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**FACULTY OF BUSINESS AND
ECONOMICS DEPARTMENT OF
ACCOUNTING AND FINANCE**

**ASSESSEMENT OF CREDIT RISK MANAGEMENT PRACTICE (IN
THE CASE OF DASHEN BANK BOLE MICHAEL BRANCH)**

**A PROPOSAL PAPER SUBMITTED TO DEPARTMENT OF
ACCOUNTING AND FINANCE IN PARTIAL FULFILMENT OF THE
BACHELOR OF ARTS DEGREE IN ACCOUNTING AND FINANCE**

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Abstract

This study will be conducted on the assessment of credit risk management practice in Dashen bank at Bole Michael branch. This research Paper will conduct with a qualitative and quantitative research approach by employing descriptive research design and these research target group is employees who directly involved in credit risk management and administration. The researcher will use primary and secondary data source. Unstructured interviews and closed questionnaires will be used to collect primary data and secondary data will be collected from books, Google, and other publishers. The researcher will use purposive sampling technique under non-probability sampling to collect data from employee of the bank and use the descriptive data analysis method.

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CHAPTER ONE: INTRODUCTION

1.1. Background of the study

Bank is financial institutions that accept deposit and make loans. After the great depression, the US congress required bank only engage in banking activities, whereas investment banks were limited to capital market activities. Banks in Ethiopia extend credit (loan) to different types of borrower for many different purposes. For most customers, bank credit is the primary source of available debt financing and for banks; good loans are the most profitable assets (Frederic's, Mushin, 2004, pp. 8 - 9).

Adequately managing credit risk in financial institutions (FIs) is critical for the survival and growth of the FIs. In the case of banks, the issue of credit risk is even greater concern because of the higher level of perceived risk resulting from some of the characteristics of client and business condition that they find themselves in. In recent times, banks' risk management has come under increasing analysis in both academia and practice. Banks have attempted to sell sophisticated credit risk management systems that can account for borrower risk and perhaps more importantly, the risk reducing benefits of diversification across borrowers in a large portfolio

Credit risk occurs when debtor/borrower fails to fulfill his obligations to pay back the loans to the principal/lender. In banking business, it happens when "payments can either be delayed or not made at all, which can cause cash flow problems and affect banks, liquidity (Greuning and Bratonovic, 2003, p.161). Hence credit risk management in the bank basically involves its practices to manage/minimize the risk exposure and occurrence.

In order to reduce the rate of default, banks all obliged to establish own credit risk management strategy. Credit risk management in a financial institution starts with the establishment of sound lending principles and an

efficient framework for managing the risk policies, industry specific standards and guide lines, together with risk concentration limits are designed under the supervision of risk management committee. “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’ (Bassel I, 2000). Hence, the purpose of this study is to assess credit risk management

problems of Dashen Bank, Bole Michael Branch in light of the practices of modern credit risk management in financial institutions.

1.2. Statement of the Problem

Credit risk is the risk of loss due to a debtor's nonpayment of loans or other line of credit. Credit risk is defined as the potential that a bank and borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Default occurs if the debtor is unable to meet its legal obligation according to the debt contract. The examples of default event include the bond default, the corporate bankruptcy, the credit card charge-off, and the mortgage foreclosure. Other forms of credit risk include the repayment delinquency in retail loans, the loss severity up on the default event, as well as the unexpected change of credit rating (Aijun, 2009). The objective of credit risk management is to minimize the risk and maximize banks risk adjusted rate of return by assuming and maintaining credit exposure within the acceptable parameters. The risk must be assessed to derive a sound investment decision and decision should be made by balancing the risks and returns. The role of credit risk management is assessing the risk, conducts monitoring and reviews of the performance of the bank (Machiraju, 2008).

Poor credit risk management result by reducing banking system profitability and stability in many places and bank failures. For example, Udunze (2013) reports that as a result of investigations regarding poor corporate governance and poor credit risk management, the chief of executive officer of Ecobank transnational agreed to forgo US\$1.14million bonus to earn for the 2012 financial year as part of efforts to rebuild public confidence in the bank against the back drop of accusations of maladministration, fraud, and technical incompetence in the bank in Nigeria. To give emphasis for the credit risk management practice, still now some studies has already been made to the literature on credit risk management in Ethiopian banks, such as that of (Girma and Tibebu2011).

According to branch manager, no previous study was conducted on assessment of credit risk management practice in the case of Dashen bank at Bole Michael branch because there was no interested person to conduct a study on this issue at this branch. The researchers study will be focus on assessment of credit risk management practice in the case of Dashen bank at Bole Michael branch.

1.3. Research Questions

In line of this, this study will try to answer the following basic research questions.

1. How credit risk management is practice in Dashen Bank at Bole Michael Branch?
2. What is the major challenge that affects credit risk management practice in Dashen Bank at Bole Michael Branch?
3. What are the effective credit risk management practices in Dashen Bank at Bole Michael Branch?

1.4. Objective of the study

1.4.1. General objectives

The main objective of the study is to assess the credit risk management practice in Dashen Bank, Bole Michael Branch.

1.4.2. Specific objectives

The specific objectives of this study will be:

- To investigate how Dashen Bank at Bole Michael Branch practice in credit risk management.
- To identify the challenges that affect credit risk management practice for Dashen Bank at Bole Michael Branch
- To investigate credit risk management for Dashen Bank at Bole Michael branch.

1.5. Significance of the study

The study will result in a clear understanding of the credit risk management for Dashen Bank, Bole Michael Branch how to manage and assess the risk faced by the bank. And also the study on credit risk management will contribute to existing knowledge and literature on the subject under investigation. Moreover, the study will also serve as a reference material to

other researchers. In fact, it is hoped that the study will have paramount importance in providing information relating to problems associated with credit risk management so that remedial action, especially in the area of providing information for enhancing policies and procedures on credit risk management at the

banks. Moreover, it will also give an insight to management in how to systematically approach risks associated with credit management.

1.6. Scope (Delimitation) of the study

The scope of the study will be based only to assess credit risk management practice of Dashen Bank, Bole Michael Branch. The bank activities of Dashen Bank are one of the greatest private banks. The magnitude of risk managements are mainly in number however, the study will encompass credit risk management.

1.7. Definition of Terms

Collection policy: It is the steps followed by a company to ensure that borrowers make their timely payment

Credit risk management: It is loss mitigation process through an understanding of adequacy of capital in the banks' and reserves for loan that is lost at any particular time

Credit risk: It is uncertainty that a borrower may not comply with the obligations that were agreed on in the terms.

Profitability: this is company's ability to make use of its resources with the aim of generating revenue more than what their expenses are.

Terms of credit: It is an agreement between a borrower and lender that outlines the timing and amount of payment that the borrower should make within a stated period of time

1.8. Research Design and Methodology

1.8.1. Research Design

This study will conduct by employing descriptive research design because it involves a systematic collection and presentation of data and describe (justify) the current nature of credit risk management practice in Dashen Bank at Bole Michael Branch.

1.8.2. Research approach

This study will be using both quantitative and qualitative (mixed) approach. Quantitative approach is based on the measurement of quantity or amount of the data. On the other hand, the purpose of qualitative approach is to search the data that occurs in the credit risk management.

1.8.3. Population (target groups)

The target groups of this study are employees who are directly involved in credit risk management and administration. This means senior bank professionals, department heads, branch manager, assistance branch managers, loan section heads, loan/credit analysis officers.

1.8.4. Sampling techniques and sample size

Purposive sampling will be use under the non-probability sampling to collect data from the employee of the bank in line of the research question. The rationale behind employing this purposive sample type is to identify the employee that have specialized knowledge of credit risk management and to share their understandings about the study. Researcher use purposively 20 respondents, from the total population of employees directly involved in credit risk management and administration, and branch manager, credit analysts' customer service officer

1.8.5. Source of data

In order to get efficient and relevant information about the study, researcher use primary and secondary data source. Primary data will be collecting from respondents through questionnaires and personal interviews.

1.8.6. Method of data collection

For the purpose of this study, will use primary and secondary data source. Unstructured interviews and closed questionnaires will use to collect primary data. Unstructured interview will prepare and administere to staffs working in loan area and district managers and assistant district manager of the bank. This helps to address the research questions more specifically or to concentrate more on the topic itself. Interview will undertake by researcher in order to effectively gather pertinent information to the study. I will also use secondary data from books, Google, and from different publishers.

1.8.7. Method of Data analysis

The relevant information that will be collected from primary and secondary source of data shall depend on the basis of descriptive analysis method. Because of, descriptive analysis uses transformation of raw data in to a form and will be easy to understand to the reader and enterprise.

Descriptive is largely the study of the distribution of one variable form. In line with descriptive data analysis the study will be use frequency, percentage and interpretation analysis.

1.9. Limitations of the Study

Because of Insufficient time and not enough budgets to conduct wide area , This study will be limited in Dashen bank in Bole Michael branch. Another limitation is the global pandemic COVID-19 which is also a factor that limits this study.

1.10. Organization of the paper

This Study will be organized into five chapters. The first chapter focuses on background of the study, statement of the problem, objective of the study, research question, significance of the study, scope of the study, organization of the paper,chapter two focuses on different literatures written on issues related to credit risk management practices. The third chapter shows the Design and methodology of the research, Chapter four is analysis of the research data with interpretation with related findings and presentation. Chapter five concludes the study with summary, conclusion and recommendations.

CHAPTER TWO: REVIEW OF RELATED LITERATURE

2.Introduction

Literature review means locating in a variety of sources Reading it carefully and thoroughly organizing it into themes along with the line of investigation. This chapter include the theoretical and empirical evidences concerning about credit risk management practice of Dashen bank at Bole Michael branch. The theoretical part includes definition and concept of risk management, general principle of sound credit risk management in banking, ensuring adequate controls over credit risk, credit risk management in bank, and credit risk management policy and strategy. Empirical evidence determines specific definition about credit risk management.

2.1. Theoretical Perspective

The theory that researchers used is bank credit risk management theory. It was developed by David

H. Pyle University of California and it will be used to study why risk management is needed and our lines some of the theoretical under pinning of contemporary bank risk management, with an emphasis on credit risk.

2.2. Empirical Evidence

Kwaku D. (2015) studied assessing credit risk management practices in the banking industry of Ghana: process and challenge and obtained the following findings. Some of the key findings from the study revealed that the bank has documented policy guidelines on credit risk management with a senior manager having oversight responsibility for implementation. However, the study shows that there are some implementation challenges of the credit risk policies which have resulted low quality of loan portfolio of the bank. It is being submitted that bank's risk policy shall be review frequently.

Chen J. and Shuping H(2012) conducted research on the credit management of commercial banks of Lianyungang city for the small scale and medium enterprise (SMEs).Investigators have found out that the risk management plan and operation method that really suit for credit demand for the SMEs is still not mature and it caused that the bad debts and dead loan were overstocked in lianyungang commercial bank, thus it seriously impact on the capital operation of commercial banks, and it has caused some adverse impact to the development of local economy .There for it

is necessary for commercial banks in Lianyungang city to supervise and manage the whole process of credit of the small and medium-sized enterprise.

Abdu's (2004) has examined empirically the performance of Bahrain a commercial bank with respect to credit (loan), liquidity and profitability during the period 1994-2001. Nine financial ratios(return on Asset ,return on Equity, cost to Revenue ,Net Loans to Total Asset, Net Loan to Deposit ,Liquid Asset to Deposit, Equity to Asset, Equity to Loan and Non-performing loan to Gross loan)are selected for measuring credit ,liquidity and profitability performance. By applying these financial measures, this paper found that commercial banks' liquidity will not at par with the Bahrain banking industry. Commercial banks are relatively less profitable and less liquid and, are exposed to risk as compared to banking industry. With regard to asset quality or credit performance, this paper found no conclusive result.

Hagos M.(2010) has investigated credit management on Wegagen banks. The main objective of the study is to evaluate the performance of credit management of Wegagen bank in Tigray Region as compared to National bank's requirements in comparison with its credit policy and procedures. The following findings are the result of the investigation: the issues impeding loan growth and rising loan clients complaint on the bank regarding the valuing of properties offered for collateral, lengthy of loan processing, amount of loan processed and approved ,loan period ,and discretionary limit affecting the performance of credit management.

The existing literature indicates that several studies are carried out about credit risk management on commercial banks abroad and Ethiopia. However due to diversified and intensified investments in the country during last 10 and or above years there is an increase of loan demands among investors from commercial banks in the country. In addition to this, high demands for loan commercial banks are highly busy in

launching branches across the country. These situations have created an environment in which commercial banks to encounter risk in credit management. Loans are becoming large and at the same time, bad loans have increased substantially during the past few years.

Risk and Risk Management Process

Risk is the element of uncertainty or possibility of loss that prevail in any business transaction in any place, in any mode and at any time. To sustain its operation, a business has to earn revenue/profit and thus has to be involved in activities whose outcome may be predictable or unpredictable. Hence, risks don't disappear, they gave users a choice; which to retain and which to shed (Bagch 2006),

In the financial arena, such risks can be broadly categorized as Credit Risk, Market risks and organization risk (Bagch 2006). Managing such risk is not a new phenomenon, has been there over the ages in some form or other, to make decision on which to retain and on which to shed, through its various forms and were not called market risk, credit risk or operational risk as they are today. Specially, the concern over risk management arose from the development of the downfall of the oldest merchant bank in February-1995, the Asian financial crisis in July 1997, the Japanese bank crisis of 1993 and Bank for International settlements (2003), Fukao (2003), International Monetary Fund (2003), Kashuap (2002), American financial crises of 2007-2009, were the consequences of uncollectible (non - performing loans). The above incidents make to come to certain conclusion about risk and risk taking decisions, among that

- risk do increase over time in a business, especially in globalized environment Increasing competition, the removal of barriers to entry to new business units by many countries, higher order expectations by stakeholders lead to assumption of risk without adequate support and safeguards.
- a mere quantitative approach to risk perceptions -arising out of trading volume, earning level. doesn't reveal the inherent drawback in an organization/ system
- The introduction of new technologies , while introducing countless

benefits, has also created many new risks for an organization

- The external operating environment in the 21 century is noticeably different. it is not possible to manage tomorrow's event with yesterday's system and procedures and today's human skill

Such incident and the existing globalized stiff competitive market highly magnify the importance of risk management in recent times. The international regulatory authority, the Bank for International Settlement at Basel, Switzerland, has been working on a well- structured risk management system. Risk management is thus a functional necessity and adds to the strength and efficiency of an organization on an ongoing basis. Effective risk management is critical to any bank for achieving financial soundness. In view of this, aligning risk management to bank's organizational structure and business strategy has become integral in banking business. The efficacy of any risk management system depends on its architecture, this comprise the following essential elements (Bagch, 2006)

- A clearly defined and structured organizational set- up to manage enterprise- wide risks
- Commitment of the highest level of those who see the policy framework and oversee implementation within the organization- that is the Board Directors and Senior Management
- Codification of risk management policies/principles, articulated in such a way that it serves the organizational risks appetite within the continuous of risk perceptions,
- Implementing strategy of the direction through specific risk management process so as to effectively identify measure and control risk.
- Manpower development initiatives to improve the skill- sets of people in the organization
- Periodic evaluation
- Risk audit

Prerequisites for Efficient Risk Management In order to implement efficient risk management, sound and consistent methods, processes and organizational structures as well as IT systems and an IT infrastructure are required for all five components of the control cycle. The methods used show how risks are captured, measured, and aggregated into a risk position for the Bank as a whole. In order to choose suitable management processes,

the methods should be used to determine the risk limits, measure the effect of management instruments on the Banks risk position, and monitor the risk positions in terms of observing the defined limits and other requirements. Processes and organizational structures have to make sure that risks are measured in a timely manner that risk positions are always matched with the defined limits, and that risk mitigation measures are taken in time if these limits are exceeded. Concerning the processes, it is necessary to determine how risk measurement can be combined with determining the limits, risk controlling, as well as monitoring. Furthermore, reporting processes have to be introduced.

The organizational structure should ensure that those areas which cause risks are strictly separated from those areas which measure, plan, manage, and control these risks. IT systems and IT infrastructure are the basis for effective risk management. The IT infrastructure is a central prerequisite for implementing modern risk management. Hence, implementing risk management will also insist to have supported with defined organizational – set up and defined role of the officials, principles and policy. It will also have a clear risk management process. Risk management process is a vehicle to implement an organization' risk principles and policies, aided by organizational structure, with the sole objective of creating and maintain a healthy risk culture across the organization.

Internationally, the risk management process has four components; - identification, measurements, monitoring and control. It is apparent, therefore that the risk management process through all its four wings – identification, measurement, monitoring and control- facilitates the organization's, sustainability and growth.

2.2.1. Definition and Concept of Risk Management

Management is the simplest understand definition can be defined as the act of planning, directing, controlling, monitoring and testing for designed results to be obtained. Risk on the other hand defined as uncertainty concerning the occurrence of loss (Radjda, 2011). When companies indulge in business, it is obvious that they would be exposed to one type of risk or another which in most cases in uncertainty although at times it can be certain that it would occur. Banks are one of such business whose risk is very sure because they do not function in isolation given the dynamic environment in which they operate.

Risk management 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 technique, for treating such exposures (Radja, 2011). Credit risk can be defined as the potential that a contractual party would fail to meet its obligations in accordance with agreed terms. Credit risk is the largest element of risk in the books of most banks and, if not managed in a proper way, can weaken individual banks or even cause many episodes (divisions) of financial instability by impacting the whole banking system. Thus to the banking sector, credit risk is

definitely an inherent and crucial part as by (Jackson and Perraudin, 1999). Credit risk management defined as the process of controlling the potential consequence of credit risk.

2.2.2. Sources of credit risk

The main source of credit risk include, limited institutional capacity, economic and market fluctuation, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, ineffective control process, poor loan underwriting, poor lending practice, government interference, absence of real financial statement from the customer, customer awareness problem, and inadequate supervision by the central bank (Kithinji,2010). He identified poor project supervision, evaluation and management, untimely loan disbursement, division of funds, and dishonesty of loan beneficiaries as a case of loan default which ultimately leads to credit risk. To reduce the probability of credit risk, financial institutions should take-part in different situations that may enables them to overcome the occurrence of un-expected default. So as to attain these objectives institutions should create a trustworthy information to both the staffs and borrowers, develop the habit of good understanding (relationship) between the high level executives' and those who are operates through the organization, follow-up regularly the performance of the debtors, recover loans which are due.

2.3. General Principles of Sound Credit Risk Management in Banking

Reviewing the general principles of credit risk management can provide a clearer picture on how banks carry out their credit risk management, despite of the specific approaches that may differ among banks.

Some of the principles of sound practices of bank credit risk management as outlined in the Basel committee publications (<http://www.ibm.com/us>, 2008) cover the following four areas:

2.3.1 Establishing an Appropriate Credit Risk Environment

To establish an appropriate credit risk environment mainly depends on a clear identification of credit risk and the development of a comprehensive credit risk strategy as well as policies. To banks, the identification of existing and potential credit risk inherent in the products they offer and the activities they engage in is a basis for an effective credit risk management, which requires a careful understanding of both the credit risk characteristics and their credit-granting activities.

Besides, the design of objective credit risk strategies and policies that guide all credit-granting activities is also the cornerstone in bank credit risk management process.

It is stated that a credit risk strategy should clarify the types of credit the bank is willing to grant and its target markets as well as the required characteristics of its credit portfolio. According to Saunders (2006), these strategies should reflect the banks tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks. Again, Boatengs (2004) study shows that the credit risk strategy of a bank should give recognition to the goals of credit quality, earnings and growth. Every bank, regardless of size, is in business to be profitable and, consequently, must determine the acceptable risk-return trade-off for its activities, factoring in the cost of capital (Richard, 2010).

While credit policies express the banks credit risk management philosophy as well as the parameters within which credit risk is to be controlled, covering topics such as portfolio mix, price terms, rules on asset classification, etc. According to Boating (2004), a cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. Moreover, establishing an appropriate credit environment also indicates the establishment of a good credit culture inside the bank, which is the implicit understanding among personnel about the lending environment and behavior that are acceptable to the bank.

2.3.2. Process Operating under a Sound Credit Granting

The Basel Committee (2000) asserts that in order to maintain a sound credit portfolio, a bank must have an established formal transaction evaluation and approval process for granting of credits. Approvals should be made in accordance with the banks written guidelines and granted by the appropriate level of management. There should be a clear audit trail documenting that the approval process was complied with and identifying the individual(s) and/or

committee(s) providing input as well as making the credit decision (Boating, 2004). A sound credit granting process requires the establishment of well-defined credit granting criteria as well as credit exposure limits in order to assess the creditworthiness of the obligors and to screen out the preferred ones. In this regard Thomas (2002) asserts that banks have traditionally focused on the principles of five Cs to estimate borrowers' creditworthiness. This five C's are:

i. Character. This refers to the borrower's personal characteristics such as honesty, willingness and commitment to pay debt. Borrowers who demonstrate high level of integrity and commitment to repay their debts are considered favorable for credit.

ii. Capacity. This also refers to borrowers' ability to contain and service debt judging from the success or otherwise of the venture into which the credit facility is employed. Borrowers who exhibit successful business performance over a reasonable past period are also considered favorable for credit facility.

iii. Capital. This refers to the financial condition of the borrower. Where the borrower has a reasonable amount of financial assets in excess of his financial liabilities, such a borrower is considered favorable for credit facility.

iv. Collateral. These are assets, normally movable or unmovable property, pledged against the performance of an obligation. Examples of collateral are buildings, inventory and account receivables. Borrowers with a lot more assets to pledge as collateral are considered favorable for credit facility.

v. Condition. This refers to the economic situation or condition prevailing at the time of the loan application. In periods of recession borrowers find it quite difficult to obtain credit facility.

Banks must develop a corps of credit risk officers who have the experience, knowledge and background to exercise prudent judgment in assessing, approving and managing credit risks.

A banks credit-granting and approval process should establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms.

2.3.3. Maintaining an Appropriate Credit Administration, Measurement and Monitoring Process

Credit administration is a critical element in maintaining the safety and soundness of a bank. Once a credit is granted, it is the responsibility of the

bank to ensure that credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out notices and preparing various documents such as loan agreements, and follow-up and inspection reports.

Credit administration, as emphasized by Wesley (1993) can play a vital role in the success of a bank, since it is influential in building and maintaining a safe credit environment and usually saves the institution from lending problems. Therefore, banks should never neglect the effectiveness of their credit administration operations. Then talking about credit risk measurement in banks, it is required that banks should adopt effective methodologies for assessing the credit risk inherent both

in the exposures to individual borrowers and credit portfolios. The last focus in this area of principles is related to credit risk monitoring, which is definitely a must in banks' risk management procedure.

A proper credit monitoring system will provide the basis for taking prompt corrective actions when warning signs point to deterioration in the financial health of the borrower.

2.3.4 Ensuring Adequate Controls over Credit Risk

In order to ensure adequate controls over credit, there must be credit limits set for each officer whose duties have something to do with credit granting. Material transactions with related parties should be subject to the approval of the board of directors (excluding board members with conflicts of interest), and in certain circumstances (e.g. a large loan to a major shareholder) reported to the banking supervisory authorities.

The means for guaranteeing adequate controls over credit risk in banks lay in the establishment of different kinds of credit reviews. Regular credit reviews can verify the accordance between granted credits and the credit policies, and an independent judgment can be provided on the asset qualities.

As types of credit, facilities of one bank can be broadly classified into two groups: funded and non-funded credit. Any type of credit facility which involved direct flow of bank's fund on account of borrowers is treated as funded credit facility.

Funded credit facility may be classified into four major types:- loans, cash credit, overdraft and bill discounted and purchase. A type of credit facility where there is no involvement of direct out of bank's fund on account of borrower termed as non-funded credit facility. Non-funded credit facilities may turn into funded facilities at times. As such, liabilities against those types of credit facilities are termed as contingent liabilities.

The major non-funded credit facilities are letter of credit, bid bond,

performance bond, advance payment guarantee and foreign counter guarantee.

2.4. Analysis of the creditworthiness of bank loan applicants

The notion 'creditworthiness' can be defined as a presumed ability to meet agreed deadlines related to repaying the credit and interest accrued without affecting the vitality of the borrower, that means the repayment process should be based on the income received in the process of the borrowers

usual activity, without affecting adversely his financial situation, his financial results as well as other business entities (stoyanov, 2008).

2.4.1. Pre-requisites of creditworthiness

According to stoyanov, the prerequisites of credit worthiness are divided in to personal and financial prerequisites.

Personal prerequisites: the will to work and demonstrate enterprise along with courage in decision making and ability to respond quickly and adequately to the changing environment. To the personal creditworthiness, prerequisites belong: the ability to make an estimate when comparing incomes and expenditure for the corresponding business activity for higher achievements and to implement effective management.

Financial pre-requisites: it is the data about the financial and economic situation of the loan applicant. These includes forecast about expected development of the industry and the role that the enterprise plays in it, a study whether the loan can be repaid in accordance with the terms and using revenue from the activity of the business entity.

2.4.2. Accounting information and creditworthiness analysis

From the presented data of creditworthiness analysis of bank loan applicants the accounting information has highest relative share in the total value of this information. The minimal required number of accounting reports presented by the loan applicants such as accounting balance sheet, profit and loss account, statement of changes in equity and statement of cash flows.

2.5. Credit Risk Management in Banks

Although the effects of all risks type cause negative consequences to the bank, credit risk has been identified as the key risk associated with negative consequences, in terms of its influences on the bank performance (Sinkey, 1996). This means if credit risk is not well managed it can lead to failure.

Thus for any bank to succeed its credit risk management, it must be handled with a lot of effective follow up activities.

A clear reason why a correct management of credit risks is very important that before a banking gives out a loan, it should try as much as possible to have a reliable view of the borrower.

The bank has to assess the credit risk worthiness of the borrower even after the loan is granted in terms. Monitoring is required until when the borrowers has finished repaying the loan. This monitoring is very important because with the uncertainty in the future any potential event that can cause a borrower to default payment can be fast identified or a mechanism can be put in place on time to reduce the frequency of loss should it occur. Early identification of borrowers at risk is good because it enables services adequately staff collections departments, determine the most effective type of customer we reached and initiate repayment plans before borrower's situation worsens to the point which for closure is on a voidable (Cocardi, 2009).

2.5.1. Obstacles to credit Risk Management

According Machiraju (2002), the task of management of credit risk is rendered difficult in developing markets by government controls , political pressures, delays in production schedule and frequent instability in production schedule and frequent instability in a business environment undermine the financial information is unreliable and the legal frame work does not support debt recovery. The difficult external context is reinforced by internal weakness of banks further undermine the asset quality.

2.5.2. Deficiency in Credit Risk Management

The common deficiencies observed in credit risk management according to Machiraju (2008) in Banks are absence of written policies, absence of portfolio concentration, inadequate financial analysis of borrowers, Excessive reliance on collateral, inadequate check and balance in the credit process, absence of loan supervision and failure to control and Audit the credit process effectively.

2.6. Credit Risk Management Policy

Banks like any other firm have formal laid down policies and principles that have been put in places by the board of directors on how to manage credits and this have to be supervisors or managers on how to take action. Manass and Zietflow (2005) specify that credit policy has three major components. The primary component is credit sanders which is the profile of minimally acceptable credit period stipulating how long from the invoice the customer has to pay and the cash discount to (if any).the second, is credit limit that the dollar amount that cumulative credit is extended and the last is collection procedures and these are detailed statement regarding when

and how the company would carry out collection of past due accounts, Despite the rules it does not mean that credit policies are stereotyped. "A good lending policy is not very restrictive, but allows for the presentation of loans to the board that officers believe are worthy of consideration but which do not fall within the parameters of written guide lines". Since the future is uncertain flexibility must be allowed for easy adaption to changing condition (may be internal or environmental). For the risk management policies and philosophies have to be used in order to control the credit risk (Geruring and Bratanvic, 2003).

2.7. Credit Risk Management Practices

Banks have different credit risk management policies or philosophies same do the risk management practices differ from the financial institution to another despite the fact that they can open to the same risk. The policies and philosophies each and every bank has their individual level of risk that they can decide to let go based on how it is out lined in their risk management policy. To exit from firms in the same industry but the implementation in practices differs practices is not consistent with theory in most cases because of data limitation for most industries, it difficult to describe which firms manage more risk than others or whether firms language in dynamic risk management strategies and more importantly it cannot be reliably tested whether firms language in dynamic risk management strategies and more importantly it cannot be reliability tested whether a firms management practices conform with existing of theories (Tufano, 1996).

2.8. Credit Risk Management Strategies

E. Michael (1996) defines a strategy as a plan (Method) for achieving something. A strategy thus, simply means a way to go about activity. This thus goes that as a bank has different credit risk policies (philosophies and different practices, their strategy to attain their deferred goals in the same way differ. A strategy position means performing different activities

from rivals or performing different activities from rivals or perform its rivals only if it can establish a difference that it can preserve by effective strategy (porter, 1996). When banks carries out its operational activities which are the same activities carried out by other banks, they should try to make differences from their rivals by not only trying to be more efficient but also try to make a difference. For example, maintaining an appropriate credit administration, monitoring process, ensuring adequate control over credit, but these practices in conjunction with sound practice

related to the assessment of asset quality adequacy of provision and reserves and the disclosure of credit risk.

2.9. Credit Risk Management process

The same way that bank has different credit culture (the policies, practices, and philosophy and management style). They also have different credit risk management process. It is a set of out lined activities aimed at managing credit risk.

These phases are not distinct like the other three phases. In the control phase, measure which can be used to avoid, reduce, prevent, or eliminate the risk are put in phase. The monitoring phase is used to make a constant check so that all process or activity which have been put in place for the risk management process are well implemented for desired result to be gotten and in case of any distortion, corrections are then made. All this is done because credit risk is a very important and delicate risk that banks face and needs to be managed with great care (precaution) because its consequences are always every detrimental to the bank. Despite the changes in the financial services sector, credit risk remains the major single cause of banks failure (Greuning of Bratanovic, 2003).

2.10. Credit risk management for Ethiopian banks

This was disclosed at a one-day seminar on Credit and Risk Management, held on Thursday, February 14 at the Sheraton Addis and organized by Zemen Bank incollaboration with eVentive and Harland Financial Solutions. The Bank is also taking the lead in the country in implementing the Basel II Framework. The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy that national supervisory authorities are now working to implement through domestic rule-making and adoption procedures. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. Basel II requires banks to collect more data about customers and consistently use best practices for credit

risk management. Participants at the seminar were credit officials from both private and government banks and from the Ministry of Capacity Building. The purpose of organizing the seminar was to create awareness among other banks so that they too would benefit by using the software. At the seminar, Harland Financial Solutions Worldwide and Kenya Commercial Bank presented a Credit Risk Symposium for Ethiopian banks. Harland Financial

Solutions Worldwide is a global software company with over 7,000 financial institution customers and delivers Credit Quest solutions for credit risk management for banks worldwide. The full day symposium also covered the Evolution of Credit Risk and Lending Systems, Regulatory Requirements for Lending and Credit Risk Systems (Basel II), a demonstration of the Credit Quest product and a Case Study of KCB's implementation of Credit Quest.

2.11. Credit Risk Models

Over the last decade, a number of the world's largest banks have developed sophisticated systems in an attempt to model the credit risk arising from important aspects of their business lines. Such models are intended to aid banks in quantifying, aggregating and managing risk across geographical and product lines. The outputs of these models also play increasingly important roles in banks' risk management and performance measurement processes, including performance-based compensation, customer profitability analysis, risk-based pricing and, to a lesser (but growing) degree, active portfolio management and capital structure decisions. The task force recognizes that credit risk modeling may indeed prove to result in better internal risk management, and may have the potential to be used in the supervisory oversight of banking organizations.

However, before a portfolio modeling approach could be used in the formal process of setting regulatory capital requirements for credit risk, regulators would have to be confident not only that models are being used to actively manage risk, but also that they are conceptually sound, empirically validated, and produce capital requirements that are comparable across institutions. At this time, significant hurdles, principally concerning data availability and model validation, still need to be cleared before these objectives can be met, and the committee sees difficulties in overcoming these hurdles in the timescale envisaged for amending the capital accord. Credit scoring models use data on observed borrower characteristics either to calculate the probability of default or to borrowers into different default

risk classes (Saunders and Cornett, 2007).

Prominent amongst the credit scoring models is the Altman 's Z-Score. The Z-score formula for predicting bankruptcy of Dr. Edward Altman is a multivariate formula for measurement of the financial health of a company and a powerful diagnostic tool that forecast the probability of a company entering bankruptcy within a two-year period with a proven accuracy of 75-80%.

The Altman 's credit scoring model takes the following form;

$$Z=1.2x_1+1.4x_2+3.3x_3+0.6x_4+1.0x_5$$

Where, X_1 = Working capital/ Total assets ratio

$X2 = \text{Retained earnings} / \text{Total assets ratio}$

$X3 = \text{Earnings before interest and taxes} / \text{Total assets ratio}$

$X4 = \text{Market value of equity} / \text{Book value of long-term debt ratio}$
 $X5 = \text{Sales} / \text{Total assets ratio}.$

The higher the value of Z, the lower the borrower's default risk classification. According to Altman's credit scoring model, any firm with a Z-Score less than 1.81 should be considered a high default risk, between 1.81-2.99 an indeterminate default risk, and greater than 2.99 a low default risk.

2.12. Tools of Risk Management

Risk is handled in several ways most authors give the following risk handling tools. These are avoidance, loss prevention and reduction, separation, diversification /combination, non-insurance transfer, retention and insurance. Those tools are classification to two (1) Risk Control and, (2) Risk finance tools.

2.12.1. Risk control tools

Avoidance: Avoidance of risk exists when the individual or the organization free itself from the exposure through abandonment or refusal to accept the risk, an individual can avoid third person disability by not owning a car, product liability can be avoided by dropping the product. Leasing avoids the risk of organizing from property ownership.

Avoidance is a useful common approach to handle the risk. By avoiding a losses or uncertainties that exposure may generate.

Loss prevention and reduction measurement: This measure refers to the safety taken by the firm to prevent the occurrence of the loss or reduce its severity. Loss reduction measurements try to minimize the severity of the loss once the partial happened. Example automobile accidents can be prevented or reduced by having good road, better light and sound affect regulations and control fast first aid service and control. The libel loss

prevention and loss reduction measures must be considered the risk manager considers the application of any risk financing instrument.

Separation: Separation of the firm exposure to loss instead of concentrating them at one location where they might be involved in some loss. For example, instead of placing its entire inventory in

one wear have, the firm may prefer to separate this exposure by placing equal parts of the inventory in ten widely separated warehouses.

Combination or Diversification: Combination is a basic principle of insurance that follows the law of large numbers. It can reduce risk by making losses more predictable with a higher degree of accuracy. The difference is that unlike separation, which spreads a specified number of exposure units under the control of the firm.

Diversification most speculative risk in the business can deal with diversification. A business firm diversifies their product, i.e. a decline in profit of one business could be compensated by profits from others.

Non-insurance transfer- this may be accomplished on two ways: -

Transfer of the activity or property: The property or activity responsible for the risk may be transferred to some another person or group of person. This type of transfer is closely related to avoidance through risk control measure because it eliminates a potential loss that may strike the firm must pass in to someone else.

Transfer of the probable loss: The risk but not the property or activity, may be transferred leasing rather than buying. If the goods remain unsold or expired, they would be returned to the consignor.

2.12.2 Risk financing tools

Retention: this is the earliest method of handling risk. The firm consciously or unconsciously, decides to assume the risk. The loss is to be borne by the person or firm, and specific measurements should be taken to retain the loss if the loss is less in severity. The firm decides to retain the risk for a number of reasons. It is probably impossible to transfer the risk as in the case of gambling besides the attitude of the individual of the firm towards risk. The value of goods to be insured compared to insurance cost is another factor that may force businesses to assume risk, cost benefit

analysis. Retention can be effectively used in a risk management program when contain conditions exist.

2.13. Policy guidelines

The fundamental credit risk management policies that are recommended for adoption by all banks in Bangladesh. The guidelines contained herein outline general principles that are designed to govern the implementation of more detailed lending procedures and risk grading systems within individual banks.

Lending Guidelines

All banks should have established Credit Policies (Lending Guidelines) that clearly outline the senior management's view of business development priorities and the terms and conditions that should be adhered to in order for loans to be approved. The Lending Guidelines should be updated at least annually to reflect changes in the economic outlook and the evolution of the bank's loan portfolio, and be distributed to all lending/marketing officers. The Lending Guidelines should be approved by the Managing Director/CEO & Board of Directors of the bank based on the endorsement of the bank's Head of Credit Risk Management and the Head of Corporate/Commercial Banking. Any departure or deviation from the Lending Guidelines should be explicitly in credit applications and a justification for approval provided. Approval of loans that do not comply with Lending Guidelines should be restricted to the bank's Head of Credit or Managing Director/CEO & Board of Directors.

The Lending Guidelines should provide the key foundations for account officers/relationship managers (RM) to formulate their recommendations for approval, and should include the following:

- Industry and Business Segment Focus

The Lending Guidelines should clearly identify the business/industry sectors that should constitute the majority of the bank's loan portfolio. For each sector, a clear indication of the bank's appetite for growth should be indicated (as an example, Textiles: Grow, Cement: Maintain, Construction:

Shrink). This will provide necessary direction to the bank's marketing staff.

- Types of Loan Facilities

The type of loans that are permitted should be clearly indicated, such as Working Capital, Trade Finance, Term Loan, etc.

- Single Borrower/Group Limits/Syndication

Details of the bank's Single Borrower/Group limits should be included as per Bangladesh Bank guidelines. Banks may wish to establish more conservative criteria in this regard.

- Lending Caps

Banks should establish a specific industry sector exposure cap to avoid over concentration in any one industry sector.

- Discouraged Business Types

Banks should outline industries or lending activities that are discouraged. As a minimum, the following should be discouraged:

- Military Equipment/Weapons Finance
- Highly Leveraged Transactions
- Finance of Speculative Investments
- Logging, Mineral Extraction/Mining, or other activity that is Ethically or Environmentally Sensitive
- Lending to companies listed on CIB black list or known defaulters
- Counterparties in countries subject to UN sanctions
- Share Lending
- Taking an Equity Stake in Borrowers
- Lending to Holding Companies
- Bridge Loans relying on equity/debt issuance as a source of repayment.
- Loan Facility Parameters

Facility parameters (e.g., maximum size, maximum tenor, and covenant and security requirements) should be clearly stated. As a minimum, the following parameters should be adopted:

Banks should not grant facilities where the bank's security position is inferior to that of any other financial institution.

Assets pledged as security should be properly insured.

Valuations of property taken as security should be performed prior to loans being granted. A recognized 3rd party professional valuation firm should be appointed to conduct valuations.

- Cross Border Risk

Risk associated with cross border lending. Borrowers of a particular country may be unable or unwilling to fulfill principle and/or interest obligations. Distinguished from ordinary credit risk because the difficulty arises from a political event, such as suspension of external payments

- Synonymous with political & sovereign risk
- Third world debt crisis

2.14. Banks Performance and Its Determinants

The role of bank remains central in financing economic activity and its effectiveness

could exert positive impact on overall economy as a sound and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system (Athanasoglou et al, 2005). Therefore, the determinants of bank performance have attracted the interest of academic research as well as of bank management, financial markets and bank supervisors since the knowledge of the internal and external determinants of banks profits and margins is essential for various parties. During the last two decades the banking sector has experienced worldwide major transformations in its operating environment. Both external and domestic factors have affected its structure and performance. Correspondingly, in the literature, bank profitability is usually expressed as a function of internal and external determinants.

The internal determinants refers to the factors originate from bank accounts (balance sheets and/or profit and loss accounts) and therefore could be termed micro or bank specific determinants of profitability. The external determinants are variables that are not related to bank management but reflect the economic and legal environment that affects the operation and

performance of financial institutions. A number of explanatory variables have been proposed for both categories, according to the nature and purpose of each study (Yuqi Li).

2.14.1. Internal determinants

Studies dealing with internal determinants employ variables such as size, capital, risk management and expenses management. Size is introduced to account for existing economies or diseconomies of scale in the market. Akhavein et al. (1997) and Smirlock (1985) find a positive and significant

relationship between size and bank profitability. Demirguc-Kunt and Maksimovic (1998) suggest that the extent to which various financial, legal and other factors (e.g. corruption) affect bank profitability is closely linked to firm size. In addition, as Short (1979) argues, size is closely related to the capital adequacy of a bank since relatively large banks tend to raise less expensive capital and, hence, appear more profitable. Taking the similar approach, Haslem (1968), Short (1979), Bourke (1989), Molyneux and Thornton (1992) Bikker and Hu (2002) and Goddard et al. (2004), all link bank size to capital ratios, which they claim to be positively related to size, results indicated that as size increases. Especially in the case of small to medium-sized banks. Profitability rises. However, many other researchers suggest that little cost saving can be achieved by increasing the size of a banking firm (Berger et al., 1987), which suggests that eventually very large banks could face scale inefficiencies. Other internal factors, such as credit or liquidity are considered as bank specific factors, which closely related to bank management, especially the risk management. The need for risk management in the banking sector is inherent in the nature of the banking business. Poor asset quality and low levels of liquidity are the two major causes of bank failures and represented as the key risk sources in terms of credit and liquidity risk and attracted great attention from researchers to examine the their impact on bank profitability.

2.14.2. External determinants

Turning to the external determinants, several factors have been suggested as impacting on profitability and these factors can further distinguish between control variables that describe the macroeconomic environment, such as inflation, interest rates and cyclical output, and variables that represent market characteristics. The latter refer to market concentration, industry size and ownership status (Athanasoglou et al, 2005).

2.15. Research Gap

Generally, The previous researchers studied about credit management, Risk and Risk management. However, My study will differ from the above researches since this study will focus on both credit management and credit risk management practice the case of Dashen Bank, Bole Michael Branch.

CHAPTER THREE: COST AND TIME PLAN

3.1. Time schedule

It describes the plan of assessing the ongoing progress toward achieving the research objectives. It specifies how each project activity is to be measured in terms of completion, the time line for its completion. Therefore, to enable Me and the advisor to monitor project progress and provide timely feedback for research modification or adjustments i provide the following time plane.

2021

NO.	Activity	April	May	June	July
1	Topic selection				
2	Submission of Proposal				
3	Preparations of Research				
4	Collection of useful material				
5	Data collection				
6	Data analysis and writing of final research				

7	Submission of research				
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8	Presentation research Of Final Research					
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3.2. Financial Budget

It will show how much it will cost to answer the question. I explicitly state cost for every budget item that should be quantitatively shown. Typically, my proposal budget reflects:-

Direct costs: Personnel, consumable supplies, Travel, Communication, Publication etc. 2021

Stationary and equipment	Item	Quantity	Per unit(Birr)	Total cost(Birr)
	PAPER	1 package	150	150
	Pen	4	8	32
	Pencil	1	4	4
	Binder	1	15	15
	Total cost			201
Personal cost				
	transportation	3 TRIP	18	90
	Typist	42	1	42
	contingency			250
	Overall total cost			583

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APPENDIX

KOTEBE METROPOLITAN UNIVERSITY

FACULTY OF BUSINESS AND

ECONOMICS DEPARTMENT OF

ACCOUNTING AND FINANCE

RESEARCH QUESTIONNAIRES

Dear respondents; The purpose of this questionnaire is to seek information in **Assessment of credit risk management practice** in Dashen bank at Bole Michael Branch. Therefore, you are kindly requested to fill all questions properly and honestly with due care because correctness of the answer will have a significant importance for the outcome of the research. The information obtained from this questionnaire will be used only for academic purpose.

The researcher will like to thank you in advance for your support to the study.

Instructions

1. No need of writing your name;
2. Mark your answer by putting check mark (✓) for closed-ended questions in the box provided.

Part I. Respondents' personal profiles

- | | | |
|----------------------|--------------------------------------|---------------------------------------|
| 1. Sex | ☐ male | ☐ female |
| 2. Age | ☐ 18 - 30 | ☐ 31 - 40 |
| | ☐ 41 - 50 | ☐ above 50 |
| 3. Status: | ☐ Married | ☐ Unmarried |
| 4. Education status: | ☐ Certificate | ☐ First degree |

1. Job title _____ ☐ Diploma ☐ Master and above

6. Years of experience within the bank.

☐ Less than 1 year ☐ 1-2 years

☐ 2 - 5 years

☐ above 5 years

Part II: Read the following statements and decide your agreement

7. IS there an awareness of risk management by the staff of the bank?

☐ Yes

☐ No

8. What do you think about the outcomes of effective credit risk management at banks? (You can use more than one answer)

☐ Reduce financial loss.

☐ Improve the competitiveness of the

☐ bank. Improve decision making.

☐ Improve resource allocation.

☐ Other (please specify) _____

9. What are the factors that increase credit risk in banks?

☐ Economic and market fluctuation

☐ Absence of real financial statement from the

☐ customer Customer awareness problem

☐ Other (please specify) _____

10. Points covered with in the guide line and policies of the bank.

☐ Setting the minimal acceptable credit period

☐ Setting the dollar amount that the cumulative credit

☐ is extend Setting collecting procedure

☐ Screening and monitor

☐ Collateral requirement

☐ Strengthen internal control

☐ system Segregation of duty and responsibilities

☐ Others (please specify) -----

11. Does these guidelines support the goals and objectives of the bank?

☐ Yes

☐ No

12. Does the bank offer training for employees on Credit risk Management?

☐ Yes

☐ No

13. If your response to question no. 12 is yes, how often the bank provide
☐ credit risk management training course? Never Twice per year

☐ Once a year ☐ More than twice per year

14. Does the bank analyse borrower's credit worthiness before approving the loan effectively?

☐ Yes

☐ No

15. If your answer for question no.14 is yes, how the bank qualify its (the borrowers) credit worthiness?

(You can choose more than one answer)

☐ By analyze its income

☐ statement report By analyze

☐ its Balance sheet report By
analyze its owner's equity
report

☐ By analyze its Cash flow statement report

☐ Other (please specify) _____

16. How does your Bank exercises to
reduce credit risk? (You can choose more
than one answer)

☐ Creating clear and trustworthy information

☐ Developing understanding between management team and

☐ employee Frequent follow up of debtor's performance

☐ Other (please specify) _____

1.7 What are the measures the bank takes to customers that

☐ failed to comply with terms of loan? ☐ Discuss with the
customer rescheduling
the loan

☐ Force closure ☐ legal action

☐ Other (please specify) _____

Interview questions to senior managers

1. How does your bank apply credit risk management?

2. From your point of view, how does credit risk management contribute to the success of the bank?

3. In order to minimize the probability of credit risk, what preventive techniques and control procedures of the risk management process the bank use?
4. What types of methods are most available to improve credit risk management practice in the bank?
5. What are the major challenges of effective credit risk management practice in the bank.