CREDIT RISK MANAGEMENT IN RURAL AND COMMUNITY BANKS IN GHANA

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Abstract - For almost all rural banks in Ghana, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including the banking book and in the trading book. The main goal of the research was to assess the credit risk management practices used by rural banks in Ghana precisely Ashanti region. To have information on this, annual reports of the selected rural banks of the years of study were thoroughly studied. In addition, interviews and questionnaire were used to collect information from key staffs that were directly related to the credit origination and credit risk management and the defaulters from the banks. A critical observation of the processes involved in the banks' credit creation to its administration was made. The results of the study revealed that, the selected rural banks were making efforts to reduce their portfolio at risk to minimal. From the findings, the banks portfolio at risk showed a downward trend from 2009 to 2013. The major causes of loan default among defaulters of the banks were also revealed. Notwithstanding the fact that banks were able to reduce their portfolios at risk, it should be recognized that an institution need not engage in business in a manner that unnecessarily imposes risk upon it: nor it should absorb risk that can be transferred to other participants.

Keywords - Portfolio, Risk, Diversion

I. INTRODUCTION

Credit is the major source of revenue to rural banks and banks in general. Credit therefore poses the major risks to banks due to the high default rate among borrowers. This calls for a sound risk management techniques on the part of rural banks. Do rural banks have risk management policies and if in existence, how are they implemented by the banks to control credit risk? This topic is intended to survey the risk management practices used by the rural banks.

Risks and uncertainties form an integral part of banking which by nature entails taking risks. The greater the risk, the higher the profit and hence the business unit must strike a trade-off between the two. Credit risks is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Another term for credit risk is default risk. Bank losses include lost principal and interest, decreased cash flow, and increased collection cost.

Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences. Rural banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

The sound practices set out in this document specifically address the following areas: (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit-granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk.

Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.

II. CREDIT RISK

Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximize bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risks inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management is essential to the long-term success of any banking organization. (Andersen & Terp, 2006).Accordingly, credit risk is diversifiable, but difficult to eliminate completely.

III. PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK

The effective management of credit risk is a critical component of a comprehensive approach to risk

management and essential to the long-term success of any banking organization. (Andersen &Terp, 2006)
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IV. FINDINGS AND DISCUSSIONS

A total of five Rural Banks were selected from Ashanti region for the study. These were Atwima Kwanwoma, Sekyere Rural Bank Ltd., Nwabiagya Rural Bank, Otuasekan Rural Bank and Bosomtwe Rural Bank. The research revealed that the four main credit risk identified were:

1. Diversion of funds

Since money, is fungible, diversion of the use of loan is possible. For instance, a cocoa farmer beneficiary of a loan meant for farm inputs can divert it for an organization of a funeral. An anticipated production increase will not be attained. This makes repayment difficult.

2. Inadequate security and difficulties in realizing securities

The rural banks operate within the rural areas and therefore most of the customers do not have the collaterals, for example, landed property.

3. Bad weather (in terms of agric loans)

Bad weather is peculiar to loan default under agriculture, because most of them is not under irrigation. It was found that most of the times the climatic condition fails the customer to have poor harvest. For example, an unusual heavy rainfall, bush fire, unexpected drought.

4. Improper appraisal

It was found from the top management perspective that the loan officials do not do proper assessment of the viability of the customer business to ascertain the cash flows from the business.

V. PORTFOLIO AT RISK

The study considered the portfolio at risk from each of the rural banks. The portfolio at risk is calculated by dividing the overdue loan by total portfolio and multiply it by hundred percent. Mathematically,

$$PAR = \frac{\text{overdue loan} \times 100}{\text{Total portfolio}}$$

Fig 1: Portfolio at Risk of Banks

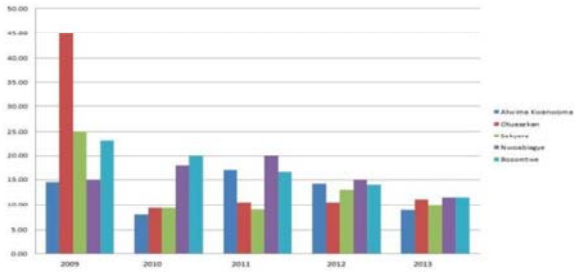
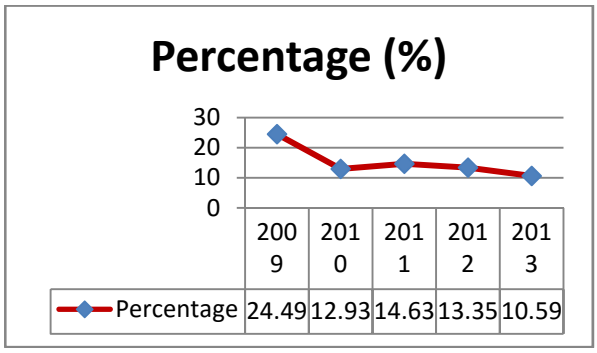


Fig. 2; Average portfolio at risk for the banks (2009-2013)



From figures1 and 2 the portfolio at risk of the selected banks and average portfolio at risk have shown a downward trend. This indicates that the banks are putting appropriate measures to control their credit risks.

VI. LOAN APPROVAL PROCESS

The following steps were identified from both the individual and group loans granting process in the selected banks:

- The customers tender in their applications
- Credit assessment of the borrowers' business by the credit officers
- The purpose of the credit and source of repayment is usually ascertained by the credit officers
- The loan application is sent to the head of credit department(Credit Manager)
- The Credit Manager will then appraise the request and check the track record/ repayment history of the borrower
- The Credit Manager then assesses the repayment capacity of the borrower and gives his recommendation.
- Afterwards, Credit Committee (Board) considers and approves the various requests.

VII. MAJOR CAUSES OF LOAN DEFAULTS AMONG THE BANKS.

A primary data was collected from some of the defaulted loan customers of the banks under study. In all a total of fifty (50) defaulted customers of the banks were interviewed. Ten (10) customers were selected from each bank. Detailed information of the respondents includes the following.

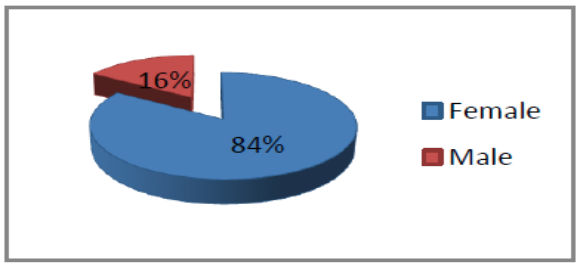


Fig 3: Sex distribution of respondents

Source: Researcher's field work – 2013

In terms of sex, 42 representing 84% of the sample of 50 defaulters were female while the remaining 8 also representing 16% were male. Majority of the banks defaulters were female according to records.

Table 1: Age distribution of Respondents

Ages	Number of Respondents	Percentages
21 – 30	3	6
31 – 40	9	18
41 – 50	21	42
51 – 60	14	28
60+	3	6
Total	**50**	**100**

Source: Researcher's Field work - 2013

In terms of age range majority of the respondents fell between the ages of 41 - 50 of the fifty (50) people interviewed. 21 respondents representing 42% fell between the ages 41 - 50. 14 were between 51 - 60 representing 28%. 9 of the respondents were between the ages of 31 and 40 representing 18% and 3 respondents each between the ages of 21-30 and 60+ which represents 6% each.

From the analysis above, majority of the defaulters was the most active work force in the Ghanaian economy.

This is shown in the table above.

Educational Level	Count	Percentage
Middle/Junior Secondary School	28	56
Secondary School	10	20
Non-formal Education	12	24
Total	**50**	**100**

Table 2: Educational level of respondents

Source: Researcher's field work – July 2013

The table above also shows that 56% of the respondents completed Middle School and Junior Secondary School; 20% of the respondents completed Secondary school; and 24% of the respondents had no formal education.

Occupational Sector	Count	Percentage
Agric	7	14
Trading	23	46
Transport	2	4
Cottage industries	18	36
Total	**50**	**100**

Table 3: Occupation of the respondents

Responses from customers on what caused their defaults

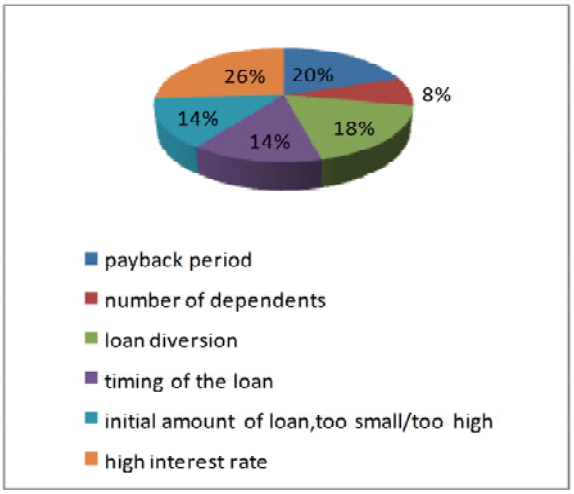


Fig4. Causes of Loan Default

To ascertain the factors that led to loan default, the views of customers were solicited. Of the six (6) factors considered: high interest rate, initial amount of loan (too small/too high), timing of the loan, loan diversion, number of dependents and payback period. As shown in figure 4, twenty-six percent (26%) of the respondents indicated that high interest rate was the major cause of loan default while eight percent (8%) indicated that the number of dependents of borrowers as the cause of loan default.

The findings from this section confirm the assertion of Sabato (2009) that the time given to the borrowers to re-pay the loan is usually too short and this leads to default in payment. By the time the lenders will be demanding their money, borrowers would have put the money into business. This normally affects their working capital as they are forced to retrieve money from the business to pay back the loan. CREDIT RISK MANAGEMENT TECHNIQUES AND PRACTICES OF THE SELECTED RURAL BANKS

After getting a general picture of the credit risk management level of performance of the banks from 2009 to 2013, the findings moves to the stage of analyzing the current practice of the banks, which is particularly important to get an understanding on how the selected banks manages their credit risk nowadays.Credit Risk Management is a discipline at the core of every financial institution and encompasses all the activities that affect its risk profile. It involves identification, measurement, monitoring and controlling risk.This is to ensure that;

- The individuals who take or manage credit risks clearly understand it.
- The organization's Credit Risk exposure is within the limits established by Board of Directors.

- Risk taking Decisions are in line with the business strategy and objectives set by Board of Directors.
- The expected pay-offs compensate for the risks taken.
- Risk taking decisions are explicit and clear.
- Sufficient capital as a buffer is available to take risk.

The responsibility for credit risk management in the selected rural banks lies with the Board of Directors, which is responsible for ensuring that an appropriate and conducive environment has been created for managing credit risk. The board has done this by setting comprehensive credit risk management policies and procedures as contained in the banks' Credit Policy Manual. The manual contains an outline of the scope and allocation of the banks' credit facilities and the manner in which the credit portfolio is managed, that is, how loans are originated, appraised, supervised and collected at both the individual credit and portfolio levels. It also outlines the governance structure with clearly defined responsibilities and credit approval authority. The Board also periodically reviews and approves the banks' credit risk strategy in addition to reviewing and approving all credits in excess of the policy limit, through its Loans Committee.

VIII. CONCLUSION AND RECOMMENDATIONS

The research deduced that the steps put in place by the banks were helping them to mitigate some of the challenges which were confronting them in their credit delivery. Some of the measures include;

- Proper assessments and appraisal of applicant
- Regular visit to customers' business sites
- Regular checks of books of the facility
- Regular checks of their accounts
- Regular phone calls
- Issuing reminder letters.

RECOMMENDATIONS

Despite a fairly good credit risk management framework in place to adequately manage the various credit risks facing the rural banks, I would like to make a couple of recommendations which I believe would help strengthen their credit risk management system and make it more competitive.

(i) Board and Senior Management

It is the overall responsibility of bank's Board to approve bank's credit risk strategy and significant policies relating to credit risk and its management which should be based on the bank's overall business strategy. To keep it current, the overall strategy has to be reviewed by the board, preferably annually. The responsibilities of the Board with regard to credit risk management shall include:

a) Delineate bank's overall risk tolerance in relation to credit risk.
b) Ensure that bank's overall credit risk exposure is maintained at prudent levels and consistent with the available capital.
c) Ensure that top management as well as individuals responsible for credit risk management possess sound expertise and knowledge to accomplish the risk management function.
d) Ensure that the bank implements sound fundamental principles that facilitate the identification, measurement, monitoring and control of credit risk.

(ii) Organizational Structure

To maintain bank's overall credit risk exposure within the parameters set by the board of directors, the importance of a sound credit risk management structure is second to none. While the banks may choose different structures, it is important that such structure should be commensurate with institution's size, complexity and diversification of its activities. It must facilitate effective management oversight and proper execution of credit risk management and control processes.

Each bank, depending upon its size, should constitute a Credit Risk Management Committee (CRMC), ideally comprising of head of Bad debt Recovery Department, Credit Department and Treasury. This committee reporting to bank's Board of Directors should be empowered to oversee credit risk taking activities and overall credit risk management function.

(iii) Systems and Procedures of Credit Origination.

Institutions have to make sure that the credit is used for the purpose it was borrowed. Pre-disbursement discussion should be held with the borrowers in order to minimize diversion of funds. Pre-discussion also make borrowers aware of their repayment obligations and the effect of non-payment on the relationship between the bank and borrower. Where the obligor has utilized funds for purposes not shown in the original proposal, institutions should take steps to determine the implications on credit worthiness.

Institution should not over rely on collaterals/covenant. Although the importance of collaterals held against loan is beyond any doubt, yet these should be considered as a buffer providing protection in case of default, primary focus should be on obligor's debt servicing ability and reputation in the market.

(iv) Credit Administration

On-going administration of the credit portfolio is an essential part of the credit process. Credit administration function is basically a back office activity that support and control extension and maintenance of credit. A typical credit administration unit performs following functions:

a. Documentation. It is the responsibility of credit administration to ensure completeness of documentation (loan agreements, guarantees, transfer of title of collaterals etc) in accordance with approved terms and conditions.

b. Credit Disbursement. The credit administration function should ensure that the loan application has proper approval before entering facility limits into computer systems. Disbursement should be effected only after completion of covenants, and receipt of collateral holdings. In case of any exceptions, approval should be obtained from competent authorities.

c. Credit monitoring. After the loan is approved and draw down allowed, the loan should be continuously watched over. These include keeping track of borrowers' compliance with credit terms, identifying early signs of irregularity, conducting periodic valuation of collateral and monitoring timely repayments.

d. Loan Repayment. The obligors should be communicated ahead of time as and when the principal/markup installment becomes due. Any exceptions such as non-payment or late payment should be tagged and communicated to the management. Proper records and updates should also be made after receipt.

e. Maintenance of Credit Files. Institutions should devise procedural guidelines and standards for maintenance of credit files. The credit files not only include all correspondence with the borrower but should also contain sufficient information necessary to assess financial health of the borrower and its repayment performance. It needs not mention that information should be filed in organized way so that external / internal auditors could review it easily.

f. Collateral and Security Documents. Institutions should ensure that all security documents are kept in a fireproof safe under dual control. Registers for documents should be maintained to keep track of their movement.

Procedures should also be established to track and review relevant insurance coverage for certain facilities/collateral. Physical checks on security documents should be conducted on a regular basis.

(v) Measuring Credit Risk

The measurement of credit risk is of vital importance in credit risk management. A number of qualitative and quantitative techniques to measure risk inherent in credit portfolio are evolving. To start with, banks should establish a credit risk rating framework across all type of credit activities. Among other things, the rating framework may, incorporate:

- Business Risk
- Industry Characteristic
- Financial condition
- Profitability
- Capital Structure
- Present and future Cash flows

CONCLUSION

The general believe is that banks in Ghana have good risk management structures since there have not been any complaints or adverse findings against them by the regulators, that is, Bank of Ghana concerning significant weaknesses in their risk management systems. The banks are believed to be generally compliant with major regulatory requirements which are basically in line with international standards. These requirements include rigorous risk and capital management requirements designed to ensure that the banks hold capital reserves appropriate to the risk they expose themselves to through its lending and investment practices. However, in order to ascertain the resilience of the Ghanaian banking sector especially the rural banks to withstand serious economic shocks, there would be the need for thorough assessments of the structure and components of the credit risk management frameworks and practices of the banks from time to time. This study was therefore a contribution to this exercise.

It has been shown from the analysis of the study that the rural banks since 2009 have been trying to reduce their average portfolio at risk (APAR). The acceptance and management of credit risk is inherent to the business of banking and banks' roles as financial intermediaries. Almost all of the major causes of loan defaults outlined by the defaulters can be controlled by management.

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