Assessment of Credit Risk Management in Micro Finance Institutions: A Case of Adama Town MFIs, Ethiopia

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Abstract: *This study is to assess the credit risk management of MFIs exist in Adama town, Ethiopia.Sound credit risk management is a crucial for a financial institutions stability and continuing profitability, while declining credit quality, the most frequent cause of poor financial performance and condition. Micro finance provides financial support to the unbanked units of the society. Since microfinance is a system that allocates small credits to poor persons in order for them to provide income and start their own small businesses, it has the ability to lessen poverty as well as encourage entrepreneurship, social and economic development for poor people.In any financial institution, the biggest risks in microfinance is loaning money and not getting it back. The study adopted a descriptive survey design. The population of study consisted of serviceprovision sectors in Adamatown MFIs.The study utilized both quantitative and qualitative technic of data analysis. The study involves that customer'sevaluation; credit risk control and collection principle had effect on credit risk management of MFIs in Adama town credit and saving institutions. The study recommends that MFIs should improve their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.*

Keywords: *credit risk management, Microfinance, Microfinance institutions, Microfinance policy*

Introduction

Micro finance is main concern in current time to the unbanked house hold over the world. Microfinance institution is a method that provides lesser loans to third world people in order to generate revenue and start their own small enterprises, it has the capacity to reduce poor as well as encourage Enterprises, community and financial development in poor social groups especially in rapid developing countries similar to Ethiopia. MFI are Established to small scale monetarily services to the low-income people who farm, unemployed, operate min-business, who have no access to financial services of modern banks(perways A.,and P.krishna M.,2017).

In addition to issuing loans, MFIs also deal a comprehensive range of financial services, such as savings and protection options (Premchander 2009). Microfinance is a providing of financial services like reserves, credit, protection, payment, etc. in a very lesser amount mostly to the poor people (Dasgupta, 2001).

It is generally accepted that lack in credit risk administration and management guideline by financial establishments have supported overall to the financial decline around the world (Fraser & Simkins, 2010). As result to this emergency, orders including credit risk management are presently being given more imperativeness, mostly in monetary related areas (Horne, 2007) like banks and other financial institutions. MFIs function in an environment where customers are without credit histories or unavoidably expected borrowing behaviors (Vincent et al 2014) creation it more necessary to deal with credit risk management.

The Ethiopian Microfinance institutions are relatively early compared to the sector in the rest of the world. The mean age of Micro finance institutions in Ethiopia is not more than 15 years. The rapid economic changes and industry has changed the risk evidence. So, several MFIs seem to continue to need growth without more consideration to risk. Numerous Micro finance institutions look to neglect even the simple credit risk management which helped MFIs realize high growth rates factually (Fernando, 2008).

About 80% of Ethiopians live under the insufficiency line with less than two dollars a day (WHO report, 2013). To conciliation these two contradicting issues i.e. financing low-income people who farm, unemployed, operate min-business, the agrarian as well as the poor and the risk involved there, microfinance institutions must apply several approach of controlling and managing the risk in the field as well as on an additional services provided through MFI. The main questions that arises is, how they can manage to keep their non-performing credits rates so low, if microfinance is about facilitating financial services to poor families with no warranty, most of them functioning in the informal sector, were the risk of just taking the money and running is very high. So the study identifies the gap as well as assesses the credit risk management of MFIs which are found in Ethiopia so that a widespread understanding of the current situations of those institutions as well as making different conclusions can be possible.

Litiruter Review

Micro finance institutions is a kind of financial organization that provides financial benefits to the low-income peoples, unemployed or group of individuals who have no access to financial benefits of commercial banks. It is a modern tool that is used almost everywhere to reduce poverty, created awareness and empower poor people that results in sustainable development (Perways A., and P. Krishna M., 2017).

Microfinance program and purposes in Ethiopia are to make presented and nearby financial services to a enormous number of actively productive Ethiopian communities which use to have no access to official financial services that might empower them to support of the country's economic growth. Microfinance is related to a collection of financial service improvements under the term microfinance, according to microfinance it is micro savings, cash transfer and micro protection (Islam, Mohd. Najmul, 2013).

The backgrounds of microfinance were the Grameen Bank of Bangladesh. They were the first to face the data problem by building a loaning institution using the information base of a public. The bank begun in the mid-1980s by Prof. Mohammed Yunus, lends to very poor family, and loans to groups of debtors rather than individual within the group. Microfinance institutions frequently represent a first chance for the local community to participate in financial systems and to advantage from access to business and capital (Amina Ahmed et. Al, 2015).

MFIs can implement more than standard bankers in some community contexts for two different causes. First, society knows one another. Second, a main source of market failure in credit markets is that a bank cannot apply financial approvals against poor peopling who evasion on a loan, since by meaning they are poor. Individuals within the group may be in a place to enact powerful non-financial permissions at low cost. With this mechanism micro finance institutions have high payment rates (Amina Ahmed et.al,2015).

Overview of Microfinance Institutions in Ethiopia

The ideas of MFI in Ethiopia is a recent era and known by rapid growing by (Ebisa Denbie, et.al. 2013). The development of lending institutions in Ethiopia in collaboration with Ethiopia Ministry of trade has providing loan to Micro and small enterprises (Kareat, 2007, cited by Gishom, 2011).

Once the Ethiopian government proclamation no.

40/1996 of MFI was allotted, this show the way for establishment of MFIs to provide financial benefits to the societies who suffered lack of financial accessibility from the formal banks, several MFIs have lawfully been registered and proceedingproviding service of microfinance like other countries and they can organize savings once they got registered and legally authorized to supervise the actions MFIs by the NBE (Wolday Amha, 2000).

As Getaneh (2005), in Ethiopia MFI spread through urban and rural areas to give deposit, removal and accept a draft to the community and to manage the microfinance commercial funds which are allowed by low. The Ethiopian deposit-taking MFIs provide different financial services such as; reserves, microinsurance, advance, payment, and return such as collecting duties, allowance payment, and another related service charge. Accordingly, a progressive change has been seen in Ethiopian MFIs from microcredit to microfinance and finally to financial inclusion (Wolday and Anteneh, 2015).

The aimof MFIs is to collect credits and share credit to the farmers and people engaged in activities similar actions as well as micro and small enterprises rural and urban entrepreneurs.

Meaning of Credit risk

Tony & Bart (2009) mentioned that Credit risk is the loss that a borrower defaults and does not principle its obligation to service debt. Nikolaidou &Vogiazas (2014) define credit risk management as the arrangement of coordinated tasks and activities for controlling and guiding risks confronted by an organization through the incorporation of key risk management strategies and processes in relation to the organizations objective.

Risk is at the core of any finance sector. It is part of the financial mediator. This creates that Risk Management to be at the half in any financial institution. Since the MFIs had been increasing in the previous decade, the importance of risk management has been in advance more and more importance for a good management. It is necessary to mention that a great part of the borrowers from MFIs are involved in a business and agricultural activities. Financing this agricultural of activities is risker than financing trade or industry, because of the inherent risk in agriculture. Risk is defined generally as the potential for events or ongoing trends to cause future losses or declines in future income of an MFI or deviate from the novel social mission of an MFI (Ferri et.al 2013).

Credit Risk Management of Financial Institution

It is broadly identified that lack in credit risk management policies by monetary establishments have helped altogether to the financial recession around the world (Fraser &Simkins, 2010) As outcome to this emergency, orders including credit risk management are now a day being given more imperativeness, particularly in financial related areas (Horne, 2007) like lending institutions and other financial institutions. Micro finance institutions operate in society where customers are without credit back ground or necessarily predictable borrowing behaviors (Vincent et.al.2014) making it more insight to deal with credit risk management.

According to Basel (1999a) supported that convenient credit risk management requires establishing an appropriate credit risk environment where board of directors approves credit policy and strategy and senior management implements these; operating under sound credit granting step by establishing well defined credit granting criteria; maintaining an appropriate credit management of credit portfolio; control and inspection process and ensuring adequate measurement over the risk

Credit risk management in the bank institutions involves the step of identification of risk issues, assessment of losses by using borrowers financials and useful models, control the activities of defined risk matters, and implementation of control and measures by known management to minimize or reduce the unneeded consequences of losses; and the process is implemented within the production and the strategic structure of the financial institutions (Basel, 2000; Rechard et al., 2009, Tafri et al., 2011).

Credit management, or moreexactly credit risk management, refers to the arrangements, procedures and controls, which a company has in place to ensure the efficient collection of customer payments thereby minimizing the risk of non-payment (Mokogi, 2003).

According toGreuning & Bratanovic, (2003).The real credit risk management (CRM) requires building an suitable credit risk (CR) atmosphere; working under a healthy credit lending process; maintaining an appropriate credit administration that need the controlling processand the sufficient monitoring over loan risk.

Nieman et al (2009) opinion that long term consist financial performance is character to non-financial factors like internal function, workers satisfaction as well as brand and customer loyalty. This opinion is shared by Ittner et al (1998) who expires that the investment in intangible assets, that is, customer satisfaction, is not accommodated in the accounting data.

The same suggestion applies to the risk of an institution that is challenges to understand if attention is alone directed at the financial systems. Through the combination of non-financial evidence, the challenges associated with the manipulation of financial statements are reduced. By following a systematic approach and through taking into considered both financial and non-financial information related to the institution, anbetter understanding of MFI risks can be achieved (CGAP, 2003).

Aim and Objective of Study

The many objectives of this study are to assess of credit risk management in micro Finance Institutions: in case of Adama town micro Finance Institutions.

Specific Objectives

- To assess credit risk management practices of Adama town MFIs.
- To identify the challenge that faced by MFIs in Adama town credit risk management.
- To find out the strategies to manage credit risk in micro finance institutions.

Research Questions

- What are credit risks management practices that are most commonly faced by MFIs in Adama town?
- What are the challenges faced by MFIs to manage credit risk in Adama town?
- What are the strategies used by MFIs in Adama town to manage credit risks?

Research Methedology

This research describe how the study has been carried out, what the activities to be done in the research design.

Research Design

Based on the statements of the problem and the objective of the study the researcher used that the descriptive type of research.The research approach used in the study is quantitative and qualitative data would be to address the objectives. Therefore, the researcher utilizes survey research methods. Generally, Primary data collected through questions and interview distributed to respondents that consists Branch Managers and operation managers working on loan processing and also Loan Officers. Secondary data was collected from different secondary sources.

Method of Data Collection

Primary data were gathered through both questionnaire and interview. The questionnaire includes close-ended questions, and distributed to respondents involving branch managers, operation managers and credit officers working on loan processing were targeted for the data collection where all the issues on the questionnaire were properly addressed.

The close ended questions are used to test the rating of various features and this helped in reducing the number of related responses in order to get more varied responses.

Semi structured interview refers to the use of already prepared questions during the study Interview schedule were held based on the pre-defined schedule. Until arranged to any interview session, respondents were made to get sufficient information on the purpose of the session as well as privacy materials. The interview meetings were held with 4 MFIs managers and the analysis of the interview was made based on the information obtained from these branch managers.

Sampling Techniques

According to the data collected from MFIs managers of the four micro finance institutions used as respondents. Therefore, the Judgmental sampling technic was used to gather data because these methods help the researcher to obtainactual information from each and every employee.

The following table indicates the judgmental used by the researcher from each institution of Managers, operation managers and loan officers.

Table 3.1 Sample and Sampling Technique

List of sample branch	Branch Mangers	Operation managers	Loan officers technique	total	Sampling
Wasasa	1	1	20	22	Judgmental
sampling					
VFCSI	1	1	21	23	
DECSI	1	1	18	20	
OCSCO	1	1	23	25	
Total	**4**	**1**	**78**	**90**	

Source: Sample taken

Data Analysis

Data were gathered using questioner and interview approach. Data analyses were carried out using simple mathematical such as frequency, average, percentile to present as well organized and useful methods.

V.Data Analysis, Results and Discussion

This part discusses the interpretation and presentation of the findings obtained from the field survey on the assessment of credit risk management on the Microfinance Institutions in the case of Adama town credit and saving institutions .Descriptive statistics were used to analysis the findings of the study. The study was targeted a population size of 90 respondents from which 84 filled in and returned the questionnaires making a response rate of 92.22%. This response rate was useful to conduct research to make conclusions for the study.

5.1 Credit risk management practices

In this section of the chapter management practices issues such as Adoption of credits risk, number of loan clients per loan offices, client appraisal extent were using tables and interpretations and analysis were done accordingly.

Table 4.1 Adoption of Credit risk Management Practices

Has your MFIs adopted Credit risk Management practices	Frequency	Percentage
Yes	76	90.48
No	8	9.52
Total	84	100

Source: Output from Survey Data, 2019

The data in Table 4.1shownto regulate the organizations that had approved Credit risk Management practices. From the findings 90.48% of the respondents specified that their organizations had implemented Credit risk Management practices, where as 9.52 % indicated that their administrations had not, this implies that a significant number of institutions had.

Table 4.2: Number of loan clients per loan officer ratio of the respective MFIs

How many customers per loan officer ratio does your organization have?	Frequency	Percentage
< 500 customers	6	7.14
b/n 500 to 1000 Customers	58	69.05
b/n1000 to 2000 customers	18	21.43
>2000 customers	2	2.38
Total	84	100

Source: Output from Survey Data, 2019

With concernsto decide the number of customers the organization had, from the findings 7.14 % of the respondents shown that their organization had been less than 500 customers 69.05% of the respondents indicated that their organization had b/n500 to 1000 Customers 21.43% of the participants indicated that their organization had b/n 1000 to 2000 customers whereas 2.38% of the respondents indicated that their organization > 2000 customers this implies that one of the reason for default loan is size of the customers so majority of the organizations featured in this study had b/n 500 to 1000 customers.

Table 4.3: Extent to which Adama MFI use client appraisal in Credit risk Management

To what extent does the MFI use client review in Credit risk Management?	Frequency	Percentage
Very great level	16	19.05
Great level	29	34.52
Moderate level	39	46.43
Total	84	100

Source: Output from Survey Data, 2019

According to the data demonstrated in Table 4.3 to determine the level to which MFIs used client assessment in Credit risk Management, from the findings 19.05% of the respondents indicated to a great extent, 34.52% of the respondents shown to a very great extent whereas 46.43 % of the respondents shown to a moderate extent, this implies that most MFIs used client assessment in Credit risk Management to a great extent.

Table 4.4: Level of agreement on client appraisal in MFI

Items	Strongly agree	Agree %	Neutral %	Disagree %	Strongly disagree
1. Client assessment is aviable strategy for credit risk management.	39.29	58.33	0	2.38	0
2. The MFI has capable personnel for carrying out client assessment.	38.1	40.48	0	13.1	8.33
3. Client assessment considers the character of the customers seeking credit facilities.	45.24	51.19	0	3.57	0
4. Aspects of collateral are considered while assessing clients.	35.71	50	0	7.14	7.14
5. Failure to assess customers ability to repay results in credit defaults	44.05	55.95	0	0	0

Source: Output from Survey Data, 2019

As seen from the table 4.4 items 1 to 5 respondents were asked to show that their level of agreement \disagreement on the significance of the practice listed as Scales: 5=Strongly Agree, 4=Agree, 3=Neutral, 2=Disagree and 1= Strongly Disagree. Accordingly, majority of the respondents agreed on the significance of the items listed as far as clear assessment is concerned specifically speaking respondents presented their agreements on failure to assess customer repayment capacity result in default. Likewise item 1 indicates that 98% of the respondents agreed on the fact that client assessment as acredit risk management strategy. Still item 2, indicates that, 78.5% of the respondents agreed on the importance of competent personnel as a key to carry out clients' assessment.Item 3, also shows that 96.43% majority response agreement on character assessment of Customers as akey for consideration. Item 4, confirmations that 85.71% of there spondent's agreed on considering physical collateral while customers' assessment as akey for MFIs. Overall, the respondents decided up on the key importance of considering the 5Cs i.e. capacity, character, collateral, condition and competence of personnel while customersassessment .

Challenges faced by MFIs in CRM

In this section of the chapter challenges faced by MFIs in credit risk management issues such as Adama micro finance Institutions use credit risk control in credit management were using tables and interpretations and analysis were done accordingly. Challenges consists reduce the resource base for further lending, weaken staff morale, and affect the borrower's confidence.

Table 4.5: level to which Adama MFI use credit risk control in Credit Management

To what level does the MFI use credit risk control in Credit Management?	Frequency	Percentage
Very great level	10	11.91
Great level	52	61.90
Moderate level	22	26.19
TATOL	84	100

Source: Output from Survey Data, 2019

The study shows to determine the extent to which Adama MFI used credit risk control in Credit Management, from the outcome 11.91% of the respondents indicated to a very great level, 61.90 % of the respondents shown to a excessive level where as 26.19% of the respondents responses to a moderate level, this implies that AdamaMFI used credit risk control in Credit Management to a great level.

Table 4.6: Level of agreement on credit risk control in Adama MFI

Items	Strongly agree	Agree %	Neutral %	Disagree %	Strongly disagree
Imposing credit amount limits is a viable strategy in credit risk management	41.67	53.57	1.19	3.57	0
The use of credit instructions on regular basis improves credit risk management.	39.29	55.95	2.38	2.38	0
Flexible settlement periods increase loan repayment	46.43	47.62	2.38	3.57	0
Penalty for late payment enhances customers promise to loan settlement	45.24	53.57	1.19	0	0
The use of beneficiary credit application forms improves checking and credit management as well	47.62	52.38	0	0	0
Credit teams involvement in making decisions regarding credits are essential in reducing credit risk	53.57	46.43	0	0	0
Interest rates charged affect performance of loans in the MFI	51.19	47.62	1.19	0	0

Source: Output from Survey Data, 2019

From the above table , item 1 to 5 respondents were asked to show their level of agreement \disagreement on the status of the practice listed as strongly agree =5 , Agree=4,Neutral=3, Disagree =2 and Strongly Disagree =1. Therefore, overall then majority of the respondents agreed on the usefulness of the items listed as far as credit risk control is concerned. The respondents indicate their agreements on the procedure to use credit risk control in Credit risk Management. likewise Item 1 and 2, shows that 95 % of the respondents agreed on the fact that Imposing loan size limits is a viable strategy in credit risk management and the importance of credit checks on regular basis improves credit risk management as a key to Cary out credit risk control.

Item 3, also indicates that 94 % of the respondents agreed on predicable repayment periods improve loan repayment as a key for consideration in credit risk control.

Finally, Item 4, Punishment for late payment senhances customer's commitment to loan repayment. Item 5,customers' credit application forms increases monitoring and credit management. Item 6 Credit teams involvement in making decisions and Item 7 Interest rates charged on performance of loans indicates that the respondents greatly agreed on considering credit risk control as a key factor for MFIs.

Generally, the general respondents agreed up on the key importance of considering Credit risk Management is risk control methods.

Strategies to manage credit risk management

In this section of the chapter strategies to manage credit risk management issues such as extent to with MFI use collection policy in credit risk management were analyzed using tables and interpretations and analysis were done accordingly.

Table 4.6: Extent to which MFI use collection policy in Credit risk Management

To Extent does the MFI use collection policy in Credit risk Management	Frequency	Percentage
Very great level	28	33.33
Great level	52	61.91
Moderate level	4	4.76
Total	84	100

Source: Output from Survey Data, 2019

The study shown to conclude the extent to which MFI use collection policy in Credit risk Management, from the findings 61.91% of the respondents shown to a great level, 33.33%of the respondents shown to a very great level whereas 4.76 % of the respondents shown to amoderate extent, this implies that MFI use Strategies to manage credit risk management through collection policy in Credit risk Management.

Table 4.7: Level of agreement on collection policy of MFI

Items	Strongly agree	Agree %	Neutral %	Disagree %	Strongly disagree
1. Accessible collection policies have assisted towards effective credit risk management.	42.86	57.14	0	0	0
2. Preparation of policies has been a challenge in credit risk management.	50	44.05	2.38	3.57	0
3. Implementation of guarantee policies provides chances for credit recovery in case of loan defaults	55.95	44.05	0	0	0
4. Staff encouragements are effective in improving recovery of criminal loans.	46.43	51.19	0	2.38	0
5. Regular evaluations have been done on collection policies to increase state of credit risk management.	46.43	53.57	0	0	0
6. A strict policy is more effective in debt recovery than a lenient policy	50	48.81	0	1.19	0

Source: Output from Survey Data, 2019

The study indicates to found the level at which respondents settled or disagreed on the importance of the practice listed as strongly agree =5, Agree=4, Neutral=3, Disagree =2 and Strongly Disagree =1. with the above items relating to collection policy of MFI. From the findings majority of the responses strongly agreed that Enforcement of guarantee policies ,Available collection policies, Regular reviews on collection policies and using astringent policy than a compassionate policy have assisted MFIs collection policy towards effective credit risk management.

Moreover Item 2 also indicates that 94 % of the respondents agreed on Design of collection policies have been a challenge in credit risk management settlement as collection policies for the institution and also Item 4 also shows that 97 % of the respondents agreed on Staff incentives are effective in enhancing recovery of delinquent loans this also a key indicator on collection policy of MFI. Generally speaking from the respondents finding agreed that well prepared collection policy is a key factor for managing credit risk.

Summaray and Conclusion

Summary

The study had shown that Adamatown MFIs uses client assessment in Credit Management to a great extent. Further it established that client assessment is a practical strategy for credit, Aspects of collateral are considered while evaluating customers, failure to assess customer's capacity to repay results in credit defaults, client assessment considers the character of the customers seeking credit facilities and that Adamatown MFIs have competent personnel for carrying out client evaluation.

The study recognized that Adama townMFI use credit risk control in Credit Management to a great extent. The study further indicated that interest rates charged affects performance of loans in the Adamatown MFIs, Credit team involvement in making decisions concerning loans are essential in reducing credit loss, the use of credit checks on regular basis improve credit management, Penalty for late payment support customers commitment to loan repayment, the use of customer credit application forms improves controlling and loan management, flexible repayment periods improve loan repayment and finally that the use of credit follow up on regular basis enhances credit risk management.

The study had shown that Adama town MFIs uses collection policy in Credit risk Management to a great extent. Design of collection policies have been a challenge in credit management , enforcement of promise policies provides chances for loan recovery in case of loan risk, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more operative in debt recovery than a lenient policy, regular checking have been done on collection policies to improve state of credit management, and finally that available collection policies have supported towards effective credit management.

The Challenges of Adamatowns MFI, to reduce credit losses are proper customers screenings, designed clear policy and also strong follow up of customers especially after loan disbursed and also follow some ways to check up the level of credit risk.

Conclusion

Micro finance provides financial support to those persons in the society who are unable to get supportfrom bank. Most of these loans are small in size and distributed to poor people in order for them to create income and start their own businesses. It has the capacity to lessen poverty as well as promote entrepreneurship, community and financial development in poor people, However at the same time microfinance selections are exposed to several kinds of risks due to their inherent characteristic particularly credit risk.

The study indicated that an increase in client assessment would lead to increase in credit risk management of MFIs this indicate client assessment improves credit risk management of MFIs of Adama town. An increase in credit risk control would lead to improves in credit risk management of Adama town MFIs , which shows that as credit risk control increase that enhanced credit risk Management and a increase in collection policy would lead to increase in credit risk management this is an indication that there was a smooth relation between credit risk management of Adama town MFIs and collection policy.

Client appraisal, credit risk control and collection policy significantly influence credit risk management of Adama town MFIs .

Recommendations

MFIs should also apply efficient and effective credit risk management that will ensure that credits are matched with ability to refund, credit risk are projected accordingly and relevant measures taken to minimize the same. MFIs should also improve periodic credit risk control of their loan collection to increase the loan performance. This can be achieved by hiring qualified debt collectors and competent personnel.

It is recommended that MFIs needs to invest on debt collections and this will involve hiring qualified and experienced debt collectors, lawyers so as to increase litigation of nonpayers and auctioneers.

It is suggests that management would organize regular modifications in areas like credit management, risk management and financial analysis. This would sharpen the knowledge and skills of credit officers so as to improve on the quality of credit evaluations.

The study also comments that there is need for Adamatown MFIs to enhance their client appraisal methods so as to enhance their financial performance. Through customers appraisal techniques, the Adama town MFIs will be able to know credit worth customers and thus reduce their non-performing credit.

Make the number of employee sufficient in the operation department where there is a need for credit risk management so that the case will be minimized and that will give opportunity for every credit officer to do the job efficiently.

Future Research

The study sought to assess credit risk management of microfinance institution in the case of Adama town MFIs. Further research should also be done on the relationship between credit risk management ranking between MFIs in Adama town and Microfinance Institutions in Ethiopia and on the reasons for loan risk in microfinance organizations from the customers perspective.

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