ST. MARY'S UNIVERSITY

BUSINESS FACULTY

DEPARTMENT OF ACCOUNTING

AN ASSESSMENT ON CREDIT RISK MANAGEMENT PRACTICE IN THE CASE OF DASHEN BANK S.CO

BY

KETSELA TILAHUN

TATEK ASHENAFI

WONDEMAGEN MEKONNEN

JUNE 2014

ADDIS ABABA

AN ASSESSMENT ON CREDIT RISK MANAGEMENT PRACTICE IN THE CASE OF DASHEN BANK

A SENIOR ESSAY SUBMITTED TO THE DEPARTMENT OF ACCOUNTING

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APPROVED BY THE COMMITTEE OF EXMINERS

______________________	______________________
Department Head	**Signature**
______________________	______________________
Advisor	**Signature**
______________________	______________________
Internal Examiner	**Signature**
______________________	______________________
External Examiner	**Signature**

STATEMENT OF DECLARATION

We, the undersigned declare that this study is our original work, has not been presented for award in any other university and that all sources of materials used for the study has been duly acknowledged.

Confirmed by advisor:

Name	Signature	Date
Meseret Kinfe		

Declared by:

Name	Signature	Date
Ketsela Tilahun		
Tatek Ashenafi		
Wondemagen Mekonnen		

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APPENDIX

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

According to Trieschman and Gustavson (1998:5), Risk can be defined as uncertainty concerning losses. The risk surrounding a potential loss creates significant economic burdens for businesses, governments, and individuals. Billions of dollars are spent each year on strategies for financing potential losses. But when losses are not planned for in advance, they may cost even more. Businesses as well as individuals may try either to avoid risk as much as possible or to reduce its negative consequences, overall, an entity's cost of risk is the sum of outlays to reduce risk, the opportunity cost of activities forgone due to risk considerations, expenses of strategies to finance potential losses and the cost of un reimbursed losses.

As stated by Samson (2001:24), risk exists whenever the future is unknown because the adverse effect of risk has plagued mankind since the beginning of time. Individuals, groups and societies have developed various methods for managing risks. Since no one knows the future exactly, everyone is a risk manager not by choice but by sheer necessity. Although financial & non financial risks inherent in the banking business and the systematic approach of handling them was in existence ever since the emergence of the business, the magnitude of the risk faced by new banks entering the market made the importance of risk management all the more exigent.

Risk management is a managerial process that involves the executive function of planning, organizing, leading and controlling those activities in a firm that deal with specified types of risks in order to maximize the value of an organization. The risk manager is charged with minimizing the adverse impact of losses on the achievement of the company's goal. Risk management is the scientific approach to the problem faced by business that deals with the techniques of forecasting future so as to plan, organize, direct and control efforts to minimize the adverse effects of those potential losses. It is the reduction and prevention of the unfavorable effects of risks at a minimum (Trieschman and Gustavson, 1998:14).

Dashen Bank is a privately owned company established in 1995 as a share company in accordance with the commercial code of Ethiopia 1960 and the licensing and supervision of Banking Business proclamation No 84/1994 of Ethiopia to undertake commercial banking activities. The Bank obtained its license from the National Bank of Ethiopia on 20 September 1995 and started normal business activities on the first of January 1996. Dashen came in to existence with an authorized and subscribed capital of Birr 50 million. The first foundation members were 11-business man and professionals that agreed to combine their financial resources and expertise.(Annual reports of Dashen Bank ,2013:23)

When the bank started its operation in January 1996, it has only 10 Area Banks, which has been start their operations at the same time. Now it has reached 117 area banks and 4 forex bureaus. The area bank and networking is designed to facilitate the business interactions of their clients. With regard to Area Bank expansion, the Bank has a continuous plan to enhance the number of Area Banks time to time. With regard to human resource development, the bank has started its operations with 230 employees (clerical and non-clerical). Currently, the number of staffs enhanced to 3690 by the end of June 2013 (Dashen Bank, 2013:15).

1.2 Statement of the Problem

Every organization, whether profit making or otherwise, has got its own mission which it endeavors to achieve during its existence. Profit making enterprises are expected to enhance the returns on the capital provided by their shareholders by way of maximizing their profits through increased efficiency that certainly give them a larger share of the market in which they operate. Likewise, non-profit organizations do have missions like providing community services and improving standards of living of the society not primarily focusing on the generation of profit.

During their course of operation, organizations will definitely be exposed to various uncertainties of different magnitude. These uncertainties are commonly known as risks, which can have enormous effects that range from inhibiting the day-to-day activities of the business to endangering the very survival of the organization. The magnitude and far reaching consequences of these exposures force business organizations to put in subsequent minimization of the impact of such risks on their overall performance. Accordingly, different organizations employ different risk management techniques, which they determine best suits them to achieve their business objectives. When we come to Dashen Bank, by interview the concerned officers the following problems are currently persisting which requires close attention of the credit risk management. Some of these are:

- Lack of adequate supervision on borrowers.
- Dependence on oral information furnished by borrowers (for regular customers) in lieu of reliable financial data and direct verification.

- Over-lending beyond the reasonable capacity of the borrower to pay.
- Lack of up-to-date risk management system due to lack of periodic review and comparison against international and industry standards.

1.3 Research Questions

In order to investigate problems encountered related to credit risk management interact the following question.

1. What are the causes of credit risk in Dashen Bank?
2. What are the policy and procedures of risk management followed in Dashen Bank?
3. What type of mechanism followed in Dashen Bank to minimize risk?
4. What are the systems of monitoring and controlling credit risk in Dashen Bank?

1.4 Objective of the Study

1.4.1. General Objective

The general objective of the study To evaluate the credit risk management performance in Dashen Bank.

1.4.2. Specific Objectives

This study will have the following specific objectives. It helps to:

- identify the major cases for credit risk
- review the policies, procedures & techniques followed by Dashen Bank in relation to risk management.
- identify the mechanisms followed by Dashen Bank to manage credit risk.

- identify the systems of monitoring and controlling credit risk methods in Dashen Bank.

1.5 Significance of the Study

The study will benefit parties such as;

- for student researcher to show their theoretical knowledge of research undertaking practically.
- For researchers, it may serves as a ground for further studies in the area.
- for partial fulfillment of the academic requirements of B.A degree

1.6 Scope of the Study

Obviously the scope of the topic is quite wide. Therefore, the scope of the study is only limited to the financial aspect of risk and credit risk management techniques, policies and procedures which are currently practiced in Dashen Bank at Head Office. The study covers the period from 2012 to 2013.

1.7 Research Design and Methodology

1.7.1 Research Design

In this study, the student researcher decided to use descriptive research design. Descriptive research involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data collection (Glass & Hopkins, 1984:17). It often uses visual aids such as graphs and charts to aid the reader in understanding the data distribution. Because the human mind cannot extract the full import of a large mass of raw data, descriptive statistics are very important in reducing the data to manageable form.

1.7.2 Population and Sampling Technique

The populations of this study are the whole employees who are working in the head office of Dashen Bank under risk management department which limited to 24 in number. Census technique be employed, because the number of employees in the department limited and manageable to collect the necessary data.

1.7.3 Data Sources

Both primary & secondary sources of data were be used. Primary data sources collected directly from employees of the bank who are working in risk management area. Whereas assessing documents of the bank & review literatures were be used as secondary sources.

1.7.4. Data Collection Instrument

Personal interview were be conducted with the selected division heads of the bank by preparing structured interview questions and for the majority of employees both close and open ended questionnaire used which helps the study to be furnished with first hand information. in addition to this, Policy manuals, procedures, annual reports, and publications will be used as means of collecting second hand information.

1.7.5. Data Analysis Method

Data collected from respondents in the questionnaires and interviews were be carefully analyzed in such a way that useful conclusions to be cultivated. In light of this, the collected data organized through counting, tallying and tabulating. Totals then be converted into proportions of percentage so that the raw data is transformed into meaningful information, which can be used to arrive at a rational conclusion.

1.8 Limitations Of Study

In the process of conducting this research study, various problems and constraints have been encountered. Firstly, the study doesn't have any financial sponsor. Secondly, the study is prepared during a limited time period. Thirdly there is a shortage of reference materials in the area of the study, which may give guidance about the theoretical aspects. Finally, some of the officials of the bank are not willing to provide certain relevant information by assuming that the information requested is very confidential.

1.9. Organization of the Study

This study is organized in to four chapters. The first chapter deals with Introduction which includes background of the study, statement of the problem, research questions, objective of the study, significance of the study, scope of the study and research design and methodology. The second chapter focuses on the review of related literature followed by the third chapter data presentation, analysis and interpretation. The forth chapter presents the summary, conclusions and recommendations part of the study.

CHAPTER TWO
REVIEW OF RELATED LITERATURE

2.1 Definition of Risk

There is no single definition of Risk. Economists, behavioral scientists, risk theorists, statisticians, and actuaries each have their own concept of risk. Therefore the researcher will try to give different authors view and definitions for the word risk.

According to Williams's et.al (1998:15), risk is a potential variation in outcomes and the exposure to a potential loss. It can also be defined as uncertainty about economic losses due to the occurrence of an event. Economic losses are caused by perils such as crimes, fire and accidents. It is the possibility of an adverse deviation from a desired outcome that is expected.

According to Trieschman and Gustavson (1998:5), risk can be defined as uncertainty concerning losses. The risk surrounding a potential loss creates significant economic burdens for businesses, governments, and individuals. Billions of dollars are spent each year on strategies for financing potential losses. But when losses are not planned for in advance, they may cost even more. Businesses as well as individuals may try either to avoid risk as much as possible or to reduce its negative consequences. Overall, an entity's cost of risk is the sum of outlays to reduce risk, the opportunity cost of activities forgone due to risk considerations, expenses of strategies to finance potential losses and the cost of un reimbursed losses.

2.2 Classifications of Risk

Risks may be classified in many ways; however, there are certain distinctions that are particularly important to our purpose. As stated by Trieschman and Gustavson (1998:51), the major categories of risk are: pure and speculative risks, fundamental and particular risks, **s**tatic and dynamic risks, objective and subjective risks. These classifications will be explained here after.

2.2.1 Pure and Speculative Risk

Pure risk-is a type of risk that exists when there is a chance of loss but no chance of gain. For instance the owner of a car faces a risk of collusion loss, if collusion occurs; he will suffer a financial loss. If there is no collusion he will not be benefited. But Speculative risk- is a type of risk that exists when there is a chance of gain as well as a chance of loss. Pure risks are always distasteful but speculative risks posses some alternative features. It exists when there is uncertainty about an event that could produce either a profit or loss. In a situation involving speculative risk the society may be benefited even though the individual is hurted.

2.2.2 Fundamental and Particular Risks

A fundamental risk is a risk that affects the entire economy, or large number of persons or groups within the economy. It involves on losses that are impersonal in origin and consequence and they are group risks mostly caused by economic, social, and political phenomena. On the other hand Particular risk is a risk that affects only individuals and not the entire community. It involves loss that arises out of individual events and is felt by a single individual rather than by the entire group.

2.2.3 Static and Dynamic Risks:

Static risks are those risks, which would occur even if there were no changes in the economy. These risks include losses caused by the regulation of the forces of nature or human errors. On the other hand, dynamic risks are those risks resulting from changes in the economy. Changes in the price level, consumer tastes, income and out puts, and technology may cause financial losses to member of the economy. These are risks related with changes in human wants. Although these dynamic risks may affect a large number of individuals, they are generally considered less predictable than static risks, since they do not occur with any precise degree of regularity.

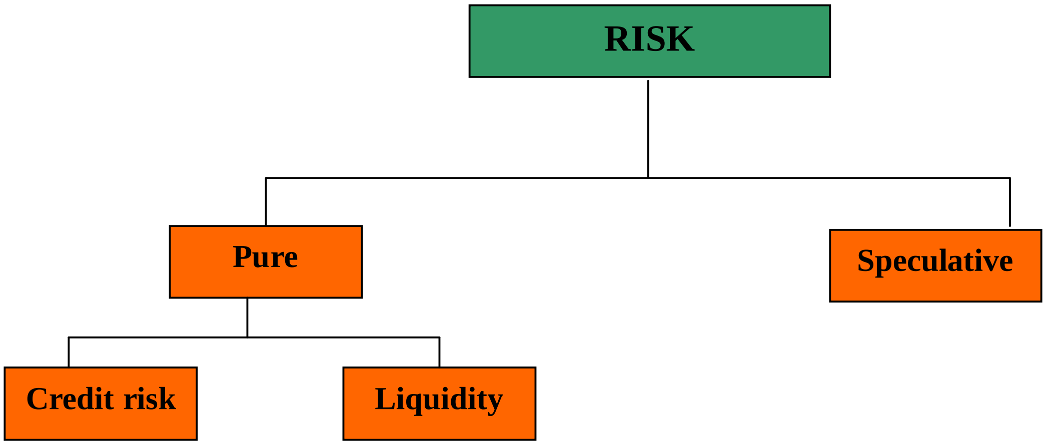
2.2.4 Objective and Subjective Risk

Subjective risk refers to the mental state of an individual who experiences, uncertainty doubt or worry as to the outcome of a given event. It is essentially the psychological uncertainty that arises from an individual's state of mind. on the other hand Objective risks are defined as the relative variation of actual from expected losses. It is mainly applicable to group of objects exposed to losses.

Objective risk can be statistically measured by some measure of dispersion, such as the standard deviation or coefficient of variation. It is an extremely useful concept for an insurer or a corporate risk manager.

In relation to classification of risk Trieschman and Gustavson (1998:7), he classified risk into two which is shown in the following figure.

Fig 2.1 different types of Risks



Source Trieschman and Gustavson (1998:7)

2.3 Types of Financial Risk

Financial risks are subject to complex interdependencies that may significantly increase a bank's overall risk profile. Based on the above figure financial risks, which this study specifically deals with, in turn comprise two types of risks. They are pure risk and speculative risk. Pure risk including liquidity, credit and solvency risks (can result in loss for a bank if they are not properly managed). The main categories of speculative risk are interest rate, currency and market price risk. Trieschman and Gustavson (2003:4)

2.3.1 Liquidity Risk

Liquidity risk is a condition of an individual or business wherein a high percentage of the assets can be quickly converted into cash without involving any considerable loss by accepting sacrifice prices. Liquidity implies a high degree of current ness and solvency in the equity sense;

the ability of current assets will be able to meet current liabilities as they mature. Liquidity risk can also be defined as uncertain future outcomes that either improve or worsen the present liquidity position of the company. It may mean that holding idle cash on one hand or failure to meet financial commitments when they are due on the other

Fund mobilization, fund application, quality service, branch expansion, and application of new technology are the critical issues that can be emphasized by management in minimizing liquidity risk Fund raising is not limited to deposit mobilization. Borrowing and equity contribution are other sources of fund raising.

Branch network expansion is another critical issue that contributes to the broadening of customer base because it helps to attain the desired level of growth and to avoid excessive dependence on particular sources. Thus, monitoring both funding mix and the concentration of depositors help to control and mitigate unnecessary exposure to liquidity crises and avoid the vulnerability associated with such situation.

In general the crucial strategic issues with in which liquidity risk management is unimaginable are fund mobilization, credit allocation (fund application), expansion of branch networks and the provision of quality services through application of new and appropriate technology.

2.3.2 Credit Risk

“Loan is the thing that is lent, specially a sum of money. The action of lending something or the state of being lent". “For each Leander a loan is an investment comparable to bonds, stocks or other assets. One the other hand, for each borrower, a loan is a debt, an obligation to repay the borrowed money plus interest" (http://thomsonreuters.com.)

Banks grant loans to borrowers assuming that they will pay the agreed interest and principal amount according to their contractual agreement. However, the borrower may fail to do. This results in nonperforming loans (NPL).

None-performing loans are those loans which are past their due dates. They are classified into:

1. ***Sub-Standard:-*** Non-performing loans or advances past due 90 days or more but less than 180 days shall at minimum be classified sub-standard.
2. ***Doubtful: -*** Non-performing loans or advances past due 180 days or more but less than 360 days will be referred as doubtful.
3. ***Loss: -*** Non-performing loans or advances past due 360 days or more will be classified as loss.

Credit risk is defined as the chance that a debtor will not be able to pay interest or repay the principal according to the terms specified in a credit agreement. Credit risk means that payment may be delayed or ultimately not paid at all which can intern cause cash flow problems and affect a bank's liquidity. It exists in all banks on balance sheet accounts. Greuning, HennieVan and Bratanovic(2003:16)

2.4 Causes of Credit Risk

A bank is successful when the risks it takes are reasonable, controlled with in its financial resources and credit competence. The vital issues for preservation of the quality of loans are: existence of a well developed policies and procedures, strong portfolio of management, effective credit controls and well trained staff that is qualified to implement the system. Conversely, absence of adequate guidelines to monitor administration of the lending function pave the way for the occurrence of substantial amount of problem on loans. Therefore there are many causes for the occurrence of credit risk. According to Dashen Bank (2003:4) the following lists are the major causes of credit risk.

2.4.1 Excessive concern for Income Growth

The loan portfolio is usually the most important sources of income. Hence growth of the loan portfolio becomes a focal point to boost the revenue. However, too much concern for revenue maximization must not permit extension of weak loans that carry undue risks. Generally, weak loans cost far more than they contribute income for the Bank.

2.4.2 Incomplete Information

Character and capacity may be determined using different means. However, complete credit information is the best acceptable, reasonable, and accurate method for determining a borrower's financial standing. Lack of supporting credit information is an important cause of credit risk. Therefore, adequate and comparable financial statements and other pertinent statistical data should be available in order to minimize the risk associated with loans.

2.4.3 Competition

Competition among banks for market and to influence community may result in the compromise of credit principles and the acquisition of unsound loans in which its ultimate cost exceeds its temporary gains in market growth.

2.4.4 Technical Incompetence

The ability to analyze financial statements and to obtain and evaluate other credit information thereby protecting in the placement and supervision of loans is processed by all qualified and experienced bankers. Hence, the management should seriously be concerned with the hiring of such employees. In general, controlling the above listed factors and several others, which are sources of failures in loans, entails financial losses, which impede growth of the Bank.

2.5 Risk Management

2.5.1 Definition of Risk Management

Risk Management has been defined by different authors based on their area of emphasis and their attitudes to wards their exposures. Accordingly we have tried to indicate different authors view in the following manner.

According to Trieschman and Gustavson (1998:14) risk management is a managerial process that involves the executive function of planning, organizing, leading and controlling those activities in a firm that deal with specified types of risks in order to maximize the value of an organization. The risk manager is charged with minimizing the adverse impact of losses on the achievement of the company's goal.

Risk management is the scientific approach to the problem faced by business that deals with the techniques of forecasting future so as to plan, organize, direct and control efforts to minimize the adverse effects of those potential losses. It is the reduction and prevention of the unfavorable effects of risks at a minimum.

According to Williams's et.al (1998:18), risk management is a general management function that seeks to identify, asses & address the causes and effects of uncertainty and risk in an organization in order to attain the goals and objectives of that organization in the most direct, efficient and effective path. It is a systematic way of protecting business resources and income against losses so that the organization's aims are reached with out interruption, creating stability and contributing to profit.

Risk management is a scientific approach to dealing with pure risks by anticipating possible accidental losses and designing &implementing procedures that minimize the occurrence of loss or the financial impact of losses that do occur. It is a systematic process for the identification and evaluation of pure loss exposures faced by an organization or individual and for the selection and implementation of the most appropriate techniques for treating such exposures. It focuses on a part of the total bundle of risks, those that are classified as "pure risks." As a general rule, the risk manager is concerned with the management of pure risks, not speculative risks and all pure risks are considered, including those that are uninsurable. Hence, risk management is the identification, measurement and treatment of property, liability and personnel pure risk exposures. . Feseha (1996:26)

2.5.2 Objectives of Risk Management

Risk management has several important objectives that can be classified as pre loss and post loss objectives. Pre loss risk management objectives are objectives prior to the occurrence of a loss such as reduction in anxiety, analysis of safety program expenses and meeting external obligations where as post loss objectives are important risk management objectives that can be meet after the occurrence of a loss such as survival of the firm, continuity of operation, stability of earning per share and continued growth by developing new products & market or by acquisition and mergers.

The first step in the risk management process is the determination of the objectives of the risk management program. In other words the risk manager and other related departments should participate in deciding the expectation of the organization and its risk management program if it is less effective than it could be. In the absence of coherent objectives, there is a tendency to view the risk management process as a serious of individual isolated problems, rather than as one single problem and there are no guidelines to provide for a logical consistency in dealing with the risks that the organization faces. Therefore, risk management objectives serve as a prime source of guidance for those charged with responsibility for the program and also serve as a means of evaluating performance.(http://www.bambooweb.com)

2.5.3 Risk Management Process

In order to have effective Risk management program, the risk manager must take certain general steps that can be systematically analyze and deal with risk. These are:

1. Identifying potential losses
2. Evaluating Potential Losses
3. Selecting the appropriate techniques for handling looses

4.Impliment and review decisions

5. Evaluating & controlling the result

(http://www.riskmanagementguide.com)

2.5.3.1 Risk identification

Risk identification is the process by which a business systematically and continuously identifies property, liability, and personnel exposures as soon as or before they emerge.

Unless the sources of possible losses are recognized, it is impossible to consciously choose appropriate and efficient methods for dealing with those losses should they occur. Risk identification is a very difficult process because the risk manager has to look into all operations of the company, so as to identify where exactly risks emanate from. It is a continuous job for the risk manager since risk environment is dynamic (Williams's et.al, 1998:15).

Approaches used by many risk managers involve, losses exposure checklists, financial statement analysis, flow charts, contract analysis, on site inspection, and statically analysis of past losses. Loss exposure checklist is a risk identification tool that can be used by business and individuals, which specifies numerous potential sources of loss from the destruction of assets and from legal liability. Financial statement analysis is another approach that can be used by business to identify risks. Using this method all items on a firm's balance sheet and income statement are analyzed with regard to that may be present. By including budgets, long range for casts, and written strategic plans in the analysis, this method can also be helpful in identifying possible future risks that may not currently exist. Flow charts are especially helpful to business in identifying sources of risk in their production process.

2.5.3.2 Risk Evaluation

After risks are identified, they should be evaluated regarding their expected frequency of occurrence, the probable severity of associated losses, the maximum probable and possible losses. In this case the risk manager obtains information that is helpful in determining the relative importance of identified risks and in selecting particular techniques for managing those risks. As part of the over all risk evaluation; it may be possible to measure the degree of risk in a meaningful way in some situation (Trieschman and Gustavson, 1998:105).

2.5.3.3 Select Appropriate Risk Management Tool

After identifying and evaluating various exposures to risk, alternative considerations can be given to alternative methods for managing each exposure. These tools include primarily avoiding the risk, reducing the chance that the loss will occur or reducing its magnitude, transferring the risk to some other party, retaining or bearing the risk internally. In selecting the proper tool the risk manager must establish the cost and other consequences of using each or combination of tools. He must also consider the current financial position of the firm, its overall policy with regard to risk management and its specific objective (Trieschman and Gustavson 1998:106).

2.5.3.4 Implement and Review Decisions

Based on the decision about the optimal methods for handling identified risks, the business or individuals must implement the best techniques selected. However, risk management should be an on going process in which previous decisions are reviewed regularly because some times new risk exposures may arise or significant changes in expected loss frequency or severity occur. Therefore the dynamic nature of many risks requires a continual scrutiny of past analysis and decisions (Feseha, 1996:21).

2.5.3.5 Evaluating & Controlling the Result

The result of the decisions made and implemented in the first four steps must be monitored to evaluate the wisdom of those decisions and to determine whether changing conditions suggest different solutions.

2.5.4 Risk Management Techniques

The selection of appropriate risk management technique is a dynamic problem. A best method for handling a particular exposure today may not be the best method for next year because so many relevant factors change regularly. The cost and availability of different risk management tools cannot be assumed to remain constant. Thus the risk management plan that seems to be both effective and efficient in one year may not make as much sense in the next. All of these factors make it clear that the risk management techniques should be an on going one rather than an exercise that is performed once and then forgotten. With in this framework there are four basic methods available for handling risk. These are: Risk avoidance, loss control, risk retention, and risk transfer (William's et.al, 998:17).

2.5.4.1. Risk Avoidance

Risk avoidance is a conscious decision not to expose one self or one's firm to a particular risk of loss. It can be said to decrease one's chance of loss to zero. Risk avoidance is common particularly among those with a strong aversion to risk. However, avoidance is not always feasible and may not be desirable even it is possible. There fore the risk manager must always weigh the relative costs and benefits associated with activities that give rise to risks. When risks are avoided the potential benefits as well as costs are given-up. If business is to operate at all certain risks are nearly impossible to avoid (Trieschman and Gustavson, 1998:106).

2.5.4.2 Loss Measurement/Control/

Loss measurement involves reducing the losses associated with particular risks. When a particular risk cannot be avoided, actions may often be taken to reduce the loss associated with it. Loss control is different from risk avoidance because a firm or an individual engages in operations that give rise to particular risks, rather than abandoning specific activities. It involves making conscious decisions regarding the manner in which these activities can be conducted to reduce either the probability of loss or to decrease the cost of loss that may occur. Before measuring and controlling any loss, the risk manager should be aware of the fact that the expected gains from an investment in loss control should be at least equal to the expected costs to justify the expenditure (William's et.al, 1998:18).

Loss control is important for the reduction of costs associated with: repair or replacement of damaged property, income loss due to destruction of property, extra costs to maintain operations following the losses, adverse liability judgment, medical costs to treat injuries, and income losses due to death or disabilities.

Other quantifiable benefits of loss control are a reduction in the cost of other risk management techniques used in conjunction with the loss control such as installations and maintenance expenses. Some forms of loss control concentrate on reducing the frequency of loss, where as others focus on reducing loss severity.

2.5.5 Risk Financing Techniques

After selecting appropriate risk management techniques that are going to be applied in order to minimize the occurrence of various risks, the risk manager should look for the risk financing techniques because by no means we can not avoid all risks rather we can minimize them to the minimum level. Accordingly, there are four best techniques of financing risk. As stated by Trieschman and Gustavson (1998:106), the risk financing technique includes: risk retention, self-insurance, risk transfer and insurance. Which are explained here after.

2.5.5.1 Risk Retention

It is a technique of risk financing, which involves assumption of risk. That is if a loss occurs, an individual or a firm will pay for it out of whatever funds that are available at the time. Retention can be planned or unplanned and the losses that occur can either be funded or unfunded in advance. Planned retention involves conscious and deliberate assumptions of recognizing risk. Sometimes it occurs because it is the most convenient risk treatment technique. Unplanned retention some times occurs even when the existence of risk is acknowledged. Thus, even though the exposure is recognized, the firm is engages in unplanned retention of losses that exceed its estimate of the maximum possible losses.

Many risk retention strategies involve the intention to pay for losses as they occur with out making any funding arrangements in advance of a loss. If a loss happens, it is paid for from the firm's current revenue. Such type of retention is unfunded retention. In contrast funded retention is made by making various pre-loss arrangements to ensure that money is readily available to pay for losses that occur. In many situations the risk manager should consider several techniques as financial resources, ability to predict losses and feasibility of establishing retention programs in order to make decisions regarding retention.

2.5.5.2 Risk Transfer/Insurance/

Risk transfer or insurance is another risk financing technique which involves payment by the transferor to the transferee (risk bearer). The transferee agrees to assume a risk that the transferor wants to escape. It reduces risk by combining under one management a group of objects situated so that the aggregate losses on the insured became predictable with in narrow limit. Some times the degree of risk is reduced through the transfer process because the transferee may be in a better position to use the law of large numbers to predict losses. In other cases the degree of risk remains the same and is merely shifted from the transferor to the transferee for the price.

2.5.5.3 Self Insurance

If the firm has a group of exposure units large enough to reduce risk and there by predicting losses, the establishment of a fund to pay for those losses as a special form of planned-funded retention known as self insurance. In this case there are two necessary elements of self-insurance. The first one is the existence of a group of exposure units that is sufficiently large to enable accurate loss prediction and the second one is pre-funding of expected losses through a fund specially designed for that purpose.

2.5.6 Importance of Risk Management to the Banking Business

Risk exists whenever the future is unknown because the adverse effect of risk plagued mankind since the beginning of time. As a result accidental losses each day had threaten the survival of some businesses, causing their earnings to drop below acceptable levels, intercept their operations, or, slow their growth. All businesses face the threat of losses that may never occur. Worrying about these possibilities does more than make life less pleasant; it may stop a business from engaging in certain activities or other wise alter how it conducts its operations. Proper risk management enables a business to handle its exposures to accidental losses in the most economic and effective way (William's et.al, 1985:20).

Organizations of all sorts have recognized the increasing importance of sound risk management. As life has become more complicated, more interrelated and more uncertain new loss exposures have been created and the severity of many old exposures increased. In some firms top management has assigned primary responsibility for the risk management to a specialized department.

According to William's et.al (1985:7), the purpose of risk management is to minimize the risk of loss at a minimum cost and its contribution to the business can also be categorized as follows:

- Risk management may take the difference between survival and failure that means it can contribute directly to business profits for business organizations and increase efficiency for nonprofit making organizations because profits can be improved by reducing exposures as well as increasing income.

- If a business has successfully managed its pure risks, the peace of mind and confidence permits its managers to investigate and assume attractive speculative risks that they might otherwise seek to avoid.

- By altering general managers to the pure risk aspects of speculative ventures, risk management improves the quality of the decision regarding such ventures.

- Once decision aids are made to assume speculative ventures, proper handling of the pure risk aspects permits the business to handle the speculative risks more wisely and efficiently.

- Risk management can reduce the fluctuations in annual profits and cash flows that investors regard more favorably a stable earnings record.

- Through advance preparation, risk management can in many cases make it possible to continue operations following a loss.

Thus, retaining customers or suppliers who might otherwise turn to other competitors will be more feasible.

- Risk management encourages customers, creditors, suppliers, and employees of the firm to work with the organization that has a sound protection against pure risk.
- The peace of mind that is made possible by sound management of pure risks may itself be valuable for non-economic assets because it improves the physical and mental health of the management and the owners. Because the risk management plan may also help others such as employees, who would be affected by loss of the firm. It also helps to satisfy the firm's sense of social responsibility and creates good public image.

Generally, this chapter has dealt about the concept of risk management, which focuses on different authors view regarding definitions of risk, the types/natures/ of risk, different causes of risk and their management techniques, processes and procedures.

CHAPTER THREE

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

In this chapter, the student researcher used both primary & secondary data sources. The primary data was collected through questionnaire and interview. The secondary data collected from different literatures, manuals and reports of the bank.

The questionnaire was distributed to 24 people who are assumed to have a direct work relationship with our topic of concern i.e. credit risk management system of Dashen Bank. Out of these, 22 respondents, who have completed and returned. The questionnaire distributed to Department Managers, Deputy Managers, Section Heads and Loan Officers. The data acquired from respondents is narrated here below.

3.1. Respondents Background Information

No	Items	Options	No	%
1	*Sex*	Male	16	73
		Female	6	27
		Total	**22**	**100**
2	*Educational Background*	Certificate	0	0
		Diploma	2	9
		First Degree	18	82
		Above First Degree	2	9
		Total	**22**	**100**
3	*Position*	Department mangers	2	9
		Deputy Managers	2	9
		Section Heads	2	9
		Loan officers	14	64
		Others	2	9
		Total	**22**	**100**
4	*Service Year*	Below 5 Year	12	55
		5-10 Years	8	36
		Above 10 Years	2	9
		Total	**22**	**100**
5	*Category of work*	High level management	6	27
		Medium level management	14	64
		Other professions	2	9
		Total	**22**	**100**

From Item 1 of table 3.1, the student researcher can see that 16(73%) and 6(27%) of respondents are Male and Female respectively. As shown from this male respondent is more than female respondent.

Item 2 of table 3.1, the respondents have an educational qualification of 2(9%) Diploma, 18(82%) first Degree and 2(9%) are above first Degree. As we see the percentage of degree holders is more than those of diploma and above first degree holders. This shows that most of the respondents are professional and above all answers given by the respondents are expected to be logical and indicates the real ways to solve the existing problem.

Item 3 of table 3.1 describes the position of respondents that constitutes 2(9%) of Department Managers, 2(9%) Deputy Managers, 2(9%) that constitutes Section Heads and 14(64%) of Loan Officers.
As the numerical value shows that the percentage of loan officers is more than the other respondents. Especially loan officers are expected to have more information which helps them to answer the research questions in the right manner.

As can be seen from Item 4 of table 3.1, 5-10 years 8(36%) and 2(9%) above 10 years and 12(55%) below 5 year, this shows that the company is filled with either by new comers to this bank or by youngsters.

Item 5 of table 3.1 shows the category of work 6(27%) high level management, 14(64%) medium level management and 2(9%) are other professions. It is mainly higher level managements are involved in the credit risk management process. Majority of respondents loan Officers(middle line management) which mostly authorizers of the request for credit approval and other main decisions.

Credit Risk Management Analysis

In the following sub section, the student researchers have summarized the response of the various respondents on the credit risk management system of the bank.

3.2. Data Related to Risk Management Process

No.	Items	Options	No.	%
1	*Do you participate in any of the risk management process?*	Yes	10	45
		No	12	55
		Total	**22**	**100**
2	*If your answer in the above question is "Yes" what type of risk management activities is delegated to you?*	Credit risk Management	4	40
		Credit & Liquidity risk Management	2	20
		Credit , Interest rate & foreign exchange risk management	2	20
		Credit & Others	2	20
		Total	**10**	**100**
3	*Are you satisfied with the quality of risk management system adopted in Dashen bank?*	Yes	13	59
		No	9	41
		Total	**22**	**100**
4	*How much Do you think you know about the credit risk management system adopted by Dashen Bank?*	Not Much	2	9
		Some how	11	50
		Very much	9	41
		Not at all	**-**	**-**
		Total	**22**	**100**
5	*Are the existing risk management policies, procedures of the Bank well communicated to you?*	Yes	6	27
		Some how	14	64
		No	2	9
		Total	**22**	**100**

As it can be seen from Item 1 of table 3.2, 10(45%) of respondent participate risk in management process and 12(55%) not participate. It shown that most of respondents middle line management not participate decision process. From this one can conclude by saying all higher level management of the bank involves in risk management decision.

As shown in item 2 of table 3.2, 4(40**%**) are participating in credit risk management, 2(20%) are participating in credit and liquidity risk management, 2(20**%**) are participating in credit, interest rate and foreign exchange risk management and 2(20**%**) are participating in credit risk and other activities respectively.

As it is observed from item 3 of table 3.2, 13(59%) of the respondents have replied that they are fully satisfied with the quality of the existing risk management system currently adopted in the Bank. But 9(41%) of them are dissatisfied with the matter because they said that there is “No” delegated office who evaluates and monitor the risk management process in the Bank. The respondents also commented that in Dashen Bank there is a belief that every manager is a risk manager but there has to be a supervisory body that is responsible to evaluate the overall risk management system of the bank and fill the gap.

As can be seen from Item 4 of table 3.2 the majority of the respondents accounting for 11(50%) know about the credit risk management at a medium level. 2(9%) of them have responded that they don’t know much about the system. Only 9(41%) of the respondents have a good understanding about credit risk management system adopted in Dashen Bank. This shows that more than 50% of the participants have lack of awareness about the bank’s credit risk management system currently adopted in the bank. This condition is being questionable of the bank activity; the situation shows that there is no follow-up on the sector.

As can be seen from Item 5 of table 3.2 the majority of the respondents accounting for 14(64%) believed that the existing risk management policies and procedures of the Bank are communicated to them only to some extent. 6(27%) of the participants have said that “yes” it is well communicated. But 2(9%)of the respondents have suggested that it is not communicated at all. majority of the respondents don’t have clear understanding about the existing risk management policies and procedures of the Bank.

3.3. Basis for Assignment of Lone Officers

Items	Options	No.	%
How loan officers are assigned in their positions?	Based on qualification	4	18
	Based on experience	2	9
	Based on experience and qualification	13	59
	Based on blood r/ship with owners	3	14
	Total	**22**	**100**

Table 3.3 concerning the assignment of loan officers in their respective position about 13(59%) of the respondents assume that the bank uses both qualification and experience as a requirement to hire loan officers. And about 4(18%) of the respondents assume that loan officers are hired based on their qualification only, 2(9%) of them said that experience as a key factor to provide position for loan officers. but 3(14%) of the respondents said that in some instances some loan officers are assigned to their position based on blood relationship with the managers. Majority respondents have given their comment based on their experience and qualification. But some respondents have given their comments based on their relationship with the managers. This relationship might be influenced on the bank credit risk management.

3.4. Assessment and Follow-up of Credit Customers

No.	**Items**	**Options**	**No**	**%**
1	*Does the Bank assesses borrowers past financial history, credit worthiness and perform detail financial analysis before extending loans*	Yes definitely	16	72
		Yes, but not enough	4	18
		Not at all	-	-
		I am not quite aware of it	2	9
		Total	**22**	**100**
2	*Is there any follow-up mechanism of your customers after granting a loan?*	Yes	20	91
		No	2	9
		No response	-	-
		Total	**22**	**100**
3	*In the above question if your answer is "Yes" how often?*	Quarterly	4	20
		Semi Annually	2	10
		Annually	-	-
		Monthly	14	70
		Total	**20**	**100**
4	*When the borrower faces certain problem and unable to pay the loan what mechanism do you apply in order to collect the loan?*	Rearrangement of loan repayment structure and Extension of the life of the loan	19	86
		Rearrangement of loan repayment structure	2	9
		Changing the loan type and waiving of the loan	1	5
		Total	**22**	**100**

Table 3.4 Item 1 with regard to the performance evaluation of borrowers 16(72%) of the respondents has agreed that the bank assesses borrowers past financial history, credit worthiness, and perform a detail and strict financial analysis before lending the loan. This shows that the managers and loan officers have almost close understanding about the banks assessment of the borrowers past financial history, credit worthiness and detail financial analysis before extending loans and 4(18%) of them said that the bank assesses the financial status of customers moderately, but

they think it is not enough, while 2(9%) of the respondents have no any idea about the matter. This shows that the managers have no a diversified understanding about the policies and procedures of risk management system adopted in Dashen Bank.

Item 2 of table 3.4 also shows that, the majority of the respondents accounting for 20(91%) have agreed that there is a strong follow-up mechanism of customers after granting the loan, 2(9%) of them are indifferent as to the existence of any follow up mechanism. This show that the bank have a strong follow-up mechanism.

Item 3 of table 3.4 regarding the frequency of follow-up diversified opinions are observed, i.e. 4(20%) the participants who said “Yes” said that follow-up is made quarterly, 2(10%) of them said that the follow-up is made semiannually. None of the respondents said that follow-up is made annually. Above half of our respondents i.e. 14(70%) have said that follow- up is made monthly which make the collectivity of the loan reliable.

Item 4 of table 3.4 regarding the loan repayment techniques different opinions are also observed, 19(86%) of the respondents have believed that when borrowers face certain problem and unable to pay the loan, the life time of the loan will be extended so that the customer will get some additional time for revival and repayment and rearrangement of loan repayment structure. About 2(9%) have replied that rearrangement of loan repayment structure will also be given, therefore, the customer will make money and becomes in a better position or condition to repay the loan. 1(5%) said that changing the loan type and waiving of the loan are solutions when the borrower is unable to repay the loan. From the above analysis we can deduct that there is no specific technique or mechanism to be applied but depending on the condition or situation of the environment each method /technique/ can be interchangeably applied.

3.5. Sector Identification for Granting Loan

Items	Options	No	%
From the total loans & advance granted to its customers in which sector does the bank usually emphasized?	Agricultural Sector	3	14
	Manufacturing	-	
	Domestic trade& services	12	54
	Export & Import	7	32
	Building & construction	-	
	Transport	-	
	Total	**22**	**100**

Table 3.5 according to the sector 12(54%) of the respondents has emphasized that, domestic trade service sectors have been interchangeably leading the others. From the above observation we can conclude that the bank emphasized on Domestic Trade and Service due to business viability and high demand on the sector. Most of the customers who are come to the bank are Domestic Trade & Services customers, which are compared to other sector short term loan. 3(14%) of respondents replied that for Agriculture Sector and 7(32%) Import Export Sectors. For instance, currently export business has minimum risk because the National Bank of Ethiopia will give a guaranty for it. Additionally, the foreign currency earnings from such business is encouraging to the Bank as well as the country, on the other hand the manufacturing sector substitute import goods that contributes to the foreign currency earnings and overall socio–economic benefits of the country. In general, most of the respondents agreed that the current and future situation of the market, its profitability, risk bearing capacity of the sector to be selected and many other factors may determine the area of emphasis to be selected.

3.6 Causes of Credit Risk

As per the interview conducted with the Risk Management Division head of Dashen Bank, "a Bank is successful when risk it takes are reasonable, controlled within its financial resources and credit competence". Experience has proved that the fundamental issue for preservation of the quality of loans is existence of well-developed policies and procedures. Therefore, the basic causes for the occurrence of credit risk are:

Causes at borrower level

- Diversion of borrowed fund to other purpose
- Insufficient credit awareness
- Unwilling customers to disclose the information required
- Contingencies at borrower level e.g. death, sickness
- Lack of proper business plan
- Willful default/ Unwillingness to payback- is the only factor which is considered as having insignificant as well as difficult to judge as causes of NPL.

Causes at Bank Level

The various causes for NPL at bank level are the following

- Lack of consultation and communication with defaulter
- Lack of continuous follow up and proper risk management
- Lack of credit information from other commercial banks
- Mistake on estimation of collateral and evaluating the borrower's financial report
- Problem associated with loan eligibility criteria's
- Lack of adequate supervision on borrowers
- Dependence on oral information furnished by borrowers(for regular customers) in lieu of reliable financial data and direct verification

- Absence of established system of credit follow-up
- Technical in competence – The ability to analyze financial statements and to obtain and evaluate other credit information.
- Over lending - lending beyond the prudent level of financial requirement a reasonable capacity of the borrowers to repay the lean. This is the basic problem of Dashen Bank and in one sense it is related with technical incompetence.

Causes of NPL at Economic Level

- Unstable political situation
- Excessive government intervention
- Political power of the borrower
- Weak economic plan and strategy implementation
- Impact of change in fiscal and monetary policies

3.7 Mechanisms which are applied to manage credit risk

- Proper analysis of the borrowers request and documents- have higher (better) efficiency
- Properly collect required information from other Banks
- Give efficient awareness for the borrowers
- Efficient and proper follow up and risk assessment
- Provide relevant trainings for loan officers and related staffs
- Well attention & treatment of sick loan- which they consider it as a less efficient.

3.8 System of monitoring and control

For the credit risk management function to be effective the systematic handling of the risk factor has to be supported by the following monitoring and controlling mechanisms. Some of these are:

- Performance review
- Credit follow-up

a) Performance review: at this stage the Bank evaluates the performance of individual & group loans, through examining the collection rate. It can also be evaluated in different ways to asses, determine, monitor and control the risk factor. This evaluation process facilitates the risk management and also serves as measure of the standard of the loan portfolio management in order to monitor acceptable and predictable level of credit losses. It also indicates the way to develop diversification with the portfolio to obtain the balance between maximum return and minimum risk to enhance sound loan portfolio management.

b) Credit follow-up: Used to facilitate effective management of problem loans, to enhance debt recovery, and to monitor the risk associated with loaning, Dashen Bank has developed and put in place a credit follow-up system, which advocates the two-way approach. The basic objectives of credit follow-up are:

☞ Minimization of the magnitude of problem loans.

☞ Minimization of loss loans so as to ascertain constant income growth, strong balance sheet, enhanced public acceptance and lasting success of the bank.

3.9 Policy and procedure of credit risk management

Dashen Bank sets credit risk policies and procedures to keep on course towards its goals. These policies and procedures serves as the guardrails and signs on the road. It avoids rationalizing exceptions as acceptable behavior without validating the consequences. The policies and procedures followed in lending can broadly be classified in to five. These are:

- Initiation
- Evaluation
- Approval

- Disbursement and
- Follow-up

These police and procedure helps the bank stay on course by identifying and mitigating risks

Credit policies and procedure of Dashen Bank will be in a continuous process of evaluation and review to meet changing situations and the challenges ahead. To this end, the policy and procedures will be updated as and when deemed necessary but not later than five years. Any change during the fiscal year will be updated/amended each year just after closing.

According to secondary sources, the position of NPL in Dashen Bank can be analyzed from the following table.

Table 3.10: Ratio of NPL to outstanding Loans as of June 30, 2013

*Amounts are presented in (000) birr

Year	Total O/S Amount	Total NPL Amount	Proportion of O/S NPL in %
2010	5,033,073	150,890	3.00
2011	6,141,666	204,393	3.33
2012	8,041,997	193,379	2.4
2013	8,836,627	482,194	5.46

It could be noted in Table 3.10 that the ratio of the total balance of Non-performing loans to outstanding loans has shown an improvement from year to year (especially during the fiscal year 2012-2013.

Table 3.11: Growth Rates of Outstanding Loan Balances

*Amounts are presented in ‘000 birr as at June 30 2013

Year	Total O/S loan Amount	Growth rate
2009	4,447,024	
2010	5,033,073	13%
2011	6,141,666	22%
2012	8,041,997	31%
2013	8,836,627	9%

As could be seen from the table 3.11, the four-year average annual growth rate of outstanding loan of the Bank in the year 2012 exhibited relatively higher percentage by 31%. In contrast the difficulties faced in the year 2012, the bank was capable to decrease its outstanding loans for the following years 2013 by 9%.From this it observed that the bank has shown a fluctuating pattern of growth in its total outstanding loans and advances balance.

Table 3.12 show that amount of NPL as of June 2013, has exhibited an excessive increase by 49%, which is the largest increase as compared to other years. This very high increase of NPL reported especially in the year 2013, because most of outstanding loan of this year on agricultural sector and globally it was the year when coffee price significantly decline in the world market.

Table-3.12 Growth Rates of total NPL IN '000 birr

Year	Total NPL Amount	Growth rate %
2009	328,472	
2010	150,890	-54
2011	204,393	35
2012	193,379	-5
2013	482,194	49

Despite the challenging encounters in the year 2013, the Bank was able to decrease its NPL to -54% on June 2010, which was an encouraging achievement. However, the downward trend was reversed during the subsequent years of 2011 & 2012 where the growth rate of NPL goes up to 35% and down -5% respectively. This has an adverse effect on the overall performance of the bank.

Table 3.13: The Number of Borrowers with outstanding Loans & Advance

Amounts are presented in '000 birr as at June 30

Year	Total outstanding loan Amount	Numbers of Borrowers
2010	5,033,073	2,754
2011	6,141,666	3,495
2012	8,041,997	4,193
2013	8,836,627	4,895

Based on the finding for four consecutive years, the number of borrower's increases in each year, similarly the total outstanding loan and advance also enhanced.

CHAPTER FOUR

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The study will focus on credit risk management the mechanisms put in place to manage these risk by the bank. In order to investigate problems encountered related to credit risk management interact the following question.

- ✓ What are the causes of credit risk? The policy and procedures of risk management followed? What type of mechanism followed to minimize risk? And what are the systems of monitoring and controlling credit risk in Dashen Bank?

The data, which was obtained by preparing structured interview questions and for the majority of employees both close and open ended questionnaire was used which helps the study to be furnished with first hand information. The questionnaire was distributed to 24 people who are assumed to have a direct work relationship with our topic of concern i.e. credit risk management system of Dashen Bank. Out of these, 22 respondents, who have completed and returned the questionnaire. In addition to this, policy manuals, procedures, annual reports, and publications were used as means of collecting second hand information.

4.1 Summary

Based data presentation, analysis and interpretation made in chapter three, the following are summary of the major findings.

- ✓ According to interview case of credit risks are
  - Mistake on estimation of collateral and evaluating the borrower's financial report

- Lack of consultation and communication with defaulter
- Lack of continuous follow up and proper risk management
- Lack of adequate supervision on borrowers
- Absence of established system of credit follow-up
- Technical in competence

✓ 10(45%) of respondent participated risk management process and while 12(55%) of them did not participated in risk management process.

✓ The majority of the respondents accounting for 59% have not clear understanding about the existing credit risk management system adopted by the Bank.

✓ concerning the assignment of loan officers in their respective position about 13(59%) of the respondents both qualification and experience as a requirement.

✓ 20(91%) of the respondents agree that the bank has follow up mechanism after granting the loan. While 2(9%) of the respondents indicated that there is no follow up mechanism after granting the loan.

✓ 16(72%) of the respondents has agreed that the bank assesses borrowers past financial history, credit worthiness, and perform a detail and strict financial analysis before lending the loan.

✓ About 55% of the respondents have less than 5 year of services.

✓ the majority of the respondents accounting for 14(64%) believed that the existing risk management policies and procedures of the Bank are communicated to them only to some extent. 6(27%) of the participants have said that “yes” it is well communicated.

- ✓ 12(54%) of the respondents said that the bank usually emphasized on Domestic Trade and Services (DTS) loan, 7(32%) on import & export & 3(14%) on agricultural sector.

4.2 Conclusions

Based on summary of the findings the following conclusions are drawn. From the findings of the study, the researcher makes the following conclusion.

- ✓ The major case of credit risks are Mistake on estimation of collateral and evaluating the borrower's financial report, Lack of continuous follow up and proper risk management and Lack of consultation and communication with defaulter.
- ✓ Majority of staffs in the department are not participating in risk management decision.
- ✓ more than 50% of the participants have lack of awareness about the bank's credit risk management system currently adopted in the bank.
- ✓ The bank uses both qualification and experience as a requirement to hire loan officers.
- ✓ There are strong follow-up mechanisms with the customers after granting the loan.
- ✓ It will assess the borrowers past financial history and credit worthiness. Detail financial analysis of past financial history of the borrowers and forecasting of the future prospective development will enable the bank to identify the capacity of the borrowers and to process loan in the safest condition this is one of the bank's strong points.

- ✓ The majority of employees are youngsters. With in this age group employees have willingness and more preferable to facilitate working environment.
- ✓ The majority of the employees not aware about the policies, procedures and strategies of risk management system.
- ✓ The Domestic Trade and Service take the largest share of outstanding loans during the period under the study.

4.3 Recommendations

Based on summary of the findings and conclusions, the following recommendations are forwarded.

1. The top level management of the bank should give attention for middle line management bodies to participate in risk management decision.
2. The top level management of the bank should assign responsible officer, who evaluates the overall risk management system and monitors the risk management process in the Bank. Moreover, the risk management system should be reviewed and updated frequently in consideration of marketing situation.
3. The Management body of the bank should give attention for long term credit to attract agriculture sector.
4. The Management body of the bank should create awareness about the Risk management manuals, policies and procedures, among employees so that every employee will have a clear understanding about the risk management process of the bank so that they can protect the company accordingly and recommend alternative ways.

5. The practical evidence indicates that the staffing system of the bank is based qualification and job experience, therefore the Bank should assign qualified, professional and experienced individuals to their proper position.
6. The Management body of the bank should design adequate professional training scheme through providing off and on the job training, so that the risk management cost will be minimized.
7. Finally, the researcher stress that it is a high time for the Bank to adopt a contemporary, proactive and decentralized risk management system if it tends to survive the thunder of local competition, the flood of globalization and the tremble of our dynamic market & economic condition.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

According to Trieschman and Gustavson (1998:5), Risk can be defined as uncertainty concerning losses. The risk surrounding a potential loss creates significant economic burdens for businesses, governments, and individuals. Billions of dollars are spent each year on strategies for financing potential losses. But when losses are not planned for in advance, they may cost even more. Businesses as well as individuals may try either to avoid risk as much as possible or to reduce its negative consequences, overall, an entity's cost of risk is the sum of outlays to reduce risk, the opportunity cost of activities forgone due to risk considerations, expenses of strategies to finance potential losses and the cost of un reimbursed losses.

As stated by Samson (2001:24), risk exists whenever the future is unknown because the adverse effect of risk has plagued mankind since the beginning of time. Individuals, groups and societies have developed various methods for managing risks. Since no one knows the future exactly, everyone is a risk manager not by choice but by sheer necessity. Although financial & non financial risks inherent in the banking business and the systematic approach of handling them was in existence ever since the emergence of the business, the magnitude of the risk faced by new banks entering the market made the importance of risk management all the more exigent.

Risk management is a managerial process that involves the executive function of planning, organizing, leading and controlling those activities in a firm that deal with specified types of risks in order to maximize the value of an organization. The risk manager is charged with minimizing the adverse impact of losses on the achievement of the company's goal. Risk management is the scientific approach to the problem faced by business that deals with the techniques of forecasting future so as to plan, organize, direct and control efforts to minimize the adverse effects of those potential losses. It is the reduction and prevention of the unfavorable effects of risks at a minimum (Trieschman and Gustavson, 1998:14).

Dashen Bank is a privately owned company established in 1995 as a share company in accordance with the commercial code of Ethiopia 1960 and the licensing and supervision of Banking Business proclamation No 84/1994 of Ethiopia to undertake commercial banking activities. The Bank obtained its license from the National Bank of Ethiopia on 20 September 1995 and started normal business activities on the first of January 1996. Dashen came in to existence with an authorized and subscribed capital of Birr 50 million. The first foundation members were 11-business man and professionals that agreed to combine their financial resources and expertise.(Annual reports of Dashen Bank ,2013:23)

When the bank started its operation in January 1996, it has only 10 Area Banks, which has been start their operations at the same time. Now it has reached 117 area banks and 4 forex bureaus. The area bank and networking is designed to facilitate the business interactions of their clients. With regard to Area Bank expansion, the Bank has a continuous plan to enhance the number of Area Banks time to time. With regard to human resource development, the bank has started its operations with 230 employees (clerical and non-clerical). Currently, the number of staffs enhanced to 3690 by the end of June 2013 (Dashen Bank, 2013:15).

1.2 Statement of the Problem

Every organization, whether profit making or otherwise, has got its own mission which it endeavors to achieve during its existence. Profit making enterprises are expected to enhance the returns on the capital provided by their shareholders by way of maximizing their profits through increased efficiency that certainly give them a larger share of the market in which they operate. Likewise, non-profit organizations do have missions like providing community services and improving standards of living of the society not primarily focusing on the generation of profit.

During their course of operation, organizations will definitely be exposed to various uncertainties of different magnitude. These uncertainties are commonly known as risks, which can have enormous effects that range from inhibiting the day-to-day activities of the business to endangering the very survival of the organization. The magnitude and far reaching consequences of these exposures force business organizations to put in subsequent minimization of the impact of such risks on their overall performance. Accordingly, different organizations employ different risk management techniques, which they determine best suits them to achieve their business objectives. When we come to Dashen Bank, by interview the concerned officers the following problems are currently persisting which requires close attention of the credit risk management. Some of these are:

- Lack of adequate supervision on borrowers.
- Dependence on oral information furnished by borrowers (for regular customers) in lieu of reliable financial data and direct verification.

- Over-lending beyond the reasonable capacity of the borrower to pay.
- Lack of up-to-date risk management system due to lack of periodic review and comparison against international and industry standards.

1.3 Research Questions

In order to investigate problems encountered related to credit risk management interact the following question.

1. What are the causes of credit risk in Dashen Bank?
2. What are the policy and procedures of risk management followed in Dashen Bank?
3. What type of mechanism followed in Dashen Bank to minimize risk?
4. What are the systems of monitoring and controlling credit risk in Dashen Bank?

1.4 Objective of the Study

1.4.1. General Objective

The general objective of the study To evaluate the credit risk management performance in Dashen Bank.

1.4.2. Specific Objectives

This study will have the following specific objectives. It helps to:

- identify the major cases for credit risk
- review the policies, procedures & techniques followed by Dashen Bank in relation to risk management.
- identify the mechanisms followed by Dashen Bank to manage credit risk.

- identify the systems of monitoring and controlling credit risk methods in Dashen Bank.

1.5 Significance of the Study

The study will benefit parties such as;

- for student researcher to show their theoretical knowledge of research undertaking practically.
- For researchers, it may serves as a ground for further studies in the area.
- for partial fulfillment of the academic requirements of B.A degree

1.6 Scope of the Study

Obviously the scope of the topic is quite wide. Therefore, the scope of the study is only limited to the financial aspect of risk and credit risk management techniques, policies and procedures which are currently practiced in Dashen Bank at Head Office. The study covers the period from 2012 to 2013.

1.7 Research Design and Methodology

1.7.1 Research Design

In this study, the student researcher decided to use descriptive research design. Descriptive research involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data collection (Glass & Hopkins, 1984:17). It often uses visual aids such as graphs and charts to aid the reader in understanding the data distribution. Because the human mind cannot extract the full import of a large mass of raw data, descriptive statistics are very important in reducing the data to manageable form.

1.7.2 Population and Sampling Technique

The populations of this study are the whole employees who are working in the head office of Dashen Bank under risk management department which limited to 24 in number. Census technique be employed, because the number of employees in the department limited and manageable to collect the necessary data.

1.7.3 Data Sources

Both primary & secondary sources of data were be used. Primary data sources collected directly from employees of the bank who are working in risk management area. Whereas assessing documents of the bank & review literatures were be used as secondary sources.

1.7.4. Data Collection Instrument

Personal interview were be conducted with the selected division heads of the bank by preparing structured interview questions and for the majority of employees both close and open ended questionnaire used which helps the study to be furnished with first hand information. in addition to this, Policy manuals, procedures, annual reports, and publications will be used as means of collecting second hand information.

1.7.5. Data Analysis Method

Data collected from respondents in the questionnaires and interviews were be carefully analyzed in such a way that useful conclusions to be cultivated. In light of this, the collected data organized through counting, tallying and tabulating. Totals then be converted into proportions of percentage so that the raw data is transformed into meaningful information, which can be used to arrive at a rational conclusion.

1.8 Limitations Of Study

In the process of conducting this research study, various problems and constraints have been encountered. Firstly, the study doesn't have any financial sponsor. Secondly, the study is prepared during a limited time period. Thirdly there is a shortage of reference materials in the area of the study, which may give guidance about the theoretical aspects. Finally, some of the officials of the bank are not willing to provide certain relevant information by assuming that the information requested is very confidential.

1.9. Organization of the Study

This study is organized in to four chapters. The first chapter deals with Introduction which includes background of the study, statement of the problem, research questions, objective of the study, significance of the study, scope of the study and research design and methodology. The second chapter focuses on the review of related literature followed by the third chapter data presentation, analysis and interpretation. The forth chapter presents the summary, conclusions and recommendations part of the study.

CHAPTER TWO
REVIEW OF RELATED LITERATURE

2.1 Definition of Risk

There is no single definition of Risk. Economists, behavioral scientists, risk theorists, statisticians, and actuaries each have their own concept of risk. Therefore the researcher will try to give different authors view and definitions for the word risk.

According to Williams's et.al (1998:15), risk is a potential variation in outcomes and the exposure to a potential loss. It can also be defined as uncertainty about economic losses due to the occurrence of an event. Economic losses are caused by perils such as crimes, fire and accidents. It is the possibility of an adverse deviation from a desired outcome that is expected.

According to Trieschman and Gustavson (1998:5), risk can be defined as uncertainty concerning losses. The risk surrounding a potential loss creates significant economic burdens for businesses, governments, and individuals. Billions of dollars are spent each year on strategies for financing potential losses. But when losses are not planned for in advance, they may cost even more. Businesses as well as individuals may try either to avoid risk as much as possible or to reduce its negative consequences. Overall, an entity's cost of risk is the sum of outlays to reduce risk, the opportunity cost of activities forgone due to risk considerations, expenses of strategies to finance potential losses and the cost of un reimbursed losses.

2.2 Classifications of Risk

Risks may be classified in many ways; however, there are certain distinctions that are particularly important to our purpose. As stated by Trieschman and Gustavson (1998:51), the major categories of risk are: pure and speculative risks, fundamental and particular risks, **s**tatic and dynamic risks, objective and subjective risks. These classifications will be explained here after.

2.2.1 Pure and Speculative Risk

Pure risk-is a type of risk that exists when there is a chance of loss but no chance of gain. For instance the owner of a car faces a risk of collusion loss, if collusion occurs; he will suffer a financial loss. If there is no collusion he will not be benefited. But Speculative risk- is a type of risk that exists when there is a chance of gain as well as a chance of loss. Pure risks are always distasteful but speculative risks posses some alternative features. It exists when there is uncertainty about an event that could produce either a profit or loss. In a situation involving speculative risk the society may be benefited even though the individual is hurted.

2.2.2 Fundamental and Particular Risks

A fundamental risk is a risk that affects the entire economy, or large number of persons or groups within the economy. It involves on losses that are impersonal in origin and consequence and they are group risks mostly caused by economic, social, and political phenomena. On the other hand Particular risk is a risk that affects only individuals and not the entire community. It involves loss that arises out of individual events and is felt by a single individual rather than by the entire group.

2.2.3 Static and Dynamic Risks:

Static risks are those risks, which would occur even if there were no changes in the economy. These risks include losses caused by the regulation of the forces of nature or human errors. On the other hand, dynamic risks are those risks resulting from changes in the economy. Changes in the price level, consumer tastes, income and out puts, and technology may cause financial losses to member of the economy. These are risks related with changes in human wants. Although these dynamic risks may affect a large number of individuals, they are generally considered less predictable than static risks, since they do not occur with any precise degree of regularity.

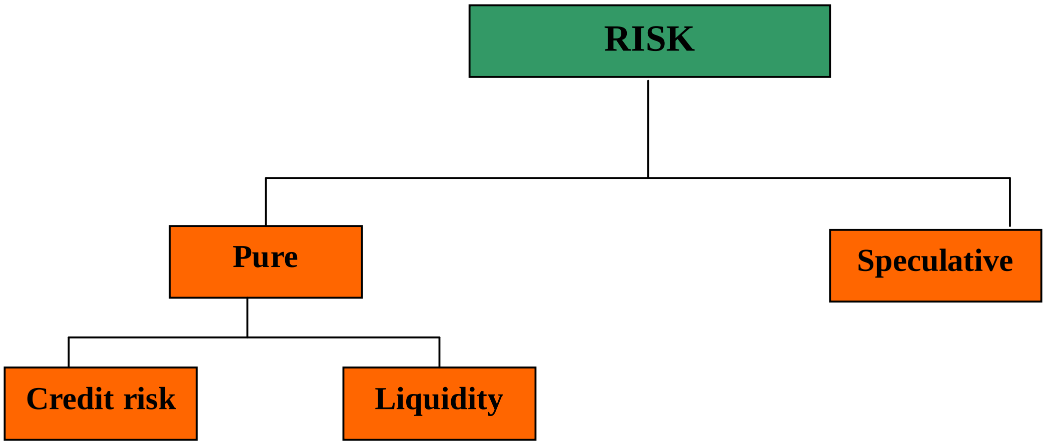
2.2.4 Objective and Subjective Risk

Subjective risk refers to the mental state of an individual who experiences, uncertainty doubt or worry as to the outcome of a given event. It is essentially the psychological uncertainty that arises from an individual's state of mind. on the other hand Objective risks are defined as the relative variation of actual from expected losses. It is mainly applicable to group of objects exposed to losses.

Objective risk can be statistically measured by some measure of dispersion, such as the standard deviation or coefficient of variation. It is an extremely useful concept for an insurer or a corporate risk manager.

In relation to classification of risk Trieschman and Gustavson (1998:7), he classified risk into two which is shown in the following figure.

Fig 2.1 different types of Risks



Source Trieschman and Gustavson (1998:7)

2.3 Types of Financial Risk

Financial risks are subject to complex interdependencies that may significantly increase a bank's overall risk profile. Based on the above figure financial risks, which this study specifically deals with, in turn comprise two types of risks. They are pure risk and speculative risk. Pure risk including liquidity, credit and solvency risks (can result in loss for a bank if they are not properly managed). The main categories of speculative risk are interest rate, currency and market price risk. Trieschman and Gustavson (2003:4)

2.3.1 Liquidity Risk

Liquidity risk is a condition of an individual or business wherein a high percentage of the assets can be quickly converted into cash without involving any considerable loss by accepting sacrifice prices. Liquidity implies a high degree of current ness and solvency in the equity sense;

the ability of current assets will be able to meet current liabilities as they mature. Liquidity risk can also be defined as uncertain future outcomes that either improve or worsen the present liquidity position of the company. It may mean that holding idle cash on one hand or failure to meet financial commitments when they are due on the other

Fund mobilization, fund application, quality service, branch expansion, and application of new technology are the critical issues that can be emphasized by management in minimizing liquidity risk Fund raising is not limited to deposit mobilization. Borrowing and equity contribution are other sources of fund raising.

Branch network expansion is another critical issue that contributes to the broadening of customer base because it helps to attain the desired level of growth and to avoid excessive dependence on particular sources. Thus, monitoring both funding mix and the concentration of depositors help to control and mitigate unnecessary exposure to liquidity crises and avoid the vulnerability associated with such situation.

In general the crucial strategic issues with in which liquidity risk management is unimaginable are fund mobilization, credit allocation (fund application), expansion of branch networks and the provision of quality services through application of new and appropriate technology.

2.3.2 Credit Risk

“Loan is the thing that is lent, specially a sum of money. The action of lending something or the state of being lent". “For each Leander a loan is an investment comparable to bonds, stocks or other assets. One the other hand, for each borrower, a loan is a debt, an obligation to repay the borrowed money plus interest" (http://thomsonreuters.com.)

Banks grant loans to borrowers assuming that they will pay the agreed interest and principal amount according to their contractual agreement. However, the borrower may fail to do. This results in nonperforming loans (NPL).

None-performing loans are those loans which are past their due dates. They are classified into:

1. ***Sub-Standard:-*** Non-performing loans or advances past due 90 days or more but less than 180 days shall at minimum be classified sub-standard.
2. ***Doubtful: -*** Non-performing loans or advances past due 180 days or more but less than 360 days will be referred as doubtful.
3. ***Loss: -*** Non-performing loans or advances past due 360 days or more will be classified as loss.

Credit risk is defined as the chance that a debtor will not be able to pay interest or repay the principal according to the terms specified in a credit agreement. Credit risk means that payment may be delayed or ultimately not paid at all which can intern cause cash flow problems and affect a bank's liquidity. It exists in all banks on balance sheet accounts. Greuning, HennieVan and Bratanovic(2003:16)

2.4 Causes of Credit Risk

A bank is successful when the risks it takes are reasonable, controlled with in its financial resources and credit competence. The vital issues for preservation of the quality of loans are: existence of a well developed policies and procedures, strong portfolio of management, effective credit controls and well trained staff that is qualified to implement the system. Conversely, absence of adequate guidelines to monitor administration of the lending function pave the way for the occurrence of substantial amount of problem on loans. Therefore there are many causes for the occurrence of credit risk. According to Dashen Bank (2003:4) the following lists are the major causes of credit risk.

2.4.1 Excessive concern for Income Growth

The loan portfolio is usually the most important sources of income. Hence growth of the loan portfolio becomes a focal point to boost the revenue. However, too much concern for revenue maximization must not permit extension of weak loans that carry undue risks. Generally, weak loans cost far more than they contribute income for the Bank.

2.4.2 Incomplete Information

Character and capacity may be determined using different means. However, complete credit information is the best acceptable, reasonable, and accurate method for determining a borrower’s financial standing. Lack of supporting credit information is an important cause of credit risk. Therefore, adequate and comparable financial statements and other pertinent statistical data should be available in order to minimize the risk associated with loans.

2.4.3 Competition

Competition among banks for market and to influence community may result in the compromise of credit principles and the acquisition of unsound loans in which its ultimate cost exceeds its temporary gains in market growth.

2.4.4 Technical Incompetence

The ability to analyze financial statements and to obtain and evaluate other credit information thereby protecting in the placement and supervision of loans is processed by all qualified and experienced bankers. Hence, the management should seriously be concerned with the hiring of such employees. In general, controlling the above listed factors and several others, which are sources of failures in loans, entails financial losses, which impede growth of the Bank.

2.5 Risk Management

2.5.1 Definition of Risk Management

Risk Management has been defined by different authors based on their area of emphasis and their attitudes to wards their exposures. Accordingly we have tried to indicate different authors view in the following manner.

According to Trieschman and Gustavson (1998:14) risk management is a managerial process that involves the executive function of planning, organizing, leading and controlling those activities in a firm that deal with specified types of risks in order to maximize the value of an organization. The risk manager is charged with minimizing the adverse impact of losses on the achievement of the company's goal.

Risk management is the scientific approach to the problem faced by business that deals with the techniques of forecasting future so as to plan, organize, direct and control efforts to minimize the adverse effects of those potential losses. It is the reduction and prevention of the unfavorable effects of risks at a minimum.

According to Williams's et.al (1998:18), risk management is a general management function that seeks to identify, asses & address the causes and effects of uncertainty and risk in an organization in order to attain the goals and objectives of that organization in the most direct, efficient and effective path. It is a systematic way of protecting business resources and income against losses so that the organization's aims are reached with out interruption, creating stability and contributing to profit.

Risk management is a scientific approach to dealing with pure risks by anticipating possible accidental losses and designing &implementing procedures that minimize the occurrence of loss or the financial impact of losses that do occur. It is a systematic process for the identification and evaluation of pure loss exposures faced by an organization or individual and for the selection and implementation of the most appropriate techniques for treating such exposures. It focuses on a part of the total bundle of risks, those that are classified as "pure risks." As a general rule, the risk manager is concerned with the management of pure risks, not speculative risks and all pure risks are considered, including those that are uninsurable. Hence, risk management is the identification, measurement and treatment of property, liability and personnel pure risk exposures. . Feseha (1996:26)

2.5.2 Objectives of Risk Management

Risk management has several important objectives that can be classified as pre loss and post loss objectives. Pre loss risk management objectives are objectives prior to the occurrence of a loss such as reduction in anxiety, analysis of safety program expenses and meeting external obligations where as post loss objectives are important risk management objectives that can be meet after the occurrence of a loss such as survival of the firm, continuity of operation, stability of earning per share and continued growth by developing new products & market or by acquisition and mergers.

The first step in the risk management process is the determination of the objectives of the risk management program. In other words the risk manager and other related departments should participate in deciding the expectation of the organization and its risk management program if it is less effective than it could be. In the absence of coherent objectives, there is a tendency to view the risk management process as a serious of individual isolated problems, rather than as one single problem and there are no guidelines to provide for a logical consistency in dealing with the risks that the organization faces. Therefore, risk management objectives serve as a prime source of guidance for those charged with responsibility for the program and also serve as a means of evaluating performance.(http://www.bambooweb.com)

2.5.3 Risk Management Process

In order to have effective Risk management program, the risk manager must take certain general steps that can be systematically analyze and deal with risk. These are:

1. Identifying potential losses
2. Evaluating Potential Losses
3. Selecting the appropriate techniques for handling looses

4.Impliment and review decisions

5. Evaluating & controlling the result

(http://www.riskmanagementguide.com)

2.5.3.1 Risk identification

Risk identification is the process by which a business systematically and continuously identifies property, liability, and personnel exposures as soon as or before they emerge.

Unless the sources of possible losses are recognized, it is impossible to consciously choose appropriate and efficient methods for dealing with those losses should they occur. Risk identification is a very difficult process because the risk manager has to look into all operations of the company, so as to identify where exactly risks emanate from. It is a continuous job for the risk manager since risk environment is dynamic (Williams's et.al, 1998:15).

Approaches used by many risk managers involve, losses exposure checklists, financial statement analysis, flow charts, contract analysis, on site inspection, and statically analysis of past losses. Loss exposure checklist is a risk identification tool that can be used by business and individuals, which specifies numerous potential sources of loss from the destruction of assets and from legal liability. Financial statement analysis is another approach that can be used by business to identify risks. Using this method all items on a firm's balance sheet and income statement are analyzed with regard to that may be present. By including budgets, long range for casts, and written strategic plans in the analysis, this method can also be helpful in identifying possible future risks that may not currently exist. Flow charts are especially helpful to business in identifying sources of risk in their production process.

2.5.3.2 Risk Evaluation

After risks are identified, they should be evaluated regarding their expected frequency of occurrence, the probable severity of associated losses, the maximum probable and possible losses. In this case the risk manager obtains information that is helpful in determining the relative importance of identified risks and in selecting particular techniques for managing those risks. As part of the over all risk evaluation; it may be possible to measure the degree of risk in a meaningful way in some situation (Trieschman and Gustavson, 1998:105).

2.5.3.3 Select Appropriate Risk Management Tool

After identifying and evaluating various exposures to risk, alternative considerations can be given to alternative methods for managing each exposure. These tools include primarily avoiding the risk, reducing the chance that the loss will occur or reducing its magnitude, transferring the risk to some other party, retaining or bearing the risk internally. In selecting the proper tool the risk manager must establish the cost and other consequences of using each or combination of tools. He must also consider the current financial position of the firm, its overall policy with regard to risk management and its specific objective (Trieschman and Gustavson 1998:106).

2.5.3.4 Implement and Review Decisions

Based on the decision about the optimal methods for handling identified risks, the business or individuals must implement the best techniques selected. However, risk management should be an on going process in which previous decisions are reviewed regularly because some times new risk exposures may arise or significant changes in expected loss frequency or severity occur. Therefore the dynamic nature of many risks requires a continual scrutiny of past analysis and decisions (Feseha, 1996:21).

2.5.3.5 Evaluating & Controlling the Result

The result of the decisions made and implemented in the first four steps must be monitored to evaluate the wisdom of those decisions and to determine whether changing conditions suggest different solutions.

2.5.4 Risk Management Techniques

The selection of appropriate risk management technique is a dynamic problem. A best method for handling a particular exposure today may not be the best method for next year because so many relevant factors change regularly. The cost and availability of different risk management tools cannot be assumed to remain constant. Thus the risk management plan that seems to be both effective and efficient in one year may not make as much sense in the next. All of these factors make it clear that the risk management techniques should be an on going one rather than an exercise that is performed once and then forgotten. With in this framework there are four basic methods available for handling risk. These are: Risk avoidance, loss control, risk retention, and risk transfer (William's et.al, 998:17).

2.5.4.1. Risk Avoidance

Risk avoidance is a conscious decision not to expose one self or one's firm to a particular risk of loss. It can be said to decrease one's chance of loss to zero. Risk avoidance is common particularly among those with a strong aversion to risk. However, avoidance is not always feasible and may not be desirable even it is possible. There fore the risk manager must always weigh the relative costs and benefits associated with activities that give rise to risks. When risks are avoided the potential benefits as well as costs are given-up. If business is to operate at all certain risks are nearly impossible to avoid (Trieschman and Gustavson, 1998:106).

2.5.4.2 Loss Measurement/Control/

Loss measurement involves reducing the losses associated with particular risks. When a particular risk cannot be avoided, actions may often be taken to reduce the loss associated with it. Loss control is different from risk avoidance because a firm or an individual engages in operations that give rise to particular risks, rather than abandoning specific activities. It involves making conscious decisions regarding the manner in which these activities can be conducted to reduce either the probability of loss or to decrease the cost of loss that may occur. Before measuring and controlling any loss, the risk manager should be aware of the fact that the expected gains from an investment in loss control should be at least equal to the expected costs to justify the expenditure (William's et.al, 1998:18).

Loss control is important for the reduction of costs associated with: repair or replacement of damaged property, income loss due to destruction of property, extra costs to maintain operations following the losses, adverse liability judgment, medical costs to treat injuries, and income losses due to death or disabilities.

Other quantifiable benefits of loss control are a reduction in the cost of other risk management techniques used in conjunction with the loss control such as installations and maintenance expenses. Some forms of loss control concentrate on reducing the frequency of loss, where as others focus on reducing loss severity.

2.5.5 Risk Financing Techniques

After selecting appropriate risk management techniques that are going to be applied in order to minimize the occurrence of various risks, the risk manager should look for the risk financing techniques because by no means we can not avoid all risks rather we can minimize them to the minimum level. Accordingly, there are four best techniques of financing risk. As stated by Trieschman and Gustavson (1998:106), the risk financing technique includes: risk retention, self-insurance, risk transfer and insurance. Which are explained here after.

2.5.5.1 Risk Retention

It is a technique of risk financing, which involves assumption of risk. That is if a loss occurs, an individual or a firm will pay for it out of whatever funds that are available at the time. Retention can be planned or unplanned and the losses that occur can either be funded or unfunded in advance. Planned retention involves conscious and deliberate assumptions of recognizing risk. Sometimes it occurs because it is the most convenient risk treatment technique. Unplanned retention some times occurs even when the existence of risk is acknowledged. Thus, even though the exposure is recognized, the firm is engages in unplanned retention of losses that exceed its estimate of the maximum possible losses.

Many risk retention strategies involve the intention to pay for losses as they occur with out making any funding arrangements in advance of a loss. If a loss happens, it is paid for from the firm's current revenue. Such type of retention is unfunded retention. In contrast funded retention is made by making various pre-loss arrangements to ensure that money is readily available to pay for losses that occur. In many situations the risk manager should consider several techniques as financial resources, ability to predict losses and feasibility of establishing retention programs in order to make decisions regarding retention.

2.5.5.2 Risk Transfer/Insurance/

Risk transfer or insurance is another risk financing technique which involves payment by the transferor to the transferee (risk bearer). The transferee agrees to assume a risk that the transferor wants to escape. It reduces risk by combining under one management a group of objects situated so that the aggregate losses on the insured became predictable with in narrow limit. Some times the degree of risk is reduced through the transfer process because the transferee may be in a better position to use the law of large numbers to predict losses. In other cases the degree of risk remains the same and is merely shifted from the transferor to the transferee for the price.

2.5.5.3 Self Insurance

If the firm has a group of exposure units large enough to reduce risk and there by predicting losses, the establishment of a fund to pay for those losses as a special form of planned-funded retention known as self insurance. In this case there are two necessary elements of self-insurance. The first one is the existence of a group of exposure units that is sufficiently large to enable accurate loss prediction and the second one is pre-funding of expected losses through a fund specially designed for that purpose.

2.5.6 Importance of Risk Management to the Banking Business

Risk exists whenever the future is unknown because the adverse effect of risk plagued mankind since the beginning of time. As a result accidental losses each day had threaten the survival of some businesses, causing their earnings to drop below acceptable levels, intercept their operations, or, slow their growth. All businesses face the threat of losses that may never occur. Worrying about these possibilities does more than make life less pleasant; it may stop a business from engaging in certain activities or other wise alter how it conducts its operations. Proper risk management enables a business to handle its exposures to accidental losses in the most economic and effective way (William's et.al, 1985:20).

Organizations of all sorts have recognized the increasing importance of sound risk management. As life has become more complicated, more interrelated and more uncertain new loss exposures have been created and the severity of many old exposures increased. In some firms top management has assigned primary responsibility for the risk management to a specialized department.

According to William's et.al (1985:7), the purpose of risk management is to minimize the risk of loss at a minimum cost and its contribution to the business can also be categorized as follows:

- Risk management may take the difference between survival and failure that means it can contribute directly to business profits for business organizations and increase efficiency for nonprofit making organizations because profits can be improved by reducing exposures as well as increasing income.

- If a business has successfully managed its pure risks, the peace of mind and confidence permits its managers to investigate and assume attractive speculative risks that they might otherwise seek to avoid.

- By altering general managers to the pure risk aspects of speculative ventures, risk management improves the quality of the decision regarding such ventures.

- Once decision aids are made to assume speculative ventures, proper handling of the pure risk aspects permits the business to handle the speculative risks more wisely and efficiently.

- Risk management can reduce the fluctuations in annual profits and cash flows that investors regard more favorably a stable earnings record.

- Through advance preparation, risk management can in many cases make it possible to continue operations following a loss.

Thus, retaining customers or suppliers who might otherwise turn to other competitors will be more feasible.

- Risk management encourages customers, creditors, suppliers, and employees of the firm to work with the organization that has a sound protection against pure risk.
- The peace of mind that is made possible by sound management of pure risks may itself be valuable for non-economic assets because it improves the physical and mental health of the management and the owners. Because the risk management plan may also help others such as employees, who would be affected by loss of the firm. It also helps to satisfy the firm's sense of social responsibility and creates good public image.

Generally, this chapter has dealt about the concept of risk management, which focuses on different authors view regarding definitions of risk, the types/natures/ of risk, different causes of risk and their management techniques, processes and procedures.

CHAPTER THREE

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

In this chapter, the student researcher used both primary & secondary data sources. The primary data was collected through questionnaire and interview. The secondary data collected from different literatures, manuals and reports of the bank.

The questionnaire was distributed to 24 people who are assumed to have a direct work relationship with our topic of concern i.e. credit risk management system of Dashen Bank. Out of these, 22 respondents, who have completed and returned. The questionnaire distributed to Department Managers, Deputy Managers, Section Heads and Loan Officers. The data acquired from respondents is narrated here below.

3.1. Respondents Background Information

No	Items	Options	No	%
1	*Sex*	Male	16	73
		Female	6	27
		Total	**22**	**100**
2	*Educational Background*	Certificate	0	0
		Diploma	2	9
		First Degree	18	82
		Above First Degree	2	9
		Total	**22**	**100**
3	*Position*	Department mangers	2	9
		Deputy Managers	2	9
		Section Heads	2	9
		Loan officers	14	64
		Others	2	9
		Total	**22**	**100**
4	*Service Year*	Below 5 Year	12	55
		5-10 Years	8	36
		Above 10 Years	2	9
		Total	**22**	**100**
5	*Category of work*	High level management	6	27
		Medium level management	14	64
		Other professions	2	9
		Total	**22**	**100**

From Item 1 of table 3.1, the student researcher can see that 16(73%) and 6(27%) of respondents are Male and Female respectively. As shown from this male respondent is more than female respondent.

Item 2 of table 3.1, the respondents have an educational qualification of 2(9%) Diploma, 18(82%) first Degree and 2(9%) are above first Degree. As we see the percentage of degree holders is more than those of diploma and above first degree holders. This shows that most of the respondents are professional and above all answers given by the respondents are expected to be logical and indicates the real ways to solve the existing problem.

Item 3 of table 3.1 describes the position of respondents that constitutes 2(9%) of Department Managers, 2(9%) Deputy Managers, 2(9%) that constitutes Section Heads and 14(64%) of Loan Officers.
As the numerical value shows that the percentage of loan officers is more than the other respondents. Especially loan officers are expected to have more information which helps them to answer the research questions in the right manner.

As can be seen from Item 4 of table 3.1, 5-10 years 8(36%) and 2(9%) above 10 years and 12(55%) below 5 year, this shows that the company is filled with either by new comers to this bank or by youngsters.

Item 5 of table 3.1 shows the category of work 6(27%) high level management, 14(64%) medium level management and 2(9%) are other professions. It is mainly higher level managements are involved in the credit risk management process. Majority of respondents loan Officers(middle line management) which mostly authorizers of the request for credit approval and other main decisions.

Credit Risk Management Analysis

In the following sub section, the student researchers have summarized the response of the various respondents on the credit risk management system of the bank.

3.2. Data Related to Risk Management Process

No.	Items	Options	No.	%
1	*Do you participate in any of the risk management process?*	Yes	10	45
		No	12	55
		Total	**22**	**100**
2	*If your answer in the above question is "Yes" what type of risk management activities is delegated to you?*	Credit risk Management	4	40
		Credit & Liquidity risk Management	2	20
		Credit , Interest rate & foreign exchange risk management	2	20
		Credit & Others	2	20
		Total	**10**	**100**
3	*Are you satisfied with the quality of risk management system adopted in Dashen bank?*	Yes	13	59
		No	9	41
		Total	**22**	**100**
4	*How much Do you think you know about the credit risk management system adopted by Dashen Bank?*	Not Much	2	9
		Some how	11	50
		Very much	9	41
		Not at all	**-**	**-**
		Total	**22**	**100**
5	*Are the existing risk management policies, procedures of the Bank well communicated to you?*	Yes	6	27
		Some how	14	64
		No	2	9
		Total	**22**	**100**

As it can be seen from Item 1 of table 3.2, 10(45%) of respondent participate risk in management process and 12(55%) not participate. It shown that most of respondents middle line management not participate decision process. From this one can conclude by saying all higher level management of the bank involves in risk management decision.

As shown in item 2 of table 3.2, 4(40**%**) are participating in credit risk management, 2(20%) are participating in credit and liquidity risk management, 2(20**%**) are participating in credit, interest rate and foreign exchange risk management and 2(20**%**) are participating in credit risk and other activities respectively.

As it is observed from item 3 of table 3.2, 13(59%) of the respondents have replied that they are fully satisfied with the quality of the existing risk management system currently adopted in the Bank. But 9(41%) of them are dissatisfied with the matter because they said that there is “No” delegated office who evaluates and monitor the risk management process in the Bank. The respondents also commented that in Dashen Bank there is a belief that every manager is a risk manager but there has to be a supervisory body that is responsible to evaluate the overall risk management system of the bank and fill the gap.

As can be seen from Item 4 of table 3.2 the majority of the respondents accounting for 11(50%) know about the credit risk management at a medium level. 2(9%) of them have responded that they don’t know much about the system. Only 9(41%) of the respondents have a good understanding about credit risk management system adopted in Dashen Bank. This shows that more than 50% of the participants have lack of awareness about the bank’s credit risk management system currently adopted in the bank. This condition is being questionable of the bank activity; the situation shows that there is no follow-up on the sector.

As can be seen from Item 5 of table 3.2 the majority of the respondents accounting for 14(64%) believed that the existing risk management policies and procedures of the Bank are communicated to them only to some extent. 6(27%) of the participants have said that “yes” it is well communicated. But 2(9%)of the respondents have suggested that it is not communicated at all. majority of the respondents don’t have clear understanding about the existing risk management policies and procedures of the Bank.

3.3. Basis for Assignment of Lone Officers

Items	Options	No.	%
How loan officers are assigned in their positions?	Based on qualification	4	18
	Based on experience	2	9
	Based on experience and qualification	13	59
	Based on blood r/ship with owners	3	14
	Total	**22**	**100**

Table 3.3 concerning the assignment of loan officers in their respective position about 13(59%) of the respondents assume that the bank uses both qualification and experience as a requirement to hire loan officers. And about 4(18%) of the respondents assume that loan officers are hired based on their qualification only, 2(9%) of them said that experience as a key factor to provide position for loan officers. but 3(14%) of the respondents said that in some instances some loan officers are assigned to their position based on blood relationship with the managers. Majority respondents have given their comment based on their experience and qualification. But some respondents have given their comments based on their relationship with the managers. This relationship might be influenced on the bank credit risk management.

3.4. Assessment and Follow-up of Credit Customers

No.	**Items**	**Options**	**No**	**%**
1	*Does the Bank assesses borrowers past financial history, credit worthiness and perform detail financial analysis before extending loans*	Yes definitely	16	72
		Yes, but not enough	4	18
		Not at all	-	-
		I am not quite aware of it	2	9
		Total	**22**	**100**
2	*Is there any follow-up mechanism of your customers after granting a loan?*	Yes	20	91
		No	2	9
		No response	-	-
		Total	**22**	**100**
3	*In the above question if your answer is "Yes" how often?*	Quarterly	4	20
		Semi Annually	2	10
		Annually	-	-
		Monthly	14	70
		Total	**20**	**100**
4	*When the borrower faces certain problem and unable to pay the loan what mechanism do you apply in order to collect the loan?*	Rearrangement of loan repayment structure and Extension of the life of the loan	19	86
		Rearrangement of loan repayment structure	2	9
		Changing the loan type and waiving of the loan	1	5
		Total	**22**	**100**

Table 3.4 Item 1 with regard to the performance evaluation of borrowers 16(72%) of the respondents has agreed that the bank assesses borrowers past financial history, credit worthiness, and perform a detail and strict financial analysis before lending the loan. This shows that the managers and loan officers have almost close understanding about the banks assessment of the borrowers past financial history, credit worthiness and detail financial analysis before extending loans and 4(18%) of them said that the bank assesses the financial status of customers moderately, but

they think it is not enough, while 2(9%) of the respondents have no any idea about the matter. This shows that the managers have no a diversified understanding about the policies and procedures of risk management system adopted in Dashen Bank.

Item 2 of table 3.4 also shows that, the majority of the respondents accounting for 20(91%) have agreed that there is a strong follow-up mechanism of customers after granting the loan, 2(9%) of them are indifferent as to the existence of any follow up mechanism. This show that the bank have a strong follow-up mechanism.

Item 3 of table 3.4 regarding the frequency of follow-up diversified opinions are observed, i.e. 4(20%) the participants who said “Yes” said that follow-up is made quarterly, 2(10%) of them said that the follow-up is made semiannually. None of the respondents said that follow-up is made annually. Above half of our respondents i.e. 14(70%) have said that follow- up is made monthly which make the collectivity of the loan reliable.

Item 4 of table 3.4 regarding the loan repayment techniques different opinions are also observed, 19(86%) of the respondents have believed that when borrowers face certain problem and unable to pay the loan, the life time of the loan will be extended so that the customer will get some additional time for revival and repayment and rearrangement of loan repayment structure. About 2(9%) have replied that rearrangement of loan repayment structure will also be given, therefore, the customer will make money and becomes in a better position or condition to repay the loan. 1(5%) said that changing the loan type and waiving of the loan are solutions when the borrower is unable to repay the loan. From the above analysis we can deduct that there is no specific technique or mechanism to be applied but depending on the condition or situation of the environment each method /technique/ can be interchangeably applied.

3.5. Sector Identification for Granting Loan

Items	Options	No	%
From the total loans & advance granted to its customers in which sector does the bank usually emphasized?	Agricultural Sector	3	14
	Manufacturing	-	
	Domestic trade& services	12	54
	Export & Import	7	32
	Building & construction	-	
	Transport	-	
	Total	**22**	**100**

Table 3.5 according to the sector 12(54%) of the respondents has emphasized that, domestic trade service sectors have been interchangeably leading the others. From the above observation we can conclude that the bank emphasized on Domestic Trade and Service due to business viability and high demand on the sector. Most of the customers who are come to the bank are Domestic Trade & Services customers, which are compared to other sector short term loan. 3(14%) of respondents replied that for Agriculture Sector and 7(32%) Import Export Sectors. For instance, currently export business has minimum risk because the National Bank of Ethiopia will give a guaranty for it. Additionally, the foreign currency earnings from such business is encouraging to the Bank as well as the country, on the other hand the manufacturing sector substitute import goods that contributes to the foreign currency earnings and overall socio–economic benefits of the country. In general, most of the respondents agreed that the current and future situation of the market, its profitability, risk bearing capacity of the sector to be selected and many other factors may determine the area of emphasis to be selected.

3.6 Causes of Credit Risk

As per the interview conducted with the Risk Management Division head of Dashen Bank, “a Bank is successful when risk it takes are reasonable, controlled within its financial resources and credit competence”. Experience has proved that the fundamental issue for preservation of the quality of loans is existence of well-developed policies and procedures. Therefore, the basic causes for the occurrence of credit risk are:

Causes at borrower level

- Diversion of borrowed fund to other purpose
- Insufficient credit awareness
- Unwilling customers to disclose the information required
- Contingencies at borrower level e.g. death, sickness
- Lack of proper business plan
- Willful default/ Unwillingness to payback- is the only factor which is considered as having insignificant as well as difficult to judge as causes of NPL.

Causes at Bank Level

The various causes for NPL at bank level are the following

- Lack of consultation and communication with defaulter
- Lack of continuous follow up and proper risk management
- Lack of credit information from other commercial banks
- Mistake on estimation of collateral and evaluating the borrower’s financial report
- Problem associated with loan eligibility criteria’s
- Lack of adequate supervision on borrowers
- Dependence on oral information furnished by borrowers(for regular customers) in lieu of reliable financial data and direct verification

- Absence of established system of credit follow-up
- Technical in competence – The ability to analyze financial statements and to obtain and evaluate other credit information.
- Over lending - lending beyond the prudent level of financial requirement a reasonable capacity of the borrowers to repay the lean. This is the basic problem of Dashen Bank and in one sense it is related with technical incompetence.

Causes of NPL at Economic Level

- Unstable political situation
- Excessive government intervention
- Political power of the borrower
- Weak economic plan and strategy implementation
- Impact of change in fiscal and monetary policies

3.7 Mechanisms which are applied to manage credit risk

- Proper analysis of the borrowers request and documents- have higher (better) efficiency
- Properly collect required information from other Banks
- Give efficient awareness for the borrowers
- Efficient and proper follow up and risk assessment
- Provide relevant trainings for loan officers and related staffs
- Well attention & treatment of sick loan- which they consider it as a less efficient.

3.8 System of monitoring and control

For the credit risk management function to be effective the systematic handling of the risk factor has to be supported by the following monitoring and controlling mechanisms. Some of these are:

- Performance review
- Credit follow-up

a) Performance review: at this stage the Bank evaluates the performance of individual & group loans, through examining the collection rate. It can also be evaluated in different ways to asses, determine, monitor and control the risk factor. This evaluation process facilitates the risk management and also serves as measure of the standard of the loan portfolio management in order to monitor acceptable and predictable level of credit losses. It also indicates the way to develop diversification with the portfolio to obtain the balance between maximum return and minimum risk to enhance sound loan portfolio management.

b) Credit follow-up: Used to facilitate effective management of problem loans, to enhance debt recovery, and to monitor the risk associated with loaning, Dashen Bank has developed and put in place a credit follow-up system, which advocates the two-way approach. The basic objectives of credit follow-up are:

☞ Minimization of the magnitude of problem loans.

☞ Minimization of loss loans so as to ascertain constant income growth, strong balance sheet, enhanced public acceptance and lasting success of the bank.

3.9 Policy and procedure of credit risk management

Dashen Bank sets credit risk policies and procedures to keep on course towards its goals. These policies and procedures serves as the guardrails and signs on the road. It avoids rationalizing exceptions as acceptable behavior without validating the consequences. The policies and procedures followed in lending can broadly be classified in to five. These are:

- Initiation
- Evaluation
- Approval

- Disbursement and
- Follow-up

These police and procedure helps the bank stay on course by identifying and mitigating risks

Credit policies and procedure of Dashen Bank will be in a continuous process of evaluation and review to meet changing situations and the challenges ahead. To this end, the policy and procedures will be updated as and when deemed necessary but not later than five years. Any change during the fiscal year will be updated/amended each year just after closing.

According to secondary sources, the position of NPL in Dashen Bank can be analyzed from the following table.

Table 3.10: Ratio of NPL to outstanding Loans as of June 30, 2013

*Amounts are presented in (000) birr

Year	Total O/S Amount	Total NPL Amount	Proportion of O/S NPL in %
2010	5,033,073	150,890	3.00
2011	6,141,666	204,393	3.33
2012	8,041,997	193,379	2.4
2013	8,836,627	482,194	5.46

It could be noted in Table 3.10 that the ratio of the total balance of Non-performing loans to outstanding loans has shown an improvement from year to year (especially during the fiscal year 2012-2013.

Table 3.11: Growth Rates of Outstanding Loan Balances

*Amounts are presented in '000 birr as at June 30 2013

Year	Total O/S loan Amount	Growth rate
2009	4,447,024	
2010	5,033,073	13%
2011	6,141,666	22%
2012	8,041,997	31%
2013	8,836,627	9%

As could be seen from the table 3.11, the four-year average annual growth rate of outstanding loan of the Bank in the year 2012 exhibited relatively higher percentage by 31%. In contrast the difficulties faced in the year 2012, the bank was capable to decrease its outstanding loans for the following years 2013 by 9%.From this it observed that the bank has shown a fluctuating pattern of growth in its total outstanding loans and advances balance.

Table 3.12 show that amount of NPL as of June 2013, has exhibited an excessive increase by 49%, which is the largest increase as compared to other years. This very high increase of NPL reported especially in the year 2013, because most of outstanding loan of this year on agricultural sector and globally it was the year when coffee price significantly decline in the world market.

Table-3.12 Growth Rates of total NPL IN '000 birr

Year	Total NPL Amount	Growth rate %
2009	328,472	
2010	150,890	-54
2011	204,393	35
2012	193,379	-5
2013	482,194	49

Despite the challenging encounters in the year 2013, the Bank was able to decrease its NPL to -54% on June 2010, which was an encouraging achievement. However, the downward trend was reversed during the subsequent years of 2011 & 2012 where the growth rate of NPL goes up to 35% and down -5% respectively. This has an adverse effect on the overall performance of the bank.

Table 3.13: The Number of Borrowers with outstanding Loans & Advance

Amounts are presented in '000 birr as at June 30

Year	Total outstanding loan Amount	Numbers of Borrowers
2010	5,033,073	2,754
2011	6,141,666	3,495
2012	8,041,997	4,193
2013	8,836,627	4,895

Based on the finding for four consecutive years, the number of borrower's increases in each year, similarly the total outstanding loan and advance also enhanced.

CHAPTER FOUR

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The study will focus on credit risk management the mechanisms put in place to manage these risk by the bank. In order to investigate problems encountered related to credit risk management interact the following question.

- ✓ What are the causes of credit risk? The policy and procedures of risk management followed? What type of mechanism followed to minimize risk? And what are the systems of monitoring and controlling credit risk in Dashen Bank?

The data, which was obtained by preparing structured interview questions and for the majority of employees both close and open ended questionnaire was used which helps the study to be furnished with first hand information. The questionnaire was distributed to 24 people who are assumed to have a direct work relationship with our topic of concern i.e. credit risk management system of Dashen Bank. Out of these, 22 respondents, who have completed and returned the questionnaire. In addition to this, policy manuals, procedures, annual reports, and publications were used as means of collecting second hand information.

4.1 Summary

Based data presentation, analysis and interpretation made in chapter three, the following are summary of the major findings.

- ✓ According to interview case of credit risks are
  - Mistake on estimation of collateral and evaluating the borrower’s financial report

- Lack of consultation and communication with defaulter
- Lack of continuous follow up and proper risk management
- Lack of adequate supervision on borrowers
- Absence of established system of credit follow-up
- Technical in competence

✓ 10(45%) of respondent participated risk management process and while 12(55%) of them did not participated in risk management process.

✓ The majority of the respondents accounting for 59% have not clear understanding about the existing credit risk management system adopted by the Bank.

✓ concerning the assignment of loan officers in their respective position about 13(59%) of the respondents both qualification and experience as a requirement.

✓ 20(91%) of the respondents agree that the bank has follow up mechanism after granting the loan. While 2(9%) of the respondents indicated that there is no follow up mechanism after granting the loan.

✓ 16(72%) of the respondents has agreed that the bank assesses borrowers past financial history, credit worthiness, and perform a detail and strict financial analysis before lending the loan.

✓ About 55% of the respondents have less than 5 year of services.

✓ the majority of the respondents accounting for 14(64%) believed that the existing risk management policies and procedures of the Bank are communicated to them only to some extent. 6(27%) of the participants have said that “yes” it is well communicated.

- ✓ 12(54%) of the respondents said that the bank usually emphasized on Domestic Trade and Services (DTS) loan, 7(32%) on import & export & 3(14%) on agricultural sector.

4.2 Conclusions

Based on summary of the findings the following conclusions are drawn. From the findings of the study, the researcher makes the following conclusion.

- ✓ The major case of credit risks are Mistake on estimation of collateral and evaluating the borrower's financial report, Lack of continuous follow up and proper risk management and Lack of consultation and communication with defaulter.
- ✓ Majority of staffs in the department are not participating in risk management decision.
- ✓ more than 50% of the participants have lack of awareness about the bank's credit risk management system currently adopted in the bank.
- ✓ The bank uses both qualification and experience as a requirement to hire loan officers.
- ✓ There are strong follow-up mechanisms with the customers after granting the loan.
- ✓ It will assess the borrowers past financial history and credit worthiness. Detail financial analysis of past financial history of the borrowers and forecasting of the future prospective development will enable the bank to identify the capacity of the borrowers and to process loan in the safest condition this is one of the bank's strong points.

- ✓ The majority of employees are youngsters. With in this age group employees have willingness and more preferable to facilitate working environment.
- ✓ The majority of the employees not aware about the policies, procedures and strategies of risk management system.
- ✓ The Domestic Trade and Service take the largest share of outstanding loans during the period under the study.

4.3 Recommendations

Based on summary of the findings and conclusions, the following recommendations are forwarded.

1. The top level management of the bank should give attention for middle line management bodies to participate in risk management decision.
2. The top level management of the bank should assign responsible officer, who evaluates the overall risk management system and monitors the risk management process in the Bank. Moreover, the risk management system should be reviewed and updated frequently in consideration of marketing situation.
3. The Management body of the bank should give attention for long term credit to attract agriculture sector.
4. The Management body of the bank should create awareness about the Risk management manuals, policies and procedures, among employees so that every employee will have a clear understanding about the risk management process of the bank so that they can protect the company accordingly and recommend alternative ways.

5. The practical evidence indicates that the staffing system of the bank is based qualification and job experience, therefore the Bank should assign qualified, professional and experienced individuals to their proper position.

6. The Management body of the bank should design adequate professional training scheme through providing off and on the job training, so that the risk management cost will be minimized.

7. Finally, the researcher stress that it is a high time for the Bank to adopt a contemporary, proactive and decentralized risk management system if it tends to survive the thunder of local competition, the flood of globalization and the tremble of our dynamic market & economic condition.