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

AN ASSESSMENT OF CREDIT RISK MANAGEMENT IN BANK OF ABYSSINIA

BY
MESERET BEHAILU

JUNE, 2010
SMUC
ADDIS ABABA

AN ASSESSMENT OF CREDIT RISK MANAGEMENT IN BANK OF ABYSSINIA

A SENIOR ESSAY SUBMITTED
TO THE DEPARTENT OF MANAGEMENT
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APPROVED BY THE COMMITTEE OF EXMINERS

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Examiner	Signature

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CHAPTER ONE
INTRODUCTION

1.1. Background of the study

The Bank of Abyssinia (BOA) is a privately owned share company established after the licensing and supervision of banking business proclamation No. 83/1994 that vests authority to private banks to operate in Ethiopia.

Being the third privately owned bank allowed operating in the country; the Bank of Abyssinia was inaugurated and opened on February 15, 1996 with a subscribed capital of Birr 25 million and with an authorized capital of Birr 50 million. The Bank had 131 share holders. When the bank started its operation in August 03, 1996 it had one office and 38 employees only.

Among the various functional areas of the bank, Administration and Human Resource Department, Legal Services Department, Control Department, Information Technology Department, Corporate Planning and Research Department, Finance Department, Purchasing Department, Public Relations Department, International Banking Department, Credit Department, and Risk Management and Monitoring Services Department are the major ones.

In association with the various ancillary banking services like Rental of safe vault and Insurance of Guaranty, the bank also gives two basic banking services: - They are Deposits in the form of saving, checking, non-resident/non-transferable foreign currency account, time deposits, and loans (extension of credit). The bank also provides international banking services majoring Import-Export, and Foreign money incoming transfer services.

In order to catch up with the recently booming international business, BOA grants loan in the form of advances for imports and exports. Opens Letter of Credits purchase and sales of foreign money, gives money transfer service issues and accepts proxies to money like draft cheques, money orders and traveler's cheques. (Annual Bulletin of BOA, Date: December 2006).

According to Thomson's Dictionary of Banking, "Loan is a thing that is lent, specially a sum of money. The action of lending something or the state of being lent. For each lender a loan is an investment comparable to bonds stocks or other assets. On the other hand, for each borrower, a loan is debt, an obligation to repay the borrowed money plus interest" Banks Grants 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).

Credits are the most important resources for any commercial Bank. They constitute almost three quarters of the total value of all banks' assets. In the competitive environment, more and more lines of business, which need a huge investment, are being opened. Some of these huge investments are financed through commercial Banks' loan. With this respect, Banks play a major role in the overall economic development of a country. However, in this process of extending credit to loan customers, a Bank should have a way of scrutinizing its borrowers so that it would minimize the risk of default. The effect of default is not limited to that of affecting the profit of one particular bank but it has a ripple effect that extends itself into the economy, at large. Hence, prudent Banks are concerned about the quality of their loan and the effectiveness of their risk management process in order to safeguarding their business as well as the overall economy. (Thomson William, 1974: 27)

Sound practices of Credit Risk Management address the following areas:-

A. Establishing appropriate credit risk environment;
B. Operating under a sound credit granting process; bank operate under sound, ell defined credit granting criteria; the criteria include a thorough understanding of borrowing as well as the purpose and structure of credit, and its source of repayment.
C. Maintaining an appropriate credit administration, Measurement and monitoring process. Bank's have a system the on-going administration of their various portfolios:-
    i. Monitoring documentation (keeping credit files up to date). Contractual agreements, legal covenants, collateral (including insurance).
    ii. Ensuring the accuracy and timeliness of information to Top Management.
    iii. Ensuring compliance with prescribed policies and procedures.
D. Ensuring adequate controls over credit risk. Banks have a system in place for managing problems credit and various other workout situations. When a bank has significant credit related problems, there should be a workout section that can rehabilitate a troubled credit or to increase the amount of repayment ultimately collected.

The taking of credit risk is a principal function of banks. How a bank approaches credit risk represents one of its important polices. The willingness of banks to take credit risk has provided a major service to market economics throughout banking history. The heart of the banking business is assessing credit risk-not necessarily taking risks, but assessing them. The distinction is important because ability to assess is a skill and whether credit risk are taken or not taken is a management decision. (Credit Manual of BOA, Date: February 2008).

Credit is based on taking risks and managing and controlling these risks. That will be the key to the bank's overall profitability and survival. Thus, the primary purpose of extending credit facilities shall be generated from a reasonable return on the funds that the bank extends to its credit customers.

Credit analysis of each prospective borrower shall be made. The bank shall try to determine the borrower's ability to repay the borrowed amount plus interest by looking deep in to the four "Cs" of credit which are: - Character (the borrowers willingness to cooperate with the lender), Collateral, Capital, Condition (of the business), and Capacity to pay.

1.2. Statement of the Problem

Like any other business, the business of banking is exposed to a number of risks which might affect its profitability under controlled. Those risks happen as results of the natures of the various transactions the bank undertakes.

Bank of Abyssinia is performing various profit making banking activities. Those profit making activities are weak to a number of risk exposures like Financial Risk, Operational Risk, Business Risk and Event Risk.Credit Risk, which is categorized under financial risk, is the major type of risk that emanate from one of the two basic activities of any Commercial Bank, Credit and Deposit.

As it's sited in the BOA's annual report issued for the (2007/08:3) fiscal year, the bank's profit for the year has declined by 77% (and became ETB 21.91 million) when compared with the profit harvested a year before that. This was not because the bank's revenue reduction. The bank's revenue has exhibited a 30% rise when compared with the revenue for the previous fiscal year. Rather, the profit decline has occurred due to the availability of considerably higher NPL which in turn obliged the bank the largest part of the profit as provision for those doubtful loans and advances. Therefore, this researcher tries to assess the credit risk management practice of BOA and its failures (if any).

In doing so, the researcher tries to address the following points: -

1. The deployed Credit risk management in BOA.
2. Major reason associates with poor credit risk management.
3. Factors that provide for the non – return of credit resource granted as loan to borrowers.
4. The degree of awareness of the BOA's credit department staffs and credit customers to the credit risk management system of the bank.

1.3. Research Questions

1. What are the major factors associated with poor credit risk management practice in BOA?
2. What are the systems used in credit risk management in BOA?
3. What are the factors that hinder the bank's borrowers from repaying the credit granted to them as per their repayment schedule?
4. To what extent are borrowers familiar with the banks credit risk management system?

1.4. Objective of the study

The general objective of the study is;

To assess the overall credit risk management practice in the Bank of Abyssinia.

The specific objectives of the study are the following;

- ❖ To check the existing system of credit risk management in BOA.
- ❖ To see the major factors associated with poor credit risk management in BOA.
- ❖ To look into the basic factors no return credit resources granted as a loan to borrowers.
- ❖ To see the degree of awareness of the BOA's credit customers and credit department staffs about the bank's credit risk management system.

1.5. Significance of the study

The risk is always expected to exist as far as the bank continues to provide credit. As credit is the basic function and the major source of banks earning through interest, credit risk management is the crucial function that any commercial bank can't lay it aside.

Therefore, this study benefit:-

- The bank (BOA)
- Stake holders of the bank
- National Bank of Ethiopia
- To other researchers.

The **Bank of Abyssinia** is the first beneficiary since the study serves as a reference to see and check their strengths and weaknesses in credit risk management. Since proper credit risk management brings a difference between a bank's survival and failure, any other commercial bank will also be benefited from this study. The controlling authority **(The National Bank of Ethiopia)** will be the other beneficiary because it may need this research for further and wider research, and/or to make adjustments to its directives, policies and regulations based on some of the useful highlights which develops from this study. As they invest their assets in the bank, and as credit risk is a matter of failure and existence of their bank, **stake holders** of the bank are one of the direct beneficiaries of this study. Finally, like any other useful study, this study will initiate other interested **researchers** to undertake a better and detailed study in the area.

1.6. Scope of the study

This study mainly aims at investigating the Credit Risk Management practice of BOA. Obviously, BOA has 48 branches. However, this study is not looking in to the credit risk management practice of all branches. Rather, it is focus on Head Office, Credit & Risk Management and Monitoring Departments of the bank and only on three bigger branches (Filwuha branch, Negadras branch, & Raguel Branch). This is because all the staffs of this department have the same information about it. And all credit sections who are working at branches are under the control of the head office credit department. It is visible that the scope of the topic is wide. Given the constraints listed in the limitations, it will not be feasible to go deep in to every aspect of credit risk management since each aspect has a wide coverage. However, efforts are made to review the most important aspects of credit risk management of Bank of Abyssinia. To this end, the bank's manuals and memos, the internet, journals, publications, books and other sources are carefully looked.

1.7. Limitations of the study

In the process of conducting the study, various problems hinder from exert the maximum effort. Firstly, the study is prepared with in a very short period of time. Secondly, the topic chosen is a bit complicated and there is scarcity of reference materials in the area under study. Thirdly, the study were refer 2007/2008 Board of Director Report the 2008/2009 reports is not publicized. And finally, some of the officers of the bank were not willing to provide certain relevant information's for confidentiality. So that this researcher is trying to get information from publications, reports and some willing officers' open explanations.

1.8. Definitions of terms or Operational Definitions

Condition: Refer to external factors beyond the control of the firm that may affect their ability to repay such as the economy and industry specifics environment.

Non-Performing loans and advances: These are loans on which principal and interest payments have not been made as agreed. N L Ps includes arrears, overdue loans, expired O/D, and loans transferred to legal department for legal action.

Mortgage: A lien on real property used to secure a loan.

Pledge: An express agreement which gives a bank possession, but not ownership, of specific goods or title documents for those goods as a direct security for a borrowing.

Arrears: Amount of loan repayment accrued unpaid for a number of payment periods.

Expired O/D: An over draft facility that expires and needs extension request from the borrowing customer.

(Amended Credit Manual of BOA, Date: February 2008)

1.9. Research Design and Methodology

1.9.1. Population and Sampling Technique

The sample group for this study is chosen from a population of 40 employees of BOA, and 40 credit customers of BOA, who are being served at three branches of the bank, whose loans and/or advances are currently operating, or pending for legal case.

The sampling technique was simple random sampling in order to have equal chance for all members of the population. The sample size of the employees of BOA are up to 20 employees selected from three bigger branches and the credit department laid at the head office of the bank. Each of the three branches included in the sample and the credit department have a manager, an assistant manager and various combinations of loan officers. However, almost all loans worked out at the branch level are analyzed and approved by the credit approving committee of the bank, in the credit department, therefore, all the credit analysts are working at the credit department. The population size and the sample taken are explained in the following table: -

Name of Br. /Dept.	Population Size				Sample Size			
	Mgr	**Ass. Mgr**	**Loan Officer/s**	**Credit Analyst/s**	**Mgr**	**Ass. Mgr**	**Loan Officer/s**	**Credit Analyst/s**
Filwuha	1	1	5	-	1	1	1	-
Negadras	1	1	4	-	1	1	1	-
Raguel	1	1	3	-	1	1	1	-
Credit Dept.	1	1	6	14	1	1	3	6
Sum	**4**	**4**	**18**	**14**	**4**	**4**	**6**	**6**
Total size	**40**				**20**			

1.9.2. Type of Data Collection

Both primary and secondary data will be used in this study.

Primary Data

- Based on the questionnaire, the Credit Department customers of BOA are filled questionnaire. This is done while the customers come to get services.
- Also the employees of the bank who are working in Fiwuha Branch, Negadras Branch, Raguel Branch, Credit and Risk Department, are interviewed and questionnaire are filled based on the questionnaire.

Secondary Data

- Furthermore, different manuals of the bank, directives of the controlling authority (The National Bank of Ethiopia); Inter-office-memos that may show changes and additional information, publications, annual reports and previous researches related to the subject matter of this study is used as sources of secondary data.

1.9.3 Method of Data Collection

To come up with the required result, interview conducted and questioners distributed to Credit customers, to Head Office Credit Department staffs and also the three bigger branches staffs. In order to evaluate the Credit Risk Management practice of the Bank.

1.9.4 Method of Data Analysis

Information conducted to the sample group though questionnaire, interview and from the secondary sources are summarized and tabulated. As a result, the summarized data is analyzed by using various statistical methods. The information collected through interview analyzed in a way that it supports the questionnaire and the secondary sources analyses. Finally, the researcher extracts conclusion and gives recommendations.

1.10 Organization of the Study

The paper is containing four chapters; the first chapter deals with Introduction which covers Statement of the Problems, Scope of the Study, Significance of the Study and Research Methodology. The Second chapter contains Related Review of Literature. The third chapter contains Data Presentation, Analysis and Interpretation. And the fourth chapter included summary, conclusion and recommendation 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, Staticians and actuaries each have their own concepts of risk. Therefore the research will try to give different authors' view for the word Risk.
According to Williams Jr., 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 the desired outcome that is expected. (Williams Jr, L.smiht and others, 1998:15)

According to Trieschman, 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 financial potential losses. But when losses are not planned for advance, they may cost even more. Businesses as well ass individuals may try either to avoid risk as much as possible or 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 cost of un reimbursed losses. (Trieschmann, James and Gustavson, Sandra G, 1998:5)
Credit risk is the risk of loss due to the financial weakness of the Ban's customer. Generally, the customers will not be able to settle their transaction due to bankruptcy or some other liquidity crises. (Mayland Paul, 1991: p-35.)
It is the risk that borrowers will b unable to meet its obligation. A Bank reflects and aims to profit from taking credit risk by charging higher interest margins

on loans to those customers that are considered at present a higher risk. (Burt Edwards, 1976: p-60.)

Banks are exposed for four basic types of risk called financial risk, Operational risk, Business risk and even risk**.** (Hennie Van Greuning & Sonja Brojovic Bratonovic, 2000)

2.2 Credit

According to Thomson's Dictionary of Banking "Loan is a thing that is lent specially a sum of money. The action of lending something or the state of being lent. For each lender a loan is an investment comparable to bonds stocks or other assets. On the other hand, for each borrower, a loan is debt, an obligation to repay the borrowed money plus interest" (Thomson's Dictionary of Banking) Banks Grants 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).

N L P is those loans which are past their due dates. They are classified in to:-

1. Sub-Standard: - Non-performing loans or advances past due 90 days or more but less than 180 days.

2. Doubtful: - Non-performing loans or advances past due 180 days or more but less than 360 days.

3. Loss: - Non-performing loans or advances past due 360 days or more will be classified as loss.

2.3 Credit Risk

Credit risk is the risk of loss due to a debtor's non-payment of a loan or other line of credit (either the principal or interest (coupon) or both).

2.3.1 Faced by Lenders to Consumers

Most lenders employ their own models (credit scorecards) to rank potential and existing customers according to risk, and then apply appropriate strategies. With products such as unsecured personal loans or mortgages, lenders charge a higher price for higher risk customers and vice versa. With revolving products such as credit cards and overdrafts, risk is controlled through the setting of credit limits. Some products also require security, most commonly in the form of property. (http://en.wikipedia.org/wiki/Risk_managment, Date: December 15, 2009)

2.3.2 Faced by Lenders to Business

Lenders will trade off the cost/benefits of a loan according to its risks and the interest charged. But interest rates are not the only method to compensate for risk. Protective covenants are written into loan agreements that allow the lender some controls. These covenants may:

- Limit the borrower's ability to weaken their balance sheet voluntarily e.g., by buying back shares, or paying dividends, or borrowing further.
- allow for monitoring the debt requiring audits, and monthly reports
- Allow the lender to decide when he can recall the loan based on specific events or when financial ratios like debt/equity or interest coverage deteriorate.

A recent innovation to protect lenders and bond holders from the danger of default are credit derivatives, most commonly in the form of a credit default swap. These financial contracts allow companies to buy protection against defaults, from a third party, the protection seller. The protection seller receives a periodic fee (the credit spread) as compensation for the risk it takes, and in return it agrees to buy the debt should a credit event ("default") occur.

Credit scoring models also form part of the framework used by banks or lending institutions grant credit to clients. For corporate and commercial borrowers, these models generally have qualitative and quantitative sections outlining various aspects of the risk including, but not limited to, operating experience, management expertise, asset quality, and leverage and liquidity ratios, respectively. Once this information has been fully reviewed by credit officers and credit committees, the lender provides the funds subject to the terms and conditions presented within the contact (as outlined above). (http://en.wikipedia.org/wiki/Risk_managment, Date: December 15, 2009)

2.3.3 Faced by Business

Companies carry credit risk when, for example, they do not demand up-front cash payment for products or services. By delivering the product or service first and billing the customer later - if it's a business customer the terms may be quoted as net 30 - the company is carrying a risk between the delivery and payment.

Significant resources and sophisticated programs are used to analyze and manage risk. Some companies run a credit risk department whose job is to assess the financial health of their customers, and extend credit (or not) accordingly. They may use in house programs to advice on avoiding, reducing and transferring risk. They also use third party provided intelligence. Companies like Standard & Poor's, Moody's, Fitch Ratings, and Dun and Bradstreet provide such information for a fee.

For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by tightening payment terms to "net 15", or by actually selling fewer products on credit to the retailer, or even cutting off credit entirely, and demanding payment in advance. Such strategies impact sales volume but reduce exposure to credit risk and subsequent payment defaults.

Credit risk is not really manageable for very small companies (i.e., those with only one or two customers). This makes these companies very vulnerable to defaults, or even payment delays by their customers.

The use of a collection agency is not really a tool to manage credit risk; rather, it is an extreme measure closer to a write down in that the creditor expects a below-agreed return after the collection agency takes its share, if it is able to get anything at all. (http://en.wikipedia.org/wiki/Risk_managment, Date: December 15, 2009)

2.3.4 Faced by Individuals

Consumers may face credit risk in a direct form as depositors at banks or as investors/lenders. They may also face credit risk when entering into standard commercial transactions by providing a deposit to their counterparty, e.g., for a large purchase or a real estate rental. Employees of any firm also depend on the firm's ability to pay wages, and are exposed to the credit risk of their employer.

In some cases, governments recognize that an individual's capacity to evaluate credit risk may be limited, and the risk may reduce economic efficiency; governments may enact various legal measures or mechanisms with the intention of protecting consumers against some of these risks. Bank deposits, notably, are insured in many countries (to some maximum amount) for individuals, effectively limiting their credit risk to banks and increasing their willingness to use the banking system. (http://en.wikipedia.org/wiki/Risk_managment, Date: December 15, 2009)

2.3.5 Counterparty Risk

Counterparty risk, otherwise known as default risk, is the risk that an organization does not pay out on a credit derivative, credit default swap, credit insurance contract, or other trade or transaction when it is supposed to. Even organizations who think that they have hedged their bets by buying credit insurance of some sort still face the risk that the insurer will be unable to pay, either due to temporary liquidity issues or longer term systemic issues.

Large insurers are counterparties to many transactions, and thus this is the kind of risk that prompts financial regulators to act, e.g., the bailout of insurer

On the methodological side, counterparty risk can be affected by wrong way risk, namely the risk that different risk factors be correlated in the most harmful direction. Including correlation between the portfolio risk factors and the counterparty default into the methodology is not trivial; see for example Brigo and Pallavicini.(http://en.wikipedia.org/wiki/Financial_risk_managment, Date: December 15, 2009)

2.3.6 Sovereign Risk

Sovereign risk is the risk of a government becoming unwilling or unable to meet its loan obligations, or reneging on loans it guarantees. The existence of sovereign risk means that creditors should take a two-stage decision process when deciding to lend to a firm based in a foreign country. Firstly one should consider the sovereign risk quality of the country and then consider the firm's credit quality.

Five macroeconomic variables that affect the probability of sovereign debt rescheduling are:

- Debt service ratio
- Import ratio
- Investment ratio
- Variance of export revenue
- Domestic money supply growth

The probability of rescheduling is an increasing function of debt service ratio, import ratio, variance of export revenue and domestic money supply growth. Frenkel, Karmann and Scholtens also argue that the likelihood of rescheduling is a decreasing function of investment ratio due to future economic productivity gains. Saunders argues that rescheduling can become more likely if the investment ratio rises as the foreign country could become less dependent on its external creditors and so be less concerned about receiving credit from these countries/investors. (http://en.wikipedia.org/wiki/Financial_risk_mgt, Date: December 15, 2009)

2.4 Credit Risk Management

According to the **Credit Manual of Bank of Abyssinia**, the goal of credit risk management is to maximize a bank's risk adjusted rate of return by maintaining credit risk exposure with in acceptable parameters. Banks should identify measure, monitor and control their credit risks as well as determine that they hold adequately compensated for these risks. (Credit Manual of BOA, Date: February 2008).

Sound practices of Credit Risk Management address the following areas:-

A. Establishing appropriate credit risk environment;
B. Operating under a sound credit granting process; bank operate under sound, ell defined credit granting criteria; the criteria include a thorough understanding of borrowing as well as the purpose and structure of credit, and its source of repayment.
C. Maintaining an appropriate credit administration, Measurement and monitoring process. Bank's have a system the on-going administration of their various portfolios:-
    i. Monitoring documentation (keeping credit files up to date). Contractual agreements, legal covenants, collateral (including insurance).

ii. Ensuring the accuracy and timeliness of information to Top Management.
iii. Ensuring compliance with prescribed polices and procedures.

D. Ensuring adequate controls over credit risk. Banks have a system in place for managing problems credit and various other workout situations. When a bank has significant credit related problems, there should be a workout section that can rehabilitate a troubled credit or to increase the amount of repayment ultimately collected.

The taking of credit risk is a principal function of banks. How a bank approaches credit risk represents on of its important polices. The willingness of banks to take credit risk has provided a major service to market economics throughout banking history. The heart of the banking business is assessing credit risk-not necessarily taking risks, but assessing them. The distinction is important because ability to assess is a skill and whether credit risk are taken or not taken is a management decision. (Credit Manual of BOA, Date: February 2008).

Since exposure to credit risk continues to be leading source of problems in banks and their supervisor should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they adequately compensated for risks incurred. (Credit Manual of BOA, Date: February 2008).

2.5 Credit Processing

i. Credit Origination and Documentation.

According to the **Credit Manual of BOA** any loan request shall be made by the client at branch or head office level. Their request shall be addressed to the specified bank in written application. Branch is responsible for obtaining all pertinent document related to the credit request. (Credit Manual of BOA, Date: February 2008).

ii. Credit Analysis

Bank shall process all application upon fulfillment of the required documents and communicate the decision to the customer in writing. All documents submitted by the applicant should be kept in confidential. All new loans and related requests shall undergo appropriate credit analysis and appraisal. Credit personnel shall at all time keep in mind that credit analysis constitutes the critical phase of the banks credit granting process. In case where the loan application is related to a project an in-depth analysis of the feasibility study shall be made in respect of the technical, financial and economical feasibility of the project. (Credit Manual of BOA, Date: February 2008).

In line with the practice of banking industry, credit analyses shall be performed by assessing the five Cs:-

Character: the quality of desiring to repay debts when due is ranked above all other consideration. Of course, honesty is a necessity, but character implies integrity empathy for the lenders positions. Also, character of business organizations follows that of top management, its facilities for keeping records, the utilization of office functions and relations with employees. (Credit Manual of BOA, Date: February 2008).

Capacity: is the ability to repay debts as scheduled. Customer capacity is a reflection of safety margin between income and committed outflows and the stability of each. Business capacity, likewise, depends upon sales income, expenditure patterns and dept commitments.

Capital: this facet of the applicant refers to his/her financial strength that is the ability to raise funds from the liquidation of assets or other businesses. (Credit Manual of BOA, Date: February 2008).

Conditions: borrowers may be subject to unfavorable economic conditions beyond their control. Repayment depends not only upon character, capacity and collateral, but those factors over which the borrower exercise little or no control.

Collateral: it is an asset normally movable property pledged against the performance of an obligation. Bank can sell the collateral if the borrower defaults, while collateral reduce banks risk it enhances cost in terms of documentation and monitoring collateral. (Credit Manual of BOA, Date: February 2008).

iii. Credit Negotiation.

Credit negotiation aims at reaching an understanding with the borrower on the credit structure and the major terms and condition of the loan before submission of the loan request to the appropriate credit committee for approval. (Credit Manual of BOA, Date: February 2008).

iv. Credit Approval

Decision on loan request shall take place at five levels of the bank: Branch, Credit Department, Head Office, Senior Management and Board of Directors level. The base for loan approval shall be credit committee decision except in the case of over withdrawal on overdraft and current account.

Approval of all types of credit requests shall be evidenced by a loan approval form (LAF) dully completed and signed by the majority of the members of the appropriate loan approval committee. The decision made on the LAF shall constitute the only authority and basis for extending credits by lending branches except for overdrawals.

An approval loan shall be available for a maximum period of three months from the date of approval after which it will automatically lapped. A request for reconsideration shall require a reassessment in light of any changed situations. (Credit Manual of BOA, Date: February 2008).

v. Appeal

Any customer, who applied for al loan has the right to appeal accredit decision made by a loan approving committee. Request case shall be referred to the next higher credit committee of the bank except the credit decision by board of directors. The decision of the higher organ will be final. (Credit Manual of BOA, Date: February 2008).

vi. Loan Contract

- An appropriate loan contract shall be drawn for all approved loans. The loan contract shall be signed by the borrower, guarantor, the bank, mortgager/pledge, and spouse where appropriate.
- Mortgage/pledge contracts shall be registered at the appropriate bureau.
- Any disclosure like relationship with other borrowers shall be enclosed a part of the contract.

Loan contracts shall included, as appropriate, affirmative and/or negative covenants including a material adverse change clause to protect the bank and to provide acceptable options if the borrowers financial position and/or prospects began to deteriorate. Steps shall be taken, as appropriate, to accelerate repayment in the event of borrowers non-compliance. (Credit Manual of BOA, Date: February 2008).

vii. Loan Documentation

- Along with written application, the following and other documents should be submitted as may be demanded by the bank.
- Trade licenses, registration certificate, investment certificate from the appropriate ministry of bureau.

- Financial statements (preferably audited and reflecting the current years position), including case flow statements especially if the borrower runs a sizeable business.
- Feasibility study, where applicable (ordinarily for project loans extending beyond two years).
- Memorandum and articles of association where appropriate and other documents that may justify the need for the loan as may be required by the bank on merit of each application. (Credit Manual of BOA, Date: February 2008).

viii. Disbursement

Disbursement shall be made on a loan only after all prior conditions (credit processing, approval conditions, auditing, contracts etc) have been fully met. In exceptional case and up on the written recommendation of the branch manager and endorsement by the manager of the credit department, the president may authorize the release of a part of an approval loan. This, however, can be done only after loan contract and the collateral/guarantee agreement have been duly signed.

The availability period of the approval loan shall be 90 days for all credit facilities, but phase d disbursement shall be made in accordance with the approved schedule. (Credit Manual of BOA, Date: February 2008).

2.6 Classification of Loans and Advances

All loans whether they have pre-established repayment programs or not can classified in to the following five categories:-

Pass: - (Loans in this category are fully protected by the current financial and payment capacity of the borrower.)

Special Mention: - (any loan past due 30 days or more, but less than 90 days shall be classified as special mention)

Substandard: - (Non performing loans or advances past due 90 days or more but less than 180 days)

Doubtful: - (Non-performing loans past due 180 days or more but less than 360) and

Loss: - (Non-performing loans or advances past due 360 days or more) (Credit Manual of BOA, Date: February 2008).

2.7 Loan Follow-Up

Credit follow-up shall encompass analyses of performance in relation to such variables as trend in growth and portfolio mix, trends in growth and portfolio mix, trends in loan quality as indicated by risk rating, delinquencies, non-performance loans, work-our and write-offs.

Branch shall insure that a customer utilizes the loan only for the specified purpose. In the case where there are violations, report should be made to the credit department without delay. The Bank shall employ repayment schedules for each loan extended to a borrower. This schedule shall be used as a tool for following up repayment. The repayment schedule shall be as reasonable as possible taking in to account the cash flow projection of the client and the requisite number of reminders shall be given to a borrower before the loan is classified as non-performing loan. (National Bank of Ethiopia's Directive No. SBB/32/2002)

2.8 Factors that Affect Loan Processing and Collection

Corporate Planning and Development Department of BOA classified the causes in two broad groups:-

- **Internal Factors:-** are lack of continuous follow-up of repayment Due to manpower shortage, lack of continuous and communication with defaulter, overstating the collateral value at the time of estimation, lack of credit information to be gathered from other commercial banks and agency problem (i.e. Branch Managers focus merely on increasing their loan portfolio by accepting loans without making due analysis.)

- **External Factors: -** are diversion of the borrowed fund to other purposes, unavailability of demand and price fluctuation on both local and international market, country's economic and political condition, impact of change in fiscal and monetary policy, insufficient credit awareness, unwilling customers to disclose the information required, unethical competition made between banks and willful default.

2.9 Risks faced in Lending

As the magnitude of loan disbursed in the banking sector become greater and greater than the risk associated with its un collectiveness becomes higher and higher. Above single digit ration of non-performing loan to total loan is a symptom of poor credit analysis and follow-up in order to minimize the risk associated with credit. (NBE Memorandum ref. no. SD/290/04, 2004).

Credit as it has its advantages, has also risks associated to it. Expanding credit generally reflects a period of business prosperity, whereas contracting credit usually reflects a period of declining economic activity or depression. Fluctuations in the credit system may affect the level of prices; that is, as credit expands the money supply increases and may cause price rise depending on the features of the economy. According to **M L Jhingan (2004: 45)** there are causes where banks sometimes give too much or too little credit that may lead to inflation which caused direct and immediate damage to creditors and consumer. On the contrary, too little credit leads to deflation that brings down the level of output, employment and income. Such a credit leading to hyperinflation creates political instability.

2.10 The Need of Credit Risk Management

According to the **Credit Manual of Bank of Abyssinia**, the goal of credit risk management is to maximize a bank's risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks should identify measure, monitor and control their credit risks as well as determine that they hold adequate capital (provisions) for these risks and that they are adequately compensated for these risks.

Sound practices of Credit Risk Management address the following areas:-

A. Establishing appropriate credit risk environment;
B. Operating under a sound credit granting process; bank operate under sound, well defined credit granting criteria; the criteria include a thorough understanding of borrower as well as the purpose and structure of credit, and its source of repayment.
C. Maintaining an appropriate credit administration, Measurement and monitoring process. Banks have a system the on-going administration of their various portfolios:-
    a) Monitoring documentation (keeping credit files up to date). Contractual agreements, legal covenants, collateral (including insurance).
    b) Ensuring the accuracy and timeliness of information to Top Management.
    c) Ensuring compliance with prescribed policies and procedures.
D. Ensuring adequate controls over credit risk. Banks have a system in place for managing problems credit and various other workout situations. When a bank has significant credit related problems, there should be a workout section that can rehabilitate a troubled credit or to increase the amount of repayment ultimately collected.

The taking of credit risk is a principal function of banks. How a bank approaches credit risk represents on of its important polices. The willingness of banks to take credit risk has provided a major service to market economics throughout banking history. The heart of the banking business is assessing credit risk-not necessarily taking risks, but assessing them. The distinction is important because ability to assess is a skill and whether credit risk are taken or not taken is a management decision. (Credit Manual of BOA, Date: February 2008).

Since exposure to credit risk continues to be leading source of problems in banks and their supervisory should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they adequately compensated for risks incurred. (Credit Manual of BOA)

CHAPTER THREE

DATA ANALYSIS AND INTERPRETATION

This chapter deals with a tabular data presentations along with their interpretations. The data were collected from random supportive interview of the staffs and the customers of the bank included in the sample.

3.1. Analysis of responses given by the selected staff

The selected staffs have played a great role in the finalization of this paper by answering questions forwarded in the form of questionnaire and interview. Their responses for the presented questions are analyzed as follows:-

Table1. Information of the Staffs

Items	Responses	No. of staff	percentage
Level of Education	Diploma	3	15%
	First Degree	16	80%
	Second Degree & Above	1	5%
	Others	0	0
	Total	20	100%
Position Assumed	Manager	4	20%
	Assistant Manager	4	20%
	Loan Officer	6	30%
	Credit Analyst	6	30%
	Others	0	0
	Total	20	100%
Service Years	Less than 2 years	2	10%
	From 2-4 years	8	40%
	From 4-6 years	6	30%
	Above 6 years	4	20%
	Total	20	100%

The Credit department of BOA has combination of staffs with different educational level (ranking from diploma to 2nd degree). Assumed position (from loan officers to branch managers), and also years of service (from less than two years up to more than six years).

As it can be observed from table 1 majority of the staffs are 1st degree holders (80%). This shows that the bank has educational qualified staffs, so that problems of computation are reduced.

Majority of the staffs (40%) have been working in the bank between working in the bank 2-4 years. This shows that they are not experience enough to the vast credit job which needs deeper experience. This in turn may put the bank on risk that might arise delivery of credit information to the decision makers. In addition majority of the staffs (60%) working as Credit Analysts and Loan Officers, and it is advisable because the largest part of the job working by Credit Analysts and by Loan Officers.

Table 2. Credit Risk Management System adopted in BOA.

Item	Responses	Number	Percentage
Explain the degree of knowledge you have on credit risk management system adopted by the bank:-	Very much	12	60%
	Well	7	35%
	To Some Extent	1	5%
	Not at all	-	-
	Total	20	100%

As it can be seen from table 2, at least 95% of the respondents know about the credit risk management system adopted by the bank. This indicates that most of the respondents have awareness about the system. However, 5% of them know to some extent about the system and this shows that the bank should give awareness developing trainings to its credit staff to reduce its credit risk that may be caused by operational errors & mistakes.

Table 3. Assignment of Loan Officers.

Item	Responses	Number	percentage
Explain how credit officers are assigned in their positions in your bank:-	Based on qualification	4	20%
	Based on experience	2	10%
	Based on experience & qualification	14	70%
	Based on kin r/ship with management	-	-
	Based on relation with board members	-	-
	I am not quit aware of it	-	-
	Total	20	100%

Table 3 shows that 70% of the respondents believe that the bank assigns loan officers looking at both qualification & experience & about 20% of them believe that loan officers are hired on their qualification only, while the rest 10% assume experiences as a key factor to provide position for loan officers. This shows that the bank has a qualified and experienced credit staffs in addition to this; the system is not exposed to corruption. This in turn provides for accuracy in credit operation of the bank.

Table 4. Assessment of borrowers' past financial history, credit worthiness before extending any loan.

Item	Responses	Number	Percentage
Explain the degree to which your bank assess borrowers' past financial history, credit worthiness, performs detail financial analysis before granting any loan?	Yes Definitely	-	-
	Yes, but not sufficiently	20	100%
	Not at all	-	-
	I am not quite aware of it	-	-
	Total	**20**	**100%**

With regard to the performance evaluation of borrowers, 100% of the respondents agreed that the bank assesses borrowers' past financial history, credit worthiness and performs financial analysis before granting any loan. However, all of them complain that the assessment, which is currently carried out by the bank, is not sufficient. This implies that, the bank is in risk of borrowing funds to borrowers who are not sufficiently known for credit worthiness. This in turn leads the bank to high risk of NPL.

The selected staffs have also indicted as how they evaluate the credit Worthiness of the customer.

The following variables are used in borrower's rating

1. The five characteristics of Credit (Character, Collateral, Capital, Condition, and Capacity to pay)
2. Repayment history regarding past or current loans and advances, i.e. whether they pay their liabilities strictly and as per the repayment schedule.
3. Trend in sales and net income; long history of strong, high quality earnings and total Debt-to-Equity ratio. Generally they prepare a detailed loan approval form (LAF) which can show the borrowers financial status.

4. Financial statements, Management profile and prospective financial conditions.

Letting what the staffs responded about the insufficiency of borrowers' assessment aside, the variables that the bank is using to rate a potential borrowers are good and standard. This preserves the bank from default of repayment and finally to the creation of NPLs.

Based on the interview made with loan officers, the items held as collateral are enumerated here below:-

It is the general policy of the Bank of Abyssinia that, approval of all shall be backed by acceptable collateral.

The following shall constitute acceptable collateral for BOA loans:

- Buildings
- Motor Vehicles (Trucks and Trailers, Buses, Dump-Trucks,
- Automobiles)
- Machinery, Equipment and Business Mortgage
- Cash: - cash blocked in the name of an individual or company can be used as collateral for a loan taken by an applicant.
- Personal Guarantee
- Bank Guarantee
- Merchandise, Trade Receivable, and Negotiable Instruments

Under exceptional cases, however, the bank may extend loans and advances with no specific collateral or guarantee to some credit worthy customers either on account of their track record, or volume of business they run, which is relatively free from default risk. Collateral or assets securing BOA's loans must be readily marketable, accessible, stable in value and easily transferable.

As per the explanation of those loan officers, sometimes some loans are given without collateral to some borrowers who can't be justified as credit worthy especially when those people are found to be major share holders. This shows that the credit system of the bank is corrupted to some extent. If loans are given without collateral to anyone who is not sufficiently credit worthy, the probability of non repayment to that loan is very high. Such kinds of compromises to the credit policy of the bank may be major causes to the creation of NPL in BOA.

Table 5. Supervision and Follow-up mechanism after granting loan.

Item	Responses	Number	Percentage
Explain the degree of supervision & follow-up mechanism in your bank?	Yes, definitely	19	95%
	Yes, but not sufficiently	1	5%
	Not at all	-	-
	No response	-	-
	Total	**20**	**100%**

Table 5 shows that, 95% of the respondents agreed that there is strong & continuous follow-up mechanism of borrowers after granting loan. However, 5% of them complain that, the credit supervision & follow-up, which currently exists in the bank, is not sufficient. This implies that, to some extent, the bank is exposed to risk factors like diversion of borrowed fund to some other purpose by the borrower, which in turn may lead to the happening of NPLs.

Table 6. Supervision & Follow up

Item	Responses	Number	Percentage
How often does your bank supervise and follow up the granted loans?	Annually	-	-
	Semi annually	-	-
	Quarterly	-	-
	Monthly	20	100%
	Other period	-	-
	Total	**20**	**100%**

Regarding the frequency of credit follow-up, 100% of the respondents who already responded. As "yes definitely" & "yes, but not sufficient", explain monthly credit supervision & follow-up. However, since the reasonability of credit supervision & follow-up frequency depends on the type of business the borrower is running and also on whom the borrower is, so that sometimes a less than monthly follow-up may suit. Otherwise the bank may fall to risk of default by borrower who themselves need strong follow-up as to not divert the borrowed fund to some other purpose, or by borrowers who run some extremely sensitive type of business.

The respondents also listed some of the major problems they faced during loan processing as follows:-

- Initially, matching generalized credit policy and procedures of the bank to specific loan request,
- Some borrowers are reluctant to disclose necessary information. Specially, failure to provide their financial statements which is unavoidable and vital to know the financial position of the prospect borrower.
- Lack of sufficient information to evaluate new projects.

This implies that there are some bureaucratic bottle necks hampering the credit procedure of the bank from going swiftly. This seems to be happened due to lower analytical ability of the staffs of the credit department of the bank towards deducting the generalized credit policy of the bank to specific loan requests. This in turn leads the bank to wrong analysis and decision that might end up leaving it in flood of high credit risk. In addition to this, the reason behind some borrowers' unwillingness to present their financial documents might be lack of knowledge about credit work and the necessity of those documents to the lending borrowing work.

This implies that the bank is not giving sufficient briefing to its potential credit customers about the general lending – borrowing procedure and the necessity of each document it requests in the way that the borrower understands and cooperates. This in turn may lead the bank to lose some useful customers due to lack of knowledge and understanding, which may let them consider everything the bank requests them as a means of avoidance be develop.

Table 7. Mechanism applied by the Bank to save its loans from default

Item	Responses	Number of Responses	Percentage
Which mechanism does the bank apply to save its loans from default when a borrower faces certain problem & unable to continue repayment?	Extends the time of repayments	10	50%
	Injects of additional loan	5	25%
	Rearranges the loan repayment structure	4	20%
	Waives the loan	1	5%
	Specify, if any other	-	-
	Total	20	100%

From the data presented under table 7, we can deduct that, the bank tries to help its credit customers by using various alternatives to sake problematic loans from default. However, as 25% of the respondents responded, the bank applies additional loan injection as the 2nd major technique of solving problems of credit non-performance. This intern loan a big risk of additional default, plus it may also hurt the bank's liquidity position if in case it injects same big loans.

Table 8. Factors that aggravate occurrence of nonperforming Loan (NPL)

Item	Responses	Number of Responses	Percentage
What are the major factors that aggravate the occurrence of non-performing loan (NPL) in your bank?	A. Lack of continuous follow-up supervision	4	6.67%
	B. Diversion of the borrowed fund to some other purpose by the borrower than the borrowed	8	13.33%
	C. Incapability of managing the business that the borrower runs	4	6.67%
	D. Overstating the collateral value by the borrower, at the time of estimation by the bank.	13	21.67%
	E. Willful default	16	26.67%
	F. Lack of pre & post advisory service to the needy borrowers	12	20%
	G. Specify, if any other	3	5%

All the twenty respondents were requested to give their responses about this question. However, some of them put more than one factor as reasons that aggravate the occurrence of NPL in the bank. Finally the number of responses added up to be 60. From Table 8, we can see that “willful default”, “overstating collateral value” and “lack of pre & post credit advisory service to the needy borrower” are the major factors that aggravate the occurrence of NPL in BOA. This shows that bank is not following the rules of 5Cs of Credit (Character, Collateral, Capital, Condition, and Capacity to pay). This means, they don’t know the character of their prospective borrower, so that such kinds of customer will fully default the fund raised to him/her. On the other hand, the bank fails to evaluate the exact collateral value that same cheating prospective borrower presents, so that at the time of default, the bank couldn’t cover all the unpaid balance of the defaulted loan since the collateral value becomes dwarf.

3.2. Analysis of the Response of the Selected Customers

Some selected credit customers of the Bank of Abyssinia have also given the opportunity to express their attitude towards the credit facility that the Bank of Abyssinia renders to them. Their response is analyzed as follows.

Table 9. Personal Profiles of the Customers

Items	Responses	No. of staff	percentage
Gender	Male	12	60%
	Female	8	40%
	Total	20	100%
Level of Education	12 Grade complete	3	15%
	Diploma	16	80%
	First Degree & above	1	5%
	Others	0	0
	Total	20	100%

As we can see on table 9 majority of the customers are male & level of education is shown diploma graduate.

Table 10. Duration in the business.

Item	Responses	Number	Percentage
For how long have you been in the business that you are running now?	Less than 2 years	0	0%
	From 2 to 4 years	7	35%
	From 4 to 6 years	10	50%
	More than 6 years	3	15%
	Total	20	100%

From the findings, it can be seen that the majority of the respondents have been in the business for more than 2 years. This shows that they are experienced in the business area and they have much knowledge about managing the business.

Table 11. The length of time that respondents stayed as customer of Bank of Abyssinia (BOA)

Item	Responses	Number	Percentage
For how long have you stayed being a customer of bank of Abyssinia?	Less than 2 years	-	0%
	From 2 to 4 years	2	10%
	From 4 to 6 years	16	80%
	More than 6 years	2	10%
	Total	20	100%

BOA renders different kinds of services, such as Current/Checking account, Saving account, Time Deposit, Foreign Banking Service, Loan Service and others. Among the above mentioned services, loan service takes the higher contribution to the overall profitability of the bank. So, making the loan service smooth and easy is important to increase the profitability and to attract more customers.

Based on the above table, it can be seen that the majority of respondents have been customers of Bank of Abyssinia for about 4 to 6 years. This shows that most of the customers have gone a long way with the bank. Since the bank issues short and medium term loans range from 1 up to 5 years to the maximum. Therefore, the bank has to put much thought and also make use of serious effort to satisfy its customers by providing a more effective credit service. Moreover, it is easy to identify the credit worthiness of such kinds of customers.

The respondents were requested to list some of the major problems they ever faced while working with the bank as credit customers

Which are stated here below:-

- High value collateral are asked
- The time wasted to process the loan is unnecessarily longer
- The amount of Loan the bank approves less than (not comparable with) the collateral value it requests.
- Lack of flexibility (it means that sometimes some loans require subjective judgment beyond the loan procedure set by the bank. However, afraid of crucial managerial decisions are exhibited by the bank)

The above responses implied that the customers are not encouraged to request loan is some future time. The presence of these problems is an implication of slow working flow, dependence of the bank on high value of collateral than diversifying its dependence on the other parts of the 5C's of credit. However, collateral alone can't be a guarantee for a loan to be repaid. So that the bank may fall in risk of loosing good customers which in turn reduces its profitability unless it becomes fair while asking collateral to loans. In addition to this, the bank seems in risk of loosing some good customers which in turn is happening due to lack of flexibility. Lack of flexibility arises from either lack of sufficient awareness by the staffs or lack of sufficiently flexible rules followed by the bank. Both ways may lead the bank to loose some good customers which in turn reduces the banks profitability.

Table 12. Loan processing from Application to Approval

Item	Responses	Number	Percentage
How do you rate the quality of the lending procedure of the bank from application to disbursement?	Excellent	2	10%
	Very Good	4	20%
	Good	6	30%
	Need some improvement	8	40%
	Not good at all	-	-
	Total	20	100%

Any loan request shall be made by the client at branch or head office level. Their requests shall be addressed to the specific bank in written application. Then after, various procedures are set to be followed before granting the credit.

As indicated in table 14, majority of the respondents are well satisfied to different degrees by the lending procedure of the bank. This implies that the bank's credit procedure is a quality one. This in turn implies that the bank is following a credit procedure that provides for customer satisfaction and ultimately profitability.

The respondents were also requested to list some of their major complaints about the lending process of the bank and they listed them as follows:-

- Even though all the necessary documents are listed on the credit manual, the customers complain, stating that they are not told every necessary document that must be presented at once.
- Standard Banking Practice describes a loan must be approved in not more than 5 days, but customers complain that the bank takes more than one month to approved a single loan.
- Some of the bank staffs are not familiarized with the procedure that the bank sets.

What those customers listed here indicate that staff training towards staff motivation and adaptation with the credit manual and others related documents is a missed thing by the bank. So that a great deal of negligence by the part of the credit staffs to serve a potential credit customer at their desk is exhibited. This in turn may lead the bank to loose some good customers, hinder other new ones from coming so that the banks profitability may be reduced.

Table 13. Advisory Service given to Customer

Item	Responses	Number	Percentage
Specify whether the bank gives any advisory service to help its customers to understand the things of credit:	Yes	20	100%
	No	-	-
	Total	20	100%

Consultancy is one of the key factors, in addition to the 5Cs' of credit as indicated in the Credit Manual of Bank of Abyssinia. It helps in analyzing credit, for the final success of loan processing and ease of collection of disbursed loans. Accordingly, from the above table it could be understood that the respondents were provided with advisory service from the Bank. This helps them to increase the knowhow of the business and enables them to efficiently utilize the disbursed loan. So that, they are motivated to work with this bank, and may be also encouraged to plan their business and willing and able to repay the fund they borrowed and finally NPL level can be reduced.

Table 14. Quality of the banks advisory service

Item	Responses	Number	Percentage
Please rate the quality of the banks advisory service:-	Excellent	2	10%
	Very Good	4	20%
	Good	7	35%
	Poor	6	30%
	Very Poor	1	5%
	Total	20	100%

Based on table 14, it can be seen that the majority of respondents rates the quality of the banks advisory service is sufficient (as excellent, very good or good). However, those who put it as insufficient (poor or very poor) are also added up to be significant (35%) from this it's possible to deduct that the bank is significantly on the way to risk its borrowed funds by disbursing them to borrowers who are not fully informed about the sensitivity of credit business. So that, the amount of NPL level may increases due to repeated inability of repayment to the borrowed fund.

Table 15. Efficiency and Cooperativeness of Front Line Officers

Item	Responses	Number	Percentage
Please rate the degree of cooperativeness of the front line officers to provide loans service:-	Excellent	13	65%
	Very Good	-	-
	Good	-	-
	Poor	7	35%
	Very Poor	-	-
	Total	20	100%

Efficiency, Prudence, Effective Customer Service, and Good Public Image shall be used as fundamental guidelines to be observed by all credit personnel of the bank. Customers are very susceptible of not being satisfied if they cannot get an attractive approach of bright face from the front line workers whom they face directly. From table 17 it can be easily seen that the majority of the respondents are satisfied with the level of cooperativeness that the staffs of the bank have. This shows that the bank worked well in developing good public image which in turn could attract customers itself. Finally the level of profitability will rise.

Table 16. Time taken to get a loan approved

Item	Responses	Number	Percentage
How much time had it taken to get your loan approved?	From 1-10 days	4	20%
	From 11-20 days	5	25%
	From 21-30 days	8	40%
	Above 30 days	2	10%
	Total	20	100%

It is clear that banks being intermediaries who mobilize money from the public at large, they need to utilize this public fund effectively, efficiently and safely. Credits are the most important asset in any commercial bank and represent almost three quarters of the total value of all banks assets. This shows that the bank emphases on credit and its process. The time given to process the credit is assumed to be criteria used by the customer to evaluate the efficiency of the bank. The longer the time that the bank takes to process the loan the higher the opportunity to push the customer to shift to other banks will be. As we can see from the above table, most of the customers are of the view that the number of days spent to secure loans is significant which is up to 30 days and/or more.

The standard banking practice describes a loan must be approved in not more than 5 days. Hence, one can see that the bank's service in disbursing loans need improvement as customers might start looking for better offers. This is a mismanagement of credit service. So that it might lead the bank to lose some opportunities of profit and having valued customers.

Table 17. Customers were asked about the interest rate applied by the Bank

Item	Responses	Number	Percentage
Please evaluate the amount of lending rate applied by the bank:-	Very High	-	-
	High	12	60%
	Moderate	8	40%
	Low	-	-
	Unfair	-	-
	Total	20	100%

The current credit rate of return of BOA is 9.25%, 9.5%, and 10% for short, medium and long term loans respectively. The higher the term is, the bigger the interest rate will be.

Even if the upper limit of interest rate is affixed by the National Bank of Ethiopia (NBE), actual rates may vary in accordance with criterion which the bank may establish priority activities or sectors, as long as the bank's profitability is not unduly impaired. Based on the above table, 60% of the respondents evaluated the interest rate applied by the bank is high and 40% of them stated it as Moderate. This implies that the bank may be putting burden on its borrowers so that some borrowers may fail to repay their obligation due to accumulation of unnecessarily high interest expense. This in turn leads the bank to have higher NP's in its books.

Supportive actual data regarding on NPL of Bank of Abyssinia
(From year 2001-2008 G.C.)

According to the annual reports of BOA the size and trend of Non-Performing Loan is analyzed as follows:-

Table 18. Ratio of Non-Performing Loan (NPL) to Outstanding Loans (OSL) as of June 30 (figures are in millions)

Year	Total OSL	Amount of NPL	Total OSL by percentage
2001	686.91m	18.05m	2.63%
2002	669.54m	38.17m	5.70%
2003	809.21m	62.05m	7.67%
2004	962.40m	73.02m	7.59%
2005	1,234.46m	61.49m	4.98%
2006	1,962.51m	61.05m	3.11%
2007	2,305.15m	107.80	4.68%
2008	3,100.60	150.75	4.86%

As it can be seen from table 18, the ratio of NPL to Out Standing Loan of the bank fluctuates from year to year. The total market economy faces inflation in the year 2002, as a result Bank of Abyssinia NPL increased by birr 20.12

million (3.07%) as compared to year 2001. But, when we see the figure of subsequent years that is from year 2003-2006 outstanding loan of BOA increased year to year even though the increment in NPL show is not that much significant. This shows that, BOA's NPL level is highly dependent on the macro economic conditions of the country. This in turn implies that the bank is disbursing the higher portion of its loans to the sectors which are highly vulnerable to macroeconomic fluctuations.

Table 19. Growth rate of Outstanding Loan Balance (OSL)

Years	Total OSL	OSL growth rate
2001	686.91m	-
2002	669.54m	-2.55%
2003	809.21m	20.86%
2004	962.40m	18.93%
2005	1234.46m	28.27%
2006	1962.51m	58.93%
2007	2305.15m	17.46%
2008	3100.60	30.15%

Based on table 19, the outstanding loan growth rate is highly fluctuating and this is due to the different investment areas introduced in our country, the bank gets the opportunity to borrow loans to the investors.

As per the interview conducted with Risk Management and Monitoring Department Manager of BOA, "A Bank is successful when the risk it takes is reasonable and controlled within its financial resources and credit competence". Experience has proved that the essential issue for preservation of the quality of loans is existence of well-developed policies and procedures, effective credit controls and the most critical element of all is a well-trained staff that is qualified to implement the system, regardless of what the economic situation exhibits. Conversely, Risk Management and Monitoring Department Manager of BOA gave various additional reasons that become the cause of large amount of problematic loans in the bank. Therefore, the basic causes for the occurrence of credit risk, other than decline in economic conditions are:-

- Excessive concern for income growth: - too much concern for revenue must not permit extension of weak loans that carry undue risk. Because weak loans usually cost more than they contribute for income.
- Compromise of credit principles
- Incomplete information: - complete credit information is the best acceptable, accurate and reasonable method
- Lack of supporting documents to determine a borrower's financial standing
- Insufficient credit information is an important cause of credit risk
- Lack of adequate supervision of old and familiar borrowers
- Dependence on oral information furnished by borrowers instead of reliable financial data and direct verification
- Ignoring warning signs pertaining to the borrowers' Economy, region, industry of other related factors
- Absence of established system of credit follow-up
- Technical incompetence:- the inability of credit staffs to analyze financial statements and evaluate other credit information
- Weakness in collateral arrangements i.e. availing loans without adequate margin of safety
- Over lending: - lending beyond the prudent level of financial requirement a reasonable capacity of the borrowers to repay the loan. This is the basic problem of BOA and in one sense it is related with technical incompetence.
- Competitor: - currently many government and private banks are competing in market; as a result competition among banks for market and to influence community may result in the compromise of credit principles and the question of un sound loans.

CHAPTER FOUR

SUMMARY, CONCLUSSION, AND RECOMMENDATION

4.1. Summary

The following findings are summarized from the data collected from staffs through questionnaire.

- 95% of the respondents know about the credit risk management system adopted in the bank. However, 5% of them do not know much about the systems and this shows that the bank should give awareness development training to its credit staffs in order to reduce errors and mistakes.
- 70% of the respondents assume that both qualification and experience are the criteria to hired loan officers. This shows that the assignment doesn't expose the bank for corruption.
- 100% of the respondents agreed that the bank assesses borrowers past financial history, credit worthiness and performs a detailed and strict financial analysis before granting a loan.
- 95% of the respondents agreed that there is a strong follow-up mechanism of borrowers after granting a loan. And all are agreed that follow-up made monthly.
- 40% of the total respondents have come across some problems on loan processing and 60% of respondents in different. This problems are like; some customers are reluctant to disclose necessary information specially failure to provide their financial statements which is unavoidable and vital to know the financial position of the prospect borrower.
- 50% of the respondents respond that when borrower's face a certain problem such as unable to pay their loan repayment, the bank give some extra/additional period for revival.
- 80% of the respondent agreed that there is lack of cooperation among banks on sharing customer's credit information and also close relationships between customers and staffs.

The following findings are summarized from the data collected from customers of the bank through questionnaires.

- The majority of the respondents have been in the business for more than 2 years. This shows that they are experienced in the business area.
- 80% of the respondents are customer of the bank from 4 years up to 6 years.
- 70% of the respondent faces some difficulties, with getting loan service such as high value collateral are needed, the time required to process the loan is very long, limited amount of loan approved and lack of flexibility.
- 40% of the respondents agreed that loan processing need improvement on documentation and loan approval time. The complaint is like; Standard Banking Practice describes a loan must be approved in not more than 5 days, but customers complain that the bank takes more than one month to approved a single loan.
- 100% of the respondent was provided advisory service from the bank. This helps to increase the knowhow of the business and enables them to efficiently utilize the disbursed loan. The majority of respondents rate the quality of the banks advisory service is good.
- 65% of the respondent agreed that there is considerable problem of front desk workers approach. Therefore, the must give some kind of customer service training to its front desk staffs in order to improve their approach with the customers.
- 40% of the respondent responds that the longer time to process the loan leads the customer to shift to other banks.
- 60% of the respondents expressed as interest rate applied by the bank are high and 40% of them stated as moderate.

4.2. Conclusion

Commercial banks are exposed to various types of risks. These risks are both controllable and uncontrollable in nature. Bank of Abyssinia, as a commercial bank and as a financial intermediary, borrows money from those who have surplus of it, with a lower interest rate, and lends the same to those who are in scarce of it with a higher interest rate. This is what is known as the two basic banking service, deposit and credit. By this way of buying and selling of idle money mediating interest as a medium of exchange, banks maximize their income.

The transaction of credit against deposit involves credit risk. Since credit risk is occurred due to the presence of Non Performing Loans (NPLs), which are problematic or totally defaulted; therefore, it can hurt the existence and wellbeing of the bank unless it's managed properly.

There are a number of reasons (both manageable and non manageable by the bank) for the happening of credit risk. However, those entire reasons end up with creation of NPL. Among these causes of NPL, those which are caused by Macroeconomic change are less controllable while causes at bank level and causes at borrower level can be controlled.

AS the cause of credit risk is the presence of Non Performing Loans, the success or failure of credit function of any bank is determined by the level of NPL in its books. A bank, if it wants to be successful in its credit function, must reduce the amount of NPLs already in its books and it must minimize the probability of occurrence of NPLs by using the various credit risk prevention methods.

Like any commercial bank, the Bank of Abyssinia is exposed to credit risk i.e., it has NPLs in its books and always exposed to the possibility of having NPLs on its future credit activities. Therefore, the bank shall properly manage its credit risk for its safety.

This study tried to assess credit risk management of BOA, which indirectly means, NPL management in BOA. From the data presented and analyzed in this study, BOA's NPL doesn't have a regular trend i.e, it fluctuates from year to year. Even if the bank's annual reports blame the general decline in the business and economic activities of the country and the change in macroeconomic environment for the increase in the bank's NPL for those years which showed increase in NPL, it can be concluded from this study that there are other causes for the happening of BOA's NPL, which could have been controlled by the bank if it wouldn't be for the weakness of the bank in credit functions.

From the data presented and analyzed under this study, we can conclude that:-

- The credit management system of the Bank of Abyssinia is not efficient enough.
- The Bank of Abyssinia is exposed to various causes of NPL at bank level i.e., which could have been controlled by the bank.
- Unlike the reports, documents, Financial statements, questionnaire and interview with officers of the Bank of Abyssinia, macroeconomic fluctuation are not the only causes of the bank's NPL rather, lack of adequate follow-up and supervision, ignoring NPL warning signals, over lending, technical incompetence of the credit personnel, Compromise of credit principles, incomplete information about the prospective borrower's status, granting of weak loans being devoted to income, inappropriate borrower rating and dependence on mere promises of mouth are causes of credit risk(NPL) in BOA due to inefficient credit risk management.

4.3. Recommendation

It is my belief that this study assesses how credit risk is being managed in The Bank of Abyssinia. The various credit risk exposures are presented. As it can be seen easily from the questioner analysis and interview, there are a number of causes at different level, both controllable and uncontrollable, that may expose the bank to credit risk. Even if some of the major causes of credit risk that contribute to Non-Performing-Loans(NPL) are uncontrollable situations like decline in the general business and economic conditions of the country, the bank, as far as possible, should manage the credit risks that may be caused at the bank level to pin them down to their minimum level. By reducing the credit risk at bank level, BOA can indirectly reduce some of the risk variables that may happen at borrower level.

To reduce credit risk at the bank level, the bank should follow clear and reliable borrower rating system by giving stress to the following variables before and after granting any loan:-

- Repayment history regarding past or current loans and advances, i.e. they pay strictly as per the repayment schedule
- Internal organization and system in the borrower's firm,
- Trend in sales and net income of the borrower ,
- Long history of strong & high quality earnings of the borrower,
- Review of genuine financial statements of the borrower's firm,
- Management profile of the borrower's firm,
- Prospective financial conditions.

Credit follow-up and supervision for risk assessment should be made on every loan granted to every borrower. For this, BOA shall employ a systematic way of loan follow-up for the effective and timely repayment of outstanding loans as follows:-

- Preparing repayment schedule for each loan extended to a borrower. Therefore, this schedule shall be used as a tool for follow-up on repayments.

- The borrowers pay as per the loan repayment schedule which is made ready for each of them and whenever a loan shows a sign of default by refusing to pay as per the repayment schedule, the borrower should be reminded to pay before the loan is classified as NPL.
- Continuous supervision should be made on the status of the borrowers and their business after granting of loan. This is very useful to identify early warning signals of non repayment.
- Strong supervision and follow up should be made to avoid diversion of funds by borrowers.
- The credit committee of the bank at different level should know their borrower, they should have rich information about the prospective borrower as far as possible,
- The personnel of the credit department should be given with training and be fully qualified in credit analysis and they should be made fully aware of the credit risk management system adopted by the bank,
- The bank's personnel of the credit department and loan approving personnel at any level in the bank should avoid compromise of credit principles, rules, and regulations of the monitoring authority (NBE)
- BOA should make exchange of credit information with other commercial banks, for mutual benefit, without any negligence and as far as it is not against the bank's benefits,
- As fluctuations in the general business and economic conditions in the country are one of the major causes of the bank's NPLs, BOA at times of those economic fluctuations, should concentrate on granting of loan to the economic sectors which are relatively stable and less risky ones.
- The bank shall try to have the best credit portfolio at all times.

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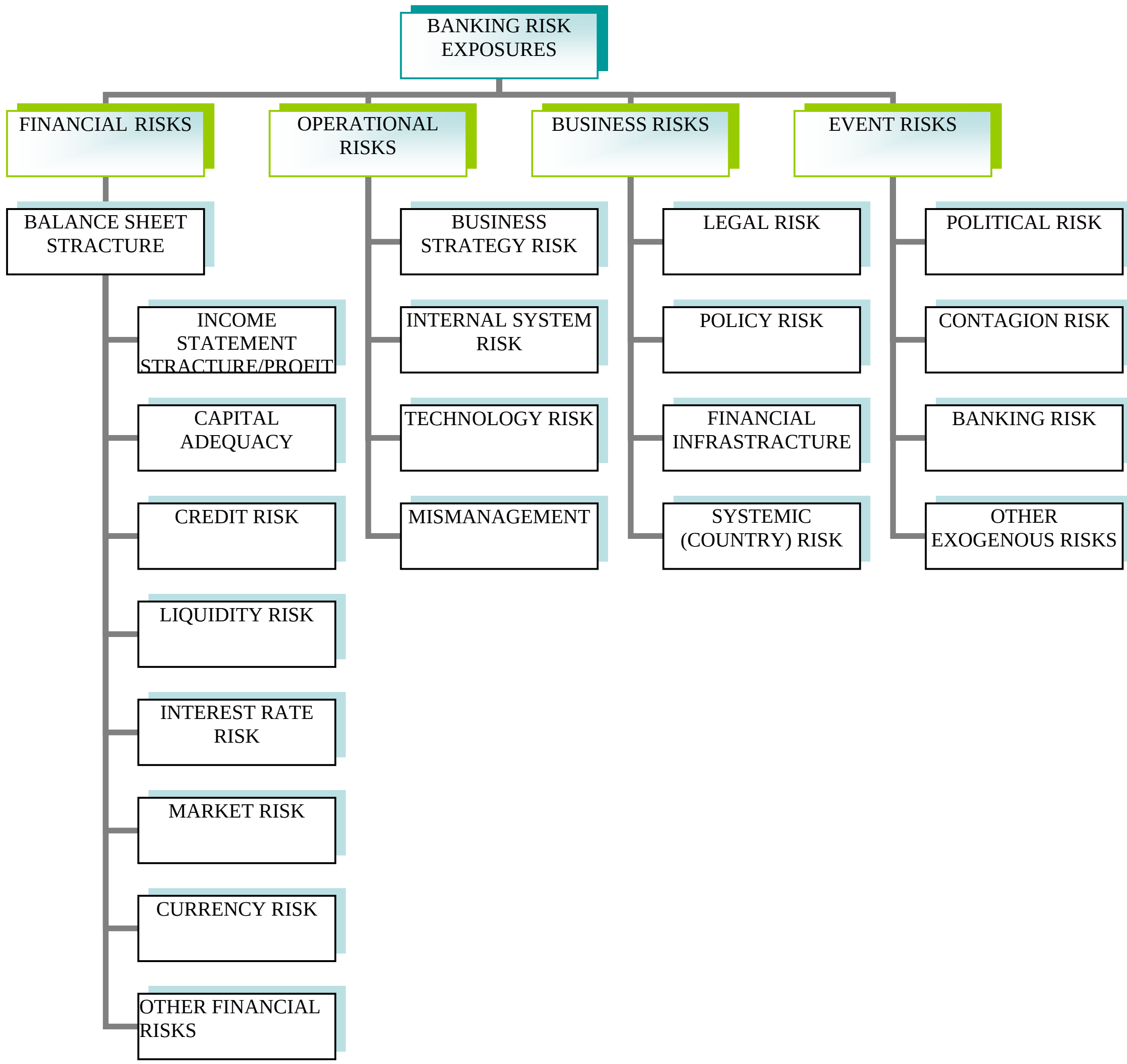

APPENDIX-1

Source:-Hennie Van Greuning & Sonja Bratanovic, Analyzing Banking Risk-A Framework for Assessing Corporate and Financial Management, the World Bank, Washington D.C., 2000.

Questionnaire

St. Mary University College
Department of Management

Questionnaire Designed for the Staffs' of Credit Dep't in BOA & for Credit Customers.

This questionnaire is designed for preparing a senior essay under the title **"Assessment of Credit Risk Management the case of Bank of Abyssinia ".** Please take a few minutes to complete this questionnaire and return it as soon as possible. Your frank and honest opinion will have a positive contribution to the success of the study.

I assure you that any of the information you provide below will be kept completely confidential and will not be used for any other purpose than for academic. You are not required to write your name.

Greetings to all whom this questionnaire would appear! I would like to express my heartfelt appreciation in advance for the cooperation you show in completing the questionnaire sparing your precious time.

Directions

- You are kindly requested to make a tick (✓) mark in the boxes provided and write your response on the space given.
- You may tick more than one alternative where necessary.
- Your honest and frank answers are appreciated.

I- General Information

1. Educational Background
   - ☐ College/University Diploma
   - ☐ First Degree
   - ☐ Second Degree & above
   - ☐ Other, specify______________________________

   ____

2. Job Position
   - ☐ Manager
   - ☐ Assistant Manager
   - ☐ Loan Officer
   - ☐ Credit Analyst
   - ☐ Other, specify______________________________

   ____

3. Year of service on loan in a bank
   - ☐ Less than 2 years
   - ☐ From 2-4 years
   - ☐ From 4-6 years
   - ☐ Above 6 years

II- Specific Information

1. How much do you think you know about the credit risk management system Adopted by the bank?
   - ☐ Very well
   - ☐ Well
   - ☐ To some extent
   - ☐ Not at all

2. How loan officers are assigned in their positions?
   - ☐ Based on qualification
   - ☐ Based on Experience
   - ☐ Based on Experience and qualification
   - ☐ Based on kin r/ship with management
   - ☐ Based on relation with board members
   - ☐ I am not quite aware of it

3. Does the Bank assesses borrowers past financial history, credit worthiness and performs detail financial analysis before granting loans?
   - ☐ Yes, definitely
   - ☐ Yes, but not sufficiently
   - ☐ Not at all
   - ☐ I am not quite aware of it

4. Is there strong & continuous follow-up mechanism of your borrowers after granting any loan?
   - ☐ Yes, definitely
   - ☐ Not at all
   - ☐ No response

5. In question no.4, if your answer is “Yes”, how often?
    - ☐ Annually
    - ☐ Semi annually
    - ☐ Quarterly
    - ☐ Monthly
    - ☐ Other period, please specify________________________

    ____

6. Have you ever came across any kind of problem regarding loan processing?
    - ☐ Yes
    - ☐ No

7. If your answer for # 6 is yes, list them_______________________

    ____

8. Which mechanism does the bank apply to save the loan from default, when a borrower faces certain problem & unable to continue repayment?
    - ☐ Extends the time of repayment
    - ☐ Injects of additional loan
    - ☐ Rearranges the loan repayment structure
    - ☐ Waives the loan
    - ☐ Specify, if any other ______________________________

    ____

9. What are the major factors that aggravate the occurrence of non-performing loan (NPL) in your bank?

    A. Lack of continuous follow-up and supervision.

    B. Diversion of the borrowed fund to some other purpose than the borrowed

    C. Incapability of management in leading the business by the borrower

    D. Overstating the collateral value at the time of estimation by the borrower

    E. Willful default

    F. Specify, if any other_____________________________________

    ____

    ____

Questionnaires for BOA Credit Department Customers

1. Gender
   - ☐ Male
   - ☐ Female

2. Education Background
   - ☐12 grade complete
   - ☐ College/University Diploma
   - ☐ First Degree
   - ☐ Second Degree & above
   - ☐ Others

3. For how long have you been in the business that you are running now?
   - ☐ Less than 2 years
   - ☐ From 2 to 4 years
   - ☐ From 4 to 6 years
   - ☐ More than 6 years

4. For how long have you stayed being a customer of Bank of Abyssinia?
   - ☐ Less than 2 years
   - ☐ From 2 to 4 years
   - ☐ From 4 to 6 years
   - ☐ More than 6 years

5. Have you ever faced any difficulties in getting loan services?
   - ☐ No
   - ☐ Yes

6. If your answer for question # 6 is yes, please mention
   ____
   ____

7. How do you rate the quality of the lending procedure of the bank from application to disbursement?
   - ☐ Excellent
   - ☐ Very Good
   - ☐ Good
   - ☐ Needs some improvement, but satisfactory
   - ☐ Not good at all

8. If you have any complain about the lending process of the bank, please list them down ______________________________________
   ____
   ____

9. Does the bank give any advisory service to the needy?
   - ☐ Yes
   - ☐ No

10. If your answer for question # 10 is yes, please rate the quality of the banks advisory service.

- ☐ Excellent
- ☐ Very Good
- ☐ Good
- ☐ Poor
- ☐ Very Poor

11. To what extent do the front line officers cooperate and in providing loan service?

- ☐ Excellent
- ☐ Very Good
- ☐ Good
- ☐ Poor
- ☐ Very Poor

12. How much time had it taken to get the loan approved?

- ☐ From 1-10 days
- ☐ From 11-20 days
- ☐ From 21-30 days
- ☐ Above 30 days

13. How do you evaluate the amount of lending rate applied by the bank?

- ☐ Very High
- ☐ High
- ☐ Moderate
- ☐ Low
- ☐ Unfair

THE CANDEDATE'S DECLARATION

I, the undersigned declare that this senior essay/project is my original work. Prepared under the guidance of Ato Wondafrash. All sources of materials used for the manuscript have been dully acknowledged.

NAME: MESERET BEHAILU TEFERA

SIGNATURE: ________________________

PLACE: ST. MARY'S UNIVERSITY COLLEGE

DEPARTMENT OF MANAGEMENT

DATE OF SUBMISSION: JUNE 22, 2010

ADVISORIS DECLARATION

This paper has been submitted for examination with my approval as the university college advisor.

NAME:___________________________________

SIGNATURE:_____________________________

DATE:____________________________________