

Commercial Banks Vs Rural SACCOS Credits Risk Management Practices in Tanzania

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Abstract

This study applied secondary data from 20 commercial banks and primary data from 37 rural Savings and Credits Cooperative Societies (SACCOS) operating in Tanzania to compare the credits risk management practices applied by commercial banks versus the rural SACCOS. The study revealed that banks have effective credits risk management practices than the rural SACCOS. The study also revealed that because of the effective credits risk management practices all banks (100%) were making profits while only 30% of the rural SACCOS were profitable. Furthermore, the study noted that the mean value of NPL for banks and rural SACCOS was 4.4% and 23.26% respectively. This study recommends that rural SACCOS should imitate some of the best banks' credits risk management practices in order to reduce the amount of NPL and hence improve their profitability while the government should establish the credits risk regulatory framework for SACCOS as it did for commercial banks.

Keywords: Commercial banks, Rural SACCOS, Credits risk management practices, Tanzania

1.1 Introduction

Tanzania gained its independence in 1961 and it started to implement the trade liberalization policies since 1980s. About 80% of Tanzanians live in rural areas (NBS 2013). In Tanzania Cooperatives have been integrated into social and economic framework since independence up to free market era. Savings and Credits Cooperatives Societies (SACCOS) have grown rapidly in Tanzania since 1980s. Wangwe (2004) asserted that SACCOS play important role in providing the financial services in rural areas since their establishment. The government of Tanzania has recognized the importance of SACCOS in promoting social economic development of the rural people hence it facilitated the registration of 5346 SACCOS and 970665 members in March 2013 and 2011 respectively (MOFT, 2012; 2013; Bwana and Mwakujonga 2013; Qin and Ndiege 2013). Hakikazi (2006), Bibby (2006), Maghimbi (2010), Mwakajumilo (2011), Karumuna and Akyoo (2011) and Magali (2013) revealed that many cooperatives and SACCOS in Tanzania face the problems of poor management, fraud, inadequate capital, poor business practices and high Non Performing Loans (NPL).

Kaaya and Pastory (2013) emphasized that commercial banks are vital in fostering economic growth and development of Tanzania. Since through their intermediation role, banks offer various services such as accepting deposits and issuing loans for clients and in this case they promote investments. Similarly, Gwahula (2012) contended that the reform of the financial sector in Tanzania since 1990s enabled banks to expand the financial services and hence has promoted the contribution of banks to the overall economy. According to Şafakli (2007) among all risks, credit risk plays the major role because it deals with loans which account for almost three-quarters of the total bank's assets. Goyal and Agrawal (2010) asserted that in the bank portfolio losses can occur due to inability or unwillingness of the borrower to meet the commitments and this in most cases is related with poor credit risks management. Many scholars have found out that effective credit risks management reduces the amount of NPL and hence profitability of banks (Haneef et al 2012; Funso et al 2012; Kaaya and Pastory 2013). Similarly, FunHo and Yusoff (2005) asserted that the efficient credits risk management is essential for the survival of banks while Churchill and Coster (2001) argued that the MFI should take calculated risks in order to maximize the profit.

Banks use the guidelines provided by the Basel II accord in managing the credits risk. The Basel II practices have been used by central banks of different countries to formulate regulatory frameworks for regulation of banks. Basing of Basel II capital accord, banks are required to calculate the regulatory capital and disclose their risks management practices for regulatory purposes. The credits risk management practices include integration of risk management function in every section or department of the bank, calculation of internal risk scores, recruiting qualified staffs and applying the effective Management Information System (MIS) for effective credits risk management (Richard et al 2008; Goyal and Agrawal 2010; Muvingi 2011; Raj and Sindhu (2013; Bodla and Verma 2009). Furthermore, Goyal and Agrawal (2010) asserted that the banks' Basel II accord distinguishes clearly the credit, market and operational risks and it provides a range of options for determining the capital

requirements for credit risk and operational risk. This paper is organized as follows: the following section covers the problem statement and literature review on the credits risk management practices applied by banks, SACCOS and other MFIs. Then, the methodology used for the study will be presented and results and discussion will follow thereafter. Finally, the conclusion and recommendations will be provided.

1.2 Problem statement

Parent (2009) noted that the average Return on Equity (ROE) of banks registered on the microfinance MIX Market portal in Africa, Central and South America and Southern Asia were roughly higher than MFIs (18% vs 13%) in 2006. This suggests that banks have good credit risk management practices than the MFIs. Likewise, most studies revealed that poor credits risk management increases the amount of Non Performing Loans (NPL) and hence reduces the profitability of banks and SACCOS (Achoua and Tenguh 2008; Haneef et al 2012; Funso et al 2012; Kaaya and Pastory 2013; Magali 2013). Moreover, the literatures show that banks have structured credits risk management practices as opposed to rural SACCOS. However, to the best of my knowledge there is no empirical study done to compare the credits risk management practices applied by banks against those applied by SACCOS. The author perceives that since both financial institutions issue loans regardless of the volume of transaction, they require effective credits risk management practices. Therefore this paper compares the credit risk management practices applied by commercial banks and rural SACCOS in Tanzania. I anticipate that the findings from this paper will help the rural SACCOS, according to their capacities, regulations, policies and environments to imitate some of the banks' best credits risk management practices and thus improve their financial performances.

2.0 Literature review

2.1 Definitions of risk, risk management, credit risk and credit risk management

Mbeba (2007) states that risk is the potential that current and future events, expected or unanticipated may have an adverse or harmful impact on the institution's capital, earnings or achievement of its objectives while Oluchukwu (2012) defines risk management as the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events. Şafakli (2007) exposed that according to Basel Committee on Banking Supervision, credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms while Gakure et al (2012) defines credit risk management as a structured approach for managing credits uncertainties through risk assessment, developing strategies to manage it and mitigation of risk using managerial resources. The strategies include transferring to another party, avoiding, reducing the negative effects and accepting some or all effects of a specific risk. Goyal and Agrawal (2010) related credit risk with losses associated with decrease in the credit quality of the borrowers or the counter parties. Şafakli (2007) asserted that 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. Goyal and Agrawal (2010) classified risks into financial and non-Financial risks. The financial risks included credit risks and market risks. The market risks are related with interest rate, liquidity, foreign currency while the hedging risks and non financial risks involves operation, strategic, funding, political and legal risks and the credit risks includes counterpart or borrowers, intrinsic or industry and portfolio or concentration risks. Furthermore, Mustafa et al (2011) classified risks faced by agricultural bank in Near East and North Africa (NENA) region into banking risks, which affect all finance transactions and clients' risks, which include climatic, production and marketing risks.

2.2 Impacts of credit risks management on MFIs efficiency, profitability and performance

Many scholars have investigated the influence of credits risks management on banks' profitability. Haneef et al (2012) revealed that lack of credits risk management threatened the profitability of banks in Pakistan. Funso et al (2012) found the positive relationship between credits risks management and commercial banks performance in Nigeria while Kaaya and Pastory (2013) noted that higher credit risk negatively affects the performance of banks in Tanzania. Gakure et al (2012) found a positive relationship between performance of unsecured bank loans and risk identification, risk analysis and appraisal, risk monitoring and credit-approval in Kenya. Nawaz and Munir (2012) revealed that in Nigeria banks witnessed rising non-performing credit portfolios and this significantly contributed to financial distress in the banking sector. The findings revealed that credit risk management had a significant impact on the profitability of Nigerian banks. Said (2013) studied the correlation between risks and efficiency within Islamic banks in the Middle East and North Africa (MENA) area and the study revealed that credit risk has negative relationship on efficiency. Tandelilin et al (2007) found that foreign-owned banks integrated corporate governance and risk management in Indonesia. The study also found the negative

relationship between risk management and bank performance. Megeid (2013) argued that credit risk affects the health of the bank's loan portfolio, which may affect bank liquidity performance. The study revealed that credit risk was the major threat to the Egyptian banks. Khattak et al (2013) found out that understanding risk and risk management, risk assessment and analysis, risk identification, risk monitoring and credit risk analysis of Islamic banking system have positive significance impact on risk management practices and hence profitability in Pakistan.

Abdelrahim (2013) revealed that liquidity had significant strong positive impact on effectiveness of credit risk management of Saudi banks while capital adequacy, asset quality, management soundness and earning had insignificant impact on effectiveness of credits risk management while Ahmed et al (2013) revealed that size of Islamic banks has a positive relationship with credit and liquidity risk while the capital adequacy has negative relationship with credit and operational risk in Pakistan. Few scholars have studied the influence of credits risk management on SACCOS' profitability. Magali (2013) found out that poor credits risks management practices negatively influence the profitability of rural SACCOS in Tanzania while Lagat et al (2013) revealed that except risk evaluation; risk identification, analysis, monitoring and mitigation had significantly effect on lending portfolio of the SACCOS in Kenya.

2.3 Banks' implementation of Basel II credit risk guidelines

Banks use the guidelines provided by the Basel II for managing the credits risks. Achoua and Tenguh (2008) stated that according to Basel II accord banks classify their capital into Tier 1, Tier 2 and the total regulatory capital. The study further asserted that Tier 1 capital is the core measure of a bank's financial strength because it contains shareholders' equity which is the most reliable and liquid financial capital while Tier 2 capital consist of loan loss reserves plus subordinated debt. The total capital is the sum of Tier 1 and Tier 2 and the regulation demands Tier 1 and total regulatory capital to be at least 4% and 8% of total risk-weighted assets respectively. Goyal and Agrawal (2010) asserted that as per Basel I and II committee guidelines all banks in India were advised to have the Capital Adequacy Ratio (CAR-capital over risk weighted assets) at least 8% for protection of the depositors' money in case of bankruptcy. Also the study found out that, for implementation of Base II accord the Reserve, Bank of India required all banks to put their annual financial statement containing risks mitigation techniques (disclosures) on their websites. However, the study noted that investing a lot of time, manpower and energy were the main challenges towards implementations of Basel II accord in India. Similarly, Muvingi (2011) noted that Zimbabwean banks lacked capabilities to implement international best practices of risk management recommended by the Basel II accord because they required a lot of investment in MIS and manpower. Furthermore, Richard et al (2008) revealed that one bank in Tanzania had a well-documented credit risk and a credit manual which provided the full details on how to manage the credit risks according to the bank's credit policy. However, the study noted that the bank didn't use quantitative credit scoring models recommended by the Basel II accord but it applied personal judgment and intuition while assessing customers by using five Cs of credit: the borrower's capacity, character, condition, credit history and collateral. The study noted that poor records keeping and lack of effective technology were the barriers towards effective credit risks management practices recommended by the Basel II accord. Correspondingly, Ambira and Kemoni (2013) found out that commercial banks used internal rating and classified borrowers in different risk levels in Kenya. However, the study revealed that Commercial Banks in Kenya had inadequate records management practices and systems which undermined the risk management function. Conversely, Goyal and Agrawal (2010) found out that credit risk management framework in India was on the right track and it was fully in line with the guidelines provided by the Reserve bank of India. The study noted that borrower and exposure limits were the major prudential limits for credit risk management. The study revealed that more than 90% of banks performed risk rating exercise in India.

Banks compute the probability of default in order to classify borrowers in different risk levels. Foglia (2009) argued that since the exact measurement of risk is not possible, the level of risk can be determined with the help of risk rating models. Thonabauer (2004) stated that according to Basel II accord default types which measures the borrowers' risks component are probability of default (PD) which is borrower's current and future ability to fulfill its interest and principal's repayments obligations, Loss given default (LGD) which consists of collateralized portion as well as the cost of selling the collateral, Exposure at default (EAD) which is total value that a bank is exposed to at the time of default and Maturity (M). Similarly, Altman et al (2003) mentioned the three main variables affect the credit risk of a financial asset are the probability of default (PD), the loss given default (LGD) which is equal to one minus the recovery rate in the event of default (RR) and the exposure at default (EAD). Likewise Hull (2009) argued that some banks use the Internal Ratings Based (IRB) approach

where the credit risk capital for a transaction is calculated as a product of the expected default rate, the percentage loss given default, expected amount of default and maturity adjustment.

Every bank use different internal rating scores to group borrowers in risk levels according to its credit risk management policy. Treacy and Carey (2000) found out that banks' internal rating systems varied widely in USA because of disparity in business mix and human judgment in the rating process. The study noted that the median middle-market banks had three internal grades while the median banks with a substantial large-corporate business had four investment grades and two junk grades. Using bond experience as a guide, the study revealed that the default rates increased from least risky to the worsen grade. The study also revealed that the median and large banks used only two or three grades and 36% of banks assigned more loans to a single risk grade. However, they argued that although internal rating systems with larger numbers of grades are good for banks, they require the extra time to distinguish finer degrees of risk. DICO (2005) stated that for reducing credit risks borrowers in Canada, borrowers can be rated from 1 to 6 where 1 is assigned to undoubted borrowers while 6 is assigned to borrowers with high risk of default. Also 3 C's of lending analysis: Character, Cash flow and Capital can be applied.

Alam and Masukujjaman (2011) revealed that credit risk, market risk and operational risk were the major risks to the bankers in Bangladesh. The study further noted that the Board of Directors performs the responsibility of the main risk oversight while the Executive Committee monitors risk. It was also revealed that internal rating system and risk adjusted rate of return on capital were relatively more important techniques used by banks to mitigate risks. Bodla and Verma (2009) revealed that the board of directors had the authority for approval of credit risk policy as reported by 94.4% and 62.5% of the public and private sector banks respectively in India while the credit policy committee was responsible for credit risk management. The study also noted that most of the banks performed several activities for managing the credit risks such as industry study, developing MIS, risk scoring and annual review of accounts.

Global financial crises may increase the level of loans default risk in banks and MFIs. Cipovová and Jaroslav (2012) affirmed that the global crisis has led to deterioration in the performance of the banking sector due to the failure in credit risk management in Czech Republic. The study further noted that banks and ratings agencies underestimate the credit risk during the period of customers' prosperity and low probability of default. They argued that methods used for measuring credit risk are not reliable and have many imperfections. They concluded that shorter maturity of loans usually lowers the credits risk. Similarly, Jorion (2009) argued that sometimes event of big losses can occur because of business decision or bad luck. The study asserted that during 2007/2008 global financial crises, many firms got loss because of known unknowns. The study classified risk into known knowns, known unknowns and unknown unknowns. Similarly, Njanike (2009) evaluated the Zimbabwe's banks' credit risk manage in 2003/2004 bank crisis. The study found that the failure to effectively manage credit risk contributed to a greater extent to the banking crisis. Furthermore, Şafakli (2007) revealed that following the global financial crisis, the credit risk measured by Non Performing Loan ratio increased from 7.76% in 2001 to 20.90 % in 2005 in Cyprus.

2.4 Empirical literature on Credit risk management practices in banks, MFI and SACCOS

There are diverse strategies used by banks, SACCOS and MFIs for mitigation of the credit risks. FunHo and Yusoff (2005) adopted the model of Wesley (1993) to examine how credit culture, criteria, diversification, proper training of the personnel, setting of standards and rewarding success influenced the credit risks management in Malaysian financial institutions. The study noted that borrower's commitment of assets during loan default, the use of guarantee from the third part and insurance were the important instruments for risk mitigation. The study also noted that diversification of loan services, training and development of staff and guidelines for loans approval, assets quality, adequacy of provision and reserve and disclosure were important strategies for managing the credit risks. Gyamfi (2012) revealed that character, savings and cash flow, guarantor or collateral, business type and location and the quality of management of the client's firm as reported by 57.9%, 47.4%, 15.8%, and 10.5% respectively were factors considered before granting credits by MFIs in Ghana. Also the study revealed that that 26.3%, 21.1%, 10.5% and 5.3% of the MFIs required cash and cash equivalents, business assets, guarantors, premises, household appliances, stocks and mortgages respectively before granting credits. Lagat et al (2013) noted that SACCOS in Kenya relied on financial statements from their clients, cash flow projections, business plan, site visits and proforma statements for evaluation of credit risks before issuing loans as reported by 87%, 60%, 32%, 27% and 3% of the SACCOS respectively. It was also revealed that the use of tight risk mitigation policies such as insurance cover and diversification strategies influenced the lending

portfolio.

Bunning (2004), Haque et al (2011) and Evers et al (2000) found out that the use of guarantor, training and monitoring of the borrowers and credit staffs were the reasons for low credits risks in China, Bangladesh and Europe respectively. Similarly, Abdelrahim (2013) suggested that training of credit officers promotes the effective credit risk management for Saudi banks. Evers et al (2000) stressed that prevention of loan default risks for MFIs should be considered at all stages of the loan cycle: client screening, credit assessment, monitoring and repayment where traditionally the bank analyse assets/security, then cash flow projections and the client's credit history. They recommended that once default has occurred it is very important to make immediate follow-up while the court action should be prevented if possible. Similarly, Kidanu (2008) and Ross et al (2010) revealed that screening the borrowers clearly by the using the credit policy can help to reduce the loans default risks. Likewise social cohesion, group guarantor use of loan portfolio limits and diversification of loan portfolio were also applied as effective credit risks mitigation techniques in Nigeria, Bangladesh, Latin America and Kenya as reported by Ofuoku and Urang (2009), Satgar (2003), Wenner et al (2007) and Moti et al (2012) respectively.

Lam (2009) observed that Canadian as opposed to US banks, when introducing major risk management initiatives, paid more attention to identification and resolution, consensus building, corporate communication, board and management training and incentives redesign. The study recommended that for effective credit risk management practices at commercial banks; Banks must establish an effective governance structure and credit policies, should classify risks by industry or business, geographic region and portfolio segments, should integrate their credit analyses into business decisions and establish effective reporting and monitoring processes in order to identify key credit risk exposures and trends and ultimately manage them.

Lack of training, poor corporate governance and poor regulatory framework can influence negatively the effective credits risk management practices. Raj and Sindhu (2013) found out that more than 10% of the operating personnel in Indian public sector banks were not trained on credits risk compared to the foreign banks operating personnel who were trained 1 to 4 times and this reduced their effectiveness in credits risk management. Mago et al (2013) revealed that MFIs in Zimbabwe had limited capacities in the management of operational risk because of inadequate resources. Hence many MFIs collapsed because of poor operational risk management. Odhiambo (2012) revealed that poor corporate governance has led to high results of default for SACCOS' loans in Kenya. Kithinji (2010) listed the institutional capacity, inappropriate credit policies, poor management, poor loan screening, appraisal and follow-up, government interference and inadequate supervision by the central bank as the main sources of credit risk in Kenyan banks. Abdelrahim (2013) noted that some challenges facing effectiveness credit risk management in Saudi were weak corporate governance, little credit diversification, weak financial analysis, low interest rate on risky loans and corruption of credit officers. Mustafa et al (2011) disclosed that administrative risks can occur if a bank lacks qualified management staff and if corruption exists among administrative staff. However, the study recommended that use of insurance, effective collateral and information technology is vital for managing agricultural banks in NENA region.

3.0 Methods

This study applied secondary data from 20 commercial banks operating in Tanzania. The data was extracted online from annual operations and financial reports from 2009-2012. Also the study applied primary data from 37 SACCOS operating in Morogoro, Dodoma and Kilimanjaro regions in rural areas of Tanzania obtained from the survey conducted between February and May 2013. The data presentation is more qualitative with little quantitative information when seems appropriate. The analysis compares the credits risk management practices applied by commercial banks and rural SACCOS. Brief description on the impacts of proper and improper credits risks management practices for banks and SACCOS respectively is also presented.

4.0 Results

The analysis involves 20 commercial banks operating in Tanzania where the sample size included banks operate only domestically and those which operate both Tanzania and internationally (acted as branches or subsidiaries). Also the analysis involves 37 rural SACCOS operating in rural area in Tanzania. The study revealed that banks put more emphasis on improvements of credit risk management processes to reduce the non-performing loans ratio (NPL) where some banks have a policy of having NPL less than 5%. The study revealed that some banks divide the risk management functions into general, credit, operational, market, compliance, reputational and strategic risks. Credits risk management practices applied by commercial banks and rural SACCOS are compared in the following items:

4.1 Insurance coverage

All banks considered the insurance coverage before issuing loans. Banks' insurance coverage is broadened and focused on credit, life, funeral plan and general insurance covering motor insurance, house and other risks. The study noted that some banks have established the insurance agencies for promoting the risks management services. In SACCOS it was found that only 11% (4 among 37) of the rural SACCOS were having loan insurance cover for their members. The insurance covered the loans during catastrophic incidences and payment of condolences for borrower and spouse in death events. The findings indicate that the coverage of insurance in rural SACCOS was narrow where 89% of the rural SACCOS were not having the insurance services. Wenner (2007) recommended that the use of insurance cover is vital for reducing risk of agricultural loans in Latin America.

4.2 Regulatory requirements

The study found out that banks have directorate or department of risk and compliance which ensures that banks comply with credits risks regulations and procedures outlined by the Bank of Tanzania. The study noted that banks implement Basel Committee capital adequacy and risk management requirements as per Bank of Tanzania regulations. The regulations require the banks to classify regulatory capital and risk weighted assets into total qualifying tier 1, total qualifying tier 2 and total regulatory capital. The risk-weighted assets are measured after estimation of credit, market and other risks associated with each asset and counterparty and they consider the value of collateral and guarantees. Some banks have started implementing the Basel III guidelines and policies with Notices of Proposed Rule makings (NPR). The Basel III NPR was born from the 2008 global economic crisis and was adopted in June 2011. The Basel III rules are intended to raise the quantity and quality of regulatory capital by imposing broader regulatory capital and restrictions. Basel III implementation has been proposed to be effective from 1st January 2015. Goyal and Agrawal (2010) found out that banks in India followed the credit risk management guidelines provided by Reserve bank of India and this helped them to be effective in credits risk management. However, Mvingi (2011) noted that Zimbabwean banks lacked capabilities to implement international best credit risk management practices recommended by the Basel II accord because of the poor MIS technology. However, too much government regulations may pose challenges to banks' effective credits risk management as reported by Kithinji (2010) in Kenya. This study revealed that SACCOS have neither credits risk management requirements nor regulated by the bank of Tanzania or any organ. The study noted that it was the desire of a particular rural SACCOS to have credit risks management policies or not, since there was no policy, guidelines or law which forced the rural SACCOS to use the effective credits risk management practices. Absence of regulatory credits risk management practices was witnessed by high amount of NPL as confirmed by Magali (2013).

4.3 Specialized risk functions

The study noted that in banks the credit risk management and control are centralised and the risks functions are reported from the board, top management and lower cadre staffs involved with risk management functions. The study noted that at least every bank has a committee, directorate or department dealing with risks including the credits risk. It was found that in the bank credit committee and risk management committee work together to mitigate the credit risks. The two committees meet regularly, some weekly, monthly or three times a year to monitor and evaluate the credits risk management functions. The main function of the credit and risk management committee is facilitating the identification, measurement, monitoring and control of credit risks. The credits and risk committee discuss data from new and existing businesses, loan arrears and various policies regularly and propose their amendments when appropriate. In SACCOS there is only credit committee, there is no risk committee. However, the credit committee is not equipped enough to identify and manage credit risks. This is because in most rural SACCOS, credit committee consisted of unskilled people, since SACCOS appoint the credit committee members regardless of their skills, education level or experiences in credits risk management. The findings about the specialized credit risks functions in banks are in line with Alam and Masukujjaman (2011) who revealed that all management team from the board of directors and others were involved in banks credits risk management in Bangladesh.

4.4 Training in credit risks management

The study revealed that the banks train the top management and other staffs on credit risks management in order to minimize the credits risk. The study noted some banks facilitated the study visits for staffs responsible for credit risk management to enable them to acquire more skills about credit risks management. Example staffs from one bank visited Ghana for similar purpose. The banks also prepare the training materials for self risk study

and ensure that staffs responsible for credit risk management possess the mandatory skills and knowledge. The study revealed that no SACCOS conducted formal training on credits risk management. However, most SACCOS conducted informal training to borrowers on how to allocate loans before disbursement but this was seemed to be not sufficient. The study revealed that many SACCOS' workers possessed only the basic skills related to their normal daily operations. The study found out that some SACCOS in Morogoro and Dodoma region provided large amount of loans without deep analysis of credit risks. As the results the rural SACCOS accumulated high amount of NPL. The finding of this study are in tandem with Raj and Sindhu (2013) who found out that more than 10% of the operating personnel in Indian public sector banks were not trained hence were not effective in credit risks management. Similarly, Abdelrahim (2013) emphasized that training of credit officers is important for effective credit risk management for Saudi banks.

4.5 Credit risk measurement approach

The study found out that banks measure the credit risk of loans and advances to customers by grouping risk levels into probability of default (PD), Exposure at Default (EAD) and Loss Given Default (LGD), modeled at a client, industry and portfolio level. The study noted that banks assess the probability of default of individual counterparties using internal rating tools adapted to the various categories of clients in line with the Bank of Tanzania (BOT) guidelines by using the five rating classes to classify the range of default probabilities or grades of customers. The study also noted that the loan aging styles differ from one bank to another. Some banks grades start from 1 to 14 and some of the grades are further sub-classified A, B or C where the lower credit grades shows a lower likelihood of default. Example one bank grouped her customers into investment grade, sub investment grade and default grade where in each grade there are 10 scores in rating scale. Investment scale started from A+ to D+, the sub investment and default grade rating scale is D to F- and G and the last grade was ranked as default. The most popular segments applied by banks are presented in Table 1. The study noted that only few SACCOS (about 11%) practiced aging of loans. However, the study noted that data were not reliable since there was no computer software designed for internal rating. It was found that only one SACCOS used excel to group loans into five grades. However, the study noted that at least every rural SACCOS was aware about the use of the 5Cs of the credit policy but they didn't consider the parameters of 5Cs very seriously. The study revealed that majority of rural SACCOS (about 65%) scored the average marks of 5 or below (out of 10) when considered the worthiness of borrowers before issuing credit. The findings of this study are supported by Bodla and Verma (2009) who affirmed that computing the risks scores is important for reducing credits risk for banks in India. Similarly, Treacy and Carey (2000) revealed that internal rating systems with larger numbers of grades help to differentiate the level of risks for USA banks, thus was effective for reduction of credit risks while Goyal and Agrawal (2010) also revealed that more than 90% of banks in India performed the risk rating exercise.

Table 1: Bank's internal ratings scale

Bank's rating	Description of the grade	Aging mostly used	Aging for special loans	% for regulatory Provisioning
1	Current	0-30 days	0-30	0
2	Especially mentioned	31-60 days	31-90	5
3	Sub-standard	61-90 days	91-180	10
4	Doubtful	91-180 days	181-270	50
5	Loss	181 days and above	271 and above	100

Source: *Bank reports (2012)*

4.6 Credit limits and approval

The study revealed that banks' loan approval is cascaded where there are some loans limit for each level from the loan officer, head of department, director, executive directors and the board and the bank put limits on the amount of risk accepted in relation to individuals, groups or industry. The ability of borrowers to repay the loans also is analysed regularly and lending limits are adjusted when appropriate. For larger loans qualitative information such as account operation, insurance and tax status of the borrower are demanded in order to determine the level of risk. The study noted that in many SACCOS there are no lending limits for individual, group or sectors. The study revealed that many SACCOS suffered from huge amount of NPL because they issued loans without deep analysis of credits risks. The study noted that one SACCOS in Morogoro rural district lent to individual 30 million Tanzanian shillings (Tshs) without considering deeply on the risk mitigation as the results the borrowers defaulted his loan. Also one group borrowed 18 million Tshs and invested money in car business in Mvomero district but the SACCOS did not make follow-up whether the insurance company was reputable or not. As the result the group defaulted the loan because the insurance company didn't pay the insurance cover after the car breakdown, suggesting that it was not reputable. Some also SACCOS did not

consider seriously the character of borrowers. The study revealed that one SACCOS in Morogoro region issued loans to non familiar borrowers and after receiving loans they fled. During the study the SACCOS declared that they didn't know where other borrowers were. Wenner (2007) recommended that rural MFI should consider the credit limit for reducing the risk of loans default.

4.7 Collateral policies and financial strength of the borrower

The study noted that banks follow their guidelines and policies on the acceptability of collateral for credit risk mitigation. In order to minimise the credit loss, sometimes the banks seek additional collateral from the borrower after observing the signs of loan's impairment. Also the banks reduce the credit risk by focusing more on large corporate enterprises or individual customers who provide the sufficient collateral. Regularly the management monitors the market value of collateral and may request the additional collateral when appropriate. The study noted that the banks consider not only the high value of collateral for repayment of loans in case of default but also the financial strengths of the borrowers. The bank policy is that, *collateral only is not sufficient to indicate that a borrower has the capacity to repay the loan*. The situation is different from rural SACCOS where the study observed that the rural SACCOS accumulated high amount of NPL because of inadequate knowledge and skills many SACCOS accepted wrong or fake collateral. The study revealed that some SACCOS accepted the photocopies of vehicles or land plots' certificates instead of demanding the original certificates. The findings indicate that rural SACCOS didn't examine thoroughly collateral before issuing loans to borrowers. Furthermore, the study noted that majority of SACCOS did not consider the financial strengths of the borrowers but most SACCOS relied more on projected cash flows which were found to be unrealistic and hence made borrowers to default their loans. Likewise the study noted that the capacity of borrower in repaying the loans was not considered carefully. It was revealed that some SACCOS in Mvomero district, issued loans to members beyond their capacity level of management. Also in some SACCOS both spouses were allowed to borrow at the same time. Moreover, some SACCOS considered non-company business as an independent person, thus in one household you could find 3 different loans (for husband, wife and business) and this in turn accumulated large amount of NPL for the rural SACCOS. These findings are consistent with Kohansal and Mansoori (2009) who revealed that low collateral value resulted into high credit risks for MFI borrowers in Iran. Similarly, Satgar (2003) revealed that Grameen Bank considered the mutual trust as effective collateral for the repayment of loans in Bangladesh.

4.8 Impairment, provisioning policies and stress tests

The study noted that in banks normally loans and advances are impaired after being more than 90 days past due where banks decide impairment of the loans after recognizing that the borrower has no ability to repay the loan from sale of collateral or all other means including court case. The study revealed that in rural SACCOS there is no impairment policy. The study noted that some prospered rural SACCOS paid their taxes without considering the loans impairment policy. The study also noted that banks apply stress test to calculate the volume of losses happening in severe circumstances where banks compute risk factor shock for each risk category. For credit risk the shock is caused by increase in NPL where the bank determine the shock rate, then the impact of shock rate on profit and on regulatory capital is calculated. The study revealed that some banks carry out stress testing semi-annually to examine if they have enough capital to endure the adverse situation. The findings of this study are in line with Foglia (2009) who stated that financial sector stress tests provide information on potential losses and can help policymakers assess the significance vulnerabilities. However, IMF (2011) revealed that smaller banks in China faced challenges in implementing accounting principles relating to determining individual and collective impairment. The findings from this study noted that some banks use behaviour, sensitivity and scenario models to manage the credit risks and also they integrated collection and recovery functions into credit risks management functions for improving credit recoveries. The study noted that in rural SACCOS there are no stress tests. Once loans are issued, rural SACCOS wait their maturities for collection. Also the study noted that stress test for rural SACCOS were not applicable because it requires skills on investment and financial analysis and more investment in MIS. The study further revealed that some rural SACCOS' members took loans to run the very risk businesses, like car business. The author believes that if the borrowers could be advised properly by the business or financial management experts could invest in less risk and profitable businesses. The study revealed that 84% and 41% took large amount of loans for agriculture and business activities respectively. The study noted that rural SACCOS borrowers who invested their money in very risky business activities they defaulted their loans. The findings of this study are in tandem with Maximambali et al (1999) who established that MFIs clients in Tanzania defaulted their loans because of overall poor economic conditions.

4.9 Risk Monitoring and Management Information Systems (MIS)

The study noted that banks maintain effective MIS system that facilitates risk monitoring practices and reporting. The study noted that MIS help banks to update the loan portfolio and to calculate the risk scores. Also MIS help banks to assess and review the credit portfolio quality regularly, example monthly. The study noted that rural SACCOS don't use MIS in management of risk. The study revealed that only 14% of SACCOS (5 among 37) used computers for record keeping and only 1 rural SACCOS (among 37) used the excel computer program for loan's aging analysis. This indicates that the loans in rural SACCOS are in high risks since there is no effective tool for credit risks management. The study found out that due to improper record keeping, some rural SACCOS fail to disclose the information of loans issued to customers on spot, when asked to do so. The findings are consistent with Mustapha (2011) who found out that use of MIS was one of effective credit risks mitigation technique in Near East and North Africa region.

4.10 Savings and guarantor policy

The study revealed that banks request borrowers to open loans account in banks where the repayment of the loan will be made. For businessmen, banks also request borrowers that all transactions of the business should be realized in the business account so that the bank can trace all transactions. This helps banks to examine the risky of the business. The study noted that only SACCOS in Kilimanjaro region considered effectively the use of members' savings before issuing the loan. Most SACCOS stated that the loan issued should be computed 3 to 3.5 times of the member's savings. However, this was not practical by many SACCOS in Dodoma and Morogoro regions. Since some SACCOS accepted the rented passbooks from other members apart from ones who borrowed loans, in order to justify that they possess enough savings and thus the SACCOS issued loans contrary to the credit regulations. For instance members in one SACCOS in Mvomero district complained that the SACCOS management issued loans 10 million Tshs to one member without considering his savings and collateral, as the result the loan was defaulted. This case happened in many SACCOS in Morogoro and Dodoma regions and was the reason for large amount of NPL. Banks also consider the loan guarantee very seriously. Usually the creditworthiness of the guarantor is assessed by using the bank's credit policy guidelines. The main types of guarantors considered by banks include bank guarantees, insurance companies, parent companies, shareholders and export credit agencies. Moreover, for salaried loans, employers must guarantee their employees. The study noted that principally the rural SACCOS required 2-3 guarantors including their spouse for some SACCOS. However, the study noted that only SACCOS in Kilimanjaro region reported to use the guarantor money to repay the loans, implying that most rural SACCOS in Morogoro and Dodoma regions did not use the guarantor to repay the loans in default cases. Kidanu (2008) states that Ethiopian SACCOS use the guarantor's savings to repay the loans in an event of members default. Ross et al (2010) also stressed that effective guarantor is important for enhancing the repayment of the loans.

4.11 Impacts of effective credits risk management in commercial banks and rural SACCOS

The findings from Table 2 and 3 show the impacts of credit risks management on the profitability of SACCOS and NPL. The findings indicate that because the banks have structured effective credits risk management attained high profitability. The secondary data from the published reports show that all banks were profitable where the minimum and maximum profit attained was 0.64 and 97 billion Tshs respectively with a mean profit of 17.24 billion Tshs. The reverse is true for the rural SACCOS which registered the minimum loss of 315 million Tshs while the maximum profit attained was 50 million with a mean loss of 5.3 million Tshs. The study found that out that 70% of the rural SACCOS incurred loss from their operations. Despite capital for commercial banks and SACCOS differed in amount (bank higher vs rural SACCOS), the comparison was made to depict the exact situation which occurs in the banks and SACCOS in order to describe the emphasis they put on credits risk management. Hence the results from SACCOS and commercial banks lead us to conclude that, banks were performing better because of the effective credits risk management while rural SACCOS were performing poor because of ineffective credits risk management. This conclusion also is confirmed by the data of NPL ratio. The findings show that the minimum and maximum ratio for NPL for commercial banks and rural SACCOS were 0.8% and 7.4% and 1.48% and 99.54% while their mean was 4.4% and 23.4% respectively. The findings indicate that in all cases, the NPL for commercial banks was lower than the rural SACCOS. Moreover, the maximum NPL for rural SACCOS was 99.54% indicating that in some SACCOS all loans were defaulted. It is evident that high amount of NPL is an indication of poor credits risk management. The study noted that because of having large amount of NPL, Some SACCOS were having 0 cash balances in Dodoma region and they stopped to issue new loans since 2006-2013. The results of this study are in tandem with many studies which revealed the influence of credits risk management on profitability of banks and SACCOS. Haneef et al (2012) Funso et al (2012) and Kaaya and Pastory (2013) revealed the negative influence of NPL on the profitability of banks in

Pakistan, Nigeria and Tanzania respectively while Magali (2013) revealed the negatively influence of NPL on profitability of rural SACCOS in Tanzania.

Table 2: Commercial banks Credits risk indicators

Variables	Minimum	Maximum	Mean
Profit in billion Tshs*	0.64	97	17.24
NPL ratio (%)	0.8	7.4	4.4

Source: *Published banks reports (2011 and 2012)*

Table 3: Rural SACCOS Credits risk indicators

Variables	Minimum	Maximum	Mean
Loss in million (Tshs)*	(315)	50 -Profit	(5.3)
NPL ratio (%)	1.48	99.54	23.26

Source: *Own survey (2013)*

*Tshs =Tanzanian Shillings (1 USD =1610 Tshs)

5.0 Conclusion and recommendations

This study revealed that banks have effective credits risk management practices compared with the rural SACCOS. The findings showed that all banks (100%) were making profits while only 30% of the rural SACCOS were profitable. Moreover, the mean value of NPL for banks and rural SACCOS was 4.4% and 23.26% respectively, indicating that the absence of proper credit risk management practices in the rural SACCOS increased the value of NPL where in some SACCOS almost all loans were defaulted. This study recommends that SACCOS should imitate some of the banks' best credits risk management practices in order to reduce the amount of NPL and hence improve their profitability. Also the government should consider establishing credits risk regulations for rural SACCOS as it did for commercial banks because some SACCOS' members who deposited their money in SACCOS were not paid their money after the rural SACCOS to accumulate the high amounts of NPL. This happened because bank of Tanzania has not formulated the credits risk management regulatory framework for rural SACCOS.

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