.4. Periodic Review of Passbooks
Such periodic review requires that each branch manager check all the clients’ passbooks quarterly to ensure that the records of transaction in the passbooks agree with the records in the books that are held at the branch. The procedure is important for checking that no transactions are either erroneous or fraudulent.

2.1.6.5. Disbursements Made from Branch Offices
The disbursement of loans to clients is made in the branch office concerned, in the presence of loan officers employed at the branch, the branch manager. The client, the loan officer and the branch manager sign the loan application form, indicating that disbursement of the sum approved has been verified by all those who are immediately concerned with making the loan. The procedure helps to ensure that the client in question receives the whole loan amount and that any officer misappropriates no portion of it.

2.1.6.6. Internal and External Audits
An internal audit is carried out on a continuous basis, while external audits, which serve as counterchecks, are carried out periodically, on a biannual or annual basis.

2.1.7. Risk Management
Butterworths (1990) asserts that effective risk management, from the viewpoint of financial institutions, is the key to the future success in banking and therefore these institutions should focus on professional management of risk. The successful financial institutions are, and will increasingly be those that develop focused strategies, lower their overhead ratios, ingeniously exploit their advantages and know how to calculate their risks.

2.1.7.1. Pre requisites to Risk Management
One of the most important prerequisites of risk management is that of planning for the unknown. This requires asking questions such as; how do we know when a diversity will hit and how hard? Have we examined ahead of time where our financial staying power lies? Do we know what is to be our line of defense against any risk associated with a line of business we are entering into? Secondly, can we anticipate, rapidly respond and cope with changes in the business environment?
2.1.8. Credit Control Policy and Risk Management

There is need for an effective credit control policy to manage credit risk. Hence, in order to ensure a fairly healthy credit management program, with minimal expensive bad debts, and minimized credit risk, a company strives to establish an effective credit control and lending policy. Surprisingly, a few companies do not have any such policy and even more worrying, many of the companies with credit control policies still fail to operate the policies so much so that the companies’ debts soar and seriously affect the companies’ very existence, in terms of profitability and a health cash flow (CBK Survey. 2001).

Credit control policy is the general guideline governing the process of giving credit to the firm's customers. The policy sets the rules on who should get what credit and when and why one should get the credit including repayment arrangements and necessary collaterals. The method of assessment and evaluation of risk of each prospective applicant are part of a credit control policy.

2.1.9. Credit Policy Objectives

A company's credit policy objectives include: sales revenue increases through deepening on sales; encourage movement of slow moving stocks; a competitive tool to gain a competitive advantage in the market; minimize cost of idle cash; encourage growth; to effectively avoid customers nobody else wants; minimize credit risk taken by the firm; and minimize non-performing loans in the case of microfinance institutions.

Financial institutions usually consider many factors when setting up a lending policy (Abedi 2000). However, the lending policy should be in line with the overall organizational strategy. Nevertheless, the factors considered include: the existing credit policy, industry norms, general economic condition in the country and the prevailing economic climate. Further, the general trend of credit extended by other leaders, the more generous the credit they give to their customers; hence the more a firm can afford to be lenient with its debtors. The cost of a firm's overheads and the costs of credit management may influence the credit control policy in that if these costs are heavy the firm may not wish to extend too much credit, assessment, evaluation and monitoring
tools available, credit risk to the organization, including pace of technological development and changes that will enhance credit follow up as well the 6 C's characterization of the customers will impact on the firm's credit control policy (Abedi 2000).

A firm’s credit policy may be lenient or stringent. In the case of a lenient policy, the firm lends liberally even to those whose credit worthiness is questionable. This leads to higher borrowing, high profits, assuming full collections of the debts owed. With the stringent credit policy, credit is restricted to carefully determined customers through a thorough credit appraisal system. This minimizes costs and losses from bad debts; however it may reduce revenue earnings from credit profitability and cash flow (Abedi 2000).

Every financial institution bears a degree of risk when the institution lends to businesses and consumers and hence experiences some loan losses when certain borrowers fail to repay their loans as agreed. Principally, the credit risk of a bank is the possibility of loss arising from non-repayment of interest and the principal, or both, or non-realization of securities on the loans. This concept is not different from non-banking institutions Credit perspective.

2.1.10. Credit Risk Assessment and Evaluation Model

According to Abedi (2000), banks use the 6 C’s to evaluate a customer as a potential borrower. The 6 C's help banks to decrease the risk of default, as they get to know their customers. According to Abedi (2000), these 6 C’s are:

**Character:** Character is the maturity, honesty and trustworthiness, integrity, discipline, reliability and dependability of a customer. Character is no doubt the most important quality of any client. A person of good character will pay his debt whether it is secured or not. Such a person will disclose all the facts of his deal because his intentions are to seek guidance and help from the organization. When in problems, such borrowers will adhere to the credit manager's request for alternative arrangements to pay his debt instead of hiding from the bank. The business of charge and credit cards is based primarily on the character of the cardholders. A person's character can be determined through: Personal
interview, reference from people who know the client well, personal knowledge of the client and record of past performances.

**Capacity/completion:** capacity refers to a client's ability to service his debt fully. Even if one had good intentions but has no funds he will not be able to keep his loan repayment up to date. A client's capacity can be determined by retrieving his resources of income and netting off the commitments. In the case of a company, an analysis of the Audited Accounts for the past three years could reveal the surplus available to service the loan. For hire purchase, bank loan or charge card, the practice is to determine a client’s current capacity, since injection of the loan may not have sufficient influence on the client's capacity to generate income. For venture capital, the picture is completely different. Capacity is based on projections and hence integrity of such projections is quite crucial.

Capacity also refers to a client's record of performance. A client who has borrowed money from various institutions and paid regularly over long periods can be described as having experience of borrowing and paying. The client is disciplined and is likely in keep the good record. Occasionally, credit managers come across clients who will tell them that they are good borrowers because this is their first loan. Unfortunately, one cannot say so because these clients are inexperienced. They are virgins in loan management and repayment.

**Condition:** Condition refers to the overall environment. Is the commercial socioeconomic, technological and political environment conducive to a successful implementation of the project? Are there any illegal impediments and detours to the successful implementation of the project? For example, if someone wants a loan to invest in drugs business, a very profitable but illegal undertaking, would he qualify for a loan?

**Collateral:** This is the security given to secure the loan, in terms of non-encumbered assets. Perhaps the most talked about, but the least important, in terms of eventual credit success of the six C”s is collateral or security. Businesses like credit and charge cards, do not even consider collateral thus the least important (CBK. 2002). Furthermore, some
collateral are difficult to dispose of to recover the loans and in some industries and situations there are lots of indifference's that make it almost impossible to dispose of the collateral.

**Contribution:** is the client committed to the project at hand. Is he willing and able to make contribution? If it is a hire purchase, is he able to raise the 40% deposit or is the deposit borrowed from a third party making the project 100% loan financed. If a client is having difficulty raising the deposit, he is likely to be unable to pay his installments regularly. Is the client willing to contribute his time to the management of the projects or asset? Absentee management has been the main cause of failure of many projects in this country. For example, oil companies are insisting that petrol stations must be owner managed. What about where large sums of money are involved? Shouldn't owner management be mandatory?

**Common Sense:** This is the natural ability to make good judgment and behave in a practical and sensible way. Being prudent and reasonable in analyzing, presenting, using and interpreting financial, data and other related business information.

Additionally, common sense is the reasonableness of the financial information provided to support the case for financing a project as an indication of the ability of the project to pay for itself. While each of the above factors is important on their own right, they, however, should not be considered in isolation. While adverse record on each one is enough to reject an application, good reports on all the aspects improve the probabilities of success. Therefore, these elements can be used individually or in combination, depending on the level of quality of credit appraisal required and the amount of credit involved. The 6 C's model is meant to help financial institutions in Kenya to thoroughly evaluate and assess the credit worthiness of existing and potential customers before awarding them new or further credit and hence exposure of banks and the avoidance of non-performing loans. The 6 C’s model covers the entire area of credit risk and hence its application in credit risk appraisal will ensure that banks and financial institutions protect their assets against loss (Abedi. 2000).
2.1.11 Credit Appraisal Criteria in MFIs

The author further argues that some credit schemes assume that the poor people themselves know best how to better themselves and thus, credit should be targeted to particular activities. In Cameroon and Togo, consumer and investment credit is provided and there is no constraint on how loans are used (Gurgand, 1994).

The other argument contends that credit should be made available according to repayment capability based on current performance. Some of the factors of determining the size and target for credit include:

**Savings:** Gurgand (1994) notes that mandatory and voluntary savings schemes have been used effectively by Rural Finance Institutions (RFIs) where savings play a significant role in gaining access to credit. Reinke (2001) identifies savings as a means of determining who to give credit and how much, whereby a borrower is required to accumulate savings both prior to and after borrowing. The borrower may also be required to pledge such savings as collateral. This excludes the potential borrowers and contradicts logic of micro lending in that the borrowers may not have funds to save.

**Ability to pay:** In Burkina Faso and Malawi, failure of one member to repay was used to block access to new credit for all group members, increasing repayment performance due to social pressure (Gurgand 1994). Reinke (2001) notes that instead of blocking all the group members, access to future larger loans may be made dependent on punctual and full payment of small initial loans.

**Evaluation of business ability:** This approach is practiced in Burkina Faso whereby a careful analysis of the economic opportunities available in the villages where credit is provided is carried out. Use of credit is discussed with borrowers and includes a variety of firm or non-firm investments. The scheme is flexible allowing reallocation of funds to activities that had not been previously planned.

**Target group:** Target groups are also used to allocate credit. Gurgand (1994) found that Smallholder Agricultural Credit administration (SACA) in Malawi concentrates on small
holder fanners, credit soudure in Burkina Faso concentrates on poor people in rural Sahel that suffer lack of capital with emphasis on women. Other organizations target group. Among the ways identified include, target women who are seen as economically less independent, the youth due to high unemployment and insufficient jobs and the rural people who are seen not to benefit from development and employment creation in the cities and towns. A lender has to decide how to reach his target group and ensure that targeting objectives are met. A number of micro finance loans are targeted towards the employed class in order to minimize default.

**Others:** The other factors identified by Reinke (2001) include such factors like ethnicity, nationality or factors of social disadvantage such as physical disability, location and objective of the micro credit institution and mandatory framing. Objective of the lender may be to fund activities away from the trading activities so as not to dilute the sector's profit thus undermining the viability of ail trading activities An MF1 serving the poor may locale its offices where the poor live. Such criterion may sometimes lead to poor choices as cities and towns have the best infrastructure connections. Access to credit may be conditioned on undergoing credit training. This may be worthy as more borrowers will succeed in their business and be able and willing to repay their loans. Flowever, training is costly and it will exclude some potential borrowers.

**2.2. Empirical Review**

Olomola (2002) found that repayment performance is significantly affected by borrower’s characteristics, lenders characteristics and loan characteristics. Repayment problems can be in form of loan delinquency and default. Whatever the form however, the borrowers alone cannot be held responsible wherever problems arise; it is important to examine the extent to which both borrowers and lenders comply with the loan contract as well as the nature and duties, responsibilities and obligations of both parties as reflected in the design of the credit program rather than heaping blames only on the borrowers.

Linbo (2004) examined efficiency versus risk in large domestic USA banks. He found that profit efficiency is sensitive to credit risk and insolvency risk but not to liquidity risk
or to the mix of loan products. Harker and Satvros (1998) conducted an empirical study on interest rate and exchange rate exposures of institutions in pre-crisis Korea. Results indicated that Korean commercial banks and merchant banking corporations had been significantly exposed to both interest rate and exchange rate risks, and that the subsequent profitability of Microfinance Institutions was significantly associated with the degree of pre-crisis exposure. The results also indicated that the Korean case highlights the importance of upgrading financial supervision and credit risk management practices as a precondition for successful financial liberalization.

Reta (2011) carried out a study on determinants of Loan Repayment Performance using on a Case Study in the Addis Credit and Saving Institution, Addis Ababa, Ethiopia. The objective was to analyze and identify the factors that influence the loan repayment performance of the beneficiaries of AdCSI Microfinance Institution. In order to achieve this objective, primary data was collected from 200 randomly selected clients (100 defaulters and 100 non-defaulters) by using structured interview. Moreover secondary data were obtained from the record of AdCSI the data analysis involved, descriptive statistics including mean, frequency and percentages to describe the socio-economic characteristics of the borrowers. A total of twelve explanatory variables were included in the regression. Out of these, six variables were found to be significant for the probability of being defaulter. Age and five business types (Baltina & petty market, kiosk & shop, services providing, weaving & tailoring and urban agriculture) were important in influencing loan repayment performance of the borrower. In addition, sex and business experience of the respondents were found to be significant determinants of loan repayment rate. Addis microfinance institution has a number of internal and external problems like shortage of loanable funds for further expansion, competition, and improper interference of third party in the decision of loan approval.

Gestel and Baesens (2009) risk management is primarily concerned with reducing earnings volatility and avoiding large losses. In a proper risk management process, one needs to identify the risk, measure and quantify the risk and develop strategies to manage the risk. The highest concern in risk management is the most risky products. The prior
concern for the risk management is those products that can cause the highest losses: high exposures with high default risk.

Korieet al (2012) carried out a study on determinants of loan repayment of Microfinance Institutions in Southeast States of Nigeria. The objective of the study was to analyze the loan repayment performance, institutional factors, and factors affecting repayment rate of microfinance institutions (MFIs) in the South-east states of Nigeria. It was carried out in three states namely; Eboni, Enugu and Imo, out of the five southeast states. Using a cross-sectional data a multi-stage sampling technique was employed in selecting a total of 36 MFIs from the three states, that is, 12 MFIs per state. The three states were purposively selected based on the performance index of United Nations Development Programme in the selection of Micro start Projects, which made the final list in the Southeast states of Nigeria. For the sample size, four MFIs were chosen each from formal (commercial and development banks), semi-formal

Korir (2011) study was to investigate the impact of credit risk management practices on the financial performance of Deposit Taking Microfinance institutions in Kenya. The study used a descriptive survey approach in collecting data from the respondents. The number of the respondents was 36 staff working in all licensed Deposit taking microfinance institutions in Kenya. From the findings the study concludes that Deposit taking microfinance institutions in Kenya adopted credit risk management practices to counter credit risks they are exposed to and it also concluded that Deposit taking microfinance institutions adopt various approaches in screening and analyzing risk before awarding credit to clients to minimize on loan loss. This included establishing capacity/competition and conditions and use of collateral/security and character of borrower were used in screening and risk analysis in attempt to reduce manages credit risks. The study further concludes that there was a positive relationship between credit risk management practices and the financial performance of Deposit taking microfinance institutions.

Warue (2012) investigated empirical analysis of external factors affecting loan delinquency performance in MFIs in Kenya. The study used primary data. The study target population comprised 49 MFIs registered by Association of Microfinance
Institutions of Kenya (AMFIK). A survey research design was used and a census of the 49 MFIs was taken. The data was collected through a self-developed structured questionnaire and administered to MFIs loan officers for response. Multiple regression analysis was used to establish relationship between loan delinquency and microfinance institutions, self-help groups and external factors in MFIs in Kenya.

The study conducted by Okorie (1986) in Ondo state in Nigeria revealed that the nature, time of disbursement, supervision and profitability of enterprises, contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers’ income and transaction cost of the loans. Okpugie (2009) also indicated that, high interest charged by the microfinance banks has been discovered to be the reason behind the alarming default. This was also confirmed by Vandel (1993), who also found that high interest rates charged by banks tend to facilitate default by borrowers. According to Gorter and Bloem (2002) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (bad weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of non-performance in the form of bad loan provisions, or they may spread the risk by taking out insurance. The problem of non-performing loans is widespread. Nishimura, Kazuhito, and Yukiko, (2001) state that one of the underlying causes of Japan’s prolonged economic stagnation is the non-performing or bad loan problem. They explained that some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This delayed structural reforms and prevented the financial intermediary system from functioning properly. Most of the defaults arose from poor management procedures, loan diversion and unwillingness to repay loans, Kohansal and Mansoori (2009). According to them a number of factors can cause loan defaults some of which are: Interest rate ceilings usually imposed by the government, monopoly power in credit markets often exercised by informal lenders, large transaction costs incurred by borrowers in applying for loans, moral hazard problems and many more.
From the findings of the study conducted by Warue(2012) in Kenya, most cases of loan delinquency are caused by microfinance institutions and self help groups’ management failure to efficiently manage specific factors which are considered to be within the direct control of the MFIs’ and Self Help Groups’ (SHGs’) management.

The external factors outside the direct control of the MFIs’ and SHGs’ management seem to contribute little to the levels of delinquent loans. Therefore, for effective management of delinquency, it is critical for MFIs to understand and focus more on the internal causes of delinquency which they have more control over and seek practical and achievable solutions to redress these problems.

The upheaval that hit mainstream financial markets and the effects that continue to be felt across the globe from the resulting economic crisis impacted MFIs and their clients.

The findings of Waweru & Kalani (2009) indicated that some of the causes of non-performing loans in Kenyan banks were national economic downturn, reduced consumer buying ability and legal issues. The study appreciates that the nonperforming loan and loan delinquency concepts are similar. Inadequate financial analysis according to Sheila (2011) is another cause of loan default. This is when in the loans department the officers do not take a careful study of the applicants to ensure that he/she has a sound financial base such that the risk of loss is mitigated in case of default.

Sheila (2011) also points out that in Uganda; the issue of inadequate loan support is another cause of loan default. He says that it is very important that the loan personnel collectively ascertain the position in which the loanee finds himself/herself so that in case he needs support, it’s availed to him or her. Unfortunately that is not the case even when the support is given it is not adequate which leaves the business crumbling and hence leading to default. The research also pointed out that illiteracy and inadequate skills was another cause of default. Majority of the clients are engaged in traditional, low paying businesses and rarely diversify their businesses and skills. This implies that they do not have enough knowledge about alternative marketable skills that can benefit them when their businesses do not function properly. Secondly, most of them do not know how to read, write, and make simple calculations. As a result, they do not know how to account
for their businesses even when the lender makes an error, the borrowers are held liable to the loan. Again, disappearance of loan clients was seen as another cause. Poor business practice is yet another cause. Kasozi (1998) was of the view that, there are weaknesses of the borrower over which the lender has little control. Management of the business is also an essential part that needs to be emphasized. You find that many borrowers lack the technical skills like keeping records and checking on the business performance until the time of paying back the loan. This is usually hard because they never plough back the profits leading to loan default in the long run.

Competitive factors cause loan losses and default according to the study. This is occurs when as a result of existence of many banks/MFIs being involved in the business of lending, it becomes difficult to attract customers so the MFIs even go to the extent of not asking for adequate collateral just have borrowers. In addition, this has led to many of the people’s property being confiscated. Some of the factors that lead to loan default include; inadequate or non-monitoring of micro and small enterprises by banks, delays by banks in processing and disbursement of loans, diversion of funds, over-concentration of decision making, where all loans are required by some banks to be sanctioned by Area/Head Offices (Bichanger and Asey, 2013).

The study conducted by Nguta, and Guya (2013) in Kenya showed that one of the causes of loan default is the characteristic of the business. It was revealed that high cases of default of loan repayment were common (67.9%) in the manufacturing sector. This was followed by the service industry (64.0%) then by the agriculture (58.3%).

The trade sector recorded the least (34.9%) cases of loan repayment defaults. This could be attributed to the observation that trade industry deals in fast moving products on high demand, which could translate into good business performance and increased revenue that accounts for low default cases. Among businesses that had been in operation for less than two years, 52.4% had defaulted in loan repayment, 44.2% of those that had been in operation for a period of between two and five years had defaulted. It was noted that the highest (78.6%) default cases were regular in businesses that had been in operation for a period of between five and ten years. Loan repayment defaults were rare (0.0%) in
business that had survived for more than 10 years. In addition, the businesses located within the municipality had high loan repayment default rates (55.7%) as compared to businesses outside municipality. Businesses making monthly profits of below Kshs. 10,000 had the highest cases (62.8%) of loan repayment default followed by those that made profits of between Kshs. 11,000 and Kshs. 50,000 (42.5%). There were 22.7% cases of loan repayment default among businesses that made profits of between Kshs. 51,000 and Kshs. 100,000. Loan repayment default among businesses that made profits of over 100,000 was minimal.

Several studies have been performed on the group lending aspect of microfinance, and most research shows it to be an effective method. Woolcock (2001) builds on the theory that group lending leads to improved performance by the borrowers. He explains that in addition to the support and guidance from the group, there is also a strong incentive for each individual to operate effectively due to one’s personal reputation within the group.

Furthermore, since groups generally are formed of members from the same village or community, repaying loans on time and in full affects a borrower’s standing within the community at large, not limited to the lending group.

2.3 Identification of knowledge gap

Studies have shown that microfinance institutions are affected by many types of risk, the main type that has to be measured and monitored closely is the credit risk. Mismanagement of this type of risk has been found to bring about the occurrence of nonperforming loans and ultimately the bankruptcy of financial institutions causing major financial crises in various corners of the world affecting both developed and undeveloped economies.

Various studies also show that credit risk management practices improve on performance in microfinance institutions. For instance Amanuel Regassa, (2015) studied the relationship between credit risk and profitability in 12 Micro finance institution in Ethiopia. From the review of literature, study focus on influence of Credit risk management and effects on performance. This study aims at researching on assessment of

32
loan risk and its management in Addis Credit and Saving Institution Akaki Kality Branch.

2.4 Conceptual framework

Fig. 2.1 Loan risk and its factors
CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

The main purpose of this study is to assess loan risk and its management in Addis credit and saving institution S.C Akaki Kality Branch. To this effect the Research design, source of data, sample of population and sampling techniques, data collection and method of data analysis are stated here under.

3.1. Research Design

Many researches design could be used to study business problems (Hair et. al., 2011, p.147). Depending on the way in which researchers ask their research questions and present their purpose, the research design could be classified into three groups, namely exploratory, descriptive and explanatory studies (Saunders et al., 2009, p. 138 & 139). For this study the researcher uses descriptive research design methods. It employed to study the problem. It designed to be used, because the method can provide precise information concerning the status of phenomena in the study area. Besides, it helps to draw valid general conclusion and Recommendation.

Therefore, in order to analyze the existing condition of Assessment of loan risk and its management of the institution the researcher is interested to use this research design of the study.

3.2 Research Approach

Qualitative research emphasizes the words rather than quantification with data. It prefers conducting an inductive approach to the relationship between theory and research which aims on the generation of theories (Bryman & Bell, 2011, p. 27). Qualitative research rejects the combination of practice and norms of natural science model (Bryman & Bell, 2011, p. 27). It emphasizes the interpretive option which refers to the way that individuals interpret the social world (Bryman & Bell, 2011, p. 27). And it embodies the view of social reality as a constantly changing property of individual’s creation (Bryman & Bell, 2011, p. 27).

When conducting a research it is necessary to determine which approach is being implemented, because “scientific inquiry in practice typically involves alternating
between deduction and induction. Both methods involve interplay of logic and observation. And both are routes to the construction of social theories” (Babbie, 2010, p.53). Research can be done in a deductive way in order to answer questions brought out by theoretical considerations (Bryman & Bell, 2011, p.11). Alternatively, theory can be viewed as something that occurs after the collection and analysis of data related to a project (Bryman & Bell, 2011, p.11).

Deductive approach is the theory, and the hypotheses deduced from it come first and drive the process of gathering data (Bryman & Bell, 2011, p.11). While in inductive stance, theory is the outcome of research (Bryman & Bell, 2011, p.13).

The choice of research approach is important when deciding the research design. It enables us to make more learnt decision about research design, which is more than just the techniques by which data are collected and procedures by which they are analyzed (Saunders et al., 2009, p. 126). It is the overall configuration of research question about what type of subject is gathered, from where and how to interpret it in order to provide an answer to the initial questions (Saunders et al., 2009, p. 126). Additionally, it may help researchers to think about whether research strategy will work or not. For this study the researcher uses inductive research approach. Because both qualitative and quantitative research methodology will be employed as a supplementary to the study with the information gained from semi structured interview & questioner made with sub city branch manager, loan & saving expert, credit officers and other employees who have a relation to loan area.

3.3. Population and Sampling

3.3.1. Target Population

“The population in a statistical study is the entire group of individuals about which we want information” (Moore et al., 2009, p. 178). Primary and secondary source of data used in this study. Primary sources obtained from sub branch employees, Branch manager, loan and saving expert by using questioner and Interview. Secondary source of data will be collected from available documents like book of the Journal, pamphlets, and seminar papers.
3.3.2. Sample and sampling Techniques

“A sample is the part of the population from which we actually collect information used to draw conclusions about the whole” (Moore et al., 2009, p. 178).

The study conducted in Addis credit and saving Institution S.C of Akaki Kality branch. Therefore, from the workers the researcher will select purposively based on their position and their role in related with loan area and from customer the researcher select simple random sampling technique by using lottery methods.

The Researcher takes 55 employees from 9 sub branches of a branch and takes all 55 employees to distribute questionnaires. And interview questions for 5 loan officer, 1 credit and saving expert and 1 Branch Manager of the branch.

3.3.3 Sampling Size

In this research, out of the total 10 sub branches in the institution 9 sub branches selected purposively. Based on the branch information gather those sub branches which are established in early time provide more comprehensive and organized data or information on the study area of portfolio at risk (PAR) and preferred to deliver the best information regarding the performance of selected sub branches in credit risk management particularly information in relation with Loan repayment performance.

The purpose of the research is to assess loan risk and its management in Addis Credit and Saving Institution Akaki Kality Branch. Thus the target is the institution branch and all 9 sub branches of a target branch.

3.4. Data Collection Tools

In this study, the data is collected by using different data collection methods, the researcher use both primary and secondary data collection methods, in the primary data, questionnaire were conducted from employees in the institution and a semi-structured interview which was asked for the Branch Manager, Branch loan and saving expert & Sub branch loan officers and this is important for gathering primary data. In addition, secondary data were collected from the institution’s document and references.
3.5. Data analysis Technique

Once the study collected all the possible and relevant information through the methods that discussed above, it was start to analyze and interpret the data. SPSS version 20 was used to analyze the data obtained from primary sources. Descriptive data analysis which is employed to examine the finding of the study, it refers to produces for organizing, summarizing and describing qualitative data, which is more descriptive of words. The relevant data that collected processed and analyzed by using tables and compute percentage to show proportion. The data processing is including editing and classifying the collected data in to homogeneous group for simplicity and clarity.

3.6 Data Validity and Reliability

The validity and reliability of the data were checked carefully. Validity and reliability of scores on instruments, additional standards for making knowledge claims, lead to meaningful interpretations of data.

3.6.1 Validity

Validity is the most critical criterion and indicates the degree to which an instrument measures what it is supposed to measure (Kothari, 2004). In this research content, the researcher has used questionnaires that their validity and reliability are checked and are modified according to literatures within the specific topic. Also an approval from advisor was applied in order to increase the face/content validity. Prior to the actual data collection, pilot test was conducted by distributing sample questionnaires to 55 respondents within the 9 sub branches.

3.6.2 Reliability

To ensure the reliability of the instrument in this case of study and the researcher has tested the reliability using Cronbach's Alpha (α). Cronbach's Coefficient (α) is calculated to estimate the internal consistency of reliability of a measurement scale. Cronbach’s Coefficient is a reasonable indicator of the internal consistency of instruments that do not have right or wrong marking schemes, thus can be used for questionnaires using scales such as rating (Black & Leslie, 1999). For this particular study, the questionnaires Likert
scale items reliability was checked by Cronbach’s - alpha coefficient with the help of SPSS software and as shown below in table.

Table 3.1 Reliability statistics

<table>
<thead>
<tr>
<th>Cronbach’s alpha</th>
<th>No. of items</th>
</tr>
</thead>
<tbody>
<tr>
<td>.4810</td>
<td>21</td>
</tr>
</tbody>
</table>

There is a rule thumb which can be used to determine the reliability value as follows; less than 0.1 poor fit, between 0.11 to 0.30 modest fit, between 0.31 to 0.50 moderate fit & greater than 0.50 strong fit (Muijis, 2004, p 166). And shown in the table the result has fall in moderate range.

3.7. Ethical Considerations

Ethical consideration was among the main consideration of research. Before the data collection process all the necessary information about the study like who is conducting the study and for what purpose is the study conducted and other necessary information that respondents like to know were provided to all respondent so that it can help them to decide whether to participate or not in this study. Consequences and they are not harmed as a result of their participation or non-participation in the study. They were also guaranteed for the anonymity and confidentiality of their response.
CHAPTER FOUR: DATA ANALYSIS AND INTERPRETATION

This chapter presents the analysis of the data collected and interpreted on the assessment of loan risk and its management techniques adopted by Addis credit and saving institution Akaki kality branch.

4.1 Data Collected and Analyzed

Data was collected from 48 employees of the institution out of the 55 employees targeted. The questionnaire was administered using the drop-and-pick later method. The data was collected from employee of finance department and credit departments of the institution.

Out of the 55 questionnaires that were distributed, 48 were returned. This represents a response rate of 87%, which is considered significant enough to provide a basis for valid and reliable conclusions with regard to loan risk and its management techniques adopted by the branch. This is well explained in the figure 4.1 below:

![Figure 4.1 Data collected and analyzed](image)

Source: questioners, primary data
4.2. Demographic characteristics of the respondent

Source: Own Survey 2018

From the total respondents, it can be observed that 48% of the respondents were male while the rest 52% were female employee of the institution.

4.2.2 Educational level of respondents

Education refers to the process of learning and acquiring information, it is important for learning basic business skills as well as learning advanced skills that can make a person more attractive in their business evaluation, being educated person Means you have access to optimal state of mind, regardless the effectively to achieve self-selected goals and aspirations. It is also have the impact of loan repayment as per the institution schedule.
With regard to their educational background, 67% of the respondents were diploma holders and 33% of the respondent represents they were Degree holders.

### 4.2.3 Age of respondents

Source: Own Survey 2018

As shown the above figure, 27% of the respondents were the age between 18-29 years, 58% of them were the age between 30-45 years, and the rest 15% of the respondents were
the age between 46-60. However, most of the respondents are 30-45 years old, and this age shows that many employees of the institution have developed customer relation trends.

4.3. Organization of credit activity in the institution

4.3.1 Micro credit activity

From the analysis below (table 4.3.1), the branch have separate departments where micro credit activities are organized as indicated by 33.3% of the respondents and 66.7% of the respondents who indicated that micro credit activities are offered by a unit within a department. This is an indication of less growth in the loan disbursement activity of the institution.

Table 4.3.1 Micro credit activity

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Within a separate department</td>
<td>32</td>
<td>66.7</td>
</tr>
<tr>
<td>2</td>
<td>A unit within a department</td>
<td>16</td>
<td>33.3</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>48</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

4.3.2 Establishing credit control policy

Table 4.3.2 Establishing credit policy

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Existing credit policy</td>
<td>48</td>
<td>3.5833</td>
<td>.76724</td>
</tr>
<tr>
<td>2</td>
<td>Overhead cost</td>
<td>48</td>
<td>2.2500</td>
<td>.95650</td>
</tr>
<tr>
<td>3</td>
<td>General trend</td>
<td>48</td>
<td>1.5625</td>
<td>.64926</td>
</tr>
<tr>
<td>4</td>
<td>State of the economy</td>
<td>48</td>
<td>3.1875</td>
<td>.95997</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018
The above descriptive statistics clearly depicts the corresponding arithmetic mean and standard deviation of every construct. Thus, category of existing credit policy has a mean of 3.58 and a standard deviation of 0.77; Overhead cost categorical total has a mean of 2.25 and a standard deviation of 0.96; General trend categorical total has a mean of 1.56 and a standard deviation of 0.65; State of the economy categorical total has a mean of 3.19 and a standard deviation of 0.96. Which shows that establishing credit policy strongly depend on the existing credit policy and from the state of the economy. On the other hand AdCSI used to establish credit policy based on overhead cost and general trend is below the average cut-off point of three, this analysis of mean of categorical constructs showed that a mean value less than the average standard. Accordingly, it implies that the low level of establish credit policy in AdCSI, this clearly shows that the practice is not diverse and there was not a mix of relevant sources are taken to formulated credit policies.

4.3.3 Review interval of credit policy

When asked how regularly they reviewed their credit policies most respondents 41.7% indicated that this was done semi annually, while another 25.0% indicated that the review was annually. There were others 20.8% who reviewed their policies monthly, while the remaining 12.5% respondents indicated that review of credit policies were quarterly. This implies that AdCSI review its credit policy frequently and were not constant period.

Table 4.3.3 Review interval of credit policy

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Monthly</td>
<td>10</td>
<td>20.8</td>
</tr>
<tr>
<td>2</td>
<td>Quarterly</td>
<td>6</td>
<td>12.5</td>
</tr>
<tr>
<td>3</td>
<td>Semi annually</td>
<td>20</td>
<td>41.7</td>
</tr>
<tr>
<td>4</td>
<td>Annually</td>
<td>12</td>
<td>25.0</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>48</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Own Survey 2018
4.3.4 Credit appraisal process

When asked about the credit appraisal process, a reasonable number of 79.2% agreed that it is very objective as compared to only 20.8% who said it is very subjective in nature. This shows that the credit is appraised in most of the cases in an objective manner.

Table 4.3.4 Credit appraisal process

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Very subjective</td>
<td>10</td>
<td>20.8</td>
</tr>
<tr>
<td>2</td>
<td>Very objective</td>
<td>38</td>
<td>79.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>48</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

4.3.5 Employee awareness of credit risk

Table 4.3.5 Employee awareness of credit risk

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>By regular meeting</td>
<td>48</td>
<td>4.0417</td>
<td>.71335</td>
</tr>
<tr>
<td>2</td>
<td>By regular training</td>
<td>48</td>
<td>3.1250</td>
<td>.95928</td>
</tr>
<tr>
<td>3</td>
<td>By supervision</td>
<td>48</td>
<td>4.0833</td>
<td>.96389</td>
</tr>
<tr>
<td>4</td>
<td>By credit manual</td>
<td>48</td>
<td>2.7292</td>
<td>.86884</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly depicts the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI create employee awareness of credit risk by regular meeting has a mean of 4.04 and a standard deviation of 0.71; by regular training categorical total has a mean of 3.13 and a standard deviation of 0.96; By supervision categorical total has a mean of 4.08 and a standard deviation of 0.96; by credit manual categorical total has a mean of 2.73 and a standard deviation of 0.87. This implies that employee awareness of credit risk strongly depend on supervision,
regular meeting and regular training. On the other hand AdCSI aware credit risk through credit manual is below the average cut-off point of three, this analysis of mean of categorical constructs showed that a mean value less than the average standard. Accordingly, it implies that the institution aware of employee more likely through supervision, regular meeting and regular training.

4.3.6 Credit assessment of the institution

Table 4.3.6 Credit assessment of the institution

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Character of borrower</td>
<td>48</td>
<td>3.8854</td>
<td>.48091</td>
</tr>
<tr>
<td>2</td>
<td>Capacity of borrowers</td>
<td>48</td>
<td>2.9375</td>
<td>.64378</td>
</tr>
<tr>
<td>3</td>
<td>Conditions of borrowers</td>
<td>48</td>
<td>3.0833</td>
<td>.53484</td>
</tr>
<tr>
<td>4</td>
<td>Collateral of borrowers</td>
<td>48</td>
<td>2.7135</td>
<td>.49731</td>
</tr>
<tr>
<td>5</td>
<td>Common sense/Reasonableness of borrowers</td>
<td>48</td>
<td>3.1563</td>
<td>.84524</td>
</tr>
<tr>
<td>6</td>
<td>Contribution of Borrowers</td>
<td>48</td>
<td>3.2535</td>
<td>.55755</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly depicts the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI credit assessment based on character of borrower has a mean of 3.89 and a standard deviation of 0.48; based on capacity of borrowers categorical total has a mean of 2.94 and a standard deviation of 0.64; based on conditions of borrowers categorical total has a mean of 3.08 and a standard deviation of 0.53; based on collateral of a borrowers categorical total has a mean of 2.71 and a standard deviation of 0.50; based on common sense or reasonableness of borrowers categorical total has a mean of 3.16 and a standard deviation of 0.85 and based on contribution of borrowers categorical total has a mean of 3.25 and a standard deviation of 0.56. This implies that the institution credit
assessment was focus on four major criteria which have the mean value above the average level of three. On the other hand AdCSI credit assessment were least focus on capacity of borrowers and collateral of borrowers; which have a mean value of less than the average point three.

4.3.7 Credit risk assessors of institution

Table 4.3.7 Credit risk assessors of institution

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Chairman</td>
<td>48</td>
<td>1.3125</td>
<td>.55183</td>
</tr>
<tr>
<td>2</td>
<td>General Manager</td>
<td>48</td>
<td>1.8125</td>
<td>.84189</td>
</tr>
<tr>
<td>3</td>
<td>Branch manager</td>
<td>48</td>
<td>3.6667</td>
<td>.80776</td>
</tr>
<tr>
<td>4</td>
<td>Credit Manager</td>
<td>48</td>
<td>3.6667</td>
<td>.93019</td>
</tr>
<tr>
<td>5</td>
<td>Credit committee</td>
<td>48</td>
<td>2.2500</td>
<td>1.10126</td>
</tr>
<tr>
<td>6</td>
<td>Loan officer</td>
<td>48</td>
<td>4.8958</td>
<td>.30871</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly shows that the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI credit risk assessed by chairman of the institution has a mean of 1.31 and a standard deviation of 0.55; by General Manager of the institution categorical total has a mean of 1.81 and a standard deviation of 0.84; risk assessed by Branch Manager categorical total has a mean of 3.67 and a standard deviation of 0.81; risk assessed by Credit Manager categorical total has a mean of 3.67 and a standard deviation of 0.93; risk assessed by credit committee categorical total has a mean of 2.25 and a standard deviation of 1.1 and loan risk assessed by loan officers categorical total has a mean of 4.90 and a standard deviation of 0.31. This implies that the institution credit risk assessment was made mainly by loan officers, branch managers and credit managers; which have the mean value above the average level of three. On the other hand AdCSI credit risk assessment were least
involvement by chairman, General Manager and credit committee; which have a mean value less than the average point three. This data shows that the institution loan risk management department is not organized in a branch. So Employees especially loan officers are more responsible to select the borrowers, follow up the borrowers & assess the risk related with the loan.

**4.3.8 Default loan identification period**

Table 4.3.8 Loan default identification period

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>One late payment</td>
<td>48</td>
<td>1.5417</td>
<td>.71335</td>
</tr>
<tr>
<td>2</td>
<td>Two late payment</td>
<td>48</td>
<td>2.1042</td>
<td>1.09621</td>
</tr>
<tr>
<td>3</td>
<td>Three late payment</td>
<td>48</td>
<td>3.4375</td>
<td>1.27005</td>
</tr>
<tr>
<td>4</td>
<td>Four late payment</td>
<td>48</td>
<td>4.7917</td>
<td>.45934</td>
</tr>
<tr>
<td>5</td>
<td>Five late payment</td>
<td>48</td>
<td>4.9375</td>
<td>.24462</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly shows that the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI loan default identification period after one late payment has a mean value of 1.54 and a standard deviation of 0.71; loan default identification period after two late payment categorical total has a mean value of 2.10 and a standard deviation of 1.10; loan default identification period after three late payment categorical total has a mean value of 3.44 and a standard deviation of 1.27; loan default identification period after four late payment categorical total has a mean value of 4.79 and a standard deviation of 0.46; and loan default identification period after five late payment categorical total has a mean value of 4.94 and a standard deviation of 0.24. The above table implies that the institution loan identification period was made after three and above month late repayment by the client. This had an impact on the outstanding loan of the institution is at risk or un
collectible, financial shortage to provide a loan to other borrowers, it leads to shut down sub branches & affect the economy of a country’s financial sector.

4.3.9 Measures taken difficult to repay on time

Table 4.3.9 Measures taken difficult to repay on time

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Use auctioneers to recover the debt</td>
<td>48</td>
<td>1.1875</td>
<td>.39444</td>
</tr>
<tr>
<td>2</td>
<td>Sale of their property to recover the debt</td>
<td>48</td>
<td>1.6250</td>
<td>.73296</td>
</tr>
<tr>
<td>3</td>
<td>Leave them to decide when to pay</td>
<td>48</td>
<td>1.2500</td>
<td>.48378</td>
</tr>
<tr>
<td>4</td>
<td>Write off the loan and account it as bad debts</td>
<td>48</td>
<td>1.0208</td>
<td>.14434</td>
</tr>
<tr>
<td>5</td>
<td>Write off the interest and allow them to pay the principal</td>
<td>48</td>
<td>1.3125</td>
<td>.71923</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly shows that the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI taken measure difficult to repay on time use auctioneers to recover the debt has a mean value of 1.19 and a standard deviation of 0.39; sale of their property to recover the debt categorical total has a mean value of 1.63 and a standard deviation of 0.73; leave them to decide when to pay categorical total has a mean value of 1.25 and a standard deviation of 0.48; write off the loan and account it as bad debts categorical total has a mean value of 1.02 and a standard deviation of 0.14; and write off the interest and allow them to pay the principal categorical total has a mean value of 1.31 and a standard deviation of 0.72. This implies that the institution measure taken difficult to repay on time was very poor, because of all variables related to the action made by the institution which have a mean value less than the average point three.
4.3.10 Important of risk identifications

Table 4.3.10 Important of risk identifications

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Foreign exchange risk</td>
<td>48</td>
<td>1.6667</td>
<td>.85883</td>
</tr>
<tr>
<td>2</td>
<td>Technology risk</td>
<td>48</td>
<td>2.4583</td>
<td>.84949</td>
</tr>
<tr>
<td>3</td>
<td>Interest rate risk</td>
<td>48</td>
<td>2.7500</td>
<td>.81214</td>
</tr>
<tr>
<td>4</td>
<td>Market risk</td>
<td>48</td>
<td>2.5208</td>
<td>.92229</td>
</tr>
<tr>
<td>5</td>
<td>Liquidity risk</td>
<td>48</td>
<td>3.0833</td>
<td>.82083</td>
</tr>
<tr>
<td>6</td>
<td>Credit risk</td>
<td>48</td>
<td>3.6875</td>
<td>1.20559</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly shows that the corresponding arithmetic mean and standard deviation of every construct. Thus, AdCSI taken measure risk identification by foreign exchange risk has a mean value of 1.67 and a standard deviation of 0.86; by technological risk categorical total has a mean value of 2.46 and a standard deviation of 0.85; interest rate risk categorical total has a mean value of 2.75 and a standard deviation of 0.81; liquidity risk categorical total has a mean value of 3.08 and a standard deviation of 0.82; and credit risk categorical total has a mean value of 3.69 and a standard deviation of 1.21. This implies that the main credit risk of the institution is the risk of uncollectable loan and lack of cash, which have a mean value more than the average point three. On the other hand the institution risk is least associated with foreign exchange, technology risk and interest rate risk, which have a mean value less than the average point three. In addition to the questionnaire the interviewee is response that the importance of risk identification of the institution is associated with credit risk in the leading point, because of transaction risk which means the risk within individual loans and portfolio risk which is the risk inherent in the composition of the overall loan.
4.4 Organizational performance

Table 4.4.1 Impact on financial performance of institution

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Item</th>
<th>N</th>
<th>Mean</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Improve loan collection method</td>
<td>48</td>
<td>3.5208</td>
<td>.85027</td>
</tr>
<tr>
<td>2</td>
<td>Customer not willing to repay loan</td>
<td>48</td>
<td>3.3958</td>
<td>.84399</td>
</tr>
<tr>
<td>3</td>
<td>Charged to high interest rate</td>
<td>48</td>
<td>2.4375</td>
<td>.71179</td>
</tr>
<tr>
<td>4</td>
<td>Poor economic conditions</td>
<td>48</td>
<td>3.6667</td>
<td>.83369</td>
</tr>
<tr>
<td>5</td>
<td>Improved credit approval</td>
<td>48</td>
<td>3.2292</td>
<td>.90482</td>
</tr>
</tbody>
</table>

Source: Own Survey 2018

The above descriptive statistics clearly shows that the corresponding arithmetic mean and standard deviation of every construct. Thus, challenges on financial performance of the institution based on improve loan collection method has a mean value of 3.52 and a standard deviation of 0.85; based on customer not willing to repay loan categorical total has a mean value of 3.40 and a standard deviation of 0.84; based on charged to high interest rate categorical total has a mean value of 2.44 and a standard deviation of 0.71; based on poor economic conditions categorical total has a mean value of 3.67 and a standard deviation of 0.83; and based on improved credit approval categorical total has a mean value of 3.23 and a standard deviation of 0.90. This implies that the impact on financial performance of the institution mainly based on from improve loan collection method, customers not willing to repay loan, poor economic condition and improved credit approval, which have a mean value more than the average point three. On the other hand the impact on financial performance of the institution is least relation with charged to high interest rate, which has a mean value less than the average point three.
CHAPTER FIVE: SUMMARY, CONCLUSION, AND RECOMMENDATION

5.1. Summary of major findings

The objective of the study was to examine the causes of loan default/delinquency in Addis Credit and Saving Institution Akaki Kality Branch and to determine the effect of loan risk. To satisfy the objective of the study, primary data was collected, by use of a questionnaire from 48 employees of AdCSI Akaki kality branch. The primary data was supplemented by information obtained from brochures and direct interviews to clarify answers on the questionnaires. The data was analyzed by use of statistical package for social sciences (SPSS) version 20 that is used internationally for statistical analysis. The results have been presented in form of frequency tables, descriptive analysis and percentages.

The research findings reveal that:

All the 48 employees studied (100%) indicated that they were directly involved in credit services. The analysis further showed that all the employees offer micro credit to small scale entrepreneurs, a clear indication of a better future in terms of entrepreneurial behavior and thus better living standards for the citizens.

A significant number of 79.20% (38 out of 48 respondents) have credit management policies as a basis for objective credit risk appraisal. A majority which has a mean value of 3.58 establishing credit control policy through the existing credit policy. Also a majority of the respondents who have a mean value of 4.08 said they used the supervision to sensitize their employees about credit risk awareness. A majority (41.7%) of the respondents indicated that the institution review interval of credit policy semi annually.

Most (66.7%) respondents aware the institution has a distinctive separate department where micro credit activities are organized. This is an indication of growth in the development of loan service of the institution. Majority of the respondents indicated that the credit risk assessment is mostly done by the loan officers who have a mean value of 4.90, followed by, branch manager & Credit manager who have equal mean value of 3.67,
and then credit committee, General Manager and Chairman of the institution is least involvement of credit risk assessment who have a mean value of below three.

A majority of respondents who have a mean value of 4.94 indicated that too late to take an action for defaulter which is five late repayment, a loanee was considered a defaulter and thus the collection effort were poor. This partly explains why AdCSI command high default rates. On dealing with difficult-to-repay-on-time clients, all respondents’ response below a mean value of the middle points three. A majority indicated the preferred method was sale of property to recover the money which has a mean value of 1.63 followed by write-off of the interest and allow them to pay the principal balance which has a mean value of 1.31 while another which has a mean value of 1.25 would consider leave them to decide when to pay.

Most of the institutions used the 6 C’s criteria and used all the C’s appraising their borrowers loan in the following order: character of borrower which has a mean value of 3.89, Contribution of borrowers which has a mean value of 3.25, Common sense (reasonableness) which has a mean value of 3.16, conditions of borrowers which has a mean value of 3.08, Capacity of borrowers which has a mean value of 2.94, and finally, Collateral of borrowers which has a mean value of 2.94.

Majority of the institutions ranked credit risk which has a mean value of 3.69 as most important risk followed by liquidity risk which has a mean value of 3.08, and lastly interest risk which has a mean value of 2.75. This finding is consistent with Abedi (2000) who found that liquidity risk and credit risk are the most important risks that banks in the U.S.A. face.
5.2 Conclusion
Effective credit risk management is critical for the success of MFIs in these days of global competition. It is therefore recommended that:

To fulfill the key objectives of MFIs mainly to assist the poor and increase profitability of the institution, the micro credit products will need to be managed in a more robust manner.

AdCSI should, in addition, have credit management policies as a basis for objective credit risk appraisal. They should involve their employees in developing credit management policies to ensure ownership and home-grown credit policies. AdCSI should use the credit manuals to sensitize their employees about credit risk.

AdCSI were encouraged to train in-house credit officers for effective credit risk management

AdCSI considered a loanee to have defaulted delay as five late repayments and loan officers are not take immediate action to decrease outstanding loan at risk. This partly explains why microfinance institutions command high default rates. While many MFIs preferred method of dealing with defaulters was sale of property to recover the money, a number write off the interest and allowed defaulters to repay the principal loan only. This ensures that you do not lose the principal sum and in a way helps meet the objective of supporting the poor. In addition to these AdCSI should reached to the borrower who don’t repay their loan at a time of repayment period.

AdCSI were encouraged applying the 6 C’s of credit risk appraisal model in their credit risk evaluation as applied in commercial banks. In a study of applying the 6 C’s model on commercial banks, Mutwiri (2003) found that character was the most considered followed by capacity/completion and common sense/reasonableness, collateral and least considered was contribution
5.3 Recommendations

- MFIs are slowly expanding their activities and recruiting more clients for their micro credit products, AdCSI should categorize the credit client which has not been able to repay their loan during loan repayment period like:
  - Those clients who have a capacity to repay their loan but they are reluctant to repay their debts on time. For this kind of clients the institution should take a legal action immediately, otherwise the institution arrears rate fall above the allowed default rate of 3% and which leads the institutions shut down.
  - Those clients who don’t have a capacity or unable to afford to repay the loan due to the bankruptcy of their business. It is also necessary to enter into a payment system by direct support on business transactions by allowing refinancing loans and by rescheduling of their repayment period.

- AdCSI must be taken an immediate legal action who doesn’t meet their obligation in their appropriate period of loan repayment time. Otherwise the uncollectable of outstanding loan administration is very difficult and it leads the institution to liquidity risk & unable to give loan service to their clients.

- AdCSI should aware about assessment of credit risk to its employee with preparing credit manual guidelines to keep the consistency and follow up of risk assessment and take a corrective measure to the appropriate risk identified.

- AdCSI should have credit risk management policies as a basis for objective credit risk appraisal. They should involve their employees in developing credit management policies to ensure ownership and home-grown credit policies. AdCSI also use credit manuals to sensitize their employees about credit risk.

- AdCSI should encourage training in-house credit officers for effective credit risk management.
➢ AdCSI should consider a borrower to have defaulted as early as one late repayment and immediately set up steps to intensify collection efforts. This partly explains why microfinance institutions command low default rates. While many MFIs preferred method of dealing with defaulters was sale of property to recover the money, Write off the interest and allowed defaulters to repay the principal loan only. This ensures that you do not lose the principal sum and in a way helps meet the objective of supporting the poor.

➢ AdCSI should encourage applying the 6 C’s of credit risk appraisal model in their credit risk evaluation as applied in commercial banks. In a study of applying the 6 C’s model on commercial banks, Mutwiri (2003) found that character was the most considered followed by capacity/completion and common sense/reasonableness, collateral and least considered was contribution.

➢ AdCSI should continue to rank credit risk as most important risk in their business.
References
Balogun, E.D Loan Delinquency Among Small Farmers in Developing Countries: A Case Study of the Small-Farmer Credit Program in Lagos State of Nigeria, CBN Economic and Financial Review, 26(3).
Bryman A Bell, 2011, business research method p. 27


Gurgand, 1994. Repayment performance in group based credit programs in Bangladesh

Hair ET. al., 2011, p. 147. Minimum sample size estimation


Okorie, A. (1986). Major Determinants of Agricultural Loan Repayments, Savings and Development,
Appendices I-Questionnaire  
Prepared for Employee  
Addis Ababa Science and Technology University  
College of Business & Management  
Department of Industrial Management  

Dear Respondents,  

My name is Getahun Sitotaw, a graduating class student of masters of business administration (MBA) degree. Currently I am conducting thesis as partial fulfillment to the requirements of the award of masters degree in Business Administration in Industrial Management.  

This questionnaire is prepared with an intention to collect data about Assessment of loan risk and its management. Your response will be kept confidential and it will be used only for academic purpose.  

Thank You in advance for your cooperation.  

Use this sign (✓) to your choice  

Part I- Personal Information  
1. Sex male □ Female □  
2. Age 18-29 □ 30 - 45 □ 46 -60 □ above 60 □  
3. Educational Level  
   Literature □ 1- 8 Grade □ 9- 12 Grade □ Diploma □ Degree □ masters and above □  

Part II- Risk Management  
1. Management of Micro credit Activities  
   a) How is your micro credit activities organized?  
      • Within a separate department ( )  
      • A unit within a department ( )  
      • Any other specify………………… …… ( )  
   
   b) Which, among the following, factors do you consider in establishing a credit control policy?  
      
      Least considered most considered  
      1 2 3 4 5  
      
      • Existing credit policy ( ) ( ) ( ) ( ) ( )
- Overhead costs
- General trend of credit extended to your organization
- The state of the economy
- Any other, specify

---

2. **Credit risk management process**

a. i) How subjective or objective is your credit appraisal process?

- Very subjective ( )
- Very objective ( )

ii) Through what way do you make your employees aware of credit risk?

<table>
<thead>
<tr>
<th>Method least used</th>
<th>Method most used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1    2    3    4    5</td>
<td></td>
</tr>
</tbody>
</table>

- Regular meetings. ( ) ( ) ( ) ( ) ( )
- Regular training ( ) ( ) ( ) ( ) ( )
- Using supervision on one to one basis ( ) ( ) ( ) ( ) ( )
- Credit manual ( ) ( ) ( ) ( ) ( )

b) Which aspects, among the following, do you consider before availing credit?

<table>
<thead>
<tr>
<th>Least Considered</th>
<th>Most Considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1    2    3    4    5</td>
<td></td>
</tr>
</tbody>
</table>

i. **Character of borrowers:**

- *Customer willingness to repay* ( ) ( ) ( ) ( ) ( )
- *Past repayment experience* ( ) ( ) ( ) ( ) ( )
- *High credit discipline* ( ) ( ) ( ) ( ) ( )
- *Past performance in repayment* ( ) ( ) ( ) ( ) ( )

i) **Capacity/completion:**

- *Cash in bank* ( ) ( ) ( ) ( ) ( )
- *Projected cash earnings* ( ) ( ) ( ) ( ) ( )
- *Business skills* ( ) ( ) ( ) ( ) ( )
ii) **Conditions:**
- Poor economic conditions
- High credit discipline
- Interest prevailing in the economy

iii) **Collateral:**
- Assets
- Capital invested in the business
- Size of security
- Cash in the bank

iv) **Common sense/reasonableness:**
- Reasonableness of cash flow
- Projected cash flow

v) **Contribution:**
- Assets
- Capital invested in the business

Willingness to do business correctly

---

c) Who are involved in credit risk assessment in your institution?

<table>
<thead>
<tr>
<th>Least involved</th>
<th>Most involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 2 3 4 5</td>
<td>1 2 3</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Chairman</td>
<td></td>
</tr>
<tr>
<td>Managing directors/GM</td>
<td></td>
</tr>
<tr>
<td>Branch Manager</td>
<td></td>
</tr>
<tr>
<td>Credit managers/head</td>
<td></td>
</tr>
<tr>
<td>Credit committee</td>
<td></td>
</tr>
<tr>
<td>Any other/specify…</td>
<td></td>
</tr>
</tbody>
</table>

---

d) When does your institution decide that a client has defaulted on loan repayment?

<table>
<thead>
<tr>
<th>Least</th>
<th>Most</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 2 3</td>
<td>4 5</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>One late payment</td>
<td></td>
</tr>
<tr>
<td>Two late payment</td>
<td></td>
</tr>
</tbody>
</table>
• Three late payment ( ) ( ) ( ) ( ) ( ) ( )
• Four late payment ( ) ( ) ( ) ( ) ( ) ( )
• Five late payment ( ) ( ) ( ) ( ) ( ) ( )
• Any other/specify………... ( ) ( ) ( ) ( ) ( )

**e) How does the institution deal with ‘difficult to repay on time’ clients?**

<table>
<thead>
<tr>
<th>Least done</th>
<th>most done</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 2 3 4 5</td>
<td></td>
</tr>
</tbody>
</table>

- Use auctioneers to recover the debt ( ) ( ) ( ) ( ) ( )
- Sale of their property to recover the money ( ) ( ) ( ) ( ) ( )
- Leave them alone to decide when to pay ( ) ( ) ( ) ( ) ( )
- Write the debt off and account it as bad debts ( ) ( ) ( ) ( ) ( )
- Write off interest and allow them to pay the principal ( ) ( ) ( ) ( ) ( )
- Any other/specify…………………… ( ) ( ) ( ) ( ) ( )

**f) How important are the risks listed below to your institution?**

<table>
<thead>
<tr>
<th>Least important</th>
<th>Most important</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 2 3 4 5</td>
<td></td>
</tr>
</tbody>
</table>

- Foreign exchange rate ( ) ( ) ( ) ( ) ( )
- Technology risk ( ) ( ) ( ) ( ) ( )
- Interest rate risks ( ) ( ) ( ) ( ) ( )
- Market risks ( ) ( ) ( ) ( ) ( )
- Liquidity risks ( ) ( ) ( ) ( ) ( )
- Credit risk ( ) ( ) ( ) ( ) ( )
- Any other/specify……..( ) ( ) ( ) ( ) ( )

**3. Organizational performance**

What factors have impacted on financial performance of your institutions in the last five years (2013-2017)?

<table>
<thead>
<tr>
<th>Least considered</th>
<th>most considered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 2 3 4 5</td>
<td></td>
</tr>
</tbody>
</table>

- Improve loan collection method ( ) ( ) ( ) ( ) ( )
- Customer not willing to repay loan ( ) ( ) ( ) ( ) ( )
• Charged too high interest rate ( ) ( ) ( ) ( ) ( ) ( )
• Poor economic conditions ( ) ( ) ( ) ( ) ( ) ( )
• Improved credit approval ( ) ( ) ( ) ( ) ( ) ( )
• Any other, specify………………( ) ( ) ( ) ( ) ( ) ( )

THANK YOU FOR YOUR TIME
Appendices II

Interview Questions

1. What Kinds of Risk does your financial institution face frequently?
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________

2. Who are involved in loan risk management?
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________

3. What are the main evaluation criteria in your institution before disbursed a loan?
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________