CREDIT RISK MANAGEMENT AND PROFITABILITY OF COMMERCIAL BANKS IN HARGIESA , SOMALILAND

A Thesis presented

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In Partial Fulfillment of the Requirements for the Degree

Of Master of Business Administration

Banking and finance

BY

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Dec 2013

DECLARATION A

"This thesis is my original work and has not been presented for a Degree or any other academic award in any University or Institution of Learning".

Name and Signature of Candidate

Mohamed Omar Yusuf

08 / Jan / 2014

Date

DECLARATION B

"I confirm that the work reported in this dissertation was carried out by the candidate under our supervision".

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7th Jan, 2014

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APPROVAL SHEET

This Thesis entitled credit risk management and profitability of commercial banks in hageisa Somaliland prepared and submitted by Mohamed Omar Yusuf in partial fulfillment of the requirements for the degree of master of business administration banking and finance and approved by the panel on oral examination with a grade

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Name and sig of DVC SPGSR

DEDICATION

I dedicated this thesis to all my Brothers and sisters and mom **Amina mire magan**

And my entire relative.

ACKNOWLEDGEMENT

In the name of Allah, the most merciful the most gracious, I thank Allah the way he guided to me and the ability, the acknowledge and the wealth to write this thesis Without Allah, I could not be able to successful this thesis.

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ABSTRACT

The study investigates the credit risk management and profitability of commercial banks in Hargeisa , Somaliland. The study was guided by three research objectives. First was examining the profile of respondents in term of Age, Education and Gender. Second the level of credit risk management in Hargeisa , Somaliland. Third the level of profitability commercial bank in Hargeisa , Somaliland, Four to establish if there is significant relationship in credit risk management and profitability of commercial banks, and the study used descriptive survey research design to investigate the simple of this study was 114 respondents from managers and staff of commercial banks in select district Hargeisa , Somaliland. The findings from the study were.

The profile of respondent found that number of male 50%, respondent according the number of female were 50%. In regard to education to education level respondent who are certificate level 11.4%, those who have diploma are 19.3%, and the majority of the respondents said they held first degree or a Masters (31.6% each). These two categories represented 63.2% of the entire sample. PhD degrees were the least with 6.1%. The majority of the study respondents were in the 31-40 age groups (37.7%). The 21-30 age groups were the second with 34.2% while 18-20 was the third with 19.3%. The least were in the 41-50 (7.0%) and the 51 and above category (1.8%).58% of the respondents said they were married while 56% said they were single.

The majority had worked for between 1-2 years (44.7%) and 1-2 years (29.8%). Those who said they had worked for 7 and above years were the least, representing 3.5% of the total respondents.

The majority of the respondents had worked for less than a year (47%). Those who had worked for 2 - 4 years where 38%, the least had worked for 8 years and above

Finally the result obtained showed that there is a relationship between credit risk management and profitability commercial banks in Hargeisa Somaliland.

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CHAPTER ONE

THE PROBLEM AND ITS SCOPE

Background of the Study

Risk management began to be studied after World War II, several sources (Crock ford, 1982, Harrinton and Neihaus, 2003, Williams and Heins, 1995). Risk management has long been associated with the use of market insurance to protect individuals and companies from various losses associated with accidents (Harrington and Neihaus, 2003). In 1982 Crockford wrote: "operational convenience continues to dictate that pure and speculative risks should be handled by different functions within a company, even though theory may argue for them being managed as one. For practical purposes, therefore, the emphasis of risk management continues to be on pure risks." In this remark, speculative risks were more related to financial risks than to the current definitions of speculative risks

New forms of pure risk management emerged during the mid-1950s as alternatives to market insurance when different types of insurance when different types of insurance coverage became very costly and incomplete. Several business risks were costly or impossible to insure. During the 1960s, contingent planning activities were developed, and various risk prevention or self-protection activities and self-insurance instruments against some losses were put in place, protection activities and coverage for work-related illnesses and accidents also arose at companies during this period.

The risk focused examination process has been adopted to direct the inspection process to the more risk areas of both operations and business. Skills in risk-focused super vision are continually being developed by exposing examiners to relevant training. By adopting this Approach, the banking industry, and specifically the small banks are sensitized on the need to have formal and documented risk management frameworks (De Juan, 1991). Notably, the more complex a risk type is, the more specialized, concentrated and controlled its management must be (Seppala, 2000; Matz and Neu, 1998; Ramos, 2000).

Risk management is defined as the process that a bank puts in place to control its financial exposures. The process of risk management comprises the fundamental steps of risk identification, risk analysis and assessment, risk audit monitoring, and risk treatment or control (Bikker and Metzmakers, 2005; Buttimer, 2001). Whereas a risk in simple terms can be measured using standard deviation, some risks may be difficult to measure requiring more complex methods of risk measurement. Good risk management is not only a defensive mechanism, but also an offensive weapon for commercial banks and this is heavily dependent on the quality of leadership and governance.

Credit risk is the possibility that the actual return on an investment or loan extended will deviate from that, which was expected (Conford, 2000). Coyle (2000) credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time. The main sources of credit risk include, limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, directed lending, massive licensing of banks, poor loan underwriting, reckless lending, poor credit assessment., no non-executive directors, poor loan underwriting, laxity in credit assessment, poor lending practices, government interference and inadequate supervision by the central bank. To minimize these risks, it is necessary for the financial system to have; well-capitalized banks, service to a wide range of customers, sharing of information about borrowers, stabilization of interest rates, reduction in non-performing loans, increased bank deposits and increased credit extended to borrowers. Loan defaults and nonperforming loans need to be reduced (Bank Supervision Annual Report, 2006; Laker, 2007; Sandstorm, 2009).

While the commercial banks have faced difficulties over the years for a multitude of reasons, the major cause of serious financial problems continues to be directly related to credit standards for borrowers, poor portfolio risk management or lack of attention to changes in the economic circumstances and competitive climate (Central Bank Annual Supervision Report, 2000). The credit decision should be based on a thorough evaluation of the risk conditions of the lending and the characteristics of the borrower. Numerous approaches have been developed for incorporating risk into decision-making process by lending organizations. They range from relatively simple methods, such as the use of subjective or informal approaches, to fairly complex ones such as the use of computerized simulation models (Montes-Negret, 1998; CBS Annual Supervision Report, 2000).

According to Saunders (1996), banks need to gather adequate information about potential customers to be able to calibrate the credit risk exposure. The information gathered will guide the bank in assessing the probability of borrower default and price the loan accordingly. Much of this information is gathered during loan documentation. The bank should however go beyond information provided by the borrower and seek additional information from third parties like credit rating agencies and Credit reference bureaus (Simson and Hempel, 1999)

Credit risk management is defined as identification, measurement, monitoring and control of risk arising from the possibility of default in loan repayments (Early, 1996; Coyle, 2000). Credit extended to borrowers may be at the risk of default such that whereas banks extend credit on the understanding that borrowers wil! repay their loans, some borrowers usually default and as a result, banks income decrease due to the need to provision for the loans. Where commercial Banks do not have an indication of what proportion of their borrowers will default; earnings will vary thus exposing the banks to an additional risk of variability of their profits. Every financial institution bears a degree of risk when the institution lends to business and consumers and hence experiences some loan losses when certain borrowers fail to repay their loans as agreed. Principally, the credit risk of a bank is the possibility of loss arising from non-repayment of interest and the principle, or both, or non-realization of securities on the loans. Risks exposed to commercial banks threaten a crisis not only in the banks but to the financial market as a whole and credit risk is one of the threats to soundness of commercial banks. To minimize credit risk, banks are encouraged to use the "know your customer" principle as expounded by the Basel Committee on Banking Supervision.

Commercial banks are the foundation of the payment system in many economies by playing an intermediary role between savers and borrowers. They further enhance the financial system by ensuring that financial institutions are stable and are able to effectively facilitate financial transactions. The main challenge to commercial banks in their operations is the disbursement of loans and advances. There is need for commercial banks to adopt appropriate credit appraisal techniques to minimize the possibility of loan defaults since defaults on loan repayments leads to adverse effects such as the depositors losing their money, lose of confidence in the banking system, and financial instability (Central Bank of Somaliland, 1999).

Now a day's credit risk is a major risk for all banking institutions. Profitability of banks' depends on this sector. Liquidity is another major issue for selecting this topic, because each and every bank are now facing liquidity crisis, if they are not efficient enough to handle credit risk, they are also facing more liquidity crisis. Most of the shares of the total revenue of the bank come from credit operation and the existence of the bank depends on quality of assets portfolio. So, efficient management of credit risk is a paramount importance. Credit risk is the loss associated with degradation in the credit quality of borrowers of counter parties. In a bank's portfolio, losses stems from outright default due to the inability or unwillingness of the customer or counter party to meet commitments in relation to leading, trading, settlement and other financial transaction.

In the present, world money is circulated all over the globe. Globalization, technological advances and other factors money is circulating unimaginably. Financial Institutions mainly Banks play a pivotal role in matching a depositor and lenders and channeling money and making the economy more efficient. Although the history of Banking goes back to the 14th century in Europe but Banks are now everywhere, Banks in Somaliland play a significant role compared to other financial Institutions.

Statement of the Problem

Despite of the central bank intervention to promote profitability of commercial banks in Somaliland, profitability of commercial banks in hargeisa has remained low. banks of Somaliland (2012) reports that the net profit margin, return on investment, return on equity are deteriorating among commercial banks in hargiesa. May be attributed largely to poor credit risk management that is why the researchers investigated the influence of credit risk management on profitability of commercial banks nin hargeisa Somaliland.

Research Objective

General Objectives

The study investigated the credit risk management and profitability commercial banks in Hargeisa , Somaliland.

Specific objectives

I. To determine the level of credit risk management in Hargeisa , Somaliland
II. To determine the level of profitability commercial banks in Hargeisa , Somaliland
III. To establish if there is a significant difference in the level of credit risk management and profitability in commercial banks in Hargeisa , Somaliland
IV. To establish if there is a significant relationship between the credit risk management and profitability commercial banks in Hargeisa , Somaliland

Research Questions

i. What is the level of credit risk management in Hargeisa , Somaliland?

ii. What is the level of profitability commercial banks in Hargeisa , Somaliland?

iii. What is the difference in the level of credit risk management and profitability in commercial banks in Hargeisa Somaliland?

iv. What is the relationship between the level of credit risk management and profitability commercial banks in Hargeisa , Somaliland

Hypothesis

H_{02}: There is a significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland.

Scope of study

Geographical scope

The research investigated the commercial banks operating in Hargeisa Somaliland

Theoretical scope

The Risk Management Theory as explained by Pyle (1997) was used by the researcher to guide the analysis on Credit Risk Management in Banks. The theory was developed by David H. at Pyle University of California and it was used to study why risk management is needed, and outlines some of the theoretical underpinning of contemporary bank risk management, with an emphasis on market and credit risks.

Content scope

The purpose of the study was to examine the impact of credit risk management and profitability of commercial banks and establish whether significance relationship between credit risk management and profitability of commercial banks and cause effect relationship between the independent variable and dependent variable.

Time scope
This research covers the period from **Feb** 2013 up to **dec** 2013.

Significance of the Study

This study may show a discrepancy, and may greatly contribute to the understanding role of commercial banks in Hargeisa , Somaliland. However, it will help increase broad understanding about the obstacles, the government and civil community is important to know the challenges faced by the commercial banks and also it helps the future researchers to get data and use it as reference. Finally, this study my serve as a literature review to other researchers, and students conducting their academic studies in the area of commercial banks.

1: **Governmen**t to understand the responsibilities of performance commercial banks and the intervention and make decision how to develop the central banks.

2: **the central government** was using the findings to regulate the activities of the commercial banks in order to carry out their activity.

3: **the managers of commercial** banks was aim the goal as effective and efficiency through delegation or transferring authority to the sub units or subordinates.

4: **The future researcher was** utilizing the findings of this study to embark on related study.

Operational Definitions of Key Terms

Credit risk management is defined as identification, measurement, monitoring and control of risk arising from the possibility of default in loan repayments.

Profitability is the efficiency of banks at generating earnings which was be measured by Profitability ratios which focus on profit of the bank.

Commercial bank An institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals, yet some may be members of the Federal Reserve System. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses.

CHAPTER TWO

REVIEW OF RELATED LITERATURE

Concepts, Opinions, Ideas from Authors/ Experts

Credit Risk

Credit risk is the possibility that the actual return on an investment or loan extended will deviate from that, which was expected (Conford, 2000). Coyle (2000) defines credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time. The main sources of credit risk include, limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, directed lending, massive licensing of banks, poor loan underwriting, reckless lending, poor credit assessment., no non-executive directors, poor loan underwriting, laxity in credit assessment, poor lending practices, government interference and inadequate supervision by the central bank.

Credit risk management is defined as identification, measurement, monitoring and control of risk arising from the possibility of default in loan repayments (Early, 1996; Coyle, 2000). Credit extended to borrowers may be at the risk of default such that whereas banks extend credit on the understanding that borrowers will repay their loans, some borrowers usually default and as a result, banks income decrease due to the need to provision for the loans. Where commercial banks do not have an indication of what proportion of their borrowers will default, earnings will vary thus exposing the banks to an additional risk of variability of their profits. Every financial institution bears a degree of risk when the institution lends to business and consumers and hence experiences some loan losses when certain borrowers fail to repay their loans as agreed.
Risks exposed to commercial banks threaten crises not only in the banks but to the financial market as a whole and credit risk is one of the threats to soundness of commercial banks. To minimize credit risk, banks are encouraged to use the "know your

customer" principle as expounded by the Basel Committee on Banking Supervision. (Kunt-Demirguc and Detragiache, 1997; Parry, 1999; Kane and Rice, 1998)

The key principles in credit risk management are; firstly, establishment of a clear structure, allocation of responsibility and accountability, processes have to be prioritized and disciplined, responsibilities should be clearly communicated and accountability assigned thereto (Lindergren, 1987). According to the Demirguc-Khunt and Huzinga (1999), the overwhelming concern on bank credit risk management is two-fold .First, the Newtonian reaction against bank losses, a realization that after the losses have occurred that the losses are unbearable. Secondly, recent developments in the field of financing commercial paper, securitization, and other non-bank competition have pushed banks to find viable loan borrowers. This has seen large and stable companies shifting to open market sources of finance like bond market. Organizing and managing the lending function in a highly professional manner and doing so pro-actively can minimize whatever the degree of risk assumed losses. Banks can tap increasingly sophisticated measuring techniques in approaching risk management issues (Gill, 1989).

Technological developments, particularly the increasing availability of low cost computing power and communications, have played an important supporting role in facilitating the adoption of more rigorous credit risk; implementation of some of these new approaches still has a long way to go for the bulk of banks. The likely acceleration of change in credit risk management in banks is viewed as an inevitable response to an environment where competition in the provision of financial services is increasing and, thus, need for banks and financial institutions to identify new and profitable business opportunities and properly measure the associated risks, is growing (Lardy, 1998; Roels et. al. 1990). Inevitably, as banks improve their ability to assess risk and return associated with their various activities, the nature and relative sizes of the implicit internal subsidies will become more transparent. Brown and Manassee (2004) observe that credit risk arose before financing of business ventures.

Banks and other intermediaries can transfer the payment delays and the credit risk among producers, or between producers and outside investors (Demirguc-kunt and Huzinga, 2000).

The lending policy should be in line with the overall bank strategy and the factors considered in designing a lending policy should include; the existing credit policy, industry norms, general economic condition in the country and the prevailing economic climate. According to Simonson et al (1986), sound credit policy would help improve prudential oversight of asset quality, establish a set of minimum standards, and to apply a common language and methodology (assessment of risk, pricing, documentation, securities, authorization, and ethics), for measurement and reporting of non-performing assets, loan classification and provisioning. The credit policy should set out the bank's lending philosophy and specific procedures and means of monitoring the lending activity. Credit control policy is the general guideline governing the process of giving credit to bank customers. The policy sets the rules on who should access credit, When and why one should obtain the credit including repayment arrangements and necessary collaterals, the method of assessment and evaluation of risk of each prospective applicant are part of a credit control policy.

According to Simonson et al (1986), sound credit policy would help improve prudential oversight of asset quality, establish a set of minimum standards, and to apply a common language and methodology (assessment of risk, pricing, documentation, securities, authorization, and ethics), for measurement and reporting of non-performing assets, loan classification and provisioning. The credit policy should set out the bank's lending philosophy and specific procedures and means of monitoring the lending activity. The guiding principle in credit appraisal is to ensure that only those borrowers who require credit and are able to meet repayment obligations can access credit. Lenders may refuse to make loans even though borrowers are willing to pay a higher interest rate, or, make loans but restrict the size of loans to less than the borrowers would like to borrow (Mishkin, 1997). Financial institutions engage in the second form of credit rationing to reduce their risks.

Credit standard there is a long list of standards, not necessarily mutually exclusive, that are given varying degrees of importance in judging applications for installment credit. Conspicuous in the list are such factors as: collateral, or durability and resale value of commodity; cash selling price of commodity; size of down payment that the buyer-borrower is willing to make; the time he needs in order to repay his debt (length of contract); ratio of monthly payment to monthly income; occupation of buyer-borrower; permanence of employment as indicated by employment record; previous installment payment record with lender; past debt payment record generally; extent of present indebtedness, installment, and other; personal character of applicant; and permanence of residence or ownership of home. Information pertinent to some Of these items is obtained directly from the contract; other items are covered in the customer's credit application blank; still others necessitate reference to friends, relatives, credit bureaus or business establishments with which the customer has had dealings. Credit terms these are stipulations under which a firm grants credit to customers the firm should try as much as possible to make terms more attractive to act as an incentive to client without incurring unnecessary high level of bad debts

Collection policy The Collection policy division is structured to provide the best use of resources, both in terms of staff and finances. Our staffs have a high level of expertise and experience in collection management issues and are committed to delivering the best Possible Library services to our customers. We are also keen to explore opportunities for partnerships and collaboration at local, regional, national and international levels both to improve services and to promote the Library.

Managing credit risk

As to Laurent Clerc (2004) Participants analyzed the different risk management techniques by taking a look at the following two aspects: the emergence of a risk culture and the prevention of risk by building up regulatory capital in proportion to the level of risk exposure of each credit institution. Pillar 1 of the new Basel II framework provides banks with several options for calculating their capital requirements relative to their credit risk and their operational risk. The most innovative one is the possibility that banks have been given of using under the control of the supervisory authorities their internal assessment systems. Because calibrating these models tends to come up against the problem of the reliability and availability of data in some emerging economies, the Basel Committee has proposed a simplified standardized approach designed specifically for these economies.

The development of credit derivatives markets is taken into account when drawing up standards that better capture risk and recognizing the most advanced techniques at the prudential level. The following conclusions were drawn from the presentation of the results of the survey conducted under the aegis of the ESCB Banking Supervision Committee: the liquidity of credit derivatives markets has increased sharply, and, contrary to expectations, the transfer of credit risk to insurance companies has marked time. In Europe, activity thus appears to be principally concentrated in the banking sector.

The most standardized instruments, such as credit default swaps (CDSs) account for the lion's share of transactions. As yet, credit risk transfer activities do not appear to have substantially impacted European banks provisioning needs over the last business cycle. However, a few aspects remain unclear. They relate to the amounts actually transferred and the complexity of some of the instruments used, such as the CDOs of CDOs (Collateralized Debt Obligations), which seem particularly obscure.

Participants also commented on the decision taken by the Basel Committee in October 2003 to calibrate capital requirements against unexpected losses. This mechanism could have penalized banks that make greater provisions for their expected losses and resort more to dynamic provisioning. In order to prevent this undesirable effect from arising, excess provision amounts are to be integrated into banks' additional capital up to a certain limit, while any shortfall of provision amounts compared with expected losses is to be deducted from banks' own funds, up to 50% from their core capital (*Tier 1*) and 50% from their additional capital (*Tier 2).*

Credit assessment & risk grading

Credit assessment

A thorough credit and risk assessment should be conducted prior to the granting of loans, and at least annually thereafter for all facilities. The results of this assessment should be presented in a Credit Application that originates from the relationship manager/account officer, and is approved by Credit Risk Management (CRM). The RM should be the owner of the customer relationship, and must be held responsible to ensure the accuracy of the entire credit application submitted for approval.

RMs must be familiar with the bank's Lending Guidelines and should conduct due diligence on new borrowers, principals, and guarantors.

It is essential that RMs know their customers and conduct due diligence on new borrowers, principals, and guarantors to ensure such parties are in fact who they represent themselves to be. All banks should have established Know Your Customer (KYC) and Money Laundering guidelines which should be adhered to at all times. Credit Applications should summaries the results of the RMs risk assessment and include, as a minimum, the following details: Amount and type of loan(s) proposed.

- Purpose of loans.
- Loan Structure (Tenor, Covenants, Repayment Schedule, Interest)
- Security Arrangements In addition, the following risk areas should be addressed

Borrower Analysis: The majority shareholders, management team and group or affiliate companies should be assessed. Any issues regarding lack of management depth, complicated ownership structures or inter group transactions should be addressed, and risks mitigated.

Industry Analysis: The key risk factors of the borrower's industry should be assessed. Any issues regarding the borrower's position in the industry, overall industry concerns or competitive forces should be addressed and the strengths and weaknesses of the borrower relative to its competition should be identified.

Supplier/Buyer Analysis: Any customer or supplier concentration should be addressed, as these could have a significant impact on the future viability of the borrower.

Historical Financial Analysis: An analysis of a minimum of 3 years historical financial statements of the borrower should be presented. Where reliance is placed on a corporate guarantor, guarantor financial statements should also be analyzed. The analysis should address the quality and sustainability of earnings, cash flow and the strength of the borrower's balance sheet. Specifically, cash flow, leverage and profitability must be analyzed.

Projected Financial Performance: Where term facilities (tenor > 1 year) are being proposed, a projection of the borrower's future financial performance should be provided, indicating an analysis of the sufficiency of cash flow to service debt repayments. Loans should not be granted if projected cash flow is insufficient to repay debts.

Account Conduct: For existing borrowers, the historic performance in meeting repayment obligations (trade payments, Cheques, interest and principal payments, etc) should be assessed.

Adherence to Lending Guidelines: Credit Applications should clearly state whether or not the proposed application is in compliance with the bank's Lending Guidelines. The Bank's Head of Credit or Managing Director/CEO should approve Credit Applications that do not adhere to the bank's Lending Guidelines.

Mitigating Factors: Mitigating factors for risks identified in the credit assessment should be identified. Possible risks include, but are not limited to: margin sustainability and/or volatility, high debt load (leverage/gearing), overstocking or debtor issues; rapid growth, acquisition or expansion; new business line/product expansion; management changes or succession issues; customer or supplier concentrations; and lack of transparency or industry issues.

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Financial intermediation is essential for economic development. The international banking industry has undergone substantial structural reforms over the last two decades. There have been fundamental changes in the behavior of banks with more emphasis on profitability and comprehensive asset management in recent period. It is particularly important for emerging countries to ensure that the banking system is stable and efficient. Such a banking development should lead to private and infrastructural projects being financed effectively and allocated efficiently. As Albertazzi and Gambacorta (2009) argue, because of phenomena such as globalization, growing international financial markets, deregulation and advances in technology, identifying the determinants of bank performance is an important predictor of unstable economic conditions. Athanasoglou et al. (2008) also point out that a profitable banking system is likely to absorb negative shocks, thus maintaining the stability of the financial system. In this respect, it is important to investigate the effectiveness of emerging banks. How banks are affected by increased competitive pressures, depends partly on how efficiently they are run. Banks can increase their profitability through either improvement of their cost efficiency or exerting their market power. The latter approach to make profit can reduce total social welfare.

The term profit is an accounting concept which shows the excess of income over expenditure viewed during a specified period of time. Profit is the main reason for the continued existence of every commercial organization. On the other hand, the term profitability is a relative measure where profit is expressed as a ratio, generally as a percentage. Profitability depicts the relationship of the absolute amount of profit with various other factors. Profitability is a relative concept which is quite useful in decision-making. Another main issue here is profit planning, which consists of various steps to be taken to improve the profitability of the bank.

Profitability is the most important and reliable indicator as it gives a broad indication of the ability of a bank to raise its income level. Profitability of banks is affected by a number of factors. Some of these are endogenous, some are exogenous and yet structural.

As financial intermediaries, banks play a crucial role in the operation of most economies. Recent research, as surveyed by Levine (1996), has shown that the efficacy of financial intermediation can also affect economic growth. Crucially, financial intermediation affects the net return to savings, and the gross return for investment. The spread between these two returns mirrors the bank interest margins, in addition to Transaction costs and taxes borne directly by savers and investors, this suggests that bank interest spreads can be interpreted as an indicator of the efficiency of the banking system.

Commercial banks are in the risk business. In the process of providing financial services, they assume various kinds of financial risks. Over the last decade our understanding of the place of commercial banks within the financial sector has improved substantially.

Over this time, much has been written on the role of commercial banks in the financial sector, both in the academic literature and in the financial press. These arguments will be neither reviewed nor enumerated here. Suffice it to say that market participants seek the services of these financial institutions because of their ability to provide market knowledge, transaction efficiency and funding capability. In performing these roles they generally act as a principal in the transaction. As such, they use their own balance sheet to facilitate the transaction and to absorb the risks associated with it (Santomero 1997).

To be sure, there are activities performed by banking firms which do not have direct balance sheet implications. These services include agency and advisory activities such as; (i) Trust and investment management, (ii) private and public placements through "best efforts" or facilitating contracts, (iii) standard underwriting through Section 20 Subsidiaries of the holding company, or (iv) the packaging, securitizing, distributing and servicing of loans in the areas of consumer and real estate debt primarily.

These items are absent from the traditional financial statement because the latter rely on generally accepted accounting procedures rather than a true economic balance sheet. Nonetheless, the overwhelming majority of the risks facing the banking firm is in on-balance-sheet businesses. It is in this area that the discussion of risk management and the necessary procedures for risk management and control has centered. Accordingly, it is here that our review of risk management procedures will concentrate.

The determinants of banks' profitability are usually assorted into internal and external factors. Some studies were country specific and few of them considered panel of countries for reviewing the determinants of profitability. Overall these studies propose that the determinants of profitability for bank can be divided into two groups;

Internal and external factors These studies specify return on asset (ROA), return on equity (ROE), return on capital employed (ROCE) and net interest margin (NIM) as the dependent variables and considering the internal and external factors as independent variables.

Bank profits can also be improved by using advanced technologies in communication, information and financial technologies. The use of advanced technologies will improve the efficiency of banking operations. As a result, the cost-to income ratio (BOPO), as a proxy of operational efficiency, will decline and the impact on bank profits increase (Trujilo-Ponce, 2012).

Bank profitability is usually measured by the return on average assets and is expressed as a function of internal and external determinants. The internal determinants include bank-specific variables. The external variables reflect environmental variables that are expected to affect them profitability of financial institutions.

In most studies, variables such as bank size, risk and overhead costs are used as internal determinants of banking profitability. Pasiouras and Kosmidou (2007) find a positive and significant relationship between the size and the profitability of a bank.

Other authors, such as Berger et al. (1987), provide evidence that costs can be reduced only slightly by increasing the size of a bank and that very large bank are often even facing scale inefficiencies. Micco et al. (2007) find no correlation between the relative bank size and the ROAA for banks, i.e., the coefficient is always positive but never statistically significant.

Commercial banks are the foundation of the payment system in many economies by playing an intermediary role between savers and borrowers. They further enhance the financial system by ensuring that financial institutions are stable and are able to effectively facilitate financial transactions. The main challenge to commercial banks in their operations is the disbursement of loans and advances. There is need for commercial banks to adopt appropriate credit appraisal techniques to minimize the possibility of loan defaults since defaults on loan repayments leads to adverse effects such as the depositors losing their money, lose of confidence in the banking system, and financial instability (Central Bank of Kenya, 1997). Commercial banks adopt different credit risk management policies majorly determined by; ownership of the banks (privately owned, foreign owned, government influenced and locally owned), credit policies of banks, credit scoring systems, banks regulatory environment and the caliber of management of the banks. Banks may however have the best credit management policies but May not necessarily record high profits. Profitability has largely focused on returns on bank asset or equity and net interest margin. Also, traditionally, the impact on banks' performance has been measured by bank-specific factors such as capital adequacy, credit risk, liquidity risk, market power and regulatory costs.

Bank risk management systems

The banking industry has long viewed the problem of risk management as the need to control four of the above risks which make up most, if not all, of their risk exposure, viz., credit, interest rate, foreign exchange and liquidity risk. While they recognize counterparty and legal risks, they view them as less central to their concerns. Where counterparty risk is significant, it is evaluated using standard credit risk procedures, and often within the credit department itself. Likewise, most bankers would view legal risks as arising from their credit decisions or, more likely, proper process not employed in financial contracting.

Accordingly, the study of bank risk management processes is essentially an investigation of how they manage these four risks. In each case, the procedure outlined above is adapted to the risk considered so as to standardize, measure, constrain and manage each of these risks. To illustrate how this is achieved, this review of firm-level risk management begins with a discussion of risk management controls in each area. The more difficult issue of summing over these risks and adding still other, more amorphous, ones such as legal, regulatory or reputational risk, will be left to the end (Santomero, 1997).

Credit risk management for banks

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

Credit Risk Models

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

However, before a portfolio modeling approach could be used in the formal process of setting regulatory capital requirements for credit risk, regulators would have to be confident not only that models are being used to actively manage risk, but also that they are conceptually sound, empirically validated, and produce capital requirements that are comparable across institutions. At this time, significant hurdles, principally concerning data availability and model validation, still need to be cleared before these objectives can be met, and the committee sees difficulties in overcoming these hurdles in the timescale envisaged for amending the capital accord. Credit scoring models use data on observed borrower characteristics either to calculate the probability of default or to borrowers into different default risk classes (Saunders and Cornett, 2007).

Theoretical Perspective

The theory use by the researcher is Bank Risk Management Theory. It was developed by David H. at Pyle University of California and it was used to study why risk management is needed, and outlines some of the theoretical underpinning of contemporary bank risk management, with an emphasis on market and credit risks. This theory indicates that credit and market risks management have an effect directly or indirectly on the banks survival. As was be applied to this study, this theory holds that researcher would expect the independent variables credit risk management to influence or explain the dependent variable which are banks profitability because, according to Pyle (1997); without effective and efficient credit risk management, banks profitability, liquidity and solvency are unthinkable.

Related Studies

According to Chen and Pan (2012), credit risk is the degree of value fluctuations in debt instruments and derivatives due to changes in the underlying credit quality of borrowers and counterparties. Coyle (2000) defines credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time.

According to Lindergren (1987), the key principles in credit risk management process are sequenced as follows; establishment of a clear structure, allocation of responsibility, processes have to be prioritized and disciplined, responsibilities should be clearly communicated and accountability assigned.

According to Simonson et al (1986), sound credit policy would help improve prudential oversight of asset quality, establish a set of minimum standards, and to apply a common language and methodology (assessment of risk, pricing, documentation, securities, authorization, and ethics), for measurement and reporting of non-performing assets, loan classification and provisioning

According to Ssewagudde (2000), the business of banking is measuring and accepting risk. Because the major risk faced by commercial banks is the credit risk. Credit risk can be interchangeable called loan default risk. Guidelines and procedures to measure and contain default risk are explained in the next subsection as part of commercial bank credit policy, procedures and guidelines.

According to Bonnevie (2003) and Vanden (2004), risk appetite is the degree to which an organization links its objectives and goals to risk finally, this phase is characterized with the identification and deciding of the tools to be used in measuring monitoring and controlling risk and how to integrate them into other organizational processes.

According to Kohn (2003), and Brealy et al (1991), commercial banks like any other financial institutions are exposed to a number of different risks. These include liquidity risk. Interest rate risk, inflation risk, financial risk and credit risk. One or a combination of these risks impact in one way or another on the performance of a commercial bank this study is exclusively on credit risk management

Molyneux and Thornton (1992), Demirguc-Kunt and Huizinga (1999), and Micco et al.(2007). Following these studies and in accordance with the majority of other research analyzing the determinants of bank profitability, our paper uses a linear model to estimate the impact of various bank- and market-specific factors on the profitability of commercial banks. However, our study differs from the above papers in several important aspects and adds several key aspects to the existing literature on banking performance.

According to Kohn (2003), and Brealy et al (1991), commercial banks like any other financial institutions are exposed to a number of different risks. These include liquidity risk. Interest rate risk, inflation risk, financial risk and credit risk. One or a combination of these risks impact in one way or another on the performance of a commercial bank this study is exclusively on credit risk management.

Research Gaps

The study examined several theories that support a positive relationship between credit risk management and banks profitability. However, this study did not examine the impact on the level of profitability in the context of other macro-level factors. Instead, the design was focused on bank level factors as captured in on a five-point Likert Scale of opinion ranks. Further, the literature review did not identify any other research study that used a technique which took into account the macroeconomic, bank-specific, regulatory and institutional factors in Somaliland. The future of financial institutions in Somaliland will depend to a large extent on how well they manage risks in a wider context. Future studies should be therefore designed to examine both internal and external factors such as the bank's market position, trade area, staff capabilities and technology that were not addressed in this study, and therefore future studies are required to close these gaps.

CHAPTER THREE

METHODOLOGY

Research Design

The study was quantitative and a descriptive co relational design. The descriptive correlation quantitative design was used to establish the relationship between the independent and dependent variable through quantitative results. Descriptive studies are non-experimental researches that describe the characteristics of a particular individual, or of a group. It deals with the relationship between variables, testing of hypothesis and development of generalizations and use of theories that have universal validity. It also involves events that have already taken place and may be related to present conditions Kothari, (2004). The unit of analysis was an individual commercial bank in the study sample.

Research Population

The study was focused on three commercial banks in Hargeisa Somaliland, the target was be include the total number of 90 staff which including (Dahabshiil bank 35, salaama bank 30 and cooperate and agricultural 25) and 70 senior management. There for the total number of target population was one hundred sixty (160), the researcher were chosen commercial banks workers because he believes that they have sufficient, reliable and accurate information about the commercial banks and their happiness or depresses. Special considerations were given to the knowledge and skills of the respondents in relation to the variables under study and the for gender observance.

Sample Size

A total of 114 subjects were selected using The Sloven's formula to determine the minimum sample size. Table 1 below shows the respondents of the study with the following categories.

$$n = \frac{N}{1+N e^2}$$

N: sample size
n: population
e: level of significance

N = 160

n = 114

$$n = \frac{N}{1+Ne^2} = n = \frac{160}{1+160(0.0025)} = 160/1.4 = 114.285$$

Therefore, sample size = 114 (approximately)

Table 1

Respondents of the Study

Categories	**Target population**	**Sample size**	**Sampling methods**
1. Salaama Bank	45	32	Stratified
2. Dahabshiil Bank	55	39	Stratified
3. Cooperative and agricultural credit	60	43	Stratified
Total	**160**	**114**	

Source: Primary source 2013

Sampling Procedure

Stratified sampling technique was used to select the respondents included in the sample. Stratified sampling was used to make sure that the target population was divided into different homogenous strata and that each stratum was represented in the sample in a proportion equivalent to its size in the accessible population.

The study used stratified sampling which was proportionate to stratum size to reach as the sample of each strata using a fraction 114/160 * population of each stratum Amin (2005).

Research Instrument

The research tools that were utilized in this study include the following:

(1) Face sheet to gather data on the respondent's demographic characteristics (gender, age, qualifications and number of year's experience);

(2) Researcher devised questionnaires to determine the levels of credit risk management and profitability commercial banks.

Validity and Reliability of the Instrument

In this research validity of the respondent's instruments questionnaire was established through a content validity index, CVI given the instrument to expert in his/her field and they judge whether the instrument is valid or not. The researcher was computed the content validity from experts judgments by using content validity index formula

$$CVI = \frac{\text{Number of questions declared valid}}{\text{Total number of questions}}$$

The test-retest technique was used to determine the reliability (accuracy) of the researcher devised instruments to eight qualified respondents. These respondents were not being included in the actual study. In this test- retest technique, the questionnaires was administered twice to the same subjects.

Data Gathering Procedures

Before the administration of the questionnaires

1: the researcher was got an introduction letter was obtained from the College of Higher Degree and Research of Kampala International University, for the researcher to solicit approval to conduct the study from respective respondents.

2: When approved, the researcher was use the purposive sampling to get qualified respondents from target population and to arrive at the minimum sample size.

3: the respondents will be explaining about the study and was be requested to sign the informed consent form (appendix 3).

4. Reproduce more than enough questionnaires for distribution.

5. Select research assistants who would assist in the distribution and collection of the data; brief and orient them in order to be consistent in administering the questionnaires.

During the administration of the questionnaires

1. The respondents being requested to answer completely and not to leave any part of the questionnaires unanswered.

2. The researcher's assistants emphasizing retrieval of the questionnaires within five days from the date of distribution.

3. On retrieval, all returned a questionnaire was being checked if all are answered by assistants.

After the administration of the questionnaires

After the receiving the questionnaires back in a time, the researcher will check the completeness of all answers that whether the respondents answered the entire questionnaire. After checking the researcher will arrange the data and edit the data for the errors and completeness of whether the respondents have left unfulfilling questionnaires.

Data Analysis

The frequency and percentage distribution was used to determine the profile of respondents. The mean and standard deviations was used for the levels of credit risk management and profitability commercial banks delivery that is to demonstrate the strengths and the weaknesses of the credit risk management and profitability commercial banks. From these strengths and weaknesses, the recommendations will be derived. The unit of analysis was a single commercial bank in Hargesia.

Statistical Package for Social Science (SPSS) was used to analyze if there is significant relationship in the level of credit risk management and profitability commercial banks delivery on their profile characteristics.

A: level of credit risk management

Mean Range	**Response Mode**	**Interpretation**
3.26 – 4.00	strongly agree	very satisfaction
2.51 – 3.25	Agree	satisfactory
1.76 – 2.50	Disagree	fair
1.00 – 1.75	strongly disagree	poor

B: level of profitability of commercial banks

Mean Range	**Response Mode**	**Interpretation**
3.26 – 4.00	strongly agree	very satisfaction
2.51 – 3.25	Agree	satisfactory
1.76 – 2.50	Disagree	fair
1.00 – 1.75	Strongly Disagree	poor

Ethical Considerations

Bearing in mind the ethical issues, the researcher provided the respondents with the necessary information as regards the main purpose of the research, expecting duration and procedures to following, and be in position to keep privacy and not disclose the confidentiality of respondents and researchers responsibility.

Limitations of the Study

The following are some of antitrade that out to the validity of the research

Extraneous variables: This was beyond the researcher's control such as respondents' honesty, personal biases and uncontrolled setting of the study

Testing: The use of research assistants can bring about inconsistency in the administration of the questionnaires in terms of time of administration, understanding of the items in the questionnaires and explanations given to the respondents. To minimize this threat, the research assistants was oriented and briefed on the procedures to be done in data collection.

Attrition/Mortality: Not all questionnaires maybe returned neither completely answered nor even retrieved back due to circumstances on the part of the respondents such as travels, sickness and refusal/withdrawal to participate. In anticipation to this, the researcher will reserve more respondents by exceeding the minimum sample size. The respondents will also be reminded not to leave any item in the questionnaires unanswered and will be closely followed up as to the date of retrieval.

Environmental challenges which can disturb that researcher were not able to collect data from the respondents because there is a some sensitive areas where by respondents can against this study.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTERPRETATION OF DATA

INTRODUCTION

This chapter presents the presentation of data analysis and interpretation.

The data analysis and interpretation was based on the research questions as well as research objectives, the presentation was divided in two parts. The first part presents the respondents profile or demographic information, while the second part deals with presentation, interpretation and analysis of the research questions and objectives.

Demographic information of the respondent

This part presents the background information of respondent who participated in the study. The purpose of this background information was to find out the characteristic of respondents and show the distribution of the population in the study.

In addition to that, the first objectives of this study was to determine the profile of respondent as to Age, Gender, and experience to what category the majority of the respondents are fit in. data on this objectives was analyzed under the question what are the demographic characteristics of the respondent as to Age, Gender, education and number years work experience

Table: 2

Profile of Respondent
Demographic Characteristics of the Respondents

Category	Frequency	Percentage %
Sex		
Male	57	50.0%
Female	57	50.0%
Total	**114**	**100%**
Age		
18-20	22	19.3%
21-30	39	34.2%
31-40	43	37.7%
41-50	8	7.0%
51 and above	2	1.8%
Total	**114**	**100%**
Educational Qualifications		
Certificate	13	11.4%
Diploma	22	19.3%
Bachelors	36	31.6%
Masters	36	31.6%
PhD	7	6.1%
Total	**114**	**100%**
Number of work experienced		
6 months -1 year	47	41.2%
2 years - 4 years	38	33.3%
5 years - 7 years	22	19.3%
8 years and above	7	6.1%
Total	**114**	**100%**

Source: Primary Data 2013

The data presented above indicates that the gender distribution was equal (50.0% male and 50.0% female) in the 114 sample. The estimates of the number of men and women are consistent with the known totals of men and women, and to the extent that sex is related to the number and proportion of 114 savers and borrowers in the study sample.

The majority of the study respondents were in the 31-40 age groups (37.7%). The 21-30 age groups was the second with 34.2% while 18-20 was the third with 19.3%. The least were in the 41-50 (7.0%) and the 51 and above category (1.8%).58% of the respondents said they were married while 56% said they were single.

The majority of the respondents said they held first degree or a Masters (31.6% each). These two categories represented 63.2% of the entire sample. PhD degrees were the least with 6.1%.

The majority had worked for between 1-2 years (44.7%) and 1-2 years (29.8%). Those who said they had worked for 7 and above years were the least, representing 3.5% of the total respondents.

The majority of the respondents had worked for less than a year (47%). Those who had worked for 2 - 4 years where 38%, the least had worked for 8 years and above

Table 3

Level of Credit Risk Management in Selection Commercial Banks in Hargeisa Somaliland

Lending Policy

	Indicator	**Mean score**	**Interpretation**	**Rank**
1.	The Board Credit Committee is often involved in selecting loan applicants	2.18	Fair	11
2.	The company observes the limit set for total loan given out at any time.	2.54	Satisfactory	6
3.	There is efficiency in the company's policy on loan portfolio	2.65	very satisfactory	3
4.	The interest rate charged on various types of loans cover the cost and meet good profit margin	2.45	Satisfactory	7
5.	The company's lending policy is periodically reviewed to reflect the prevailing conditions	2.71	Satisfactory	1
6.	The company's portfolio is balanced to reflect different types of loans.	2.33	Fair	10
7.	The lending authority/ loan approval is decentralized	2.45	Fair	8
8.	The institution utilizes information from reference bureaus in appraising the customer credit	2.45	Fair	9
9.	Information sharing adds value with regard to quality of customers being granted credit.	2.67	Satisfactory	2
10.	The rate of defaulting by customers been minimized with the use of information sharing.	2.58	Satisfactory	4
11.	The institution informs customers that the bank is seeking reference information regarding their past loan servicing.	2.54	Satisfactory	5
	Overall mean	**2.50**	**Satisfactory**	

Source: primary data 2013

Responses on 11 questions regarding the lending policy were tabulated in frequencies. The mean responses on indicated that most clients were satisfied. It can therefore be stated that the bank has tried to initiate suitable lending policies that helps it to minimize on the negative effects. This may have been achieved through a strict supervision that discourages poor credit assessment. A summary of the responses are given in the frequency tables below.

Credit Standards

	Indicator	Mean score	Interpretation	Rank
1.	The institution relies on the applicants financial statements when appraising credit allocation	2.70	Satisfactory	1
2.	The institution takes the following factors into account in loan appraisal:			
a)	Character/ Integrity	2.48	Fair	10
b)	Capacity	2.52	Satisfactory	8
c)	Collateral/security	2.54	Satisfactory	6
d)	Capital/contribution	2.60	Satisfactory	3
e)	Cash flow statements	2.61	Satisfactory	2
f)	Trade and bank reference about the loan applicant	2.52	Satisfactory	9
3.	The institution is highly rated in terms of credit appraisal and loan approval	2.59	Satisfactory	4
4.	The institution's lending policy support increased revenue to the company.	2.53	Satisfactory	7
5.	There are few or no loan defaulters due to the institution's efficient lending policy	2.54	Satisfactory	6
	Overall mean	**2.56**	**Satisfactory**	

Source: primary data 2013

Responses on 5 questions with a total of 11 items regarding the credit standard were tabulated in frequencies to examine the possibility of the actual return on an investment deviating from the expected. The mean responses, like the lending policy, also indicated that most clients were satisfied.

Therefore, it was an indication that most Banks in Somaliland had taken some measures to reduce credit risks such as limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, etc., etc. (Conford, 2000). A summary of the responses are given in the frequency tables below.

Credit Terms

	Indicator	Mean score	Interpretation	Rank
1.	The institution strictly observe the credit terms.	2.52	Satisfactory	4
2.	The institution relaxes credit terms with regard to clients who are consistently paying their loan.	2.50	Fair	5
3.	Risk assessment is a priority in appraising credit	2.52	Satisfactory	3
4.	The institution's risk management policy serves its purpose.	2.63	Satisfactory	2
5.	The institution is able to recognize your good customers	2.75	Satisfactory	1
6.	The institution always relies on previous record in approving the loan.	2.46	Fair	6
	Overall mean	**2.56**	**Satisfactory**	

Source: Primary Data 2013

Responses on 6 questions regarding the credit terms were tabulated in frequencies to examine the possibility of the actual return on an investment deviating from the expected. The mean responses, like the lending policy, also indicated that most clients were satisfied. The fact that none of the mean ranks on credit terms were rated as "unsatisfactory" shows an overwhelming confidence of the customers in the credit terms set by the Banks in Somaliland.

Indications are that some credit-related factors such as; the need for collateral, durability and resale value of commodity; cash selling price of commodity; size of down payment that the buyer-borrower is willing to make; the time he needs in order to repay his debt (length of contract); etc., etc. have been restructured accordingly so as to meet the requirements of most banking clients without risking a high level of bad debts.

Collection Policy

	Indicator	Mean score	Interpretation	Rank
1.	The institution is efficient in collecting its due debts.	2.56	Satisfactory	5
2.	The institution observes the collection period given to each client.	2.56	Satisfactory	6
3.	There are systematic written down steps in the handling of defaulting customers.	2.60	Satisfactory	3
4.	The institution very often takes defaulting clients to court	2.68	Satisfactory	2
5.	There is efficiency in the keeping of client statements	2.70	Satisfactory	1
6.	Clients are encouraged to reconcile their statements with the institution	2.51	Satisfactory	7
7.	Analysis outstanding credit to total deposits done regularly	2.58	Satisfactory	4
	Overall mean	**2.60**	**Satisfactory**	

Source: Primary Data 2013

Responses on 7 questions regarding the collection policy were tabulated in frequencies to examine if the bank was efficient in collecting its due debts. All responses in this category were ranked as "satisfactory". This implies that the existing credit and collection policy is effective. These findings highlighted the importance of efficiency in collecting debts, efficiency in the keeping of client statements as well as the reconciliation of clients' statements with the institution. Frequency scores for mean ranks on collection policy are given in the table below.

Level of Profitability of Commercial Banks

	Indicator	Mean score	interpretation	Rank
1.	Doubtful loans and net losses	2.38	Fair	6
2.	Provision for bad loans	2.52	Satisfactory	4
3.	Bad debts written off	2.46	Fair	5
4.	Return on equity	2.56	Satisfactory	2
5.	Return on assets	2.70	Satisfactory	1
6.	Banks size	2.54	Satisfactory	3
	Overall mean	**2.60**	**Satisfactory**	

Source: Primary Data 2013

Responses on 6 questions regarding the level of profitability were tabulated in frequencies to examine if the bank was profitable in its operations. Most of the mean ranks were rated as "satisfactory". Considering that profitability is a major factor for all banking institutions. These study findings contributed to the researchers ability to determine the relationship between the credit risk management and profitability of commercial banks in Hargeisa , given that profitability of a banks depends on clients perception of its' operations.

Relationship between credit risk management and profitability of commercial banks in Hargeisa , Somaliland

To determine the relationship between credit risk management and the profitability of commercial banks, an analysis was done to generate the following:

1) Spearman's Rank Coefficients for credit risk management and banks' profitability measures
2) ANOVA statistics for testing the equality of means
3) Chi-square test of Independence

Spearman's Rank Coefficients

Correlations				
			character/integrity	return on assets
Spearman's rho	character/integrity	Correlation Coefficient	1.000	-.148
		Sig. (2-tailed)	.	.117
		N	114	114
	return on assets	Correlation Coefficient	-.148	1.000
		Sig. (2-tailed)	.117	.
		N	114	114

Source: Primary Data 2013

The computed Spearman's rho of -.148 indicates a weak negative correlation between the two variables (credit risk management and commercial banks' profitability). By interpretation, this indicates that the two variables are not positively related. As explained by Achou and Tenguh (2008), better Credit Risk Management should result in better bank profitability. However, it was also strongly noted that other studies (See: Nissanke and Aryeetey, 1998; Aryeetey et al.; 1997) have noted, some bank level as well as macroeconomic factors are important in explaining commercial banks' profitability.

ANOVA Statistics

The analysis of variance was done to generate a p-value which informs us if the means are significantly different from each other and how well the model fits the data.

ANOVA					
character/integrity					
	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	.762	3	.254	.305	0.822
Within Groups	91.703	110	.834		
Total	92.465	113			

The analysis of variance (One-Way ANOVA) was used to compare the means ranks of the credit risk management and profitability.

Hypothesis

H_0: $\mu 1 = \mu 2$ (The mean ranks of credit risk management and commercial banks profitability are equal)

Ha: All means are not equal (The mean ranks of credit risk management and commercial banks profitability are NOT equal)

Decision rule:

If P-value is less than or equal to the a-level (a-level of 0.05), one or more means are significantly different.

If P-value is larger than the a-level (a-level of 0.05), the means are not significantly different.

Results:

The computed P-Value of .305 is greater than the alpha of 0.05.

Conclusion

The means are significantly different. The mean ranks of credit risk management and commercial banks profitability are significantly different. We reject the NULL hypothesis.

Chi-square test of Independence

Chi-Square Test was used to generate two statistics which were used to determine if the credit risk management and commercial banks profitability are independent or associated, a chi-square and a p-value. The Chi-Square Test generated the p-values which were to decide whether the credit risk management and commercial banks profitability are associated:

Chi-Square Tests			
	Value	Df	Asymp. Sig. (2-sided)
Pearson Chi-Square	4.539[a]	9	.872
Likelihood Ratio	4.436	9	.880
Linear-by-Linear Association	.267	1	.605
N of Valid Cases	114		
a. 6 cells (37.5%) have expected count less than 5. The minimum expected count is 2.81.			

The output was interpreted in terms of the Chi-statistics such as Pearson Chi-Square p-value, Cramer's and Phi statistics to determine the strength of association

Hypothesis

H_{o1}: There is a significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland.

H_{o2}: There is no significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland

Decision Rule:

If the computed p-value is less than or equal to chosen a-level (a-level of 0.05), it is concluded that the Credit Risk Management and the Bank's Profitability are associated.

If the computed p-value is greater than chosen a-level (a-level of 0.05), it cannot be conclude that the Credit Risk Management and the Bank's Profitability are associated.

Results:

Pearson chi2 (9) = 4.5391 and Pr = 0.872. The Pearson Chi-Square p-value obtained (0.872) is greater than 0.05, which indicates that the Credit Risk Management and the Bank's Profitability are associated are not associated.

The Cramer's V value of .115 also indicated a very weak association between Credit Risk Management and the Commercial bank's profitability.

Conclusion:

There is no significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland.

CHAPTER FIVE

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

FINDINGS

This study was guided four objectives which comprised of this chapter the first objectives of study was To determine the demographic profile of respondent in terms of Age, Gender, Education In the study sample 114 respondents were selected with an equal number of male and female.

The majority of the study respondents were in the 31-40 age groups (37.7%). The 21-30 age groups was the second with 34.2% while 18-20 was the third with 19.3%. The least were in the 41-50 (7.0%) and the 51 and above category (1.8%). 58% of the respondents said they were married while 56% said they were single.

The majority of the respondents said they held first degree or a Masters (31.6% each). These two categories represented 63.2% of the entire sample. PhD degrees were the least with 6.1%.

The majority had worked for between 1-2 years (44.7%) and 1-2 years (29.8%). Those who said they had worked for 7 and above years were the least, representing 3.5% of the total respondents.

The majority of the respondents had worked for less than a year (47%). Those who had worked for 2 - 4 years where 38% the least had worked for 8 years and above

The second objectives was To determine the level of credit risk management in Hargeisa , Somaliland, It was concluded that the level of credit risk management in commercial banks in Somaliland was high with each institution assessing the client's credit worth of satisfactorily. Commutatively, 97.56% of the respondents approved the credit risk management by the banks as either "satisfactory" or "fair". The rest (2.44%) rated it as "very satisfactory." None of the clients were dissatisfied with commercial banks credit policies.

To determine the level of credit risk management in Hargeisa , Somaliland

Discussion of Study Findings

The findings indicated that the process of identification, measurement, monitoring and control of credit risk in commercial banks in Hargeisa is satisfactory. The study findings are congruent to those put forward by Al-Haschimi (2007), Miller and Noulas (1997) that the effects of credit risk on profitability could be negative. By implications, the credit risk indicators such as loans loss, growth in bank deposits, and timely recognition of weak loans are all measures of reduced credit risk identified in the study. Improved credit risk indicators means that the commercial banks in Hargeisa have developed adequate activity mix that has helped reduce the overall level of risk undertaken (See: Demirgüç-Kunt and Huizinga; 1998). The different source of income and reduced credit risks explains the high rating of the banks level of credit risk management given by respondents.

Frequency tables summarizing response-rankings on credit risk management

Interpretations	**Frequency**	**Percent**	**Cumulative**
Satisfactory	31	75.61	75.61
Fair	9	21.95	97.56
Very Satisfactory	1	2.44	100.00%
Total	**41**	**100%**	

The majority (up to the 75th percentile) ranked credit risk management by the banks as "satisfactory". Commutatively, 97.56% approved the credit risk management by the banks as either "satisfactory" or "fair". The rest (2.44%) rated it as "very satisfactory."

Conclusions

It was therefore concluded that the level of credit risk management for commercial banks in Hargeisa is acceptable to most clients.

To determine the level of profitability commercial bank in Hargeisa , Somaliland

Discussion of Study Findings

There are many factors that influence bank profitability and the study findings indicate that profitability is a dependent variable. Profitability is influenced by several macroeconomic factors (See: Short, 1979; Bourke, 1989; Molyneux and Thornton, 1992; Demirguc-Kunt and Huizinga, 2000; and Goddard et al, 2004). The analysis shows that (66%) of the responses regarded the bank's profitability as satisfactory. Provision for bad loans, return on equity, return on assets and banks size had the highest mean ranks. By interpretations, the level of profitability of commercial banks in Hargeisa was found to be sustainable.

On the other hand, some researchers (see: Molyneux and Thornton, 1992; Demirguc-Kunt and Huizinga, 2000 and Goddard et al, 2004) have cautioned that there is limited evidence that industry-specific factors have any influence on a banks' profitability. The macroeconomic factors such as interest rate, interest rate spread, inflation and per-capita income and growth in GDP also do affect profitability; however they were not factored in the study.

Conclusions

Profitability of commercial bank in Hargeisa , Somaliland is high. This is indicated by the by a high mean-rate score of clients' satisfaction.

To determine if there is a significant difference in the level of credit risk management and profitability commercial bank in Hargeisa , Somaliland

The study findings indicated that the mean ranks of credit risk management and commercial banks profitability are significantly different. Risks can have an adverse impact on profitability. Analysis shows that commercial banks in Hargeisa have accurately assessed all borrower's credit worthiness and reduced their operational inefficiencies.

The computed Spearman's rho of -.148 showed a weak negative correlation between credit risk management and commercial banks' profitability despite the fact that banks had accurately assessed credit risks associated with all borrowers. Credit risk management could have been only one of the measures the banks used to generate revenue. Other measures need to be put in place to improve on the profitability besides credit risk management strategies.

The apparent weak association was also highlighted in others studies by Smirlock (1985) and Berger (1995) who studied the profit structure relationship in banking. These two authors found out that to some extent, the relative market power also affects profitability.

They noted that here was evidence that superior management and increased market share (especially in the case of small to medium sized banks) raise profits. They advised that that efficiency not only raises profits, but may lead to market share gains and, hence, increased concentration, so that the finding of a positive relationship between concentration and profits could be a spurious result due to correlations with other variables.

To determine if there is a significant relationship between the level of credit risk management and profitability commercial bank in Hargeisa , Somaliland

It is agreed that poorly managed risk can lead to failures of banks. However, the study findings show that there is no significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland. Other measures found a very weak association between the two variables.

For instance, the ANOVA Analysis found out that the mean responses on credit risk management and commercial banks profitability were significantly different. NULL hypothesis was thus rejected. (*See: ANOVA table and table on Lending Policy*).

The above contradictions could be explained by the fact that bank profitability as a dependent variable is affected by both bank level as well as macroeconomic factors.

The study design did not consider both factors into the analysis and interpretations of results (See: Cornett and Tehania, 1992; Mercia, et al., 2002; Toddard, et al., 2004; Guru et al., 2001 and Panayiotis et al., 2006). Future studies should therefore be focused on the analysis of macroeconomic factors which include the prevailing interest rates, interest rate spread, inflation and per-capita income and growth in GDP in Somaliland. Most of these factors were not included in this study.

CONCLUSIONS

The study was designed to investigate the credit risk management and profitability commercial bank in Hargeisa , Somaliland. The study was guided by 6 specific objectives that formed the logical basis for the analysis of primary data.

The sex distribution in the study sample was balanced (50.0% male and 50.0% female).The majority of the study respondents were middle-aged (in the 31-40 age group) and very few were old (in the 51 years and above age-group). More than half the sample population was single. Education standards were high with up to 60^{th} percentile in the sampled clients holding at least a first degree or a Masters. The majority had been in employment for between 1-2 years the level of credit risk management in commercial banks in Somaliland was high with each institution assessing the client's credit worth of satisfactorily. Consequently, the profitability of commercial banks in Somaliland is satisfactory. There is no significant difference in the level of credit risk management and profitability commercial bank in Hargeisa , Somaliland. We failed to reject the NULL hypothesis. It was concluded that there is a significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland.

RECOMMENDATIONS

This section provides a summary of the study's recommendations based on the four key objectives.

1: The commercial banks should continue embrace gender equity since the sex characteristics of clients have been known to correlate with the credit risk factors.

2: The existing customer-base seems biased towards the middle-aged categories. The commercial banks in Somaliland should diversify their client portfolio to include clients across all age groups. More products need to be developed for the youths and the old aged.

3: The banks in Somaliland should also pay attention to macroeconomic variables that affect risk besides bank level factors. None of the clients were dissatisfied with commercial banks credit policies.

4: It was concluded that there is no significant relationship between credit risk management and profitability commercial banks in Hargeisa , Somaliland. Therefore in order to sustain their profit in the future and even to make them more profitable, commercial banks should explore new market share in other parts of Somaliland to sustain their profitability in the long run since most clients have rated them as "satisfactory".

Suggested Areas for Further Research

This study is need to do research in credit risk management and profitability of commercial banks, further research can also be done Somaliland and it's found that credit risk management and profitability of commercial banks in in Hargeisa , Somaliland

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APPENDICES

APPENDIX I:

QUESTIONNAIRE

Dear respondent

I Mohamed Omar Yusuf a student at Kampala International University study a Master of Business Administration, this questionnaire has been prepared for data collection concerning Credit risk management and profitability of commercial banks the purpose of questionnaire is only for academic reasoned and information you provide treated with utmost will be confident. I kind request you to answer the questions fully and honest.

Your assistance will be highly appreciated

Section A: DEMOGRAPHIC PROFILE OF RESPONDENTS

Please Tick In the Blank Provided As Your Respondent

1: Gender

- Male ☐
- Female ☐

2: Age

- 18-20 ☐
- 21-30 ☐
- 31-40 ☐
- 41-50 ☐
- 51 and above ☐

3: Marital status

- Single ☐
- Marriage ☐

4: Education Level

Certificate ☐

Diploma ☐

Degree ☐

Master ☐

PHD ☐

5: Duration worked in your Business

Less than 1 yrs ☐

1-2 yrs ☐

3-4 yrs ☐

5-6yrs ☐

7 and above ☐

6: Duration worked in your position

Less than 1 yrs ☐

2 yrs ☐

4 yrs ☐

6 yrs ☐

SECTION B: LEVEL OF CREDIT RISK MANAGEMENT

Lending Policy

(a) Please tick the most appropriate option using the scale provided

Response Mode	Rating	Description	Legend
Strongly Agree	(4)	You agree with no doubt at all.	SA
Agree	(3)	You agree with some doubt	A
Disagree	(2)	You disagree with some doubt	D
Strongly disagree	(1)	you disagree with no doubt at all	SD

		1	2	3	4
1.	The Board Credit Committee is often involved in selecting loan applicants				
2.	The company observes the limit set for total loan given out at any time.				
3.	There is efficiency in the company's policy on loan portfolio				
4.	The interest rate charged on various types of loans cover the cost and meet good profit margin				
5.	The company's lending policy is periodically reviewed to reflect the prevailing conditions				
6.	The company's portfolio is balanced to reflect different types of loans.				
7.	The lending authority/ loan approval is decentralized				
8.	The institution utilizes information from reference bureaus in appraising the customer credit				
9.	Information sharing adds value with regard to quality of customers being granted credit.				
10.	The rate of defaulting by customers been minimized with the use of information sharing.				
11.	The institution informs customers that the bank is seeking reference information regarding their past loan servicing.				

(b) Please tick the most appropriate option using the scale provided

1- Strongly disagree 2- Disagree, 3– Agree 4 – Strongly agree

Credit Standard

			1	2	3	4
1.		The institution relies on the applicants financial statements when appraising credit allocation				
2.		The institution takes the following factors into account in loan appraisal:				
	i)	Character/ Integrity				
	ii)	Capacity				
	iii)	Collateral/security				
	iv)	Capital/contribution				
	v)	Cash flow statements				
	vi)	Trade and bank reference about the loan applicant				
3.	The institution is highly rated in terms of credit appraisal and loan approval					
4.	The institution's lending policy support increased revenue to the company.					
5.	There are few or no loan defaulters due to the institution's efficient lending policy					

Credit Terms

(c) Please tick the most appropriate option using the scale provided

1- Strongly disagree 2- Disagree, 3 – Agree 4 – Strongly agree

		1	2	3	4
1.	The institution strictly observe the credit terms.				
2.	The institution relaxes credit terms with regard to clients who are consistently paying their loan.				
3.	Risk assessment is a priority in appraising credit				
4.	The institution's risk management policy serves its purpose.				
5.	The institution is able to recognize your good customers				
6	The institution always relies on previous record in approving the loan.				

Collection Policy

(d) Please tick the most appropriate option using the scale provided

1- Strongly disagree 2- Disagree, 3– Agree 4 – Strongly agree

		1	**2**	**3**	**4**
1.	The institution is efficient in collecting its due debts.				
2.	The institution observes the collection period given to each client.				
3.	There are systematic written down steps in the handling of defaulting customers.				
4.	The institution very often takes defaulting clients to court				
5.	There is efficiency in the keeping of client statements				
6.	Clients are encouraged to reconcile their statements with the institution				
7.	Analysis outstanding credit to total deposits done regularly				

SECTION C: LEVEL OF PROFITABILITY OF COMMERCIAL BANKS

Do the following factors affect your bank's profitability?

1- Strongly disagree 2- Disagree, 3– Agree 4 – Strongly agree

	Factor	1	2	3	4
1	Doubtful loans and net losses				
2	Provision for bad loans				
3	Bad debts written off				
4	Return on equity				
5	Return on assets				
6	Banks size				

APPENDIX II

CLEARANCE FROM ETHICS COMMITTEE

Date_______________

Name_______________________________________

Reg. # ______________________________________

Course ______________________

____

Title of Study

____

Ethical Review Checklist

The study reviewed considered the following:

___ Physical Safety of Human Subjects

___ Psychological Safety

___ Emotional Security

___ Privacy

___ Written Request for Author of Standardized Instrument

___ Coding of Questionnaires/Anonymity/Confidentiality

___ Permission to Conduct the Study

___ Informed Consent

___ Citations/Authors Recognized

Results of Ethical Review

___ Approved

___ Conditional (to provide the Ethics Committee with corrections)

___ Disapproved/ Resubmit Proposal

Ethics Committee (Name and Signature)

Chairperson ______________________________

Members'_____________________________

APPENDIX III

INFORMED CONSENT

I am giving my consent to be part of the research study of that will focus on credit risk management and profitability of commercial banks.

I shall be assured of privacy, anonymity and confidentiality and that I will be given the option to refuse participation and right to withdraw my participation anytime.

I have been informed that the research is voluntary and that the results will be given to me if I ask for it.

Initials: ______________________________

Date________________________________

APPENDIX IV

RESEARCH INSTRUMENT
QUESTIONNAIRE

Dear respondent,

I am conducting a study entitled **"credit risk management and profitability of commercial banks in Hargeisa -Somaliland"**.

In view of this may I request that you answer my questionnaire? I will appreciate it very much if you can return the questionnaire as soon as possible.

Please be assured that the data you provide will be used only for academic purpose and the information you provide will be treated with utmost confidentiality.

Thank you very much in advance.

Yours truly,

Mohamed Omar Yusuf

Candidate for Master of Business and Administration

Kampala International University

Kampala, Uganda

RESEARCHER'S CURRICULUM VITAE

Personal Profile

Name: Mohamed Omar Yusuf

Nationality: Somalilander

Place of Birth: Hargeisa

Date of Birth: 10th oct 1984

Marital Status: Single

Email: mcy2013@yahoo.com

Tell: +256792279712

EDUCATIONAL BACKGROUND

YEAR	INSTITUTION	AWARD
2007-2011	University of Hargeisa	Bachelor of Business Administration (Accounting stream)
2001-2005	Ilays Secondary School	
1997-2001	SH. Ali Ibrahim Intermediate School	
1993-1997	SH. Ali Ibrahim Primary School	

Work Experience

WORK EXPERIENCE: 3 Months Volunteer

TITLE: Admin and Finance Assistant Organization Somaliland Students Assemble (Solsa)

Tasks and Responsibilities:

- Assisting the administration and finance of the organization
- Assisting preparation and maintenance of statements of accounts such as calculating, checking payments for their correctness
- Assists in processing payments to staff members for their entitlements

- including salaries,
- Journal entry preparation and review of journals prepared by staff accountants;
- Assist in the production, analysis and review of balance sheets and other financial accounting services.
- Ensure that the Trust's assets and liabilities are accurately reflected in the ledger by reconciling control accounts, and resolving all differences quickly and accurately.

Assist in the timely payment of various payroll deductions and prepare for payment of urgent cheques when requested by Payroll and Payments

Other Relevant Data

TRAININGS:

- November, 2009- January, 2010
- Attended Somali Youth Labor Program (SYLP) Training organized by Research and Development Foundation (RDF)

COURSES:

- Computer skills such as hard ware, ms word, ms excel, access and power point
- Good Report writing skill
- Good proposal writing
- Problem solving skills
- Leadership skills
- Interpersonal skills

LANGUAGE PROFICIENCY:

Somali	Native
English	Fluent in both Written and Spoken Excellent
Arabic	Good