# ST. MARY'S UNIVERSITY
# SCHOOL OF GRAADUTE STUDIES

## ASSESSMENT OF CREDIT RISK MANAGMMENT IN THE CASE OF BUUSAA GONOFAA MICROFINANCE INSTITUTION

**BY**
**SEBLE ASHEBIR**

**ADVISOR: ASSMAMAW GETIE (Assistance professor)**

**SMU**
**February 4, 2018**
**Addis Ababa, Ethiopia**

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**A Thesis Submitted to the School of Graduate Studies of St. Mary's University in Partial Fulfillment of the Requirements for the Degree of Master in Accounting and Finance**


**BY**
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**ADVISOR: ASSMAMAW GETIE (Assistance professor)**



**SMU**
**February 4, 2018**
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# Declaration

I declare that the thesis entitled: Credit risk management in the case of: Buusaa Gonofaa microfinance institution, hereby submitted by me in partial fulfillment of the requirements for the Degree of Master of Science (Accounting and Finance) at the University of St. Mary's, is my original work and has not been submitted for any degree in any other university. I have undertaken it independently with the advice of my advisor, Assmamaw Getie (Assist. professor). In performing the thesis I have used different sources and material which have been acknowledged.

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Signature ________________

Jan. 2018

# Endorsement

This thesis has be submitted to St. Mary University to school of graduate studies for examination with my approval as a University advisor.

**Advisor:** ________________________________

**Signature:** _________________________________

**Date:** _________________________________

**ST. Mary University**

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**BY**
**SEBLE ASHEBE**

**Approved by Board of Examiners**

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# Acronyms

**AEMFI** Association of Ethiopian Microfinance institution

**BG MFI** Buusaa Gonofaa Micro Finance Institution

**CRM** Credit Risk Management

**MFI** Micro Finance Institution

**NBE** National Bank of Ethiopia

**RMP** Risk Management Program

**SACCO** Savings and Credit Cooperative Organization

# *Abstract*

*Managing financial risk is one of the main task needs great attention in finical industries because it has a power to affect all the operation of the company. Buusaa Gonofaa is one of Ethiopian MFI currently encountering an increasing default rate. And thus, this study analyses credit risk management of MFIs by specifically focusing on BG MFI. Descriptive approach was used by the researcher and 100% of respondents on the top managerial level were used for the study. The study clearly indicates that the company is providing group loan only and this loan is provided without any collateral, but using group liability approach. Role of credit management is mainly given for the group members. Group members manage each other than operation policy of the company. Also it is investigated that the company has different mechanism to monitor credit risk, but all mechanisms that the company has designed and implemented is not more effective in protecting the company from risk. Relatively client appraisal, screening, capacity based loan provisions are some of the mechanisms that the company is using, but revealed that it is not effective enough with the main problems of poor management in the company and poor policy implementation. Also it is investigated that the company has operation policy and the policy is not modified frequently with different reasons and the company has no standardized credit risk measuring tool. Thus, it is seen that the company is operating in risk environment and needs to design different mechanisms to minimize its future risk.*

*Key words: Credit risk management, Micro Finance Institution*

# CHAPTER ONE

## 1. Introduction

### 1.2 Background of the study

Credit risk is one of the main head hack of all financial institution. It affects their portfolio quality and even can lead them to be out of the market if it is not seriously managed. It is only if financial institution maintain credit risk that they result of the economy of the country through addressing need of poor peoples who need source of finance to improve their livelihood, but if they are poorly manage their credit they will lead to market fail which directly leads for the failure of economy of a given country.

Credit risk is most simply defined as the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximize institution's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization.

For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet. Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

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

operation." Risk is a condition in which there exists quantifiable dispersion in the possible outcomes from any activity. It can be classified in a numbers of ways" (CIMA, 2005).

Tony & Bart (2009) state that Credit risk is the risk that a borrower defaults and does not honor its obligation to service debt. Nikolaidou & Vogiazas (2014) define credit risk management as the combination of coordinated tasks and activities for controlling and directing risks confronted by an organization through the incorporation of key risk management tactics and processes in relation to the organizations objectives. Generally, the greater the credit risk, the higher the credit premiums to be charged by banks, leading to an improvement in the net interest margin (Hanweck and Ryu, 2004). However, a broader definition of credit risk also includes the risk of default by other financial institutions, which have payment obligations to MFIs (Bruet, 2004). According to Tony & Bart (2009) Credit risk consists of pre-settlement and settlement risk. Pre-settlement risk is the potential loss due to the counterparts default during the life of the transaction (loan, bond, derivative product one is exposed to settlement risk because the payment or the exchange of cash flows is not made directly to the counterpart, but via one or multiple banks that may also default at the moment of the exchange, Devi P (2017).

Greuning and Bratanoric (2009) define credit risk as the chance that a debtor or issuer of financial instrument whether an individual, a company or a country will not repay principal and other investment related cash flows according to the terms specified in accredit agreement inherent to banking, credit risk means that payments may be delayed or not made at all, which call cause cash flow problem and affect a bank's liquidity. Iqbal and Mirakhor (2007), indicate that exist a strong risk management frame work that can help either the public or private banks to minimize exposures to risks and to improve the competitive ability with in the market. The objective of risk management is to reduce the effects of different kinds of risks related to preselected domain to level accepted by environment, technology, humans, organizations and politics.

In today's dynamic environment, all micro finance institution are exposed to potential credit risks. Due to such exposure to credit risks, efficient credit risk management is required, Chua et al (2000) also found that managing credit risk is one of the basic tasks to be done in micro financial institutions, once it has been identified and known as any financial institution, the biggest risk in microfinance institution (MFIs) is default risk. Credit risk is a particular concern for MFIs because most micro lending is unsecured (i.e) traditional collateral is not often used to secure microloans Churchill and Coster, (2001).

### 1.3 Statement of the Problem

Microfinance institutions (MFIs) operate in the same environment as the universal banks, but without the associated benefits such as ample capital and extended human resources of the universal banks. MFIs encounter increasing competitive pressure fuelled by globalization, financial reforms and financial services liberalization including the relaxing of trade barriers, as well as an increase in market expansion due to technological advancement and innovation. MFIs often flourish on their malleability and agility such as their close proximity to their clients, their candidness towards new ways of working, and their risk taking approach, but many MFIs are prone to key external shocks (Mensah, 2014).

MFIs management needs to amplify the significance of risk identification and minimization in their organizations or they can suffer cataclysmic consequences if they are ill prepared for the result of a possible risk. This requires that management in MFIs need to be familiar with risk identification and analysis to manage risks from a varied range of sources (Schultz, 2001). By integrating risk management into MFIs operations, MFIs are better equipped to exploit their assets, thereby enabling MFIs to transform expense activities into undertakings that can produce a positive return (Steinwand, 2000).

Carey (2001) shows that credit risk management is more important in the financial sector than in the other parts of the economy. The important element in risk management is to create balance between risk and returns and maximize profits by providing many financial services, especially by administering risks. Mbeba (2007) asserts that managing risks effectively reduces the likelihood that loss will occur or minimizes the scale of  the loss that would have occurred, Churchil and Coster (2001) stress that risk management involve three- step which are identifying the organization's current and future vulnerability points, designing and implementing controls to mitigate risks and monitoring effectives of risks mitigation tools.

According to Greuning and Bratanovic, (2003) an effective credit risk management (CRM) requires building an appropriate credit risk (CR) environment: working under a healthy credit lending process; maintaining an appropriate credit administration that necessitate the monitoring process and the adequate controls over credit risk.

If the microfinance institution (MFIs) do not manage their, credit risks well, they are likely to far to meet their social and financial objectives. When poorly managed risks begin to result in financial loss, donors,

investors, lenders, borrowers and begin to dry up. When funds dry up, MFIs are not able to the poor and quickly go out from the business. Managing risk is a complex task for any financial organization, and increasingly important in a world where economic events and financial systems are linked. Global financial institutions and banking regulators have emphasized risk management as an essential element of long-term success. Rather than focusing on current or historical financial performance, management and regulators now focus on an organization's ability to identify and manage future risks as the best predictor of long-term success, GTZ (2000). So it is necessary to assess the risk profiles of credit saving institution. Risk management, in relation to a MFIs is the process of controlling the likelihood and potential severity of an adverse event; it is about systematically, identifying, measuring, limiting and monitoring risks faced by an institution Fernando (2008).

MFIs in Ethiopia are facing problems of loan loss, limited fund for lending, unprofitable, problems related entrepreneurial quality of the client, staff with limited technical and banking skills, and weak supervision. Therefore, MFIs in Ethiopia lack the above qualities which are crucial for the viability and sustainability and able to be in business on its own and it is doubted that MFIs will continue as viable institution in future following the past condition as means of alleviating poverty, Wolday, (2000).

Different researchers conducted studies related to credit risk management, For instance, Wagner et al, (2007) conducted research on managing credit risk in financial institutions in Latin America. In their study they found that donors and governments can assist in the capture and dissemination relevant information that would serve to reduce asymmetries that contribute to credit risk. The researcher Daniel. L. Mawanhi studied the credit risk management practices in MFIs in Kenya. Results of this study indicated that low levels of market concentration contributed to poor credit risk management of MFIs studied.

Another study conducted by Pash and Negese (2014), on performance of Loan repayment determinants in Ethiopian MFIs as a case study. The result fund that age of respondents, education level, Time lag between loan application and disbursement, complicated loan processing procedures, repayment period, and loan diversion are essential and significant determinant of loan repayment range. In study on credit risk management strategies for Malaysian financial institutions Fun Ho and Yusoff (2009) found that loan diversification, risk mitigation, credit reminder, credit criteria, credit culture and staff training are the most popular strategies.

However, even if there are many studies conducted on the credit risk management and many findings are found, credit risk is expanding from time to time than deteriorating. To minimize this credit risk MFIs of the country (Ethiopia) has designed different approach under the umbrella of Association of Ethiopian Microfinance Institution (AEMFI). More specifically while looking operational performances of the study institution indicated that there is high risk in the industry. Internal financial report of the study institution indicates that there is increasing default in the institution and as of June 2017 end a total of 8.6 million birr is under arrears from a total of 250 million birr disbursed and it is in majority of operational branches of the institution. Thus, the researcher has analyzed credit risks of Ethiopian MFI's by specifically focusing on one of Ethiopian Micro finance so called Buusaa Gonofaa. As a result this study is designed to fill the gap to identify the weakness of Buusaa Gonofaa MFI S.C (BGMFI) in terms of identify credit risks management and how they have performed in the face of various aforementioned credit risks. .

## 1.3 Research Questions

The study focus on the following research questions:

1. How effective service delivery approach of the company is to minimize credit risk?
2. What are the credit risk management related challenges that the company encountering?
3. What are the methods that are employed in Buusaa Gonofaa MFI to mitigate credit risk including credit administration, follow up of borrowers and monitoring process?

## 1.4 Objective of the Study

### 1.4.1 General objective of the study

The main objective of the study is to analyze credit risk management of Micro Finance Institution by specifically focusing on Buusaa Gonofaa Micro Finance Institution.

### 1.4.2 Specific Objectives of the Studies

To strength the main objective of the study more specifically the researcher will identified the following specific objectives,

- To investigate how service delivery approach of the company is effective in minimizing credit risk?

- To analyses and identify credit risk management related challenges of the study organization.
- To analyze approach that Buusaa Gonofaa MFI is using to minimize level of credit risk that includes credit administration, follow up of borrowers and monitoring process.

### 1.5 Significance of the Study

The subject matter of this research has the following significance. First, it will uses to practice improvement on ineffective credit risk management and boosting profitability for MFIs. Second, it will serve as a spring board for further researchers. Third, it hope that the research can give some information and suggestion to help the institutions to manage their credit risk managers to minimize their risks and also the study will have valuable importance for the researcher to improve the skill and knowledge about the credit risk management. Finally, by considering the recommendation and suggestion the MFI will take corrective action on the areas which need improvement.

### 1.6 Scope (Delimitation) of the Study

The study was limited only to Buusaa Gonofaa MFI, did not include experiences of other MFI and also specifically focused on the assessment of credit risk managements of BG MFI. Thus, the last findings, conclusion and recommendation of the study specifically represents Buusaa Gonofaa.

### 1.7 Limitation of the Study

Limitations are major problem in under taking a good research with a good result. It limits the researcher to assess and to indicate all important areas. Accordingly, shortage of time and resources make the study to be limited to Buusaa Gonofaa MFI only and this made the researcher not to explore experiences from the other financial sectors in the market. Finally, the researcher only limited to the credit risks of the financial institution, did not consider the other risk affecting performances of the sectors.

### 1.8 Organization of the Paper

This section gives a structure of every chapter in this paper. It consists of five chapters. Chapter one deals with the introduction part i.e. Background of the study, Statement of the problem, Research Questions, General & Specific Objective of the study, Significance of the study, Delimitation and Limitation of the study. Chapter two concerned with review of related literature, The Methodology employed, Target population, and Sampling data used in the research has discussed in chapter three. Chapter four presents

the main body of the paper including result that collect from the questionnaires, Data analysis and interpretation of the result. Finally, the paper presents the Conclusions of the results and the Recommendation suggests by the researcher in the last chapter.

# CHAPTER TWO

# 2 Literature Review

## 2.1 Definition of Microfinance

Oluymmo (2007) defines microfinance as globally accepted means of reaching businesses and persons that are either not served at all or that are inadequately served by the normal commercial banks. Karalan and Goldberg (2007) put it that microfinance is the provision of small-scale financial services to people who lack access to traditional banking services." Microfinance is often defined as financial services for poor and low-income clients offered by different types of services providers. In practice the term is often used more narrowly to refer to loans and other services from providers that identify themselves as microfinance institutions. More broadly, microfinance refers to a movement that envisions a world in which low – income households have permanent access to arrange of high quality and affordable financial services offered by arrange of retail providers to finance income producing activities, build assets, stabilize, consumption, and protect against risks. These services include savings, credit, insurance, remittances and payments and other." (www.microfinance gateway.org).

Carbb and Keller, (2011) see microfinance as providing financial services to individual traditionally excluded from the banking system, especially women. Consequently Lafourcade et.al. (2005) put it that microfinance is " the supply of loans, savings, money transfers, insurance and other financial services to low- income people" similarly, Udeaja and Ibe (2006) defined a microfinance institution as one that focuses on providing financial services to the low income / poor persons in the community.

Technically, microfinance is a business in which the person conducting the business holds himself out as accepting deposits on a day to day basis and any other activity of the business which is financed, wholly or to a material extent, by lending or extending credit for the account and at the risk of the person accepting the deposit, including the provision of short term loans to small or microenterprises or low income households and characterized by the use of collateral substitutes Gok, (2006).

According to Munene and Guyo, (2013), it is the way of supplying loans and small credits to finance small projects to help the poor have an income through forming their own small scale business to earn their daily bread and better their living. Microfinance is the provision of credit to the poor and low-income earners to enable them engage in productive activities." Microfinance is a source of financial services for entrepreneurs and small businesses lacking access to banking and related services. The two main mechanisms for the delivery of financial services to such clients are: (1) Relationship-based banking for individual entrepreneurs and small businesses; and (2) Group-based models, where several entrepreneurs come together to apply for loans and other services as a group".

## 2.2 Microfinance Creation

The field of microfinance institutions (MFIs) is still a fairly recent topic in economic research. Although the first MFIs have already been established in 1980s such as the Grameen Bank founded by 2006 Nobel peace prize Laureal Muhammed Yunus. (Yunus, 2003).

The idea to establish microfinance institutions traces back to Muhammed Yunus, who developed it as a way to indicate poverty in his home country Bangladesh. In 1983, he founded Gramen Bank, the first institution which realized this concept and started to operate in the microfinance business in the proper sense. Together, Yunus and Grameen Bank were laureates of the 2006 Nobel peace pricze awarded, the Norwegian Nobel Committee, (2006).

## 2.3 Operation Mechanism of Microfinance Institutions

According to Nyor et al (2013), there is huge demand for microfinance lending by low income earners and micro businesses and as such microfinance Banks have a prominent role to play. All Microfinance Banks works towards the same goal of poverty reduction and the promotion of economic growth, though different types of microfinance lending are employed throughout the world Crabb & Keller, (2006). These include:

### 2.3.1 Individual Lending

As the name suggests, this is "the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment". Each loan is specifically tailored to the individual and business involved. This approach tends to work best when used with larger urban business or small rural farmers. According to Agene (2011), Microfinance lend directly to individuals, without any sort of group self-

selection or guarantee and are more likely to take a collateral such as fixed assets, land and building or household appliances taken in pawn when it is available.

### 2.3.2 Group Lending

A strategy initially developed by the Grameen Bank of Bangladash. It was designed to serve rural and landless men and women who wish to finance –generating activities. This method of lending is designed to serve rural and landless clients who wish to borrow from the bank. Crabb and Keller (2011) explained the process thus: The group usually has a membership of four to seven individuals who are not members of a nuclear family. Before receiving any loan each member is required to contribute savings throughout the duration of the group training which last for between four to six weeks. Additional requirements for loans include prompt repayment, mandatory weekly meetings, and pre-credit orientation and assistance. After successfully meeting up these conditions the loan officer disburse the loan first to two individuals. No further lending occurs until loans are repaid. The same process occurs for the remaining members of the group.

### 2.3.3 Village Banking Approach

Village banks are "community –managed credit and savings associations established to provide access to financial services in rural areas, build community self-help group and help members accumulate savings" Lidgerwood (1999, p.85). According to Crabb and Keller (2011), village banks are made up of 25-40 women who cross guarantee each other's loans and self-manage the distribution and collection of funds. Village banks are primarily financed by loans from microfinance institutions, but forced and voluntarily savings are collected by the group and may also be loaned to finance members and non-member activities.

### 2.3.4 Wholesale Lending

According to Agene (2011), It is a methodology whereby microfinance that have corresponding relationship with the deposit money banks have easy access to working capital loans at concessional cost of funds for on-lending to their customers, especially micro-entrepreneurs and high net worth individual borrowers in their catchment areas.

## 2.4 Economic Importance of MFIs

Given the positive impact of microfinance on development, it is also worth analyzing the relationship from the other direction, i.e. how microfinance can benefit from financial sector development. It is often thought that promoting microfinance-type institutions is the right way to address poverty. Yet according to Honohan (2004), strong financial development also facilitates poverty reduction, therefore "roles played by microfinance and mainstream finance in tackling poverty should be regarded as complementary and overlapping rather than as competing alternatives" (p. 19). Further evidence comes from the new World Bank research indicating that a high level of financial development, as measured by the high percentage of private credit as a share of GDP (also called "depth of finance"), is a powerful tool to reduce poverty, Beck et al, (2008). This implies that as financial sector deepens it also increase its reach, providing financial services directly to the poor. In their earlier paper Beck et al (2004) also argue that even when financial development does not touch poor people directly; it nevertheless promotes aggregate economic growth, thus benefiting the poorest in a disproportionately better way. To quote the authors: "the more abundant private credit creates a rising tide that lifts all boats, but a bigger lift to the poorest ones" (Beck et al. 2004, page 32).

## 2.5 Concepts of Credit Risk

Risk has been defined as the possibility of loss or actual return being less than the expected return (IBFC Agusto, 2012). Credit risk is therefore the possibility that an obligor (one who binds himself to make payments) will not meet his/her obligations in line with the agreed terms, resulting in financial loss (Ibrahim, 2010). Due to the fact that MFIs exist not only to accept deposits but also they grant credit facilities, for this reason, inevitably exposed to credit risk (Kolapo et al, 2012). Credit risk is considered the most significant risk faced by MFIs and the success of their business depends on accurate measurement and efficient credit risk management to a greater extent than any other risk (Gieseche, 2004). According to Hamid and Abel (2013) credit risk is the non-receiving cash flows of granting facilities by MFIs that exact timely evaluation and examination thereof, especially for average and small facilities and this requires systematic method.

Abdullahi (2013) states that, credit risk is of concern to most authorized and banking regulators. This is because creditor risk can easily prompt bank failure. According to Global Association of Risk

Professionals, credit risk is the potential for loss due to failure of a borrower to meet its contractual obligation to repay a debt in accordance with agreed terms. Credit risk according to them includes bankruptcy, failure to pay, loan restructuring, loan moratorium and accelerated loan payments. In the case of banks, they also established that credit risk resides on the assets in its banking book (loans and bonds held to maturity) and also hold a general view that credit risk is more important than market risk for banks.

Indiael and Dickson (2013) state that credit risk can be a function of other factors such as insufficient knowledge on financial risks, especially credit risk at institutional level, lack of appropriate and effective credit policies, inadequate capital and unstable liquidity status, laxity in credit assessment, and poor lending practices and procedures. In addition, Kothari et al., (2010) posit that government interference and inadequate supervision by the Apex Banks and direct lending as other sources of credit risk.

## 2.6 Common Risks Found in Microfinance

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

### 2.6.1 Liquidity Risks

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

### 2.6.2 Market Risks

As stated by Fernando (2008), market risks are, by nature, environmental and include risks from financial losses as a result of changes in interest rates, fluctuations in foreign exchange, or mismatch in the management of long-term assets and liabilities (investment risk). Microfinance Banks in Nigeria have been managing their global operations with local borrowing to meet expansion in their loan portfolios as a way of avoiding, or hedging against, foreign currency exposures.

Generally, managing credit risk is an integral part of microfinance bank operating techniques, with reducing the risks requiring a major operational effort. As a provider of loan service, the MFI faces the hazard of imperfect selection of credit clients with little or no collateral security. Armendariz de Aghion & Morduch, (2005) observed that wrong selection may occur when the bank has insufficient information to determine between good and bad customers. Mersland and Strom (2007) conclude that such knowledge is particularly important for Microfinance Banks, whose customers frequently lack a long, or any, credit history while a loan tends to be given without any collateral and the borrower is unlikely to make repayments without strenuous monitoring efforts.

### 2.6.3 Operational Risks

Mersland and Strom (2007) said operational risks arise because of possible system or human errors in service or product delivery. Potentially, unexpected financial losses might occur as a result of a variety of issues, such as inadequate or deficient information systems, operational challenges, incompetent personnel, inadequate skill, deliberate breaches, or fraudulent tendencies. The management of such risks requires that the internal control framework is effective, the information technology (IT) used is adequate, the integrity of the employees is guaranteed, and the operating processes are streamlined.

Given the various sources of operational risk, the most obvious is the interaction of loans and clients involving financial transactions. In the case of normal traditional banks, the staff undertaking credit assessment is usually well trained, with multiple levels of crosschecking put in place. Unfortunately, in the case of MFIs, there are usually numerous short-term loans of small amounts, making elaborate crosschecking not cost-effective. As a result, the possibility of both error of assessment and deliberate fraud is relatively high.

## 2.7 Credit risk management of MFIs

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.).

Kay Associates Limited (2005) cited by Aballey (2009) states that bad loans can be restricted by ensuring that loans are made to only borrowers who are likely to be able to repay, and who are unlikely to become insolvent.

Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision. 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.

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.

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 portifolio 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.

## 2.8 Credit Risk Assessment Approaches: Theoretical Aspects

Credit risk evaluation is the process through which a bank assesses the creditworthiness of prospective loan that exposes the financial institutions to credit risk. The credit analysis ultimately results in an estimation of the likelihood of customer default. Outside microfinance, to optimize the credit decision, there exist three main approaches to estimate borrower's probability of default: Structural approach or reduced form models, statistical approach and expert-judgment approach.

Structural approach is based on modelling the underlying dynamics of interest rates and firm characteristics that can lead to a default event. These financial dynamics, generally described by stochastic processes evaluate the default probability. This approach is used in portfolio credit risk models. However, it needs the use of complex mathematical and stochastic techniques that can be hardly modelled. In addition, a clear disadvantage of this approach is their limited applicability to public firms because it requires specific information, e.g. borrower's stock prices, which are not available for all borrowers. Hence, MFI and banks offering consumer loans cannot benefit from this approach.

The second approach is the empirical or the statistical approach. Credit scoring models are used by some banks in their internal rating system. The principle 3 of Basel Committee (February, 2006) declares, 'A bank's policies should appropriately address validation of any internal credit risk assessment models'. 'Models may be used in various aspects of the credit risk assessment process including credit scoring, estimating or measuring credit risk at both the individual transaction and overall portfolio levels, portfolio administration, stress testing loans or portfolios and capital allocation. In this approach, credit scoring models link borrower characteristics, such as financial and non-financial variables to repayment performance on previous loans in order to estimate the borrower default. Hence, the relationship of default and information about the borrower is learned from historical data. The major advantage of credit

scoring models is that they can be developed for all types of credit, from consumer credit to commercial loans. However, one of the credit scoring disadvantages is that there is no common consensus or rigorous theory on which variables should be included in scoring model. The choice of the explanatory variables will depend largely on data availability.

The third approach is the expert-judgment approach or subjective-judgment approach. In this approach, creditworthiness was estimated purely by credit experts based on their judgment and their intentions. The decision of granting credit is based on adoption of certain rules or principles of lending carefully build by skilled loan officers themselves. For example, under the 5C's of credit evaluation criteria, evaluation is based on character, capacity, and condition, capital and collateral. These principles are drawn from the experience of loan officers, but should be used generally and not rigidly as laws of lending (Kwan *et al*., 1986).

### 2.8.1 Credit Risk Assessment Approaches in individual lending

Evidence regarding the better credit risk assessment approaches in individual lending in MFI is divergent and the literature highlights two main approaches: Judgmental and Statistical forecasting methods. According to Agier and Szafarz (2012), adverse selection is the main problem faced by the lending industry including microcredit institutions and in order to tackle this problem, bankers typically combine two mechanisms: subjective-judgment approach and statistical approach.

In the subjective judgment approach, the decision of granting credit is based on adoption of certain rules or principles of lending carefully build by skilled loan officers. The loan officers in MFI are trained to collect and make judgments about information on entrepreneur's personality, analyze the risk of potential borrowers and decide to approve or to reject the applicant. This would typically involve a face-to-face meeting with each applicant where the loan officer - intentionally or unintentionally - forms judgments about its creditworthiness after interviewing him. Furthermore, loan officers should consider information about business' project and business conditions such as forecasts about market, economic growth, and additional macro-economic factors. Those indications are essential in order to get a feeling about the management's ability to handle changes in the environment.

However, subjective judgment for individual loans has its weaknesses. First, subjective judgment assessment requires a fair amount of time per applicant and is expensive for the lender. According to

Babu and Singh (2007), evaluating the loan proposal and defining the terms for each particular client is costly to the MFI resulting in reduced profitability. Second, as written within the credit scoring literature judgmental approach lacks of quantification of credit risk. Moreover, borrowers' characteristics are analyzed in this approach sequentially rather than in combination thereby ignoring their correlation. Finally and more importantly, loan officer, like other people may seriously have cognitive bias in processing information that affect his judgments and beliefs, so that he may be a victim of behavioral bias and appear irrational.

Balthazar (2006) notes, 'studies of behavioral finance usually show that credit analysts are good at identifying what the main strengths and weaknesses of a borrower are, but integrating all the information into the final rating is not always done in a consistent way'. Recently, in order to reach a greater number of applicants more efficiently, several MFIs judge repayment risk by the use of statistical tool used extensively in bank to monitor their credit portfolio. This tool is the credit scoring models. Credit scoring models represent a methodology accepted by the Basel Committee for Banking Supervision and the U.S. and European financial systems in the construction of an internal rating system. This method presents an innovation for microcredit but is not at all new to others credit.

In addition, scoring model allows to adjust interest rates and fees according to risk Kuhn and Olsen, (2008); Schreiner, (2003). Furthermore, scoring approach identifies the most important risk explaining factors. This enables to gain more effective advanced risk management systems, leading to a quantitative risk culture Schreiner, (2005); Van Gool *et al*., (2011). More importantly, by making the criteria explicit, credit scoring reduces the role of subjectivity in the loan decision and then reduces the effects of discrimination and prejudice by individual loan officers and minimizes human bias in the credit decision process Kuhn and Olsen, (2008); Schreiner, (2005).

However, others advance that credit scoring is vulnerable to several limits. For example, ignoring qualitative factors and blindly applying a credit scoring in Microfinance context and led to inaccurate evaluations and hence to high arrears and default. Schreiner (2003) argues that the installation of the credit scoring models requires an important fixed cost at the beginning and requires periodic updating and persistent training with the loan officers. Cornée (2009) concludes that transaction-based technologies are not well-suited for MFI and that credit scoring technique would potentially not be able to give a ruling on a borrower's creditworthiness if the project is too innovative. They explained this by two causes. First, the situation in MFI can be referred to as uncertainty not as risk because

microenterprises are characterized by their idiosyncrasy and this high degree of uniqueness makes impossible to form homogenous classes of instances. Second, as noted by Schrader (2009), the lack of certified financial statements for microenterprises increases the difficulty to use the credit scoring models.

## 2.9 Microfinance Institutions in Ethiopia

Ethiopia has one of the largest microfinance markets and fasted growing microfinance sectors in Africa, and Ethiopian MFIs are charging some of the lowest interest rates in Africa, with a gradual shift from group to individual lending, MF Transparency, (2011). In a nutshell, Microfinance Institutions (MFIs) are contributing to poverty reduction and asset building through by provision of loans to and mobilization of savings from the low-income segments of the population. National Bank of Ethiopia (NBE, 2015a).The growth and development of deposit taking MFIs in Ethiopia has been rapid since the formalization of the sector in 1996. (NBE Proclamation No.40/1996), and according to the latest NBE quarterly report (NBE, 2015a) there are 32 Microfinance Institutions registered by the NBE to deliver financial services to the financially excluded. Unusually in Ethiopia, all MFIs are required to be registered as deposit taking institutions with the National Bank of Ethiopia and are thus supervised under bank regulations.

The National Bank of Ethiopia annual report (NBE, 2015b) suggested in 2013/14 the overall performance was positive and total capital had increased by 246% ( to birr 5.7 billion) while assets grew by 38.6% ( to birr 24.5% billion). At the same time deposit mobilization and credit provision had expanded. According to the second quarterly report for 2015 (NBE, 2015a). MFIs mobilized birr 13 billion in the form of savings. However increased (2.6 million, by the end of 2012), MFIs operating in Ethiopia are estimated to have met less than 20% of the demand for financial services Wolday, (2012). The over whelming majority of the population has no access to financial services, but by providing financial services to micro-enterprises in both urban and rural areas, MFIs are a key route to financial inclusion Zwedu, (2015). Nevertheless, MFIs are expected to provide much of the financial intermediation for communities with low access to formal financial institutions over the coming years.

### 2.9.1 Challenges Facing Ethiopian MFIs

According to Gebregziber, (2015) microfinance had developed rapidly in Ethiopia and it has been seen as key tool in promoting development. However, several key challenges remain:

- Lack of Access to Affordable Capital: to finance growth is a major challenge faced by Ethiopian MFIs. It is thought the most MFIs have the capacity to at least double their outreach and portfolios in the foreseeable future, but lack of access to capital is preventing this. As decreed by microfinance low, the main source of funding for MFIs in Ethiopia is savings mobilization.

- An imbalance in the finance sector: there is a huge imbalance in the finance sector as people tend to save in the banking sector (e.g. Commercial Bank) as it is trusted, but take loans from SACCOS or MFIs although this is common elsewhere.

- Urban MFIs: the initial focus of MFIs was on agricultural finance when group methods worked. However, when people need larger loans the group method does not work and there were problems in translating group lending to urban areas (e.g. urban groups are less cohesive than in rural areas and social areas individual lending needs to be embraced more by MFIs. Whilst this challenge was raised by several ELs, it is notable that data from MFIs participating in the MF Transparency pricing initiative revealed a shift in the focus of lending methodology to individual lending, MF Transparency, (2011).

- Historic lending practices: the government maintains a register of outstanding loans provided between 1988 and 2004 which were not recovered households with an outstanding loan under this system cannot get a new loan. However, the lists are reportedly in accurate with many households unaware they are on the list and others unaware of how or where to repay these loans.

### 2.9.2 Adequate Measurement, Monitoring and Control

Effective risk monitoring requires microfinance institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by information system that

provide senior managers and directors with timely and accurately reports on the financial condition operating performance and risk exposure of the microfinance institution, as well as with regular and sufficiently detailed reports for line managers engaged in the day to day management of the institutions activities . Banks should have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred as per the report issued by committee on banking supervision of Bank for International Settlements(BIS, 2004).

According to National Bank of Ethiopia (NBE, 2010), in order to ensure effective measurement and monitoring of risk and management information systems, the following should be observed:

A. The institution's risk monitoring practices and reports address all of its material risks.
B. Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an – going basis;
C. Reports and other forms of communication are consistent with the institution's activities, structured to monitor exposures and compliance with established limits, compare actual versus expected performance; and
D. Reports to management or to the institution's directors are accurate and timely and contain sufficient information for decision – makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution but failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the microfinance institution.

### 2.9.3 Credit Risk Management

Credit risk is managed in various ways. The most important method starts with appropriate selection of the counter parts and products. The importance of credit risk, interest rate risk, and financial sustainability credit risk is the most common and often the most serious vulnerability in a MFI, while interest rate risk in MFIs has grown in importance in recent years Churchill and Coster, (2001). The partial shift in borrowing from commercial or semi-commercial sources at fixed rates of interest to variable interest rates has contributed to this. Accepting interest rate risk is a normal part of microfinance institutions business and can be an important source of profitability and shareholder value, National Bank of Ethiopia, (2010).

### 2.9.4 Risk Management Programs

The process of risk management should be commensurate with the size and complexity of the intuition. While the types and degree of risks in microfinance institutions may vary up on a number factors such as size, complexity, business activities, volume etc. these guidelines cover the most common risks in microfinance institutions namely, strategic risk, credit risk, liquidity risk, interest rate risk and operational risk, therefore, NBE requires each microfinance institution to prepare a comprehensive risk management program (RMP) tailored to its needs and circumstance under which it operates. There is no single risk management system that would fit for all microfinance institution to develop its own compressive risk management system tailored to its needs and circumstances. Their risk management program, however, should at a minimum cover the following most common risks: Strategic risk, Credit risk, Liquidity risk, Interest rate risk and Operational risk. (Risk management guidelines for MFIs final by state bank of Ethiopia).

### 2.9.5 Credit Risk Management Guidelines

Credit risk is the financial exposure resulting from a microfinance institutions dependence on another party (counterparty) to perform an obligation as agreed. It is the risk to earnings or capital due to borrowers late and non-repayment of loan obligation. Credit risk encompasses both the loss of income resulting from the MFIs in ability to collect an anticipated interest earnings as well as the loss of principal resulting from loan defaults. Microfinance institutions need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Additionally, microfinance institutions should be aware that credit risk does not exist in isolation from other risks, but is closely intertwined with those risks, Risk management guidelines for micro finance institutions, (2010).

An effective and sound credit risk management is critical to the stability of an institution. Effective credit risk management is the process of managing an institutions activities which create credit risk exposures, in a manner that significantly reduces the likelihood that such activities will impact negatively on a microfinance institutions earnings and capital. Credit risk is not confined to a microfinance institutions on- balance sheet and its off-balance sheet accounts.

A. Active oversight by board and senior management, well designed borrower screening, careful loan structuring, close monitoring clear collection procedures etc. to avoid rapid spread and potential of significant loss, delinquency should be under stood and addressed promptly.

B. Good portfolio reporting that accurately reflects the status and monthly trends in delinquency, including a portfolio at risk aging schedule and separate reports by product, sector, loan officer, branch etc.
C. Following up concentration of credit. (Risk Management Guidelines for MFIs, Final by state bank of Ethiopia).

## 2.10 Empirical Review

Within the last few years a number of studies have provided the discipline into the practice of risk management and other issue of micro finance institutions. An insight of related studies is as follows:

Nawai and Shariff (2010) in their study found that close and informal relationship between MFIs and borrowers help in monitoring and early detection of problems that may arise in non-repayment of loans that finally lead to credit risk. In addition, cooperation and coordination among various agencies that provide additional support to borrowers may help them success in credit risk management in their business. Method used is that quantitative research method.

Laurentis and Mattei (2009) conducted research on Lessors' recovery risk management capability and found that the development of modern reliable systems of risk management can enhance even more those management capabilities. This means that credit institutions should invest significant resources in projects aimed at correctly implementing rating systems and credit risk models, and highlights once more the importance of these tools well beyond the scope of regulatory compliance. The research method used is that mixed research method.

Paul et al.(2001) in their study of viewing micro insurance as a social risk management instrument examined that there should be efficient and equitable risk management for micro finance institutions through micro insurance since micro insurances has positive impact on effective credit risk management. The study also noted that it is clear that micro insurance may be an acceptable means of managing some forms of risk, but not all in micro finance institution.

Chua et al. (2000) conduct research on microfinance, risk management, and poverty indicated that the relationship between risks to the client and risks to the loan portfolio has been largely important to the microfinance industry. This is because a more explicit recognition of this relationship in the design of products and services can reduce both the risk of borrowing for clients and the risk of lending for MFIs. Products, services, and delivery mechanisms that are designed to improve the capacity of clients to deal with risk in their lives (reduce their vulnerability) and to reduce the risk of taking a loan can lead to better repayment, fewer dropouts, and, accordingly, lower operating costs.

Peterson and Bohman (2008) in the study of credit risk management system of a commercial bank in Tanzania examined that the financial intuitions well-documented credit risk management policy that

elaborates the products offered and all activities play an important role to manage the credit risk. The institutions well organized credit manual that documents and elaborates the strategies for managing credit risk also the part of effective credit risk management and they have to formulate in compliance with the institutions credit policy. Strategies for granting credits also should focus on whom, how and what should be done at the branch and corporate division levels while assessing borrowers. Quantitative credit scoring models should be part of credit risk management mechanisms. Method used was quantitative research method.

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

Wenner et al. (2007) conduct research on managing credit risk in financial institutions in Latin America. In their study they found that donors and governments can assist in the capture and dissemination of relevant information that would serve to reduce asymmetries that contribute to credit risk. High quality and functioning databases would help to facilitate better risk measurement, better risk modeling, and the design of credit, savings, and insurance products. Method used was qualitative research method.

Hudon (2006) in his study of subsidies and financial performances of the microfinance institutions: Stated that financial institutions including micro finance institutions still exhibit better management ratings. The technical, organizational and communication competences of the top managers are the most important management dimensions to explain all financial results. Under this dimension of management, the professional skills of the top managers that must be emphasized. Therefore the institutions will be effective in credit risk management performance. Method used by researcher is qualitative research method.

Thierry van Bastelaer (2000) in his study of imperfect information, social capital and the poor access to credit found that well-documented inter-borrower relations and quality of the relation between the borrowers and the lender organization's staff plays an important role in credit risk management. Method used is qualitative research method.

A. Fernand (undated) conduct research study on managing microfinance risks: some observations and suggestions stated that risk management has become more important now and its importance will continue to grow in the future. Factors such as the increasing competition in markets and the integration of new technology into the industry further reinforce the importance of microfinance risk management. The growing interest of MFIs further reinforces the importance of risk management in MFIs. However, it is disturbing to note that systematic risk management is still not as widespread as it should be.

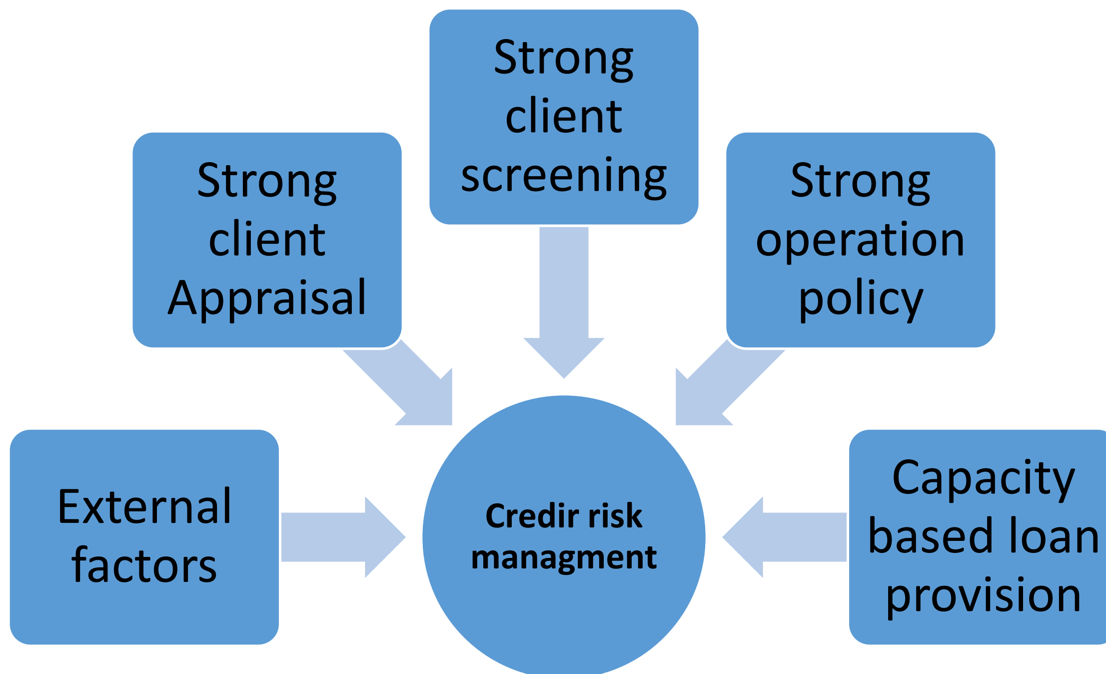
In Ethiopia, the studies by Wolday (2001), Befkadu (2007), Zigju (2008), Michael (2006) and Samuel (2006) focus on progress of micro finance institutions in terms of number of clients, loan amount and number of branches throughout the country. The studies by Michael (2006) and Samuel (2006) tries to touch the issue of credit risk management in some micro finance institutions in Ethiopia but they did not assess exhaustively the performance of micro finance institutions in credit risk management.

The empirical studies that have been reviewed in the preceding section focused on the different micro finance institutions issues that affect the performance of micro finance institutions. In addition, most prior studies regarding credit risk management tried to examine the possible methods to manage credit risk including the use of credit score rating, and the impact of borrower's financial positions on credit risk management.

However to the knowledge of the researcher, it is possible to concluded that although there have been a number of studies on credit risk management and related issues both in developed and developing countries, Ethiopia in particular, there are no similar studies that exhaustively examine the credit risk management practice of micro finance institutions in Ethiopia. All conducted studies have no similarity with the scope, objective of this study.

As a result, this study were designed to fill the aforementioned gaps and provide concluding recommends having the main objective of analyzing and examining the performance of sample micro finance institutions in credit risk management.

## 2.11 Conceptual frame work




External factors refers to situation that affect the company but not managed by the company. This includes, drought, conflict, crop failure and some others. If the company failed to consider this all sort of things during providing loan mainly for farmers, the company will directly face challenges.

This therefore will have an effect on the performance of loans since it stipulates the time of loan repayments hence creating a timely repayment and decrease in default rate. Client appraisal helps MFIs to improve loan performance, as they get to know their customers. The 5Cs considered in client appraisal are character, capacity, collateral, capital and condition. Strong operation policy is the other thing that help the company to manage its operation. If there is no policy in the company it is difficult for the company to know what is undertaking in the company and this will have direct linkage with loan repayment and service managing. Also, client screening, capacity based loan provision for clients and appraisal of the clients are some of the other factors that highly affect loan repayment. Each has positive and direct linkage with loan repayment absence of each of them will automatically expose the company for credit risk. Thus it is advisable for each financial institution to have these sort of indicators to minimize their credit risk.

# CHAPTER THREE

# 3 Research Design and Methodology

## 3.1. Target population

The research assesses credit risks management of Microfinances in Ethiopia by specifically focusing one of MFI in Ethiopia so called Buusaa Gonofaa. The researcher focuses on this MFI because the company has well known for its social mission of improving its customer's livelihood. The company has got an award of euro 100,000 from European Microfinance institution in 2008. It also stay in the market for more than 17 years and this makes it different from other MFIs in the country and as a result the researcher assumes this institution representatives of the remaining MFIs.

The company is operating in Oromia regional states and as of today the company has more than 28 operational branches in the Oromia regional state. Poor people's mainly women landless and farmers are target market of the company. The company has more than 100,000 clients using its services.

## 3.2 Research Design

The research is full of descriptive. A descriptive study is one in which information is collected without changing the environment (i.e., nothing is manipulated). As the name implies, the major purpose of descriptive research is to describe characteristics of, people, groups, organizations, or environments. In other words, descriptive research tries to "paint a picture" of a given situation by addressing who, what, when, where, and how questions, Zikmund.Babin Carr.Griffin (2012).

All relevant data and facts about "credit risk management has gathered from Buusaa Gonofaa MFI. Company's risk management procedures has further analyzed and the researcher as used sort of organized questionnaire for collecting descriptive data from the respondents of the study. Respondent's idea and subjection on the matter of the study has collected through use of this tool and analyzed further.

## 3.3 Data type and source

The study uses both primary and secondary data source. Primary data source has been collected from employees of the institution mainly on the top managerial level who mainly involved in the designing and monitoring policies in the institution. Secondly, secondary data source has collected by reviewing company side documents and also additional literatures has used to build the analyses.

## 3.4 Population of the study

As of June 2017 end Buusaa Gonofaa MFI has a total of 400 employees. There are five Managers, three section heads, 28 branch managers and 9 Regional coordinators. The remaining employees are front line staffs who provide services for customers and officers. Thus, the study focus on this institution.

## 3.5 Sample and sampling techniques

The researcher have used purposive sampling approach. A purposive sample is a non-probability sample that is selected based on characteristics of a population and the objective of the study. Purposive sampling is also known as judgmental, selective, or subjective sampling.

With this sampling approach the researcher used all employees of the company found on the managerial position. There are a total of 36 employees on the managerial position designing, leading, implementing, and supervising operation policies of the company. These employees of the company are on three different managerial classes namely, Top managers (senior managers), middle level managers and bottom level managers. To consider ideas from the policy designing, implementing and monitoring the researcher fully focused on all these employees on the managerial levels.

## 3.6 Data collection instrument

The researcher has used both open ended and close ended questionnaires to gather information from the respondents of the study. Close ended questions has been constructed with the choice form and was constructed for the company side respondents of the study. The questionnaire has designed with items covering all areas of how microfinance manage credit risk. The researcher fully excluded interview

approach because all (100%) of employees in the managerial positions have used for data filling and it is to avoided redundant data collection and it is because of the number of managerial employees of the company are small in number that I didn't split the respondent for interview and self -report.

## 3.7 Method of data analysis

The method of data analysis and presentation of finding involves using mixed approach. Hence data tabulation and statistical computations was used. To analyze the findings descriptive statistics like percentage, mean, tables and figures presentation has applied by using latest available version of Statistical Package for the Social Sciences (SPSS 22 package). The research used SPSS program to analyze the results of the questionnaire. In addition correlation and reliability analysis was part of data analyses.

# CHAPTER FOUR

## 4 Result of Data Analyses

### 4.1 Respondent profile

Basic information the respondents have analyzed and indicated in the following part. Age education, position and work experience of the respondent was some of the items used for analyses.

#### 4.1.1 Age of the respondent

Respondent's age have analyses and it is seen that the majority of them are in the age category of less than 41 - 50 years (41.7%) and followed by the age category of 20-30 years having share of 30.6%. Share of employees in the age category of 31-40 years are about 27.8%.

*Table 4. 1: Age of the respondent*

| | Frequency | Percent |
|---|---|---|
| 20-30 Years | 11 | 30.6 |
| 31-40 Years | 10 | 27.8 |
| 41-50 Years | 15 | 41.7 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

The result indicated in the table above clearly indicates that the company is led by employees old in their age. This is an opportunity for the company in minimizing credit risk because these peoples might have life experience that will contribute for their work.

#### 4.1.2 Education

Education of the respondent is one of the other indicators used to analyses to respondent's profile and also this indicators clearly tells us that educational back ground of peoples leading the institution.

Accordingly, from the table below one can understand that majority of peoples or employees involved in the managerial level have BA degree and also seen that there are employees having Masters of Art. 75% of the employees of have BA degree while the rest 25% are MA holders.

*Table 4. 2: level of education*

| | Frequency | Percent |
|---|---|---|
| BA Degree | 27 | 75.0 |
| MA Degree | 9 | 25.0 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

Thus, no employees of the company involved in the managerial position have less than BA degree. All Managers have a minimum of BA while there are also employees having MA. The indication is that managers of the institution are relatively competent in terms of their education background and this is an opportunity for the company to have low level of risk exposure.

### 4.1.3 Position

The other indicators used by the researcher to identify the Respondent's work experience is their position. It indicates to the readers who are the respondent and also how they are related with the study matter, because it is only if we consider or use all appropriate respondent that we will collect all needed and appropriate feedback that effectively contribute for the findings of the study. The following table indicate work position of the respondent in the company.

*Table 4. 3: position of the respondent*

| | Frequency | Percent |
|---|---|---|
| Branch manager | 20 | 55.6 |
| Middle level manager | 11 | 30.6 |
| Senior manager | 5 | 13.9 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

As one can see from the table above, majority of the respondents were branch manager who are very responsible in the implementation of all policy of the company (55.6%). This peoples are those who have

effective and active involvement with clients of the company. They are peoples who have major share in the knowhow of the policy because of their interaction with clients.

Middle level managers have the second line share in the category of the respondents. They are about 30.6%. However, this is not to mean that senior managers were not participated in the study. All of them have participated in the study but because their share is limited they have small share in the survey. In percent they account around 13.9%.

### 4.1.4 Work experience

It is only if the respondents have long stay with the company that they will fully respondent to the questions. If they are new with the company it is very difficult to say that they will answer all the designed question. If they have no full understanding about the company and about the study matter it will limit quality of the answer and this directly affect the finding of the research. Thus, it is more recommended to use peoples having full understanding about the company to get more accurate reliable data and accordingly the following table indicates result on experience of the respondents in the company.

*Table 4. 4: Work experience of the respondent*

| | Frequency | Percent |
|---|---|---|
| 2-4 Years | 6 | 16.7 |
| 5-7 Years | 7 | 19.4 |
| Above seven years | 23 | 63.9 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

It is seen that employees stay within the company for a long years. It is rare that the managers of the resign from the company. According to the data in the table above 63.9% of managers of has stayed with the company for more than seven years. Around 19.4 % of the respondents indicated that they have about 5- 7 years of experience. It is only 16.7% of the respondents have less than 4 years of work experience with the company. Thus, as explained above there is no managers changing in the company, but even if it is not further investigated there might be promotion in the company. Managers have greater probability to stay with the institution for more years and as it is financial institution this is greater opportunity for

the company. This has positive impact in minimizing the credit risks because the managers will have more consolidated lessons that they learn each year.

## 4.2 Basic information

### 4.2.1 Loan product

Respondents have asked about loan products of the company and they revealed that the study company has only one product type (100%). It is only group loan products that the company is providing, but it is fact that financial institutions provide both individual loan and group loan. This indicates that even if the company has operated in the market for more than 17 years, it is not expanding in terms of maximizing number of its products.

*Table 4. 5: Company's loan product*

| | Frequency | Percent |
|---|---|---|
| Group loan | 36 | 100.0 |

Source: Own computation using primary data, 2018

Actually it needs further study why the company is still more concentrated, but it is surprising that the company to only provide group loan. Group loan product is a loan product that a number of peoples come to gather and get loan without any collateral. Only group members will be guaranty for each other's.

### 4.2.2 Loan size

Even if the loan product of the company is group methodology, the researcher has further identified detail loan sizes of the company. Average loan size was used to calculate and see the loan sizes of the company. Accordingly it is seen that the average minimum loan size is 4000 while the average maximum loan size that the company is providing is 80,000 birr.

*Table 4. 6: Loan size of the company*

| Loan size | Minimum | Maximum |
|---|---|---|
| Average | 4000 birr | 80,000 birr |

Source: Own computation using primary data, 2018

The fact that one can read from this table is that it is only the age of the company that is too old. The company is not going with its age mainly in proving loan size, because the loan size the company is providing is too small while compared with the current market price and inflation in the country. However, even if additional survey is needed to investigate why the company is not moving with its age and not providing big loan size, it is impossible to say what the company is providing considered markets.

### 4.2.3 Requirements for loan

It is fact that each and every financial institution use collateral while proving loan. It is impossible to give loan without having collateral, but some institution like MFI uses different approach as a collateral. They mainly play role on the lending mechanism that do not need collateral. They use joint liability approach and this is one of the approach that makes the industry different from other financial industries likes Banks and others. Microfinance institutions are mainly crated for poor peoples who have no asset to provide collateral to get loan and thus collateral is not uniformly seen in the microfinance industry. The following table indicates requirements that study institution use to provide loan to its customers.

*Table 4. 7: Requirement for loan*

| | Frequency | Percent |
|---|---|---|
| Only joint liability | 26 | 72.2 |
| Other | 10 | 27.8 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

As it is revealed by the respondents of the survey, Buusaa Gonofaa MFI mainly uses joint liability as a requirement to provide loan (72.2%). Customers or peoples in the operation areas of the company will make a group and form joint liability. This is the only requirement that the company need from its borrowers to provide loan for them. But the other 27.8% of the respondent indicated that the company also need additional information like capacity to repay loan and plan for the loan they are applying for. As per these respondents, it is said that the company will only give loan for peoples having plan and also the plan goes with the activities that the company plan to finance that they will get loan. According to these peoples, only joint liability is not sufficient requirement.

## 4.3 Challenges

Under this part the researcher has tried to investigate all challenges that the company is encountering and how the challenges are sever. Actually, it to know and make the reader further about the company mainly regarding challenges it faces. This will put base for the study matter of credit risk in the company.

### 4.3.1 Challenges of the company

The respondents of the study indicated major challenges of the company affecting its performance. They revealed that default and liquidity problems are the major one. As per the finding about 77.8% of the respondents indicated default is head hake of the company. The remaining 22.2 % of the respondent reveled that liquidity is major problem for the company. However, even if default has a lion share one can understand that the company is in a serious situation as long as it is suffering with both of this challenges. Both challenges are not an easy, not only in Microfinance industry but also in all industries. They definitely affect the company's performance also can make the company out of the market.

Mainly default is a serious challenges for all financial institutions not only for MFIs, because in the financial institution is only if you try to collect back all your loan that you plan to lend more. Default is not only problems of the institution who faced it, it will also result for other similar financial institution in the market. If one institution fail to collect the loan it lends similar clients of other institution will reject to pay back the loan and is will kill the institution working in the industry and this will directly go for the big problem of the country through affecting the economy of the country in general.

*Table 4. 8: Challenges of the company*

| | Frequency | Percent |
|---|---|---|
| Default | 28 | 77.8 |
| Liquidity | 8 | 22.2 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

On the other hand, liquidity which is problem of the company is one of the other factor that affect performances of the company by affecting its out rich. If the company has this problem it is to mean that company's capacity to expand is to limited and even for the company it is very difficult to fulfill need

of its customer. The company will only operate by considering its internal problems of money shortage not need of the customers and this is to mean that peoples will not get all the money they need.

### 4.3.2 Frequency of the challenges

Even though the study branch is suffering with both problems indicated above, the researcher further identified how frequently that the company is suffering with indicated problems. Accordingly, the following table indicated the result.

*Table 4. 9: Frequency of the challenge*

| | Frequency | Percent |
|---|---|---|
| Semiannually | 6 | 16.7 |
| Yearly | 30 | 83.3 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

83.3% of the respondents have identified that the challenges seen in the company on yearly bases. While the other 16.7% of the respondents revealed that it is on the semiannually bases. However, this is to mean that the company is facing both of the challenges on yearly bases. Thus, one can say that the company is in a serious problem if it is facing both problems on yearly bases and this might be one of justification for the company not to grow with its age in the market.

### 4.3.3 Severity of the challenges

Understanding presence of challenges in the company is not guaranty to tell us that the challenges are affecting the institution and thus additionally to further verify that the company is seriously affected with the indicated challenges the researcher has further tried to investigate severity of the challenges. As the result in the table below indicates one can see that the company is seriously affected with the mentioned problems. 100% of the respondents clearly revealed that the challenges are sever.

*Table 4. 10: Severity of the challenge*

| | Frequency | Percent |
|---|---|---|
| Sever | 36 | 100.0 |

Source: Own computation using primary data, 2018

### 4.3.4 Reason for the challenges

Even though it is seen that both investigated challenges are affecting the company seriously, it is further tried to analyses reasons for the occurrences of the problems mentioned. The summery is indicated in the table below.

*Table 4. 11: Reason for the challenge*

| | Frequency | Percent |
|---|---|---|
| Poor management | 24 | 66.7 |
| Poor policy implementation | 12 | 33.3 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

Majority of the respondents (66.7%) revealed that management related problems are exposing the company to different problems. Even if the managers of the company working on policy design have a number of solid rated experiences in the industry, it is clearly seen that they are not contributing for company's best performance. They said that there is poor management approach in the company to manage operation of the company. Also the other 33.3% of the respondents revealed that there is poor policy implementation in the company and this is one of the biggest factors for the challenges that the company is facing.

From this analyses one can understand that the company need strong work on its management approach so as to run away from the challenges it is encountering right now. If it is not working on its management things will remain as it is and it will continue with its current challenges. It is only if the company work on its management strategy that it improve its current performance and also that policy implementation approach will be improved in the long term.

### 4.3.5 Frequency of discussion in the company

As indicated in then table below to understand how the company discuss about the challenges that they are encountering, the respondents have asked the question of how frequently the company discuss on the challenges identified to improve each. Accordingly, 80.6% of the respondents revealed that there is discussion in the company but the discussion is on yearly bases. The remaining 19.4% of the respondents indicate that there is monthly discussion in the company. And this has consistence with occurrence of

the challenge. It is because of the challenges are known at the end of year that the discussion is once on yearly bases.

*Table 4. 12: Frequency of discussions of the challenge*

| | Frequency | Percent |
|---|---|---|
| Monthly | 7 | 19.4 |
| Yearly | 29 | 80.6 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

### 4.3.6 Participants of the discussion

Even if discussion is one of the relevant thing in solving the challenges but it is only if the participants are concerned body that it will get solution. Thus, the researcher has investigated that the participants are mainly mangers of the institution (72.2%). But also seen that BOARD members are participants according to the respondents of the study (27.8%).

From this one can see that front line staffs who mainly have frequent reaction with clients and have knowhow of the gaps are not involving in the discussion.

*Table 4. 13: participants of the discussion*

| | Frequency | Percent |
|---|---|---|
| Boards | 10 | 27.8 |
| Managers | 26 | 72.2 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

## 4.4 Credit risk management of Buusaa Gonofaa MFI

A risk management framework is a tool for managers that helps to manage their risk. It should be simple and clear, comprising a short list of key ratios or figures. Tools should ease, and not complicate, the burden of already over-stretched managers. Effective tools should facilitate the manager's ability to think about risk and to respond quickly and appropriately. Complicated systems breed resistance and are less useful. Once managers commit to risk management and see the benefits of using these tools, the MFI can introduce a more detailed process for managing risks.

Managing risk is a complex task for any financial organization, and increasingly important in a world where economic events and financial systems are linked. Global financial institutions and banking regulators have emphasized risk management as an essential element of long-term success. Rather than focusing on current or historical financial performance, management and regulators now focus on an organization's ability to identify and manage future risks as the best predictor of long-term success.

As the main objectives of the study is to analyses credit risk management of the company, the research has collect data on the matter from the respondents and indicated result of data analyses in this part.

### 4.4.1 Operation policy

As long as the institution is financial industry, it is expected from the company to have operation policy to make all its operation that undertakes in different areas by different staffs similar. The other importance of operation policy is to govern all operation of the company to create same or uniform pattern and practice take place in the company. If the company has no policy to govern all its operation it is too difficult to know what is happening in the company and also know what are taking place in the company. Thus, not only from financial industries, but also for all other institutions having operation policy is one of the biggest requirement they need to fulfill to manage their operation, if they do not have it is too easy to fail for the institution and even such institution do not know when they fail.

To start with the researcher has tried to investigate presence of operation policy in the study institution and summary is presented in the table below.

*Table 4. 14: Operation policy of the company*

| | | Frequency | Percent |
|---|---|---|---|
| Do you have operation policy? | Yes | 36 | 100.0 |
| Do you modify operation policy? | No | 36 | 100.0 |

Source: Own computation using primary data, 2018

As the result indicates, the study institution has operation policy to govern all its operation. This makes the company to know what is undertaking in the company and how? Also this makes the company fully

understand how things or the loan is provided for the customers, but it is not guaranty to protect the company from credit risks. As indicated in the literature review part there are a lot of things that the company need to fulfill to minimize credit risk. The respondents (100%) revealed that the company has operation policy for its group loan that it provides in its operation areas.

However, based on the data collected from respondents the researcher has further identified that the operation policy of the company is not modified frequently. 100% of the respondents revealed that the policy is too old and the company is not modifying.

### 4.4.2 Reason for not modifying the policy

It is further investigated that the company is not modifying its operation policy with the following reasons. First, the company is not expanding not only in terms of operation or out rich but also in terms of what it is providing. The company still provides all the loan products that it starts with 17 years back. This makes the company not to focus on policy changing because there are no big changes in its operation with in all its stay in the market.

The second thing that is protecting the company from modifying its policy is that the company is not bringing any methodology change in its operational procedures. Even if the company stays in the market for a long period, there is no operational methodology change in the company. The company didn't concerned about its methodology so far and this limited the company not to change its operation policy.

The third thing identified as a reason is that poor management in the company. It is revealed that management strategy of the company is too poor and no one in the company is giving care for the operation policy. It is indicated that everything in the company that includes policy change is done informally not formally.

The fourth thing that respondents identified includes, absence serious attention for policy related issues both from senior managers and board of directors. They are not strictly undertaking follow up on the implementation of policy rather they give value on the overall returns gained. Even while observing challenges happening as a result of poor policy they are not working over the issue. Lastly, they added that poor manager's skill in managing operation policy of the company. This limited them from modifying operation policy of the company frequently.

*Table 4. 15: Managing credit risk*

| Do you manage credit risk? | Frequency | Percent |
|---|---|---|
| No | 22 | 61.1 |
| Yes | 14 | 38.9 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

As it is revealed by the majority of the respondents (61.1%) the study institution is not managing credit risk. 38.9% of the other respondent indicated that the company measures its credit risk. Here the finding that one can understand from this is that the company is in very risk environment mainly in knowing and minimizing its credit risk. While looking the respondents who said the company manages credit risk it understandable that there is no clear communication and poor management system in the company, because as long as there is system all needs to know equally.

### 4.5 Risk management approach

As Professor Mohammad Yunus saying goes (1998) credit without strict discipline is nothing but charity. Charity does not help to overcome poverty. This is to mean that MFI must have clear and strict follow up strategies so that they will get repaid as per the loan policy—the right amount, at the right time and with all terms and conditions agreed up on. With respect to the customers surveyed were presented with the question that to what extent the MFI is following up the credit it lent out to its customers and to what extent the MFI is supervising the business of its service users so that they will keep their business on the appropriate track. The following part presents responses of the respondent on the approach that the company uses to manage credit risk.

*Table 4. 16" Credit risk management approach*

| Options | Yes | | No | |
|---|---|---|---|---|
| | Frequency | Percentage | Frequency | Percentage |
| Strong client screening | 20 | 56% | 16 | 44% |
| Strong operation policy | 10 | 28% | 26 | 72% |
| Strong client appraisal | 16 | 44% | 20 | 56% |
| Credit information sharing | 5 | 14% | 31 | 86% |
| Capacity based loan provision | 10 | 28% | 26 | 72% |
| Consider external factors | 5 | 14% | 31 | 86% |
| Risk management policy | 15 | 42% | 21 | 58% |

Source: Own computation using primary data, 2018

As indicated in the table above, it is clearly seen that client screening is the only option that the company is using for managing credit risk. 56% of the respondent revealed that the company is using clients screening for risk mitigation. But even if the majority forwarded that the company is using this also 44% of respondents indicated that it is not in the company.

It is indicated that the company is screening clients through the group. Sort of question will be used by to screen clients through asking the question in presence of group members and group members will take the major responsibility to evaluate group members. If the group members explains or revealed that the members can qualify for loan the company clearly gives the responsibility for members to cover costs of default on behave of the defaulters.

The other thing that majority of respondents indicated is the company use strong follow-up for client screening, but indicated that this is not effectively used because of it is time taking and has burden to return back to client's home and this is cost for the company. The other thing the respondents mentioned is that the company is using indirect client verification so as to know their credit culture and commitment for loan. But all the respondent indicated that because of there is poor management in the company all things are not implemented according to the policy.

The other thing that respondents indicated is that there is no strong operation policy that govern all activities in the company (72%), there is no strong client appraisal mechanism that makes staff to evaluate clients per each consecutive loan cycle (56%). The implication here is that the company's management

body are not effectively working on the management of activities of the company and additionally staffs mainly in the implementation of the policy are not effectively assessing clients during appraisal to minimize credit risk.

Capacity based loan provision, information sharing with other microfinance institution operating in the same area and considering external factors have used by the researcher as a factors for credit risk management approach. Accordingly, the company has evaluated trough this indicators and it is seen that all the three indicators are poor in the company. 86%, 72% and 86% of the respondents indicated that there is no information sharing in the company, capacity based loan provision, and considering external factors for risk minimization respectively.

Follow up of the borrower in the company is not in placed in the company. The company is using group liability approach for credit risk management but this not effective enough because it is not guar anting for portfolio quality. Credit administration is fully given for the group members, and there is no separate and strong mechanism in the company. It is also added by the respondent that there is no risk policy in general (58%).

Under risk management policy Presence of Policy and strategy for managing and monitoring external risk has assessed and seen that the company has no strategy designed specifically for monitoring external risks. External risks are risks not managed by the company, but somehow that can be forecasted. Some of this risks includes, politically unrest, drought, crop failure and others. The company is using informal external risk management than having formalized policy and procedure.

### 4.6 Credit risk measuring

Credit risk management allows predicting and forecasting and also measuring the potential risk factor in any transaction. The banks management can also make use of certain credit models which can act as a valuable tool which can be used to determine the level of lending measuring the risk.

*Table 4. 17: Credit risk measuring*

| | Frequency | Percent |
|---|---|---|
| No | 20 | 54.1 |
| Yes | 17 | 45.9 |
| Total | 37 | 100.0 |

Source: Own computation using primary data, 2018

But in case of Buusaa Gonofaa respondents of the study indicated that there is no strong risk measurement mechanism to mitigate credit risk. 54% of the respondent revealed that the system is too poor or no. On the other hand, the remaining 45.9% of the respondents revealed that the company has risk measuring

## 4.7 Credit risk measuring approach of the company

Respondents have asked about the approach that their company is using to measure credit risk and the summary of the analyses is indicated in the table below.

*Table 4. 18" Credit risk measuring approach*

| | Frequency | Percentage |
|---|---|---|
| Judgmental approach | 17 | 100 |

Source: Own computation using primary data, 2018

Respondents indicated that the company is using judgmental approach for credit measuring. There is no statically approach in the company, but revealed that Risk management departments of the company is in charge of this activity and the department will simply use judgmental.

## 4.8 Staff training in the company

The investment in training that a company makes shows employees that they are valued. The training creates a supportive workplace. A training program allows you to strengthen those skills that each employee needs to improve. The importance of employee training doesn't end with new workers. Manager training and development is equally important to workplace safety, productivity, and satisfaction. Among the most useful skills that can be addressed are manager communication, employee motivation, and employee recognition.

Training has many benefits for staff: they acquire new skills, increasing their contribution to the business and building their self-esteem. The training they do can take them into other positions within the organization – positions with better prospects and/or better pay.

However, to see staff development in the company the research has identified the issue in his study and the summary is indicated in the table below.

*Table 4. 19" Staff training in the company*

| | Frequency | Percent |
|---|---|---|
| No | 28 | 77.8 |
| Yes | 8 | 22.2 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

The result indicates that staff development in the company is to poor. It is difficult to say that the company is working on staff training to develop their skill. There is no training that is designed in the company. More than 77% of the respondent who said there is no training in the company revealed that the company totally excluded work on developing staffs skill. Other 22.2% of the respondent indicated that the company is using staff training.

The implication is that the company need to design staff skill developing program so as to improve employee skill and their motivation, because it is only if employees are satisfied with the company that their efficiency and productivity will increase.

### 4.8.1 Training frequency

Even though it is revealed in the table above that the training is not integrated in the core business of the company, the researcher has further analyzed frequency of training in the company and came up with yearly bases. As it is seen in the table below, 16.7% of the respondents clearly stated that the training is on yearly bases. While the majority 83.3% of them indicate that it is not in the company in general.

*Table 4. 20" Frequency of staff training in the company*

| | Frequency | Percent |
|---|---|---|
| None | 30 | 83.3 |
| Yearly | 6 | 16.7 |
| Total | 36 | 100.0 |

Source: Own computation using primary data, 2018

As indicated in the table below the respondents of the study have asked who provide the training and accordingly all peoples who said that the raining is yearly in the company indicated that mainly internally conducted training is mainly used by the company. The company has training section having one man

mainly working on the staff development, but the section is not effectively providing the training as per its plan rather simply working in providing orientation training for new staff to make the familiar with the company. But there is not training that the section is giving beyond orientation.

### 4.8.2 Training providing body

As indicated in the table below the respondents of the study have asked who provide the training and accordingly all peoples who said the training is yearly indicated that it is mainly provided internally by internal staff of the company. The company has training section having one man working on the staff development, but the section is not effectively providing the training as per its plan rather simply working in providing orientation training for new staff to make them familiar with the company. But there is not training that the section is giving beyond orientation.

*Table 4. 21" Training providing body*

| | Frequency | Percent |
|---|---|---|
| Internal staff | 6 | 100.0 |

Source: Own computation using primary data, 2018

CHAPTER FIVE

# 5. Conclusions and recommendations

## 5.1 Summary and Findings of the study

The study conducted by specifically focusing on Buusaa Gonofaa MFI which is one of the biggest and well known MFI in Ethiopia with its social mission indicates how the institution manage credit risk, over all approach and practices they are using to minimize credit risk. This part indicates summary of finding that the researcher found.

- Buusaa Gonofaa the biggest MFI of the country is led by more experienced employees or leders. All the leaders of the institutions have more than enough experience in the sector. They are appropriate person for the position. More than of 83.3% of them have greater than five years work experience in the sectors. This indicates that peoples on managerial positions are no frequently resigning from the company and this is an opportunity for the effective management of the system in the institution, but guarantying for effective implementation of the system in the institution.
- All employees of the company who are on the managerial position have a minimum of BA degree while there are also employees who have MA degree (25%). This indicates that the employees have good educational background in having minimum requirement for their work, but this is not guarantying for the effectiveness and their productiveness in minimizing credit risks of the company.
- Even if it difficult to conclude that group loan is the only loan products of all Micro Finance Institution of the country, it is seen that Buusaa Gonofaa MFI is providing only group loan. The company is operating this loan product since its establishment and this indicates that the company have full understanding of the product, but even if they have full understanding of the product and being familiar with it, they are not equally monitoring risks of the service delivery.
- Also, the company is not providing equal and uniform loan size. The loan is different across different peoples. As per the study it is seen that the minimum average loan size is 4,000 birr while the maximum loan size is around 80,000 birr and irrespective of the loan size the company

is not taking collateral from its clients during provision of the service. The company is fully focusing on joint liability approach.

- Default (77.8%) and liquidity (22.2%) are the two biggest problems that the company is facing and relatively it is on yearly bases that the company encountered with this problems. But even if it is on yearly based it is seen that the impact is sever. Poor management style in the company and poor policy implementations are some of the reason for the challenges of the company.
- The study company has operation policy to govern its operation (100%), but seen that the company is not modifying policy to make it familiar with the condition. The company has develop its current operation policy during its establishment and currently using that policy without modifying.
- The company relatively uses strong client screening and appraisal approach for credit risk management, but also seen that there are other option that the company is using but it is not commonly used by all managerial level. Also the company is not measuring its credit risk level and no tool that the company designed and implemented to measure credit risk. Thus it is clear that the company is operating in a risky environment.
- Credit risk administration in the company is very limited. It is group members who play major role in administering the credit the company disbursed. But regarding the follow and monitoring of the loan role of employees of the company is very limited. And also the company is not considering external factors to minimize its credit risk
- Even if the there is no strong credit scoring mechanism in the company, Risk management department of the company is using judgmental approach for credit risk scoring
- Also, it is seen in the company that there is no frequent training provided for the employees so as to build their skill and make them familiar will the policy in the institution.

## 5.2 Conclusions

Inadequate supervision of borrowers by the MFIs staff on loan utilization and loan repayment create conducing environment for default to occur. Credit follow-up is an important aspect since it compels borrowers to be committed; a fact expressed by borrowers who said they considered supervision important in loan repayment. Training of borrowers before receiving of loans from MFIs is very important in giving borrowers skills in business management, savings and in book keeping. At the same time the study concluded that borrowers who did not receive any training before receiving loans from MFIs defaulted in repayments since they were unable to increase their earnings

Having operation policy that guide all service delivery of the company alone is not sufficient for risk management in the financial industry. To make the policy more effective and helpful there has to be policy review per different period and also, there has to be responsible person for monitoring implementation of the policy. If the policy is not modified or amended with change in time it will not be valuable mainly in financial industry.

In financial industry credit risk management policy is one of the minimum requirement for the health of the institution. The policy has be designed from bot external and internal side. The company has to identify some of External factors that affect its operation and expose its credit to risk and also from internal there has to be effective and strong policy on client screening and appraisal. The company also need to have strong operation policy the service has to be delivered to the client by assessing their capacity to protect both client and the institution from risk.

### 5.3 Recommendations

BG should incorporate risk management into the design of its systems, processes, and methodologies to reduce the frequency and scale of unwanted risk from the outset. Designing procedures that reduce the chance of human error can improve quality control and significantly boost productivity and efficiency. Lower delinquency rates elevate loan staff's efficiency and productivity by reducing their time spent on collection and increasing time to work with potential and existing customers. Thus BG should evaluate their procedures and information flow to see whether some "re-engineering" (i.e. systemic alterations) could result in operational improvements and enhanced quality control.

Segregation of duties and responsibilities has to be effectively incorporated in to company's work environment. This will make the company to effectively work in reducing credit risk through giving employee accountability for their work, but in the absence of such practices it will be difficult not to design new policy but also to implement the existing one. Senior management and the board share the responsibility for the overall risk management strategy. To ensure they receive useful and relevant information on a timely basis, there must be charges specific staff members with the responsibility for collecting and reporting information.

An important principle for integrating risk management into the daily operations is through the use of internal controls, such as the segregation of duties and functions. By segregating duties, the MFI can prevent conflicts of interest and reduce risk. A lack of segregation of duties creates opportunities for fraud and collusion among staff. After incorporating internal controls, the MFI conducts independent checks and reviews to ensure that the system works correctly.

All employees of the company must have well-designed performance incentives that incorporate the MFI's risk management goals. The alignment of performance objectives and incentives among investors, board members, management and staff is critical to effective and efficient strategy and execution.

The company needs to prioritize credit risks through designing and implementing credit measuring tool and based on the severity of the risks the company needs to strongly work on the areas where interventions will have the greatest leverage. An investment in a better management information system will usually have a major impact on managing several key risks. The quality, comprehensiveness and timeliness of information provided to management and boards of financial institutions are critical for risk

management. Since managing risk is costly, the MFI should ensure that the long-term return on its investment merits the costs.

Peoples who are playing major role in leading the company that includes, BOARD and senior managers need to think and identify information they need, how often they need it, and in what detail and they must focus on the key performance indicators they need on a regular basis and then direct staff to implement the systems to provide that information. In developing systems, MFIs should attempt to streamline reporting so that the board and senior management are not overwhelmed with too much information, but have access to the core information they need to monitor the institution's health and to make decisions.

More specifically the followings are some the recommendation that the researcher recommend to improve credit risks in the industry. This recommendation mainly works for the study institution Buusaa Gonofaa MFI and they includes,

- The institutions should work more in creating awareness and common understanding across the institutions about the issue of credit risk.

- The institutions also need to effectively work on the encouraging of training program mainly on credit risk since training are the tools that can provide knowledge and further understanding to employees of the institutions about credit risk.

- The institution has to ad hock credit risk committee since the committee is useful in implementation of the credit risk policy, in monitor credit risk and in deciding delegation of credit approving powers that in turn result good credit risk management in the institutions. They need also to develop credit scoring that is standardized and works for the institution that simply using judgmental approach.

- Reviewing practice mainly on credit quality has to be established in the company since it contributes efficiency in credit risk management process.

- The institutions should work more on creating of awareness to their clients about the purpose of loan and the way how to do business using the loan amount.

- It is better for the institutions to do supervision of their clients (monitoring and credit management) in strong way to minimize the probability of occurrence of credit risk.

- The company has to design policy and procedures to monitor and administer its credit risk and also the policy has to be from both internal and external side.

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# Appendix

# S.T Mary's University

# School of Graduate Studies Department of Accounting and Finance

1. **Profile of the respondent**

   1.1 Gender A. Female B. Male

   1.2 Age A. 20 - 30 years B. 31 – 40 years C. 41 - 50 years D.51-60 E. 60 and above

   1.3 Education level A. Secondary Education B. Diploma C. Bachelor's Degree D. Master's Degree

   1.4 Work position ____________________________________________

   1.5 For how long you work in Buusaa Gonofaa MFI?

   A. Less than one year B. 2-4 years C. 5- 7 Years D. Above seven years

2. **Basic information**

   2.1 Loan products of the company? A. Group loan B. Individual loan C. both loan type/product

   2.2 What is the minimum and maximum loan size for each of loan products that the company providing?

   2.3 What are requirements customers need to fulfill to get loan in both products?

   A. Nothing requirement
   B. Needed collateral
   C. Only joint liability
   D. Others: ____________________________________________

3. **Credit risk challenges of the company**

   3.1 What are the basic challenges of the company? Please select the first three challenges with their order.

   A. Liquidity
   B. Default
   C. Staff exit
   D. Others: ____________________________________________

3.2 How frequently the challenges face the company?

A. Quarterly B. semiannually C. yearly D. none

3.3 How you rate impact of each challenges on the company?

A. Sever B. Moderate

3.4 What are the reason for the major challenges of the institution?

A. Poor policy implementation B. Absence of internal control C. poor management

## 4. Credit risk management

4.1 Do you have operation policy for both products?

A. Yes B. No

4.2 If yes do you modify your operation policy frequently or not?

A. Yes B. No

4.3 If yes, how frequently?

______________________________________________

______________________________________________

______________________________________________

4.4 If no why not?

______________________________________________

______________________________________________

______________________________________________

______________________________________________

______________________________________________

4.5 Do your company manage credit risk?

A. Yes B. No

4.6 What are the approach that the company use to reduce credit risk? Please tick all the appropriate answer and also give justification for each you select.

| Options | Answer | | Justification |
|---|---|---|---|
| | Yes | No | |
| Strong client screening | ☐ | ☐ | |
| Strong operation policy | ☐ | ☐ | |
| Strong client appraisal | ☐ | ☐ | |
| Credit information sharing | ☐ | ☐ | |
| Capacity based loan provision | ☐ | ☐ | |
| Consider external factors | ☐ | ☐ | |
| No risk management policy | ☐ | ☐ | |

4.7 Do you measure risks of the company?

A. Yes B. No

4.8 How your company measure risks or what is the approach?

____________________________________________________________________

____________________________________________________________________

____________________________________________________________________

4.9 How frequently your company discuss to improve gaps or challenges?

A. Monthly B. Quarterly C. Semiannually D. Yearly

4.10 Who are mainly participants of the discussion?

A. Boards B. Senior managers C. Clients D. all staffs E. Combination of all

4.11 Is there frequent training for staffs on the operation policy of the company?

A. Yes B. No

4.12 How frequently staffs provided training?

A. Quarterly B. Semiannually C. yearly D. None

4.13 Who provide training?

A. Internally B. Externally C. None