

**MANAGEMENT OF CREDIT DEFAULT RISK IN COMMERCIAL
BANKS: THE STUDY OF NATIONAL MICROFINANCE BANK
(NMB) MWANZA REGION.**

**MANAGEMENT OF CREDIT DEFAULT RISK IN COMMERCIAL
BANKS: THE STUDY OF NATIONAL MICROFINANCE BANK
(NMB). MWANZA REGION**

By

Fortunate B Makwaia

**A Dissertation submitted for the Partial fulfillment of the Requirement of the
Award of a Degree of Masters of Science in Accounting and Finance (MSc A&F).**

Mzumbe University

2014.

CERTIFICATION

We, the undersigned, certify that we have read and hereby recommend for acceptance by the Mzumbe University a dissertation/thesis entitled, **Management of credit default risk in Commercial Banks: The study of National Microfinance Bank (NMB). Mwanza Region** in partial/fulfillment of the requirements for award of the degree of Master of Science in Procurement and Supply Chain Management (MSc-A &F) at Mzumbe University

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I, ***Fortunate B Makwaia***, declare that this dissertation is my own original work and that it has not been presented and will not be presented to any other University for a similar or any other degree award.

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Though only my name appears on the cover of this dissertation, a great many people have contributed to its production. I owe my gratitude to all those people who have made this dissertation possible and because of whom my graduate experience has been one that I will cherish forever.

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DEDICATION

To my Lovely Mother Mrs. Patricia M. Makwaia for her amazing love, care and remarkable encouragements during my entire life, thank you mother.

LIST OF ABBREVIATIONS

ATM	-	Automated Teller Machine
BOT	-	Bank of Tanzania
CR	-	Credit Risk
CRM	-	Credit Risk Management
GDP	-	Gross Domestic Product
LRM	-	Loan Review Mechanism
LTD	-	Limited
NICO	-	National Investment Company Limited
TCCIA	-	Tanzania Chambers of Commerce Industries and Agriculture
TCE	-	Total Credit Exposure
TZS	-	Tanzanian Shillings

ABSTRACT

The overall objective of this study is to identify, measure as well as examining the underlying root causes of Default Risks in Commercial Banks, challenges faced, and offer recommendations on what should be done to improve the management of credit risk in the Bank. The study applied survey method which combined both qualitative and quantitative approaches as a way to investigate both quantitative and qualitative information on the study topic.

The results have shown that, of the major challenges faced by Bank is lack of credit reference bureau which accounts to almost 50% of all challenges. Other challenges include lack of enough expertise as well as fraud and fraudulent practices.

It was an assumption of the researcher that, the tendency of NMB posing higher interest rates ranging 18% to 21% results into very expensive loans for borrowers to repay.

This was found to be the only case with business loans which cannot generate enough cash flows to service both principal and interest timely.

At the end of the study the author tries to propose a few issues which she believes can make a remarkable impact on management of credit risk. Some of her strong recommendations include the need to continue lobbying to the Government to speed up the establishment of Credit Reference Bureau. The researcher also suggests that the bank also needs to diversify its activities geographically to reduce its amount of concentration in Dar es Salaam.

The author believes that all of her recommendations can be taken up and implemented with the given resources the bank possesses, the study shall remain as one of the key reference documents for policy makers, corporate firms, students and employees of NMB.

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CHAPTER ONE

INTRODUCTION

1.1 Overview of the study

This part focuses on the background to the study which basically covers all relevant and basic information with regard to the management of credit default risk. The chapter also covers objectives, research questions and significance of the study, this chapter highlights the objectives for which the study was established around, and significance of the study.

1.2 Background to the Study

Financial institutions are very important in any economy. Their roles are similar to those of blood and arteries in human body. As they are financial resources for economic growth their disparity are very important. Richard, Chijoriga, Kaijage, Peterson & Bohman, (2008). Kaaya W & Pastory, (2013) stress that, Commercial banks play an important role for economic development, and foster economic growth of any country through their intermediation role and financial services that they provide to community and nations. The credit facilities that they offer facilitate the exploration and expansion of productive investment avenues by individuals and institutional investors. Credit default risk is a major concern for many financial institutions in Tanzania, as credit defaulters are the source of banks/ financial institutions risks. However Loan has been the major profitable venture with relatively short term maturity. Special attention should be paid with proper management and with clear indicative and reliable mechanisms.

Commercial Banks as a financial institution have a core function of allocating some of the deposited funds to more profitable ventures in terms of buying Treasury Bills, Treasury Bonds, investing in real assets with relative short term maturities and providing loans to those in need. All these are done after complying and managing certain amount of the funds (working capital management). First to meet the Central Bank's regulation (the System liquidity) and secondly after satisfying itself that the current liquidity it

holds together with those expected to mature at a short period of time are able to settle the bank's matured financial obligations.

Since loans of various types have been the greatest banks' profitable ventures with relatively short term maturities that is the Money Markets, then indeed, they need a special attention on their management especially on clear, indicative and reliable mechanisms. The mechanisms will enable the Banks' Credit officers as well as the Banks' managers in general, to identify, study, and mitigate the identified causes/factors influencing the Default risks in their way to attain their organisational desired objectives, which is making profit.

Bank loans do not only benefit the lending institutions but also have an important role to support the poverty eradication program of the country (Multiplier effect); therefore, it is only when the first borrowers comply with the bank's agreement on repayments, then the second "batch" can also be provided with such loans, failure to that, it will result in the bank's insolvency as well as inaccessibility of other borrowers to acquire such product hence the general failure of the government to fight against poverty.

On the other hand, there is a need to examine the nature of such Default risks from the operational/financial related causes to the cultural ones in such a way that the Risk managers will be in a good position to provide a valid and reliable solution.

1.3 Statement of the problem

Loan performance is a major constraint affecting the success and survival of finance institutions in developing countries like Tanzania. Lending institutions especially Commercial Banks have to a certain extent failed to identify, examine and provide sustainable, and efficient mitigation measures for the root causes of the Default risks, the issue here is not default risk generally, but it is indeed the underlying root causes as mentioned earlier from the operational related causes to cultural ones so that the lenders can have adequate solutions depending on the nature of the customers. The Commercial Banks have been enjoying only the risk free salaried workers' loans whose repayments are directly remitted by the customer employers. Despite all the complex criteria set by

the Commercial Banks, still the very same successful customers default hence cause loss to the Bank.

Most studies conducted previously focus much more on the impact of credit default and what needs to be done in improving the situation without investigating much on the underlying root causes of the problem; as a result many have failed to prepare the best credit risk strategies that would address the underlying root causes of the problem.

1.5 Objective of the study

1.5.1 General Objective

The overall objective of this study was to show the management of credit default risks in commercial banks.

1.5.2 Specific objective

The study was guided by the following specific objectives:

- a) To identify the core underlying causes of the Default Risks in Commercial Banks
- b) To identify the various methods employed by the NMB Ltd in mitigating Default risks.
- c) To identify the various techniques employed by the NMB Ltd in managing Default risks.
- d) To identify the various challenges faced by the NMB Ltd in Default Risk management.
- e) To examine whether credit evaluation criteria (5Cs) is used by the NMB Management in Credit / Loan provision.

1.4 Research questions

The study was guided by the following research questions:

- i. What are the underlying causes of credit default risk in commercial banks?
- ii. How do banks identify credit default risks at the NMB?
- iii. Which techniques does the NMB employ in managing credit default risks?
- iv. What are the major challenges does the NMB face in managing credit default risk?
- v. Does NMB use the credit evaluation criteria (5Cs) when providing loans?

1.6 Significance of the Study

The study has opened up room for the wider understanding of the various sectors such as Social, Political and Operational Business sector on the factors which causes credit default risk in Commercial Banks and especially NMB Ltd. As a result the study has enlightened the financial institutions' Credit Officers as well as the Bank managers with relative sustainable solutions and efficient measures to minimise such risks. On the other hand, the study can be helpful to borrowers if found that certain factors are cultural oriented and hence the need for the Banks to address such cultural challenges. Other benefits include development of sound, valid and reliable mitigation measures that will cater for both Quantitative as well as Qualitative factors.

The study also helps to improve Default Risk management techniques and plan happening in the bank, the study was structured around any weaknesses that the bank had, the researcher believed this study would helped the banks in developing better credit risk management techniques and plans to decrease Bank's Bad and Doubtful Debtors. This simply means that if the bank develops better techniques and plans for risk management, cases of bad and doubtful debtors will be reduced and this will improve the bank's bottom line. And this will have positive impact on company's dividend payout.

The study has helped to Increase Banks' capital as well as shareholders wealth, as the bank's doubtful debt provisions can be reduced, the improvement of the bottom line has boosted up the retained earnings which has increased company's capital adequacy.

1.7 Definition of Common Terms

1.7.1 Commercial Banks

These are financial institutions that mobilise deposits from various economic units such as firms, government/Public Institutions and households with surplus Funds (Surplus Spending Units). Also they make efficient allocation of such financial resources to the Deficit Spending Units that need Funds for consumption and investment purposes. One of the ways used by Commercial Banks to allocate their financial resource (especially Cash asset) is through lending.

1.7.2 Credit risk

Credit risk can be defined as the potential that a contractual party will fail to meet its obligations in accordance with the agreed terms. Credit risk is also variously referred to as default risk, performance risk or counterparty risk (Rouse, 2002). This type of a risk arises from the potential that an obligator is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the financial institution.

These all fundamentally refer to the same thing: the impact of credit effects on a firm's transactions. There are three characteristics that define credit risk:

- Exposure (to a party that may possibly default or suffer an adverse change in its ability to perform).
- The likelihood that this party will default (or the default probability) on its obligations.
- The recovery rate (that is, how much can be retrieved if a default takes place).

The larger the first two elements the greater the credit default risk. On the other hand, the higher the amount that can be recovered, the lower the risk. Formally, we can express the risk as:

$$\text{Credit risk} = \text{Exposure} \times \text{Probability of default} \times (1 - \text{Recovery rate})$$

Given the above, credit risk management is the process of controlling the potential consequences of credit risk. The process follows a standard risk management framework, namely: identification, evaluation and management. That is, the cause of the risk has to be identified, the extent of the risk has to be evaluated and decisions made as to how this risk is to be managed.

1.7.3 Default Risk

The term can easily be defined as the possibility that a borrower will be unable to meet interest and/or principal repayment obligation on a loan agreement. Since one of the functions of the Managers is Asset management, and cash being one of them (Organisation assets), that (Asset management) can only be achieved only if there will be a special, brilliant and effective mechanisms to forecast as well as mitigate the identified default risks which are likely to happen and cause a financial adverse effect to the organisation which will lead to the organisational failure to meet its set objectives.

1.8 Scope of the Study

The study was carried at the NMB Bank, the financial institution under which the government had the majority shareholders. The study covered five selected branches of Mwanza region. The research was done by interview schedules, giving questionnaires and by the help secondary data.

1.9 Organisation of the Dissertation

This study is organised into six chapters. Chapter one introduces the study. it begins with a brief background to the problem, a statement of the research problem, the objectives and research questions, the significance, scope of the study and the definition of the

common terms. Chapter two presents a detailed review of relevant literature written about Management of credit default in commercial banks, The System of Credit Risk Management in Tanzania's Financial Institutions, Methodology and Instruments/tools used for credit Risk Management, credit evaluation and the conceptual framework. Chapter three provides the methodology used to obtain data, how the data are analysed, and Factors taken into consideration. Chapter four presents the findings based on the objectives of the study. Chapter five contains the Discussion of the findings. Chapter six provides conclusions and area for further research.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter presents the literature review and theoretical framework, which means the theoretical and conceptual context of the study. It highlights the risk management concepts and it conceptualizes about existing ideas on the topic. It further shows how banks manage credit default risks to strike a balance between profitability, liquidity and capital adequacy with resultant consequences. Finally, it presents existing or prior studies/theories related to the area of study.

2.1.0 Theoretical part

2.1.1 Concept of Credit Default Risk Management

Management can be defined as the act of planning, directing, controlling, monitoring and testing for desired results to be obtained. Or it is simply the act, manner, or practice of managing; handling, supervision, or control. Risk on the other hand can be defined as the possibility that something unpleasant or dangerous might happen (Ngwa, 2010). Altman and Kao (1991), Carty and Fons, (1993) assert that credit risk involves the possibility that the inherent risk of the asset migrates to a lower quality level, thereby resulting in lower security values in a market-to-market pricing environment.

2.1.2 Credit Risk Description

BOT (2010) has identified the common risks in banking, the coverage of common risks that facebanking and other Financial Institutions include the following:

(i) Credit Risk: Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired resulting in economic loss to the institution.

(ii) Liquidity Risk: Liquidity risk is the potential for loss to an institution arising from either its inability to meet its obligations as they fall due or to fund increases in assets without incurring unacceptable cost or losses. Liquidity risk includes inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the failure to recognise or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

(iii) Market Risk: Market risk is the risk of losses and of balance sheet positions as a result of adverse changes in market prices i.e. interest rates, foreign exchange rates, equity prices and commodity prices. Market risk exists in both trading and banking book. A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book.

(iv) Operational Risk: Operational risk is the current and prospective risk to earnings and capital arising from inadequate or failed internal processes, people and systems or from external events.

(v) Strategic Risk: Strategic risk is the current and prospective impact on earnings, capital, reputation or good standing of an institution arising from poor business decisions, improper implementation of decisions or lack of response to industry, economic or technological changes. This risk is a function of the compatibility of an organisation's strategic goals, the business strategies developed to achieve these goals, the resources deployed to meet these goals and the quality of implementation.

(vi) Compliance Risk: Compliance risk is the current or prospective risk to earnings, capital and reputation arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices, or ethical standards, as well as from incorrect interpretation of relevant laws or regulations. Institutions are exposed to Compliance risk due to relations with a great number of stakeholders, e.g. regulators, customers, counter parties, as well as, tax authorities, local authorities and other authorised agencies.

2.1.3 Credit Risk Management

The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters (as per entity's risk appetite) which is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation (Kaaya&Pastory, 2013). Rupp (2002) asserts that credit risk management is a process that involves a series of steps; identifying and analysing loss exposures through the appraisal technique, measuring loss exposures, selecting the technique or combination of techniques to be used to handle each exposure. Moreover, it involves implementing the techniques chosen and monitoring the decisions made and making appropriate changes. It is also the support, control systems and other practices necessary to manage the outstanding risk assets, normal repayment and to monitor business risk. The appraisal technique involves credit initiation, evaluation, negotiation, and approval of facility. As an important step in initiation process, credit officer should visit the potential customer to gather information on client's business, mode of operation, management, and financial situation. Banks should base their credit analysis on the five C's principals of lending.

The 5Cs as discussed by Pandey, (1997), Van Horne, (1998), Sinkey, (1998) and Bacon (1996) include the customer's character as determined by their honesty and ethical reputation. It also refers to the capacity of the client as determined by their cash flows, and capital as determined by the client's real net worth. The collateral pledged for the credit facility is another aspect, and the condition, that is the vulnerability of economic fluctuations. In credit evaluation, a consistent and rating scheme to all investment opportunities should be applied if credit decisions are to be made in consistent manner which results in aggregate reporting of risk exposure Santomero, (1996). Several authors Santomero (1996), Bannet (1984) and Harrison (1996) agree that credit scoring should be used in the appraisal process to predict the credit worthiness of borrowers. However, external factors like competition, economic cycle, natural disasters, technological advances, regulatory changes, industry changes, demographic factors affect the credit evaluation process and this at times results in problems of loan repayment(Wayne, 1998).

Abhimal and Saibal (2007), Gabriel *et al.*, (2006), Samad (2012) and Ahmad and Ariff (2007) pointed out a number of determinants of credit risk in banks. First, there is inefficient bank performance; poor screening and monitoring of borrowers tend to have inferior portfolio. Second Collateralised loans have a high possibility of default because banks tend to trust the borrowers with secured loans and hence less incentives to undertake adequate screening and credit assessment. Third, rapid loan growth or credit expansion (over extension of credit) and extended passage of time for profit maximisation leads to poor loan quality. Fourth, economic down turn (recession) as external factor affects the ability of individuals, institutions and other borrowers' ability to repay their debts; hence, high possibility of failure to fulfill their financial commitments.

2.2 Credit Risk Management System in Tanzania Financial Institutions

Financial Institutions (FIs) may have different risk management systems depending on their sizes and complexity (BOT, 2010). As a lender of last resort BOT requires that, each institution should prepare a comprehensive Risk Management Programme (RMP) tailored to its needs and circumstances under which it operates. The RMPs should be reviewed at least annually so as to make a risk management system perform well and make the institutions to cover the identified risks that may happen in the credit provisions. These include the following guidelines. It is expected that RMPs prepared by institutions should at minimum cover the six risks contained in these guidelines:

2.2.1 Risk Management: This is a discipline at the core of every institution and encompasses all the activities that affect its risk profile. Risk management as commonly perceived does not mean minimising risk; rather the goal of risk management is to optimise risk-reward trade-off. This can be achieved through putting in place an effective risk management framework which can adequately capture and manage all risks an institution is exposed to. Risk Management entails four key processes:

2.2.2 Risk Identification: In order to manage risks, an institution must identify existing risks or risks that may arise from both existing and new business initiatives, for example, risks inherent in lending activity include credit, liquidity, interest rate and operational risks. Risk identification should be a continuing process, and should occur at both the transaction and portfolio level.

2.2.3 Risk Measurement: Once risks have been identified, they should be measured in order to determine their impact on the institution's profitability and capital. This can be done using various techniques ranging from simple to sophisticated models. Accurate and timely measurement of risk is essential to effective risk management systems. An institution that does not have a risk measurement system has limited ability to control or monitor risk levels. An institution should periodically test to make sure that the measurement tools it uses are accurate. Good risk measurement systems assess the risks of both individual transactions and portfolios.

2.2.4 Risk Control: After measuring risk, an institution should establish and communicate risk limits through policies, standards, and procedures that define responsibility and authority. Institutions may also apply various mitigating tools in minimising exposure to various risks. Institutions should have a process to authorise exceptions or changes to risk limits whenever warranted.

2.2.5 Risk Monitoring: Institutions should put in place an effective management information system (MIS) to monitor risk levels and facilitate timely review of risk positions and exceptions. Monitoring reports should be frequent, timely, accurate, and informative and should be distributed to appropriate individuals to ensure action, whenever needed.

2.3 Empirical part

A dynamic and growing Micro and Small Enterprises (MSEs) sector can contribute to the achievement of a wide range of development objectives, including: the attainment of income distribution and poverty reduction (Abdul, 2013); creation of employment (Daniels and Ngwira (1993); savings mobilisation (Beck *et al.*, (2005); and production of goods and services that meet the basic needs of the poor (Cook and Nixon (2000)). While estimates vary greatly depending on definitions, recent work by the World Bank suggests that almost 30 per cent of employment in developing countries and Tanzania alike is generated by the informal economies which run their business by means of credit from the FIs. Micro finance is the most important constraint for the MSEs sector that is, The MSEs have very limited access to financial services from formal financial institutions to meet their working and investment needs.

Rweyemamue *et al.*, (2003) assert that formal financial institutions have failed to serve the SMEs in both urban and rural communities because of the financial problem of most SMEs that arises due to poor financial management; existence of information asymmetry and bank credit rationing (Chijoriga and Cassimon (1999)). Ogawa and Suzuki (2000) point out that banks do not want to offer loans to MSEs because of the nature of loans required is too small and those banks find it more expensive to offer such loans. According to Chijoriga and Cassimon (1999), most formal institutions regard low-income households as too poor to save, and are not personally known to them, do not keep written accounts or business plans, they usually borrow small and uneconomic sums. The existence of such drawbacks led to credit risk defaults which need the careful management by the credit creator that is FIs.

SMEs in Tanzania contribute 12% and 34% of rural and urban employment respectively as well as up to 32% of the country GDP (Wangwe&Semboja, 1997). Therefore the Government of Tanzania in recognising the contribution of SMEs in country economy developed the National Microfinance Policy which aims at enabling low-income earners to access financial services (URT, 2000). Microfinance institutions (MFI's) provide a

broad range of services including deposits, loans, payment services, money transfer and insurance to the poor/low-income households and their enterprises (Chijoriga,2000).

2.4 Methodology and Instruments/tools used for credit Risk Management

Credit risk is perhaps the most significant of all risks in terms of size of potential losses. As the extension of credit has always been at the core of banking operation, the focus of banks' risk management has been credit risk management (Hosnaet *al.*, (2009). Raghavan (2003) have provided the suitable tools of credit risk management consciously with provision of remedies to commercial banks from undergoing bankrupts. The instruments and tools, through which credit risk management is carried out, are detailed below:

- a) *Exposure Ceilings*: Prudential Limit is linked to Capital Funds – say 15% for individual borrower entity, 40% for a group with additional 10% for infrastructure projects undertaken by the group, Threshold limit is fixed at a level lower than Prudential Exposure; Substantial Exposure, which is the sum total of the exposures beyond threshold limit should not exceed 600% to 800% of the Capital Funds of the bank (i.e. six to eight times)
- b) *Review/Renewal*: Multi-tier Credit Approving Authority, constitution wise delegation of powers, Higher delegated powers for better-rated customers; discriminatory time schedule for review/renewal, Hurdle rates and Bench marks for fresh exposures and periodicity for renewal based on risk rating, etc are formulated.
- c) *Risk Rating Model*: Set up comprehensive risk scoring system on a six to nine point scale. Clearly define rating thresholds and review the ratings periodically preferably at half yearly intervals. Rating migration is to be mapped to estimate the expected loss.
- d) *Risk based scientific pricing*: Link loan pricing to expected loss. High-risk category borrowers are to be priced high. Build historical data on default losses. Allocate capital to absorb the unexpected loss.

e) Portfolio Management: The need for credit portfolio management emanates from the necessity to optimise the benefits associated with diversification and to reduce the potential adverse impact of concentration of exposures to a particular borrower, sector or industry. Stipulate quantitative ceiling on aggregate exposure on specific rating categories, distribution of borrowers in various industry, business group and conduct rapid portfolio reviews. The existing framework of tracking the non-performing loans around the balance sheet date does not signal the quality of the entire loan book. There should be a proper & regular on-going system for identification of credit weaknesses well in advance. Initiate steps to preserve the desired portfolio quality and integrate portfolio reviews with credit decision-making process.

f) Loan Review Mechanism (LRM): This should be done independently of credit operations. It is also referred as Credit Audit covering review of sanction process, compliance status, review of risk rating, pick up of warning signals and recommendation of corrective action with the objective of improving credit quality. It should target all loans above certain cut-off limit ensuring that at least 30% to 40% of the portfolio is subjected to LRM in a year so as to ensure that all major credit risks embedded in the balance sheet have been tracked. This is done to bring about qualitative improvement in credit administration. Identify loans with credit weakness. Determine adequacy of loan loss provisions. Ensure adherence to lending policies and procedures. The focus of the credit audit needs to be broadened from account level to overall portfolio level. Regular, proper & prompt reporting to Top Management should be ensured. Credit Audit is conducted on site, i.e. at the branch that has appraised the advance and where the main operative limits are made available. However, it is not required to visit borrowers' factory/office premises.

2.5 Credit evaluation (The 5Cs approach)

The final stage in the credit process is the credit evaluation whereby the decision is made to either approve or reject the credit (Basel, 1999). Once the information is verified, the evaluation stage is followed. The main objective of evaluation is to;

- a) Provide the best tailored loan for the customer and a quality loan for the lender
- b) Ensure compliance with regulation and bank policy
- c) Keep the goodwill of the consumer; and
- d) Ensure that the level of risk is acceptable.

Each lending situation is unique because of its subjective judgmental approach; many lenders utilise some variation of evaluating the five Cs of credit which is character, capacity, capital, collateral, and conditions.

- a) **Character** is the moral obligation that a borrower feels to repay the loan. Since there is not an accurate quantifiable measure to judge character, the lender will decide subjectively whether or not you are sufficiently trustworthy to repay the loan. The lender will investigate your past payment experience, review a credit bureau report, and consider your educational background and experience in business. The quality of your references and the background and experience of your employees will also be considered.
- b) **Capacity** refers to the company's ability to generate sufficient cash flow from operations to meet the loan payments. Since this represents the primary source of repayment for a loan, the prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan.
- c) **Capital** is the money you personally have invested in the business and it is an indicator of how much you will lose should the business fail. Lenders expect you to contribute your own assets and to undertake personal financial risk before asking them to commit any funding. If you have a significant personal investment in the business, you are more likely to do everything in your power to make the business successful.

Lenders will generally consider the company's debt-to-equity ratio to understand how much money the lender is being asked to lend (debt) in relation to how much the owners have invested (equity).

- d) **Collateral** or third-party guarantees are additional forms of security you can provide the lender. If the business' cash flows are not adequate to repay the loan, the bank wants to know there is a second source of repayment. Equipment, buildings, accounts receivable, and inventory may be seized and sold by the bank if the company defaults on the debt. The loan agreement should carefully identify any items that serve as collateral. Business owners may be asked to place personal assets (home, stocks, bonds, etc.) in addition to the business assets as collateral for a loan. In some cases, the lender may ask for a third-party guarantee whereby someone else signs a guarantee document promising to repay the loan if you cannot. A lender will normally want the term of the loan to match the useful life of the asset used as collateral. If equipment with a five-year expected life is used as collateral, then the term of the loan will generally be five years or less.
- e) **Conditions** refer to national and local economic conditions. How sensitive is the company's sales to the overall economy? If the country enters a recession soon, will the company's sales fall dramatically or can they be expected to be relatively unaffected (like a grocery store chain, for example). Companies with stable sales that are not tied closely to the overall economy are generally looked upon more favorably by lenders.

2.6 Conceptual framework

A conceptual framework is the one that explains either graphically or in narrative form, the main things to be studied the key factors, concepts or variables and the presumed relationship among them (Miles & Huberman, 1994). Researchers generally have some idea of what will feature in the study, a tentative simple conceptual framework, and it is

better to have some idea of what you are looking for/at even if that idea changes over time (ibid).

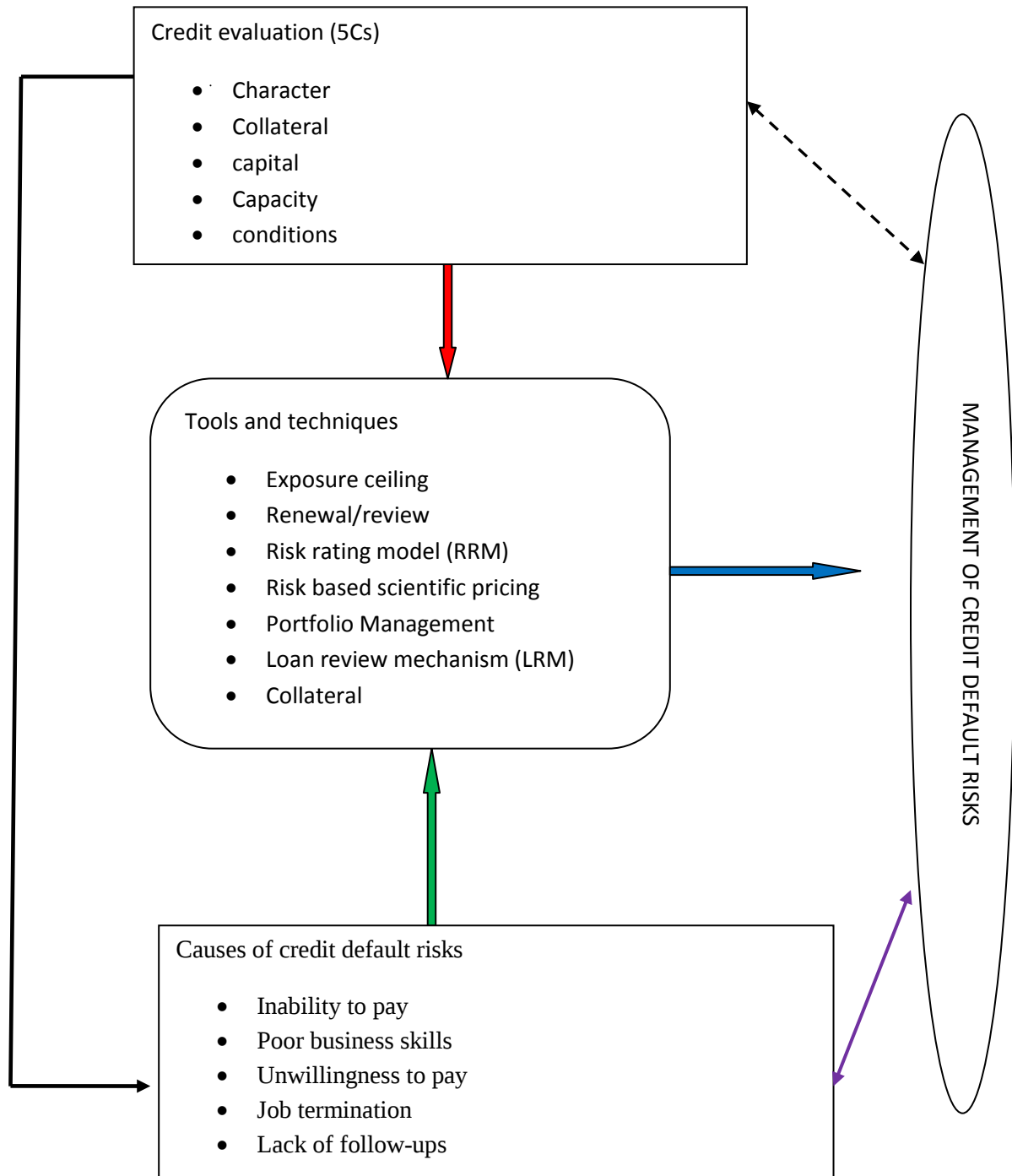


Figure 2.1 Conceptual Framework: Own source

The upper object of the conceptual framework shows the direction of borrowers credit evaluation that the bank uses to assess its' clients during credit creation process. The 5Cs conditions should be met for the borrower to qualify for a loan. The credit evaluation is subject to a given tools and technique directed by the red arrow as a means of avoiding credit default risk. However, if the management tools and techniques are not properly used credit default risks may arise/occur as indicated by the green arrow. The black arrow shows the failure to meet the 5Cs that may be caused by the inability to pay, poor business skills, and unwillingness to pay, job termination and lack of follow-ups those results to Credit Default Risk. When proper tools and techniques are applied the results is the Management of credit default risk as indicated by the blue arrow. The dotted and purple arrows shows direct measure that are applied to insure the proper management of credit default risks.

2.7 Hypotheses

H₀: NMB is not proper in the management of the Credit Default Risk.

H₁: NMB is proper in the management of credit default risk

H₀: Imperfect information, Inability to pay, Poor business skills, Unwillingness to pay, Job termination, Lack of follow-ups do not have the direct influence on the credit default risk.

H₁: Imperfect information, Inability to pay, Poor business skills, Unwillingness to pay, Job termination, Lack of follow-ups have the direct influence on the credit default risk.

The above hypotheses were used to test on the way how credit default risk occurs as caused by both Borrowers and the Bank Management. On the other side how the problem is being solved by the NMB management.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

This chapter specifies the research design used; criteria for sample selection, data sources, instruments used for data collection, data processing, and analysis. The chapter ends with a review of limitations encountered during the study.

3.1 Research Design

The study used a survey design. Survey method involves asking questions to respondents, collecting information from a small number of people representing a larger number of people. In a survey, a researcher samples a population. Basha and Harter (1980) state that "a population is any set of persons or objects that possesses at least one common characteristic." In this case a sample of five NMB branches was selected to find out the management of credit default risk in commercial banks. The study used a blend of both qualitative and quantitative approaches.

- **Qualitative approach**

The researcher used a qualitative approach to be able to get more in-depth information on the study and to give respondents more freedom to steer around the topics and issues posed.

- **Quantitative approach**

The use of quantitative approach was essential by the need to understand impact of the problem and its extent on financial costs, and magnitude of the problem on company's financial performance.

3.2 Study Area

The study was conducted at National Microfinance Bank in Mwanza region. NMB was selected because NMB is one of the largest Bank in terms of coverage and deposits as it

dealt with hundreds of risk-prone borrowers and offering a long network of credit creation to small medium enterprises(SMEs).

3.2.1 Description of the study area

Following the break-up of the old National Bank of commerce in 1997, by the act of Parliament, three new entities were created: (a) NBC Holdings Limited (b) National Bank of Tanzania (1997) (c) National Microfinance Bank. Initially the NMB could only offer savings accounts, with limited lending capabilities.

In 2005, NMB was privatised and the Government of Tanzania, the sole owner of the NMB until then, divested 49% shareholding to RABO Bank of the Netherlands. Over the years since that time, further divestiture by the Tanzania Government and subsequent listing of the bank's stock has led to a diversified ownership structure outlined as follows: the RABO Bank from Holland (34.9%), the Government of Tanzania (30%), Private Investors via DSE (21%), the National Investment Company Limited (NICO) with (6.6%), the Exim Bank Tanzania (5.8%), and Tanzania Chambers of Commerce Industries and Agriculture (TCCIA) with (1.7%).

On November 6th, 2008, the NMB was listed on the Dar es Salaam Stock Exchange. The NMB is currently the largest bank in Tanzania ranked by customer based and branch network. With well over one million customers and Up to April 2014 the NMB had 143 branches and over 450 ATMs across Tanzania. This broad branch network distinguishes the NMB from any other financial institution in Tanzania.

The NMB microfinance loan gives micro entrepreneurs and individual people access to efficient borrowing. Amounts that can be borrowed range from TZS 50,000. This allows their customers (borrowers) to pay for their needs; repayment simply takes place through equal monthly installments.

3.3 Data Collection Techniques

Both primary and secondary data were collected.

3.3.1 Primary Data

Primary data were collected through surveys with closed-ended questionnaires, and personal interviews.

- **Questionnaires**

Structured questions were prepared; the questions covered specific detailed information which were needed to cover the details of the research problems. Questionnaires were divided into two categories; one was for the bank employees and the other one for the bank's clients. However, the bank client's questionnaires were collected for descriptive purposes only.

- **Interviews**

Interviews were conducted by the researcher to selected NMB officers; the intention was to get what was really happening in the field.

3.3.2 Secondary Data

Due to time limitation and cost, secondary data were involved much in collection of information needed in the management of credit default risk in commercial banks. Data for the study were collected through reviewing literature, which included: reports, manuals, articles, pieces of legislation and policies.

3.4 Data Analysis

Data obtained from the study were reduced and summarised into patterns of information, which was then interpreted and analysed. The model/method used to analyse data was SPSS.

3.5 Sample Selection

The study drew a sample of 35 respondents. The respondents included 25 Bank officers and 10 bank clients. The purposive sampling method was preferred because it allows the

researcher to purposively identify respondents who are capable of providing valid information, according to Benard (1990) and Hubermann (1990).

3.6 Ethical Considerations

The aim of the study was communicated to each selected respondent and they were informed that their responses were voluntary and only those who provided verbal and written consent took part in the study. They were also assured of confidentiality.

CHAPTER FOUR

PRESENTATION OF RESEARCH FINDINGS

4.1.0 Introduction

This chapter presents and discusses the findings of the study. In this section, information obtained in the survey was analysed using SPSS version 16. A total of 25 staff members responded out of targeted 25. This was a response rate of 100% and a total of 7 bank clients out of 10 which was 70%. The depth of the information drawn was considered arguably indicative of the wider impact of the banking supervision.

The major focus on data collection, compiling of findings, and analysis of findings was centered around the objectives of the study.

The study revealed the following:

- a) To identify the core underlying causes of the creditdefault Risks in Commercial Banks
- b) To identify the various methods employed by the NMB Ltd in identifying and mitigating credit default risks.
- c) To identify the various techniques employed by the NMB Ltd in managing credit default risks.
- d) To identify the various challenges faced by the NMB Ltd in default Risk management.
- e) To examine whether credit evaluation criteria is used by the NMB.

4.1.1 Core reasons for default risk

On this item, the researcher found that default risk was caused by many factors, but the core ones were:

- Inability to repay most borrowers

- Unwillingness to repay
- Poor business management skills (in case of SME loans)
- Job termination (in case of salaried loans)
- Lack of proper mechanism to follow up borrowers

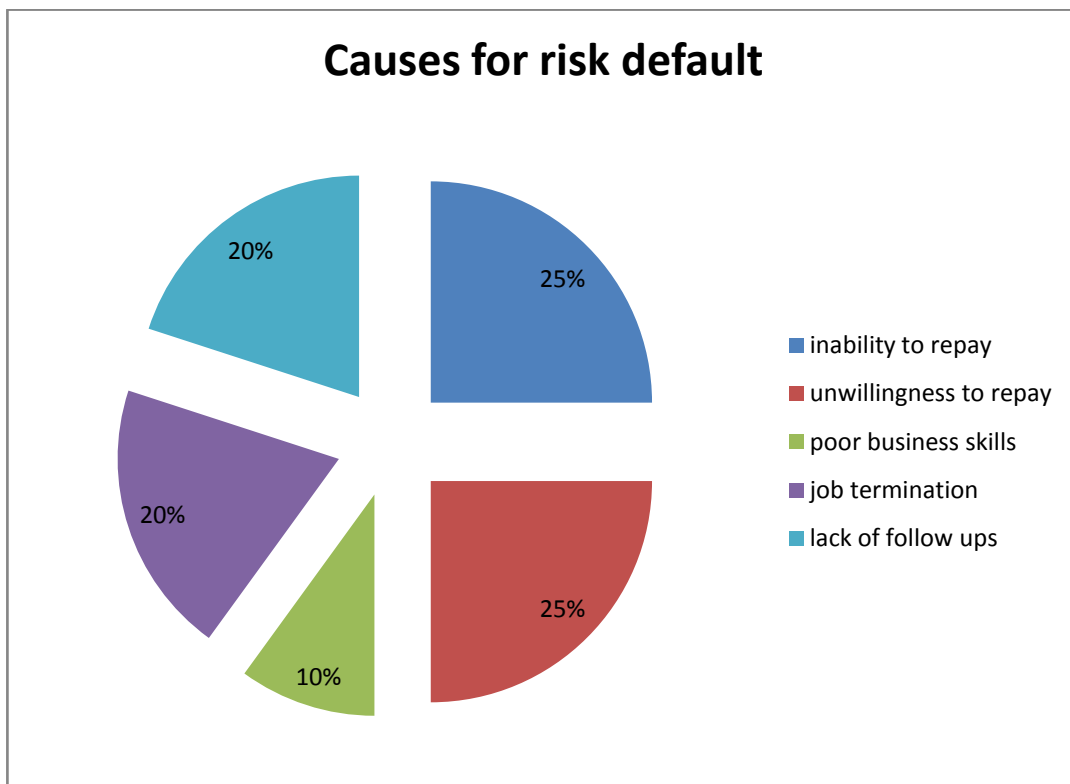


Figure 4.1 Causes of default risk

These findings show that the ability to repay and willingness to repay loans are the key issues when giving out loans.

Inability to repay the loan

Twenty percent of the respondents indicated that inability to repay the loan was one of the major reasons of credit risk. This was attributed by poor performance of their business that failed to generate enough cash flows for the case of business borrowers, and for the

retail borrowers who were mostly employees. They mostly failed to repay when they lost their jobs.

Unwillingness to repay

Most borrowers in Tanzania had a tendency to borrow and plan not to pay back. This was mostly explained as moral decay for borrowers. This was not only at the NMB, but it also affected other lending institutions. Banks tried to intervene into this through various education awareness programmes.

Poor business skills

With regard to poor business skills 10% of respondents mentioned that the cause of credit risk was more often than not to small business loans. Business skills were key to any business performance, absence of them put a business at a risk of default, if skills were not built up, this would result in default.

Job termination

Twenty percent of respondents said that the other reason why people defaulted was termination from their jobs. This loanee's whereabouts was not readily known.

Lack of proper mechanisms to follow up

This has been identified as a challenge due to the fact that most banks including the NMB lack proper mechanisms to follow up defaulters. Other countries used debt collectors and debt managers who buy defaulted loans or follow-up defaulters and get commission from the banks as their clients. This was also a challenge complicated by country's lack of physical addresses and national identity cards.

4.1.2 Methods employed by NMB in identifying and mitigating default risks

In identifying and mitigating default risks, the bank had prepared a credit risk policy that offered an overall guidance on how the credit risk should be managed. With this policy, the bank had prepared a framework, a team of experts and it used the BOT

guidelines to identify and mitigate such risks. One of the ways the bank uses to mitigate its credit risk is through the use of collateral, insuring the loans, and training SMEs before they get loans.

4.2.3 Challenges facing the Bank in managing credit default risk

In managing credit risks in the bank, the bank faced the following major challenges:

- Lack of enough expertise
- Fraud and unfaithful bank officers
- Ineffective supervision of its borrowers who scattered across the country
- Lack of credit reference bureau from where it could easily trace borrower's history

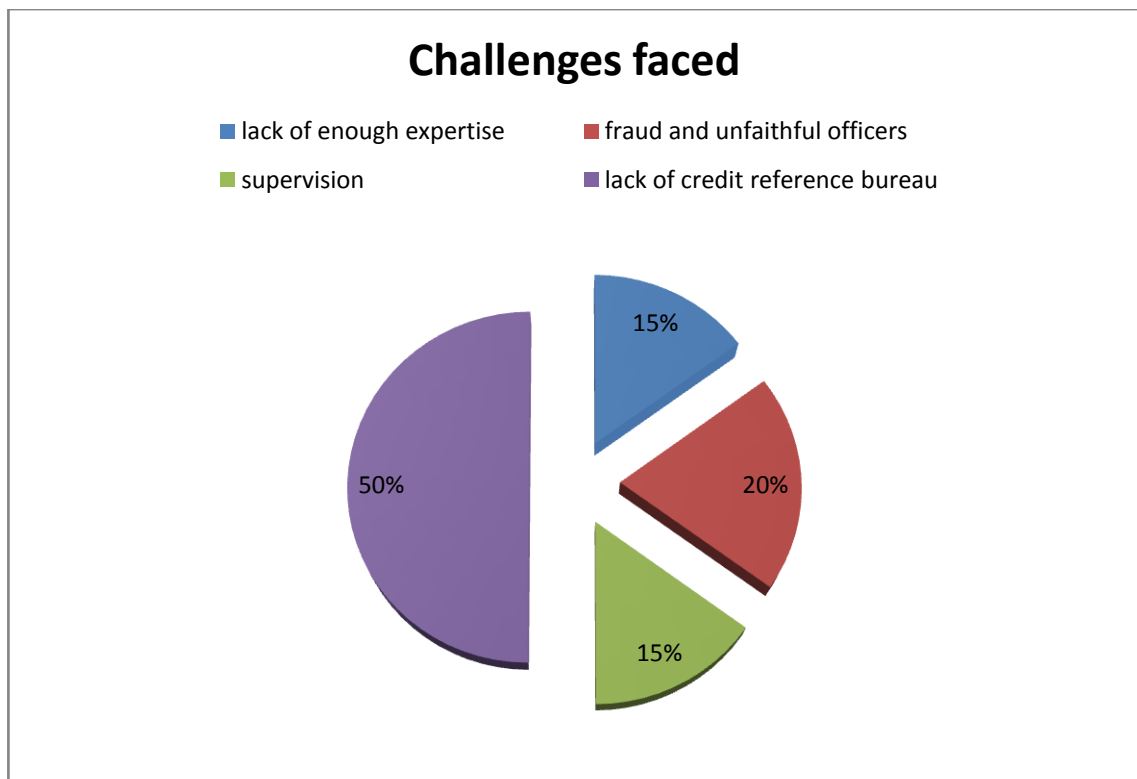


Figure 4.2 Challenges faced in risk management

In this case, it was found that lack of credit reference bureau was the major challenge faced the bank when managing its credit risk. This was because the bank failed to establish the credit history of their borrowers.

It was also found that 20% of respondents mentioned fraud and unfaithful bank officials were a challenge the NMB faced. Moreover, 15% of respondents said that lack of enough expertise and ineffective supervision of borrowers who scattered across the country was one of the challenges faced the NMB.

4.2.4 Major impacts of default risk

The researcher found the major impacts of default were:

- Decrease in profit margins
- Decrease in capital reserves
- Decreased return on loan portfolio
- Raising interest rates
- Imposing collateral on borrowing

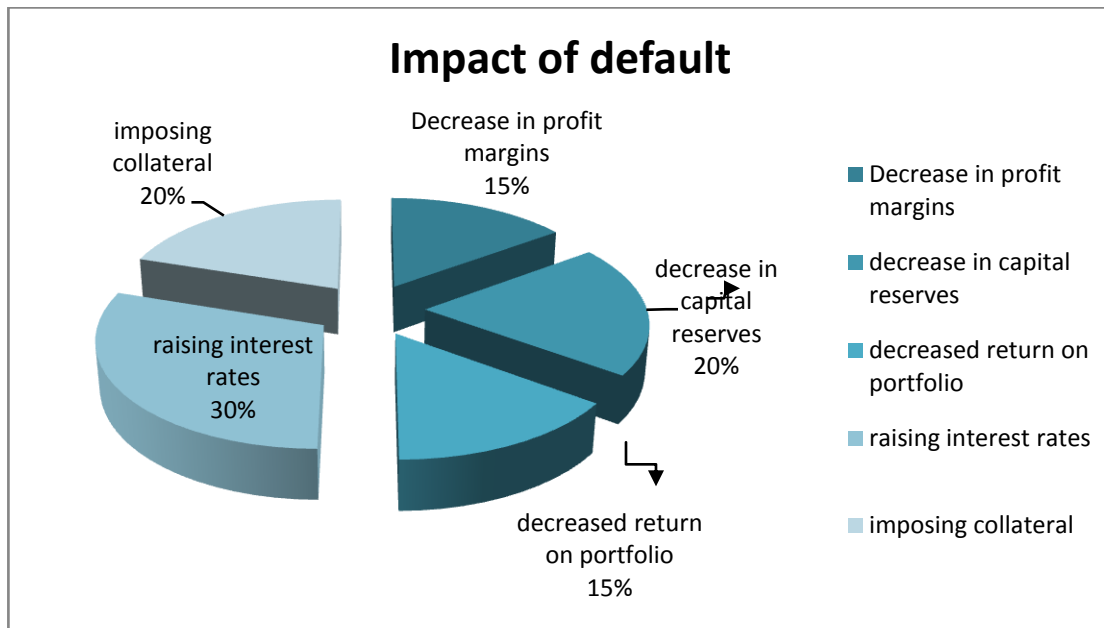


Figure 4.3 Impact of credit risk

Due to increased default risks, the bank figured out other ways to deal with such risks, one of the best ways that was adopted was raising interest rates and imposing collateral as a way to secure its loans.

Interest rates

It was found that 30% of respondents said that banks in an attempt to mitigate the credit default, they charge higher interests, one of the reasons being that those who paid back compensate those who defaulted.

Imposing collateral

Furthermore, it was revealed that 20% of respondents mentioned that imposing collateral was one way to securitise the loans against any risk of default. This helped to reduce credit risk. Collaterals helped the bank to recover its assets in case of default.

Decrease of profit margins

Also, 15% of respondents said that one other impact of default risk was the decrease of bank's profit margin; this was because the largest portion of bank's income came from interest income, and the tendency of loan default reduced profits as non-performing loans were deducted from bank's profits.

Decrease in capital reserves

Additionally, it was revealed that 20% of respondents retained earnings form part of bank's capital level in the balance sheet, its decrease, caused by deduction of written off loans, it impacted on the level of capital because capital change reduced earnings.

4.2.5 Vulnerability of commercial banks to default risk

Most commercial banks and NMB in particular are so vulnerable to default risk especially in the books of business loans whereas salaried loans are regarded as the safest loans. In this study, the NMB bank was vulnerable on mostly SME/business loans. This study further found that the vulnerability was mainly caused by:

- Failure of the bank loan officers to conduct proper inspection of the borrowers;
- The submission of 'cooked' financial data from borrowers which bank officers fail to detect;
- Lack of credit reference bureau which could have helped the bank to trace the history of the borrower whether he/she has any default history from another bank;
- Bad intentions of the borrower who borrow with an intention of not repaying the loan, this is very common among salaried borrowers who normally borrow and terminate their employments.

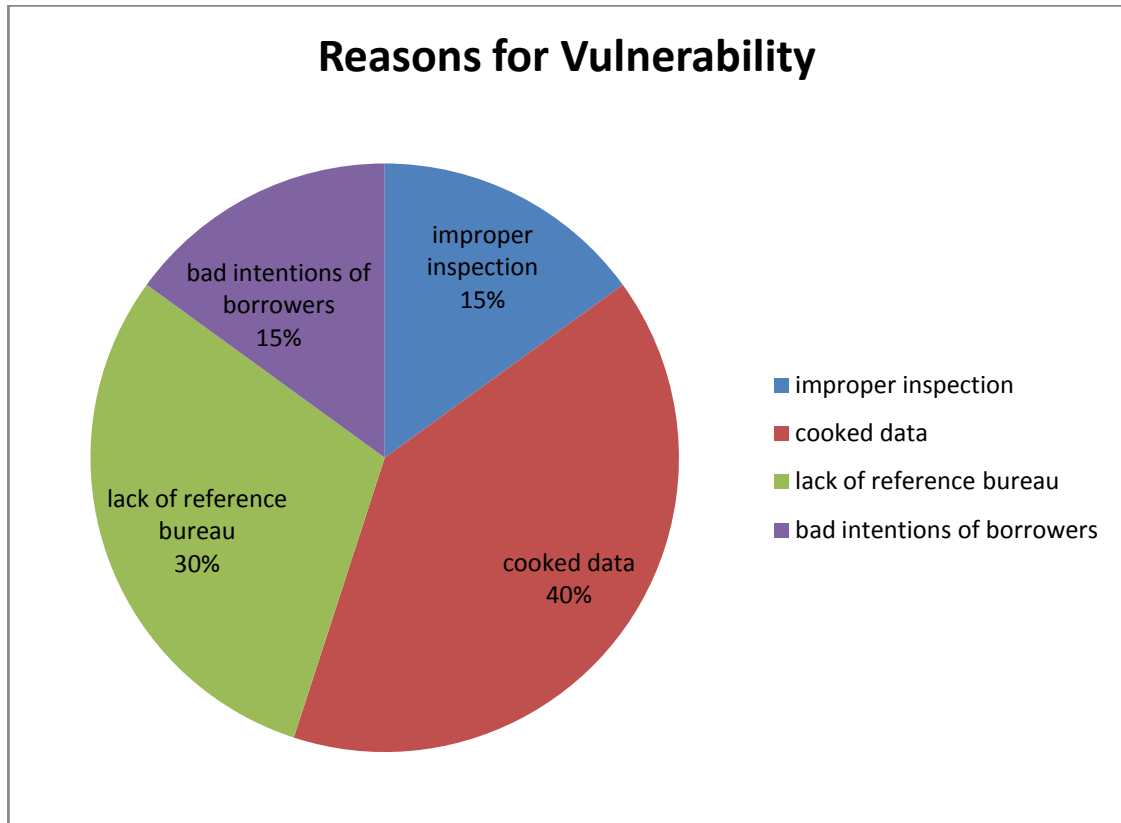


Figure 4.4 Reasons for Vulnerability

Lack of credit reference bureau

Credit reference bureaus help to assess borrowers, rate their credit worthiness and offer historical information of the borrowers. In this study it was found that 30% of respondents said that lack of this bureau increased the bank's vulnerability toward credit default.

Cooked data

When it comes to business borrowers, cooking financial data this is one of major reasons for bank's vulnerability towards default cases. Forty percent of respondents said that when bank requested for financial information on how the business borrower performed; they normally offer non-realistic information to give good impression to the lender.

Improper inspection

In this study, it was found that 15% of respondents said that banks in most cases did not even inspect their borrowers' places of business and premises before granting loans. This subjects a bank to risk of borrowers cheating and inability to trace them when they default.

4.2.6 Interest rate vs. default risk

It was an assumption of the researcher that the tendency of the NMB posing higher interest rates ranging 18% to 21% results in very expensive loans for borrowers to repay. This was found to be the only case with business loans which could not generate enough cash flows to service both principal and interest timely.

For salaried loans, this was not the case as salaried borrowers had the loan installments deducted direct from their salaries, so there was no question of inadequate cash flows to service the debt burden. This could only happen when the employee terminated the job and definitely this was not the case of higher interest rates.

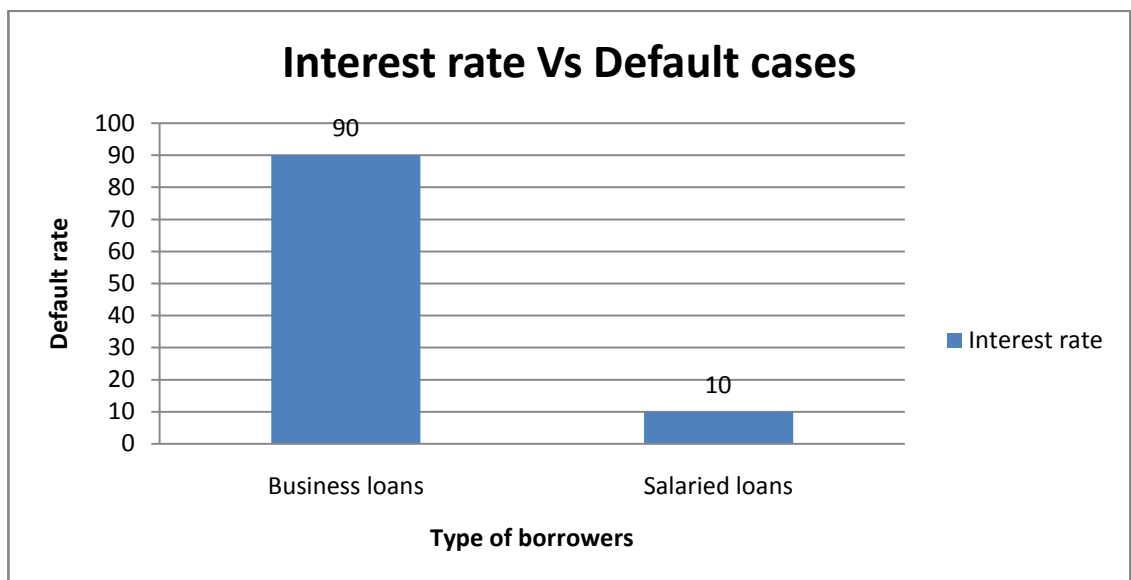


Figure 4.5 Relationship between interest rate and default cases

This table indicates that there is a strong correlation between interest rates and default cases in business loans as 90% of respondents indicated so.

Loan procedures of the bank

As a way to ensure that loan processes are not abused and all important issues before loan is granted are assessed, the bank prepared procedures and requirements which any loan applicant was to fulfill.

a. Account holding

The first procedure for a loan applicant was to open a bank account with the NMB Bank LTD.

b. Formal written credit application

The second procedure was for the borrower to submit formal written applications for credit facilities which was to indicate the amount applied for, purpose of the facility, period for which the facility was required and collateral's offered to cover the proposed facility.

c. Business profile

With regard to this, it was found that the borrower had to submit the business profile which showed the then operations and future plans, and particulars of business owners, and for the salaried borrowers, a letter from employer was to be submitted instead.

d. Board of directors resolutions

If the applicant was a limited liability company, it was required to submit the board resolution and pledging of their companies properties as collateral.

e. Status reports

The borrower was also required to disclose other banks and financial institutions where they maintain bank accounts and whether they have obtained any credit facilities.

f. Financial statements

The borrower was required to submit their audited financial statements for the most recent 3 to 5 years for the case of business loans.

g. Business plans and cash flow projections

The borrower was also required to submit the detailed business plan supported by well and elaborated cash flow projection chart. This again applies for business loan applications only.

h. Other business documents

The borrower was also required to submit copies of orders and contracts for business contracts awarded for goods or materials to be purchased.

i. Income tax official return

The applicant was also required to submit the official return for income tax purposes for the last 5 years.

j. Annual return to the registrar of companies

k. Project feasibility study report or write-up

l. Plan visits and inspection reports

m. Collateral documents

Once all the data were gathered, the credit officer analysed and evaluated the credit application in the format provided and final decision was based on the analysis. These procedures are summarised in Chart 1.

Chart 1: loan procedures

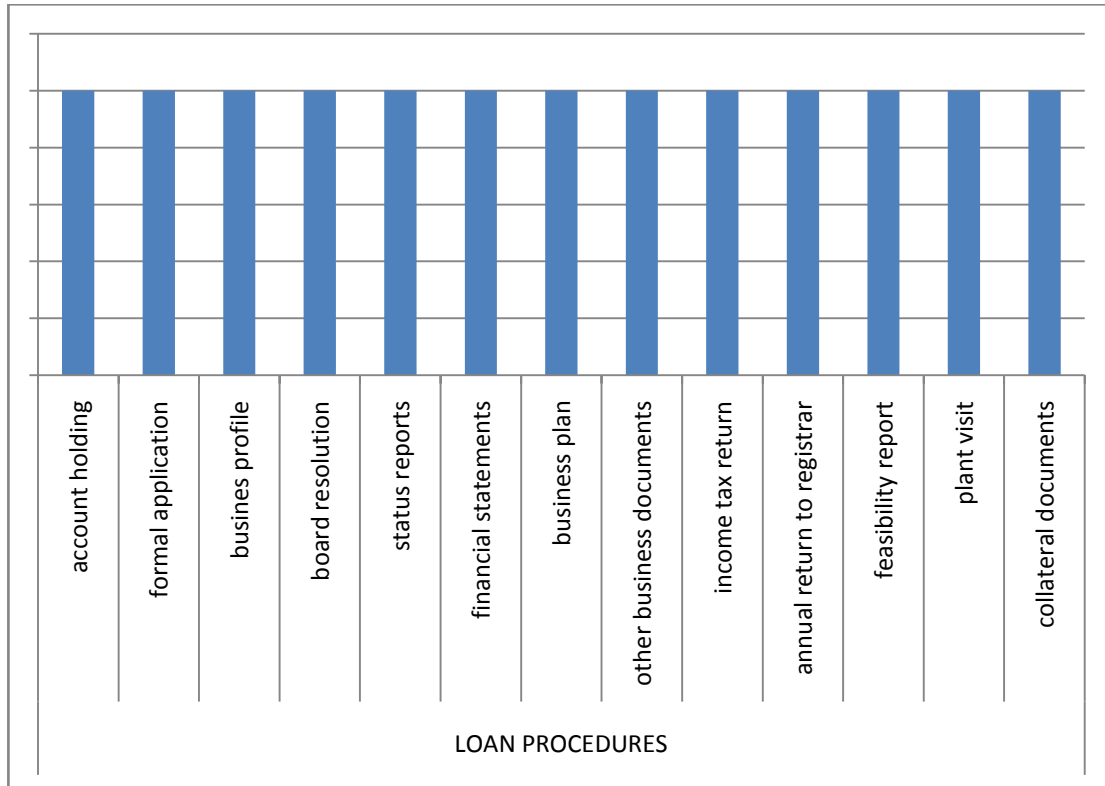


Figure 4.6 Loan procedures of the bank

During interview, it was revealed that different opinions in terms of their priorities on loan procedures. This showed that each loan officer prioritised the list of procedures and some were not very important when assessing the applicant. This addressed the question of subjectivity among loan officers which resulted in credit default in such cases where some of the key procedures were ignored and left out.

4.2.7 Level of implementation and compliance of procedures

This part required the researcher to find out whether all of the above procedures were followed and implemented.

The findings revealed that procedures were followed or applicable in all cases. Cases varied based on the type of a loan applied for, and the nature of the loan.

For salaried loans, the following procedures were not considered:

- i. Business profile
- ii. Board resolution
- iii. Status reports
- iv. Financial statements
- v. Business plan
- vi. Other documents
- vii. Income tax returns
- viii. Annual returns
- ix. Feasibility study
- x. Plant visits
- xi. Collateral

So the only requirements which were to be submitted included:

- a. Application forms
- b. Employer's approval
- c. Employer's guarantee
- d. Terms of employment

The summary of the salaried loans is shown in Chart 2.

Chart 2: salaried loans

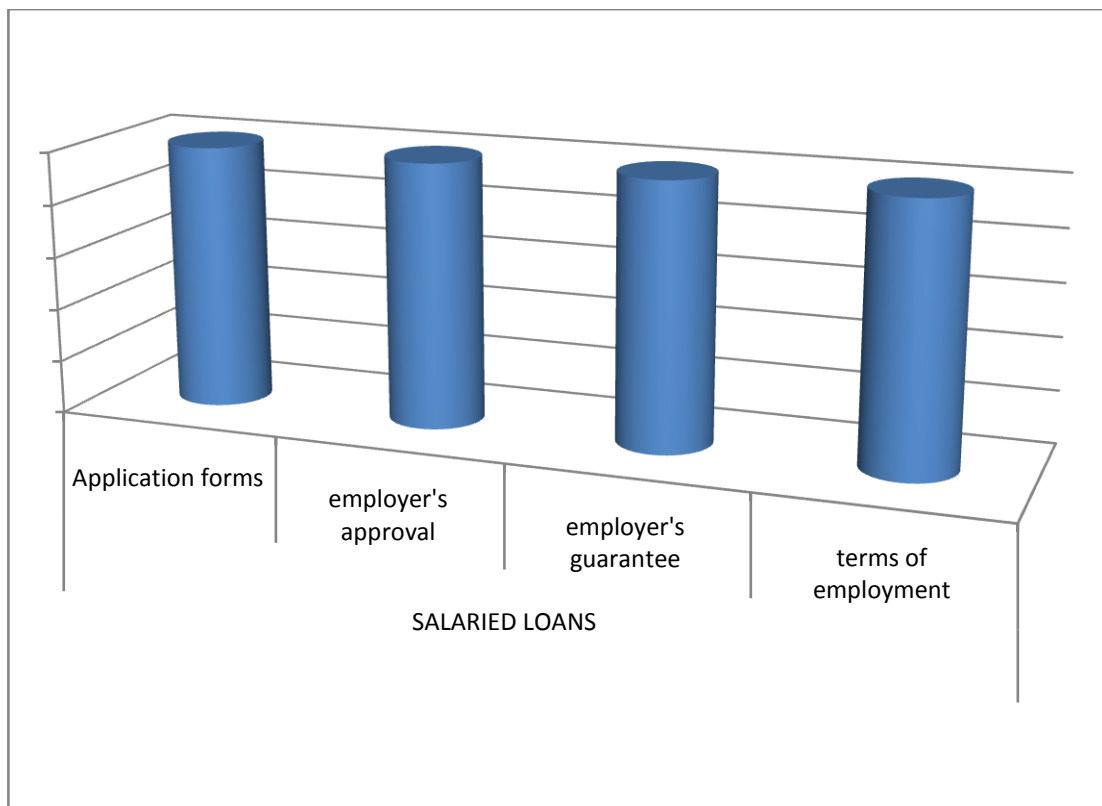


Figure 4.7 Procedures for salaried loans

The procedures were also relaxed when the loan applicant was a small and medium enterprise, this was because the procedures had to be complied with, then SMEs were not be able to access credit facilities, and so relaxation of requirements was done to make credit accessible to SMEs.

4.2.8 Level of default and measures taken

With regard to this, it was not easy to get as much information on loan defaults. But according to Bank's credit manual, due to some unforeseen factors, the bank had incurred losses from some disbursed loans. The NMB Bank had adopted guidelines from BOT on provisioning for probable losses on classified assets.

The classification is shown in Table 2.

Table 4.1 Asset classification category

SN	Category	Allowance/Reserve for Probable Losses
1	Unclassified Assets	Nil
2	Classified Assets	
	i. Loans/other assets especially mentioned	5%
	ii. Sub-standard	10%
	iii. Doubtful	50%
	iv. Loss	100%

According to the manual, the ‘allowance for probable losses’ shall be treated as a valuation reserve against the respective asset account. Such allowance shall be established through charges to ‘provision for bad and doubtful debts’ in the case of loan losses and to ‘provision for losses’ in the case of losses on other risk assets.

The amount for ‘Allowance for probable losses’ on contingent or off-balance sheet items shall be as shown in Table 4.2

Table 4.2 Allowance for probable losses

SN	Category	Allowance/Reserve for Probable Losses
1	Unclassified Assets	Nil
2	Classified Assets	
	i. Loans/other assets especially mentioned	5%
	ii. Sub-standard	10%
	iii. Doubtful	50%
	iv. Loss	100%

The ‘allowance for probable losses-contingent accounts’ shall be established by debiting ‘provision for losses on contingent accounts,’

For the year 2008, the Bank channeled credits to different sectors as shown in Table 4.

Table 4.3 Loan concentration

		2007	%	2008	%
SECTOR		AMOUNT(in million TZS)		AMOUNT (in million TZS)	
Manufacturing		43.5	0.4	364.2	1.5
Wholesale and retail trade		4011.9	37.2	14,544.1	60.2
Transport and communication		168.8	1.6	168.5	0.7
Private individuals		4169.3	38.7	4863.0	20.1
Agriculture and fishing		59.8	0.6	44.5	0.2
Energy and construction		1202.9	11.2	2788.2	11.5
Others		1114.5	10.3	1388.5	5.7
Total		10,770.7	100	24,161.0	100

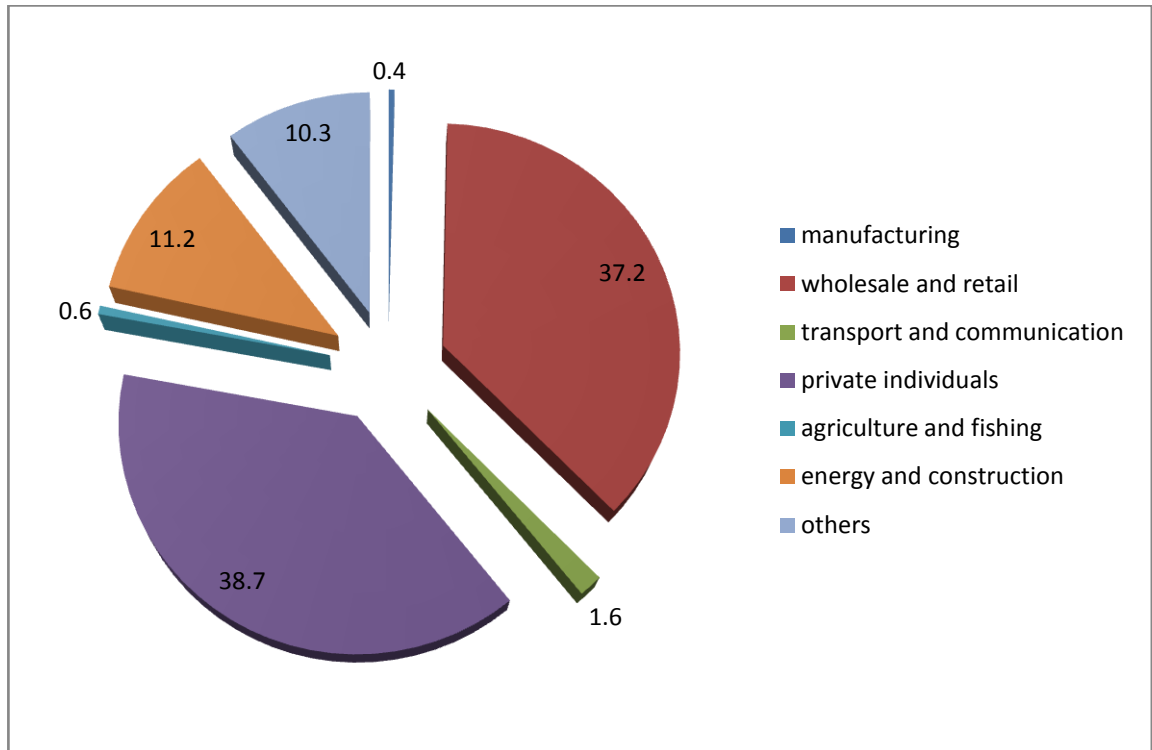


Figure 4.8 Classification of loan given by sector in 2008

This chart reveals that for the 2008, the bank offered more loans to private individual loans than any other category on the portfolio with manufacturing accounting for the least allocation. 38.7% of the respondents indicated that the NMB bank provided loans to private individuals who are employees and repay their loan through monthly salaries, also have an assurance letters from their employers. 37.2% of loans provided by the NMB bank went to the wholesale and retail businesses who repay their loan through the daily profits generated from their businesses. 11.2% of the respondents indicated that loans were provided to the energy and construction companies. The research also reveals that 10.3% of loans that the NMB bank provides go to the agriculture sector. 1.6% of loans were provided to the transportations and communication industries. Manufacturing industry gets only 0.6% of loan provided by the NMB bank.

For the year 2008, exposure to credit risk was shown in Table 4.4

Table 4.4 Loans and advances to customers

	2008 (TZS 000')	2007 (TZS 000')
Carrying amount		
Individually impaired		
Grade 3: impaired (substandard)	564,223	470,063
Grade 4: impaired (doubtful)	574,513	479,440
Grade 5: impaired (loss)	332,991	243,960
Gross Amount	1,471,727	1,190,436
Allowance for impairment	(326,568)	(324,610)
Carrying amount	1,145,159	865,853
Collectively impaired		
Grade 1: normal	23,013,873	9,728,272
Grade 2: watch list	26,555	92,597
Gross amount	23,040,428	9,820,239
Allowance for impairment	(24,554)	(4,630)
Carrying amount	23,015,874	9,816,239
Total carrying amount	24,161,033	10,682,092

The researcher also gathered statistics on loan portfolio of the bank as in 2010.

Overdraft portfolio

The data for 2010 reveals that the Bank had a total overdraft portfolio of TZS 4 billion of which TZS 3.9 billion had already been issued.

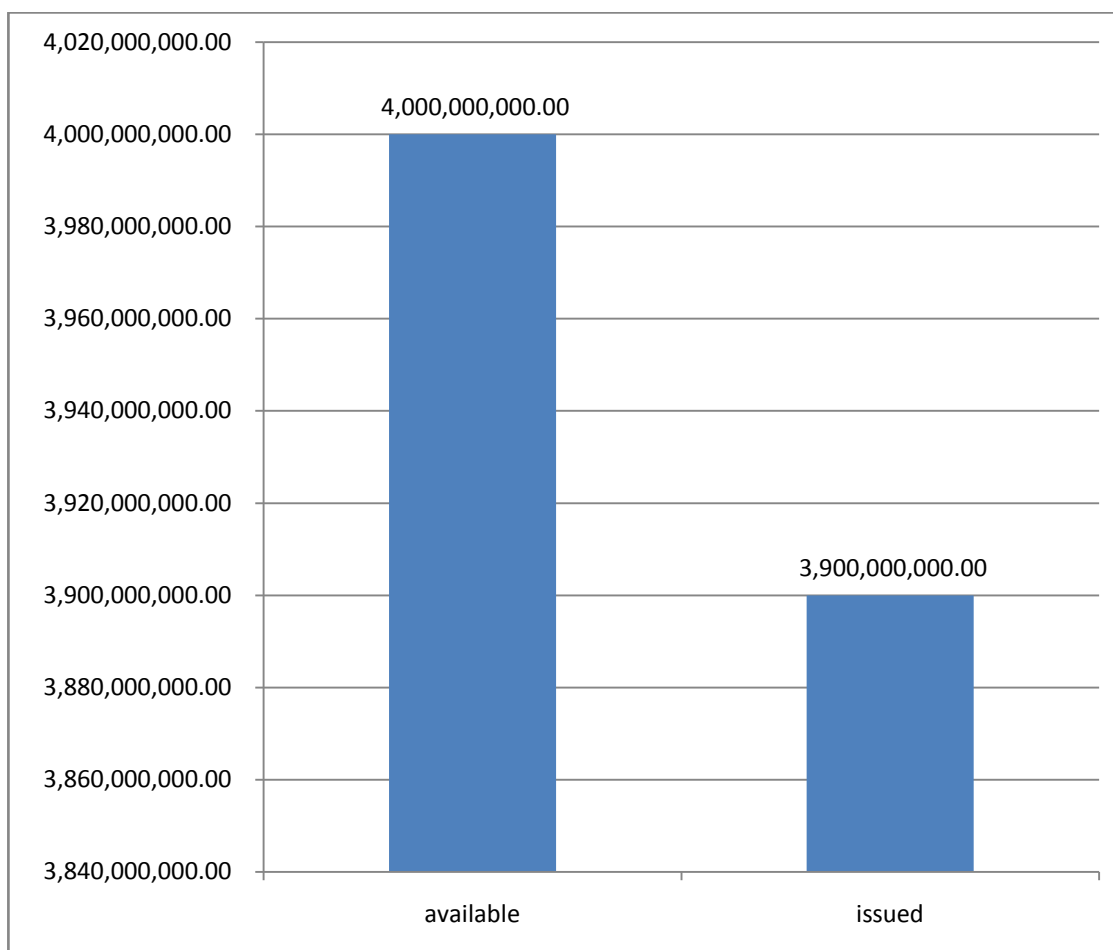


Figure 4.9 Overdraft portfolio

To deal with such default levels and losses, the bank staged the following ways to manage its credit risk.

- The Board had delegated responsibility for the management of credit risk to the credit committee chaired by the Chief Executive Officer;
- Regular audits of credit department processes were undertaken by internal audit and risk department;
- The review of individual assets and grading accounts was done on monthly basis whereby provision of non-performing loans was raised based on the guidelines of the Bank of Tanzania.

- The bank also held collateral against loans and advances to customers in the form of mortgage interests over property, other registered securities over assets and guarantees.

All these efforts plus risk management guidelines issued by Central Bank helped in one way or another to reduce the default risk levels on the portfolio.

4.3 Credit Evaluation Criteria (5cs) used by the NMB Management in Credit

Provision to borrowers

Granting credit endorsement depends on the enthusiasm of the creditor to lend money in the current economy and that same lender's assessment of the ability and willingness of the borrower to return the money or pay for the goods obtained—plus interest—in an appropriate trend. Typically a borrower seeks credit approval to obtain funds from lenders, investors, and vendors, and also grant credit approval to their customers. Finlay (2009) discloses that when you apply for a loan, the lender will evaluate your request in order to determine whether or not it is a good decision to lend you and your business money. During interview with the Loan officer at NMB bank it was revealed that evaluation procedures were used in providing loan. The NMB bank used a common evaluation framework of the **5 C's** of Credit: capacity, capital, collateral, conditions and character which were discussed as follows:

The study at the NMB bank found that the bank took into consideration the **Character** of the borrower before giving out loans. The NMB bank provided loans to borrowers with the moral obligation that a borrower feels to repay the loan. It was proven that there was no accurate quantifiable measure to judge character; therefore, the NMB loan officers and their credit management team was the one who decided subjectively whether or not a person was sufficiently trustworthy to repay the loan. The NMB loan officers investigated the borrowers' past payment experience, and assessed the borrower educational background and experience in business.

The NMB bank considered clients who had the **Capacity**/ability to pay and handle the proposed debt. The NMB bank considered capacity to be the company's/borrowers' ability to generate sufficient cash flow from business operations to meet the loan payments. Since this represents the primary source of repayment for a loan, the NMB wanted to know exactly how its client intended to repay the loan. Before providing any loan, the NMB bank considered the cash flow generated from the borrowers business, the loan time of the repayment, and the probability of successful repayment of the loan, most important, the clients/borrowers' age was required to be above the legal age of 18 years to be capable of entering into a contractual borrowing relationship with the bank and any other financial institution.

The study revealed that the bank considered the **Capital** that the client had at the time they applied for a loan. The capital that was considered by the NMB bank was the money that the borrower had personally invested in the business that he/she wanted to borrow for. This investment was also considered as an indicator of how much the borrower would lose should the business fail to generate enough cash flow to continue. The NMB bank expected their client to contribute their own assets and to undertake personal financial risk before asking them to provide any loan if a person had a significant personal investment in the business; he/she was more likely to do everything in their power to make the business successful so that they did not lose their investment/money.

For business person to get a loan from the NMB bank he/she should provide **Collateral** or third-party guarantees which were additional forms of security. One could provide the lender. If the borrowers' business cash flows were not adequate to repay the loan, the NMB bank wanted to satisfy itself that there was a second source of repayment. Things like equipment, buildings, accounts receivable, and inventory which could be forfeited and sold by the bank if the company defaults on the debt. The NMB bank loan agreement carefully identified any items that served as collateral before even providing the loan. Business owners are asked to place personal assets (home, stocks, bonds, etc.) in addition to the business assets as collateral for a loan requested.

In some cases, the NMB bank asks for a third-party guarantee whereby someone else signed a guarantee document promising to repay the loan if one could not pay it. The NMB bank requires the term of the loan to match the useful life of the asset used as collateral. If equipment with a five-year expected life was used as collateral, then the term of the loan will generally be five years or less.

The NMB bank also took into consideration the overall **Conditions** based on the national and local economic conditions in the country. How sensitive was the borrowers' company/ business sales to the overall economy? If the country would enter a recession soon, would the clients' business sales fall dramatically or could they be expected to be relatively unaffected. Most of the financial institutions the NMB included tended to favor companies/businesses with stable sales that were not tied closely to the overall economy of the country, thus even if the nation's economy would enter recession the business cash flow would not be highly affected and enabled the borrowers to repay their obligation (Loan).

CHAPTER FIVE

DISCUSSION OF FINDINGS

5.0 Introduction

The chapter presents discussion of the findings with respect to results presented in chapter four arising out of the findings of the study. The findings are presented based on the objectives of the study. The objectives include:

- a) To identify the core underlying causes of the creditdefault Risks in Commercial Banks
- b) To identify the various methods employed by the NMB Ltd in identifying and mitigating credit default risks.
- c) To identify the various techniques employed by the NMB Ltd in managing credit default risks.
- d) To identify the various challenges faced by the NMB Ltd in default Risk management.
- e) To examine whether credit evaluation criteria is used by the NMB.

Corereasons for default risk in Commercial Banks withreference to NMB

Underlying causes of the credit default are among the objectives of our study.The study found that underlying causes for the risk defaulter. The study found various causes for risk default, but the major ones are:-

Inability to repay the loan

It is revealed that 20% of respondents are unable to repay the loan. This is one of the major reasons of credit risk. The study has established that this is caused by poor performance of their business that fail to produce enough cash flows for the case of business borrowers, and for the retail borrowers who are most of them employees. Most of them fail to repay when they lose their jobs. This can help in case of business loans if borrowers are trained by the bank that provide them with loans on the techniques that help them (borrower) to run their business in a profitable way so that they are able to generate enough cash to pay back the loan.

Unwillingness to repay

In this study, it is found that 10% of respondents agree that it is the nature of Tanzanians to borrow money with the intent not paying back it, this is perceived as moral decay for borrowers. This problem does not affect the NMB only, but it is a big problem to so many other lending institutions. Financial institutions are trying to intervene into this through various education awareness programmes to their clients before providing them with loans. It is always safe to ask for a collateral before giving out any loan.

Poor business skills

It is also revealed that 10% of respondents mention that poor business cause credit risk mainly to small business loans. Here again training is very important to borrowers as we know good Business skills are the key to any good business performance and absence of which put a business at a risk of default. If skills are not built up, business will fail to generate enough income/cash to repay loans and run itself.

Job termination

It is found that 20% of respondents say that the other reason why people evade is job termination. The terminated employees are normally hard to trace. This has always been a great problem especially for the workers from the Private sectors. It is safe for the

lending institution to be assured by the employer that loans that their employees take can be repaid out of their final benefits when the employee is terminated from job.

Lack of proper mechanisms to follow up

Findings indicate that most financial institutions in Tanzania including the NMB lack proper mechanisms to follow up defaulters when they fails/refuse to pay up their loans. Financial institutions should use debt collectors and debt managers who buy defaulted loans or follow-up defaulters and obtain commission from the financial intuitions/banks for collecting back those loans. Lack of proper mechanisms to follow up is also a challenge complicated by the country's lack of physical addresses and national identity cards which would have helped to trace back the borrowers.

5.2 Methods employed by NMB in identifying and mitigating default risks

Risk mitigation for indebted consumers in societies where so much borrowing is stacked against property – that is, against people's homes – generally depends on some kind of partnership between banks and borrowers. However, over the last two decades, countries have retreated from direct mitigation; encouraging market based insurance providers to take their place. Old partnerships have thus dissolved and the principle of solidarity has been replaced by one of mutuality, as well as by other kinds of private safety net (such as debt cancellation and suspension contracts, third-party guarantees, and over collateralisation of loan pools).

In order to minimise credit risk defaulters, it is crucial for banks to have an effective credit risk management systems in place (Santomera 1997, Basel 1999). As a result of asymmetric information that exists between banks and borrowers, banks must have a system in place to ensure that they can do analysis and evaluate default risk that is hidden from them. Information asymmetry may make it impossible to differentiate good

borrowers from bad ones (which may culminate in adverse selection and moral hazards) have led to huge accumulation of non-performing accounts in banks.

Credit risk management is very vital to measuring and optimising the profitability of banks. The long term success of any banking institution depends on effective system that ensures repayments of loans by borrowers which are critical in dealing with asymmetric information problems, thus, reduces the level of loan losses (Basel, (1999). Effective credit risk management system involves the following ones:

Establishing a suitable credit risk environment; operating under a sound credit granting process; maintaining an appropriate credit administration that involves monitoring; processing as well as enough controls over credit risk (Greuning and Bratanovic 2003). Top management must ensure that in managing credit risk, that all guidelines are properly communicated throughout the organisation and that everybody involved in credit risk management understands what is required of him/her.

Sound credit risk management system (which includes risk identification, measurement, assessment, monitoring and control) are policies and strategies (guidelines) which clearly outline the purview and allocation of a bank credit facilities and the way in which credit portfolio is managed; that is, how loans are originated, appraised, supervised and collected (Basel, 1999; Greuning&Bratanovic 2003, Pricewaterhouse, 1994). The activity of screening borrowers had widely been recommended by, among other, Derbanet *al.*, (2005). The theory of asymmetric information from prospective borrowers becomes critical in achieving effective screening.

In screening loan applicants, both qualitative and quantitative techniques should be used with due consideration of their relative strengths and weaknesses. It must be stressed that borrowers attributes, assessed through qualitative models can be assigned numbers with the sum of values compared to a threshold. This technique is termed as “credit scoring” (Heffernan, 1996).

The rating systems, if meaningful, should signal changes in expected level of loan loss (Santomero, 1997). Chijoriga (1997) posited that quantitative models make it possible to

among others, numerically establish factors that are important in explaining default risk, evaluate the relative degree of importance of the factors, improving the pricing of default risk, be more able to screen out bad loans application and be in a better position to calculate any reserve needed to meet anticipated future loan losses.

Establishing a clear process for approving new credit and extending existing credit (Heffernan, 1996) and monitoring credits granted to borrowers (Mwisho, 2001) are considered important when managing credit risk (Heffernan, 1996). Instruments such as covenants, collateral, credit rationing, loan securitisation and syndication have been used by banks in developing countries in controlling credit losses (Benveniste&Bergar, 1987). It has also been identified that high-quality credit risk management staff are critical to ensuring that the depth of knowledge and judgment needed is always available, thus ensuring the successfully management of credit risk in banks (Koford&Tschoegl, 1997; Wyman, 1999).

5.3 Credit Evaluation Criteria (5cs) used by the NMB Management in Credit

Provision to borrowers

One of the objectives in the study was to examine whether credit evaluation criteria (5Cs) is used properly by the NMB Management in Credit / Loan provision. Credit evaluations are not based on a single factor, but upon how an applicant matches up to a set of lending criteria laid down by the lender. These lending criteria inherently reflect the risk attitudes and risk tolerance levels of the credit grantor concerned. In short, these criteria reflect how the lenders want to do business, their business policies, strategies, their risks tendency, etc. the risk attitudes, tolerance, business philosophy, policies and strategies; however,they vary from one financier to the next. What one financier finds unacceptable may well be within another's' tolerable units. Ultimately, Lenders will only assume risks that they find comfortable and acceptable within the limits set by their organisations.

Granting credit endorsement depends on the enthusiasm of the creditor to lend money in the current economy and that same lender's assessment of the ability and willingness of the borrower to return the money or pay for the goods obtained—plus interest—in an appropriate trend. Typically borrowers seek credit approval to obtain funds from lenders, investors, and vendors, and also grant credit approval to their customers. Finlay (2009) disclosed that, when you apply for a loan, the lender will evaluate your request in order to determine whether or not it is a good decision to lend you and your business money. A common evaluation framework is the Five C's of Credit: capacity, capital, collateral, conditions and character which are discussed as follows:

The study shows that the NMB bank takes into consideration the **Character** of the borrower before disbursing loans. The NMB bank provides loans to borrowers with the moral obligation that a borrower feels to repay the loan. It has been proven that there is no an accurate quantifiable measure to judge character; therefore, the NMB loan officers and their credit management team is the one that decides subjectively whether or not a person is sufficiently trustworthy to repay the loan. The NMB loan officers investigate the borrowers' past payment experience, and consider ones educational background and experience in business.

The NMB bank considers Clients' that have the **Capacity**/ability to pay and handle the proposed debt. The NMB bank considers Capacity of the company's/borrowers' ability to generate sufficient cash flow from business operations to meet the loan payments. Since this represents the primary source of repayment for a loan, the NMB wants to know exactly how its client intends to repay the loan. Before providing any loan the NMB bank considers the cash flow generated from the borrowers business; the loan time of the repayment; and the probability of successful repayment of the loan. Mostly importantly, the clients/borrowers' age must be above the legal age of 18 years to be capable of entering into a contractual borrowing relationship with the bank and any other financial institution.

The study shows that the NMB bank considers the **Capital** that the client has when they apply for a loan. The capital that is considered by the NMB bank is the money that the borrower has personally invested in the business that he/she wants to borrow for. This investment is also considered as an indication of how much the borrower will lose should the business fail to generate enough cash flow to continue. The NMB bank expects their client to contribute their own assets and to undertake personal financial risk before asking them to provide any loan. If a person has a significant personal investment in the business, he/she is more likely to do everything in their power to make the business successful so that they do not lose their investment/money.

For a business person to get loan from the NMB bank, he/she has to provide **Collateral** or third-party guarantees which are additional forms of security. she/he provides to the lender. If the borrowers' business cash flows are not adequate to repay the loan, the NMB bank wants to satisfy itself that there is a second source of repayment. The source can be: equipment, buildings, accounts receivable, and inventory may be seized and sold by the bank if the company defaults on the debt. The NMB bank loan agreement carefully identifies any items that serve as collateral before even providing the loan. Business owners may be asked to place personal assets (home, stocks, bonds, etc.) in addition to the business assets as collateral for a loan. In some cases, the lender may ask for a third-party guarantee where someone else signs a guarantee document promising to repay the loan if one cannot. The NMB bank normally wants the term of the loan to match the useful life of the asset used as collateral. If equipment with a five-year expected life is used as collateral, then the term of the loan will generally be five years or less.

The NMB bank also takes into consideration the overall **Conditions** which refer to the national and local economic conditions in the country. How sensitive it is the borrowers' company/ business sales to the overall economy if the country enters a recession soon, will the clients' business sales fall dramatically or can they be expected to be relatively unaffected. Most of financial institutions the NMB included tend to favor Companies/businesses with stable sales that are not tied closely to the overall

economy of the country, thus even if the nations' economy enters recession the business cash flows will not be highly affected and enables the borrowers to repay their obligation(Loan).

5.4 Challenges faced by NMB on the management of credit default risk

The study has revealed that the biggest challenge of the NMB bank and most of other financial institutions in Tanzania is the Lack of credit reference bureau that would have helped them to trace borrower's history on financial situation including their past/previous loans. This includes knowing their credibility before giving them loans. Credit reference bureau would have helped to recognise customers/borrowers who are troublesome so as to avoid them. Financial institutions should put more efforts in supervising its borrowers by following them up after every short period of time to see if they still live in the same address they have given to the bank and insist that if the borrower moves should provide to the bank his/her new address. The occasional visits to the borrower will also help the bank to know the financial status of the borrowers' business.

CHAPTER SIX

CONCLUSION, RECOMMENDATION AND AREA FOR FURTHER STUDIES

6.1 Conclusion

The study concludes that the bank has a systematic laid down risk management system which is used to manage credit and other types of risks. Because some of the risks are unforeseen, it becomes inevitable for the bank to provide for bad and doubtful loans in its portfolio.

The loan portfolio is not very well diversified and is more concentrated on one or two sectors which bring even more market risks. The study also reveals that the bank is not able to put measures in place which resulted in the increase of amount of provisions in the credit default from gross amount of TZS **1,190,436 ('000)** in 2007 to TZS **1,471,727 ('000)** in 2008. This is an indication of what more is needed by the bank to deal with that challenge.

The loan portfolio of the bank also shows that wholesale and retail trade dominates the portfolio occupying more than 60% of the total loans issued. This indicates that the bank sees this section as less risky in terms of credit portfolio but possess a non-diversified risk to their portfolio.

Agriculture, which is the country's mainstay of the economy employing an estimated 80% of country's population, has not received equal attention from the bank's lending priorities and seeing even the allocation being reduced from 0.6% to 0.2% of the portfolio in 2007 and 2008, respectively.

The bank however, shows an impressive level of compliance to central bank's regulation by complying with bank's provided risk management guidelines.

The bank also shows clear and well elaborated procedures for loan application and processing, if all bank loan officers comply with such procedures and make sure that

every single loan application is subjected to that process, it might reduce the level of loan default currently experienced by the bank.

In comparison with other commercial banks in a country, the NMB is still placed in better position when it comes to credit risk management. This is because of the size and capital base of the bank which is able to install much better systems and employ more experts in the area of risk management.

Availability of credit risk management policy also helps the bank to come up with more ways and procedures which are laid down to deal with loans and risk issues. The policy outlines procedures and roles of different people in managing credit risk of the bank. If the policy is honored and keeps on improving, it will set a good stage for reducing default risk levels at the bank.

6.2 Recommendations

As it has been highlighted in the whole study, there are some areas which need to be studied upon, especially in the risk management processes. The study provides the following recommendations which in one way or another, if the management will work on them, it will increase the bank's effectiveness in dealing with credit risks.

- a) The bank needs to diversify its portfolio and reduce concentration on a few sectors which cause higher market risks;
- b) .The bank needs to review its loan procedures regularly and make them flexible as per applicant's business needs and business environment;
- c) The bank also needs to diversify its activities geographically to reduce its amount of concentration in Dar es Salaam;
- d) More capacity building is still needed for bank loan officers to enable them to deal with more complex risk issues; and
- e) More studies need to be done in the area of risk exposures among SMEs and agricultural sector in order to assist banks to understand these markets and give them more assistance.

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APPENDICES

APPENDIX I

QUESTIONNAIRE NMB EMPLOYEES

This questionnaire is designed to gather information on how you, as NMB Employee, find the practice of Credit Risk Management at NMB Bank. Your responses will be mysterious and the highest degree of confidentiality will be maintained. Therefore, I request you to answer the following questions honestly and openly as you can. It is my sincere hope that I will receive maximum cooperation.

The interview shall be conducted to the following employees;

- I. Risk manager
- II. Credit manager
- III. Loan officer (s)
- IV. Legal counsel

1. PERSONAL DETAILS

- | |
|-------------------------------|
| A. Name..... (Not obligatory) |
| B. Designation..... |
| C. Department..... |
| D. Working experience..... |

2. EMPLOYEES DETAILS

a. What is your major role in your working position?

.....
.....

b. Does your position put you in a direct involvement in credit management issue? Yes...No...

c. If yes, how?

.....
.....
.....

3. Do you think NMB Bank is vulnerable to credit risk? Yes....No.... (*tick where appropriate*)

4. Give reasons for your response.

.....
.....
.....

5. Do you play any role in ensuring that credit risk is well managed?
Yes.....No..... (*tick where appropriate*)

6. If yes, what kind of role do you play?

.....
.....
.....

7. Please list the main procedures of loan processing before granted

.....
.....
.....
.....
.....

8. What is the level of compliance of loan procedures? Tick where appropriate

- a. 100% ()
- b. Above 50% ()
- c. Below 50% ()
- d. Below 25% ()

9. What is the percentage of loan allocation to the following sectors in your portfolio? Tick where appropriate

- a. Manufacturing ()
- b. Wholesale and retail trade ()
- c. Transport and communication ()
- d. Private individuals ()
- e. Agriculture ()
- f. Construction ()
- g. Other ()

10. Which of the following induces default risk in your bank? Tick where appropriate

- a. Lack of culture of loan repayment ()
- b. Lack of credit reference bureau ()
- c. Poor business management skills of borrowers ()
- d. Inefficient risk management of the bank ()

11. How does NMB identify, measure and analyze risks?

.....
.....
.....
.....

12. Does the bank do one of the following in managing its risks? (tick where appropriate)

- a. Formation of credit committee ()
- b. Regular audits of credit department ()
- c. Review of individual accounts and grading on monthly basis ()
- d. Holding collateral against loans ()

13. Please list the major challenges that NMB Bank faces in managing default risk

i.....
ii.....
iii.....

14. What is NMB Bank doing to deal with such challenges?

i.....

ii.....

iii.....

15. Have you ever received any training on credit risk management? Yes....No....

(tick where appropriate)

16. If Yes, say on what and how it helps you in managing the risks now

.....
.....
.....
.....

17. What is the current level of credit default in your bank? Tick where appropriate

a. Above 50% ()

b. Between 25%-50% ()

c. Between 10%-15% ()

d. Between 5%-10% ()

e. Below 5% ()

18. What major impacts do you think credit default risk brings to the Bank?

i.....

ii.....

iii.....

iv.....

19. Do you think the credit risk policy of NMB Bank helps to reduce credit default?

Yes... No.....(*tick where appropriate*)

20. Does NMB bank follow/use the 5Cs of credit evaluation before giving out loans?.....

21. Any other comments?

.....
.....
.....

Thank you for your cooperation

APPENDIX II

WATEJA WA NMB

Maswalihayanikwaajiliyawatejawa NMB.

Majibuyenuyatatunzwakwasirikubwanakufanyiwakazibilakutoamajinayamteja.

Hivyobasimnaombwakujibumaswaliyafuatayokwaukwelinauwazibilakuhofiachochote.

Ni matumaini yangukuwamtanipaushirikianowenu.

MASWALI.

1. Jinsia; Mke _ Mme _
2. Umri; _
3. Je umeolewa/umeo, mtalakiwa, au badohujaingiakwenyendoa?
4. Unakiwangogani cha elimugani?
.....
5. Unafanyaainaganiyabiashara?
.....
6. Mtaji wabiasharayakonikiasigani?
.....
7. Je unaelimuyeyoteyakijasiliamli?
.....
8. Je unazifahamutaratibuzakuombamkopo NMB?
9. Unaridhishawanataratibuhizo? Ndio_ Hapana_
10. Kama hapana, je nikwanini?
.....

11. Umepokeamkopowakiasiganikutoka NMB?

.....

12. Unalipaasilimi angapi kama Riba (ziada ya mkopo)?

.....

13. Je unaridhikanayo? Ndio_ Hapana_

14. Kama hapana, je nikwanini?

.....

15. Je Unadhanini iniki nawezakusababisha ukashindwa kulipa mkopo uliochukua?

.....

16. Maoni mengine yeyote kuhusiana na mkopo?

.....

APPENDIX III

NMB Risk Management Policy



NMB RISK MANAGEMENT POLICY

1.0 Introduction

This document details and establishes NMB's Risk Management Policy, in conformity with the regulatory guidelines of the Bank of Tanzania (BOT). In the wake of the Banking and Financial Institutions Act (BFIA) and the Basel II Accords, the BOT has directed all locally-operating banking and financial institutions to prepare and adapt a comprehensive risk management regime. This strategy and policy framework document is also in line with NMB's ongoing quest to maximize shareholder value by prudently managing and minimizing all perceived risks. This document therefore seeks to clearly outline and define NMB's risk philosophy, operating framework and risk management objectives. The document will need full Board approval before becoming operational so as to ensure that any stated risk appetite and/or risk management strategy is in line with NMB's long term financial objectives. On approval, a copy of this strategy and policy document will be disseminated to all relevant NMB stakeholders.

2.0 NMB Risk Management Agenda

2.1 In line with the above stated objectives, risk management here at NMB will specifically aim at achieving the following:

- 2.1.1 To serve as a useful and workable channel through which a means of communicating Board decisions regarding risk appetite make their way through to senior and frontline management in the form of strategies and policies;
- 2.1.2 To identify, quantify, control and monitor all of the Bank's inherent and operating risks;
- 2.1.3 To quantify, assess and weigh each risk, so as to provide the Board with sufficient information when deciding to allocate adequate capital on a risk-by-risk basis, when provisioning for possible losses.
- 2.1.4 To analyze and document all associated risks and controls for every product, process and system that is put in place so as to manage them together along with other key risk indicators;
- 2.1.5 To continually review the Bank's products offerings, internal systems and processes to ensure that risks associated with them have been identified, quantified, weighted and priced.
- 2.1.6 To ensure that an adequate Management Information System (MIS) is put in place, so as to ensure that various risk control measures and processes are continually monitored. The system should also be capable of generating accurate reports so as to ensure that NMB's Board can make appropriate and correct decisions and/or take necessary remedial measures if and when the need arises.
- 2.1.7 To ensure that the bank is continually and proactively seeking, identifying and working through various potential risk scenarios that may arise from its regular operations, in an effort to mitigate as many of them as is possible.

2.1.8 To regularly stress test various risk control measures in order to evaluate and ensure their efficacy.

3.0 Identified Risk Areas:

3.1 In keeping with BOT guidelines and directives, NMB Bank identifies and manages the following main categories of risk:

3.1.1 Credit risk is the current or prospective risk to earnings and capital arising from an obligor's failure to meet the terms of any contract with NMB, or if the obligor otherwise fails to meet the terms as agreed. The largest source of credit risk is loans. However, credit risk exists throughout the other activities of the bank both on and off the balance sheet. Further related to credit risk are settlement and country risks:

(i) Settlement risk is the risk of losses arising from the settlement of payments, where payments are effected before it is possible to ascertain remittance into the offsetting account/s involved in the transaction.

(ii) Country risk is the risk of losses arising from the economic or political circumstances in a country, factoring in various potential scenarios such as the possibilities of nationalization, expropriation and debt restructurings.

3.1.2 Market risk is the risk that a financial institution may experience loss due to unfavorable movements in market prices. It arises from the volatility of positions taken in four key areas: debt securities, equities, currencies and commodities.

(i) Foreign Exchange risk which arises from fluctuation of foreign currency exchange rates;

(ii) Price Risk which arises from fluctuation of commodity, equity, or bond prices..

3.1.3 Liquidity risk is the current or prospective loss to earnings and capital arising from a bank's inability to meet its liabilities when they fall due without incurring unacceptable losses. It arises when the cushion provided by the liquid assets are not sufficient to meet its obligations.

3.1.4 Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, systems or external events. It is the potential risk of loss arising from inadequate information systems, technology failures, breaches in internal controls, fraud, unforeseen emergencies and catastrophes, or other operational problems. It also includes reputational, legal and franchise risks associated with business practices or market conduct that NMB may undertake with respect to activities as a principal or as agent.

3.1.5 Interest rate risk is the current or prospective risk to earnings and capital arising from the fluctuation of interest rates on either loans or deposits, or both. The variance in spreads between lending rates and borrowing rates is a risk factor that needs close monitoring, due to its significant potential impact to NMB's balance sheet.

4.0 Policies to Mitigate Perceived Risks

4.1 NMB shall develop the following policies for managing the main risks:

No.	Risk Area	Policy
1	Credit Risk	Credit Policy
2	Liquidity Risk	Liquidity Policy
3	Interest Rate Risk / Market Risk	Treasury Operating Manual, ALCO Policy
4	Operational Risk	Operational Risk Policy

5.0 Internal Procedures and Control Policy

5.1 NMB will make its Risk Management Policy Manual as available as possible to its staff, including through its corporate intranet website. This manual will focus in-depth on the following areas:

5.1.1 Outlining ownership of areas of responsibility – process-by-process, and function-by-function, i.e. who is accountable and for what?

5.1.2 Identification and measurement of various components of risk, using risk management balanced scorecard metrics.

5.1.3 Giving an explanation of the objectives of the internal controls being proposed;

5.1.4 Giving a clear description of the control environment which must be maintained: including outlining possible risk mitigation tactics and strategies to be employed by management and corporate values to be adhered to.

5.1.5 Giving a clear outline and definition of NMB's control activities, encompassing the handling and processing and control of appropriate, timely, accurate and accessible financial information; segregation of duties; reconciliation procedures; monitoring and reporting.

6.0 Organizational Framework for Risk Management

6.1 NMB will adopt a BOT-compliant risk review framework or structure, consisting of an independent Risk Management Department to review, evaluate and report its findings of risk to the Board of Directors. The Risk department will remain segregated in structure from the Management Team, in order to serve as an independent and objective voice when presenting its findings of risk to the Board. The ultimate responsibility for managing NMB's risk will remain the preserve of the Board of Directors, and assisted by the Management Team (MT), with the Risk Department acting in a reporting and advisory capacity. Good corporate governance requires the decisions of the Board and Management on risk management be based on.

- 6.1.1 Analysis of the environment in which NMB is operating;
- 6.1.2 The capitalization of NMB, i.e. the ability to absorb losses;
- 6.1.3 The risk appetite of NMB, strategy for expansion etc;
- 6.1.4 The operational capacity, e.g. systems and staff.

Risk Philosophy and Appetite

NMB Bank shall consider management of risk as one of its core competencies and a key factor in providing a stable, high return to shareholders. The Bank shall develop policies and procedures and tools that spell out the risk appetite to match the best practices in risk management and ensure that risks are adequately identified, measured, monitored and managed.

6.2 Role of Board of Directors in Managing Risk

The Board shall have an ultimate responsibility for the risk management function at NMB. Its responsibilities include:

- (a) To formulate the Bank's risk philosophy and determine risk appetite through policies and strategies;
- (b) To ensure that MT implements the risk policies and strategies and takes the necessary steps to identify, measure, monitor and control the bank's risks;
- (c) To define the nature, role, responsibility and authority of the risk management function within the Bank and outline scope of risk management work.;
- (d) To ensure that the MT possesses adequate skills and knowledge to manage risks;
- (e) Ensure the internal audit function reviews adherence to risk policies and procedures;
- (f) Approving strategies or actions to be taken by the Bank which are beyond MT's level of decision making.

6.2.1 Role of the Management Team (MT) in Managing Risk

The main responsibilities of the MT shall be:

- (a) Implementing strategies, policies and other directives given by the Board with regard to Risk Management Practices
- (b) Developing procedures to guide implementation of risk management policies set by the Board;
- (c) Ensure that risks inherent in the Bank's operations are well identified in all business units;
- (d) Putting in place systems to measure, monitor and control the risks identified;
- (e) Periodically monitor the Bank's exposure to risks and set strategies on how to mitigate them;
- (f) Periodically reporting to the Board and its committee on the level of the Bank's exposure to various risks and actions taken to mitigate it;
- (g) Conducting a detailed analysis on the risks associated with new products and advise the Board;
- (h) Ensuring that there is risk awareness in the Bank and all staff abide by policies, procedures and control set by the Bank.

6.3 Role of the Board Audit, Risk and Compliance Committee

The Board shall have a committee named as the Board Audit Committee which among other responsibilities will be to oversee risk management practices in the Bank. The Committee shall meet at minimum quarterly to discuss among other issues, those related to risk management practices in the Bank.

The Committee shall do the following:

- (a) Monitor all key risks and performance indicators through reports from MT to determine the level of bank's exposure and whether it is within the limits set by the Board;
- (b) Periodically review risk policies, limits and controls to ensure that they remain appropriate;

- (c) Periodically assess capital at risk to ensure that it remains adequate;
- (d) Specify frequency and content of risk reporting; and
- (e) Advise the Board on issues risk management, audit and compliance-related issues.

6.4. The Risk Management Department

NMB has established an independent Risk Management Department headed by a Risk Manager which is responsible for providing an independent overview and assessment of NMB's risk-taking and risk management capacities and initiatives in the course of its routine operations. This unit will perform independent analysis and serve as an independent voice when presenting its findings of risk at NMB.

The main functions of the Risk Department shall be:

- (a) Providing periodic and routine an independent summary and analysis of NMB's various risk-taking functions.
- (b) Rendering advice in the process of establishing risk tolerance limits to be approved by the Board;
- (c) Reviewing policies and limits periodically to ensure they adequately address the Bank's exposure to the risks, and corresponding limits established by the Board.
- (d) Assisting business units in identification of risks inherent in their operations;
- (e) Assisting business units in developing systems to measure, monitor and control their risks;
- (f) Designing reports which will assist Management in assessing and monitoring the Bank's level of exposure to risks including compliance with policies, procedures and limits;
- (g) Preparing various risk management reports in order to assist the Board through its Audit, Risk and Compliance Committee in the task of assessing NMB's various risk exposures. This will then help the Board and senior management to establish effective risk management and mitigation strategies.

- (h) Monitoring market, economic and financial trends both within and outside the Bank and their impacts, and advise management on how minimize exposure;
- (i) Conducting an analysis of the risks associated with new product to determine the Bank's ability to manage those risks before venturing into it and provide guidance on what to do to minimize exposure;
- (j) Conducting period reviews to assess compliance with bank's policies, procedures and tolerance limits by all departments and report the same to both management and board risk committees.
- (k) Creating awareness to all staff in the Bank on risk management practices; and
- (l) Liaise with other bodies and banks both at local and international levels on risk management issues to ensure that the Bank is in line with international best practices.

6.5 Role of Internal Audit in Risk Management

Internal Audit Function plays the role of independent assessment of the risk management practices in the Bank. Internal Audit shall do the following:

- (a) Assessing whether risks are well identified, measured and monitored;
- (b) Assessing whether assumptions used in the risk measurement are valid and well documented;
- (c) Reviewing the adequacy of policies and procedures with regard to risk management;
- (d) Assessing whether staff observe policies and procedures applicable in their operations;
- (e) Assessing whether limits are observed and necessary actions are taken when such limits are breached;
- (f) Reporting to the Board Audit, Risk and Compliance Committee on the adequacy and effectiveness of the risk management practices in the Bank.

7.0 Framework Procedure Review Mechanism

NMB's Risk Management Policy shall be reviewed at least once in a year to ensure that it is adequate and effective. The Risk Management department shall coordinate the review and present it to the Board Audit, Risk and Compliance Committee before it is sent to the Board for approval.

Since limits have not been stipulated in the policy, they are subject to review whenever the need arises and presented to the Board for approval.