AN ANALYSIS OF CREDIT RISK MANAGEMENT PRACTICES IN COMMERCIAL BANKING INSTITUTIONS IN ZIMBABWE

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Abstract
The collapse of banking institutions is primarily driven by inadequate credit risk practices. With a declining economy, Zimbabwe was forced to adopt lending policies that directed credit to particularly agriculture. The Reserve Bank of Zimbabwe between 2004 and 2008 through the introduction of Productive Sector Facility (PSF) and subsequently Agricultural Support Facility (ASPEF), sought to increase economic productivity through cheap money offered at negative real interest rates. It was also established that even though credit risk is the major cause of bank failures, agribusiness divisions of commercial banks in Zimbabwe that account for 30% of loan portfolio, were not fully using modern credit risk frameworks or models and were solely relying on traditional credit management techniques. While best practices propose that lending should mainly be based on capacity, it was established that commercial banks in Zimbabwe place much weight and emphasis on collateral. The effect has been poor asset quality that in turn increases bank exposure. Regional and international commercial banks operating in Zimbabwe were found to be having better credit risk practices than indigenous commercial banks.

Key Words: credit risk, commercial banks, agricultural lending

Introduction
Risks have always been of major interests for banks and financial institutions. Financial institutions assume risks in their bid to create as well as maximize shareholder wealth. Conversely risky investments pose the threat of diminishing shareholder returns and on the extreme the capital of the business. Risk is important for financial institutions as it affects the debt holders through capital adequacy and shareholders through return. However the level and magnitude of the risks need to be bench marked by regulatory benchmarks or self imposed benchmarks (Pazarbasioglu, 2003).The existence of cross border subsidiaries and the general regional and global financial integration has increased the appetite for understanding risk. Many forms of financial risks now occur and these include interest rate, liquidity, operational, foreign currency, reputational, strategic, legal and credit risk (Bessis J 1998)

The understanding, experiences and knowledge of credit and other forms of risk has not helped prevented financial crises. Economic and financial crises have been linked to the inadequacy of risk management and the willingness to adopt a more proactive risk based management style (Bessis 1998). Credit risk has been identified as a major problem in any financial crises. Though it is understood since banks started lending, credit risk presents challenges to management. Outstanding loan balances at the time of default are not known in advance, for other lines of credit such as overdrafts the future use of these and the extend of credit recovery rate are unknown.
Counterparty default (the risk that the other party in an agreement will default) has been linked to moral hazard and adverse selection problems in the financial services sector (Caprio 1997). In Kenya two local banks and ten non-bank financial institutions were closed or taken over between 1984 and 1989. In Nigeria, four local banks were put into liquidation in 1994 while in 1995, 13 local banks were taken over by the Central Bank of Nigeria. The reasons for these are chiefly: insider lending, lending to high risk borrowers, macroeconomic instability, and to a lesser extent liquidity support and prudential regulation (Brownbridge 1998). The same reasons can be attributed to the Zimbabwean financial crises—RBZ Troubled Banking Institutions (12/2006) that saw the closure of five banking institutions between 2003 and 2006. Macroeconomic instability can worsen adverse incentives on credit portfolios. Credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance to agreed terms (Basel Committee 1999). The Basel Committee agrees with Falkena et al. (1989) who emphasizes the risk of the debtor failing to meet obligations punctually. The obligations would include the interest accruing thereof including the capital. Santomero (1997) defines credit risk as the inability or an unwillingness to perform in the pre-committed contracted manner and adds on, the definition of counterparty risk as the risk that comes from non-performance of a trading partner. Bessis (1998) argues that credit risk arises even in the event of deterioration of the borrower’s credit quality and Cook (1991) argues that the cost of the debtor failing to meet obligations on time is part of the risk taken by the creditor. These include the costs of following up, costs of new terms such as interest rates and rescheduling of the debt. Taking credit risk involves a high probability of earning small return, coupled with a small chance of losing a large amount according to Froot et al. (1993). Therefore risk arises before the actual default. In all the definitions of risk above none elaborates on the quantity of risk and its impact. A debtor includes individuals, company, parastatals, and government. Credit risk is thus mainly divided into personal (consumer risk), corporate (company risk) and country (sovereign risk). Falkena et al. (1989) outlines the agreement of company law on personal and corporate risk in that the two are legal persona hence can be declared insolvent/bankrupt in the court of law. This is however different with country risk as countries can never be declared insolvent as they are sovereign entities when they fail to meet their obligations as the case of Zimbabwe versus the IMF. Hendricks (1996) concludes that credit risk turns into solvency risk when the debtor fails to meet obligations indefinitely. Credit risk management is defined by Falkena et al. (1989) as the process of controlling the impact of credit risk related events through identification, understanding, quantifying monitoring and controlling.

Credit risk is linked to the capital adequacy ratio. Capital Adequacy ratio measures the amount of bank capital in relation to the amount of its credit exposures. The capital adequacy of Banks should therefore be linked to the level of risk that a bank can take. The higher the level of risk incurred the greater should be the capital as capital serves to cushion the losses and declines in the value of the bank assets. The paper will determine why bank failures occurred in Zimbabwe if Prompt Corrective Action (PCA) done by the supervisor to resolve bank problems early, are conducted. Given this scenario this paper will provide information on the resilience of Zimbabwe's banks to credit risk problems.
Morgan (1997) acknowledges that credit risk has become the key risk management challenge of today’s age. Today the financial services sector is encountering drastic environmental changes vis-à-vis the adoption and creation of new financial instruments that is changing financial services industry. The adoption of electronic business and the current wave of electronic technology in banking (ATMs, Internet Banking, smart cards, virtual banks, mobile banking) has added a new dimension to risk. The current wave of mergers, acquisitions and dissolutions of financial institutions in Zimbabwe between 2003 and 2008 has resulted in consolidation of financial institutions into one stop large financial houses.

Credit risk is the oldest form of risk in the financial sector. It is the risk of customers’ defaulting on their obligations to service debt. Increasingly Bankers Acceptances, Interbank transactions and Derivatives have been sources of credit risk in addition to the traditional source i.e. loans. Credit risk does not occur in isolation and a holistic approach to management of all forms of risk is required by a banking institution. Credit risk may result from operational, foreign exchange, legal compliance and strategic risk while it may lead to liquidity risk. Credit risk is critical since the default of a small number of important customers can generate large losses which can lead to insolvency (Bessis 1998). Credit risk has been linked with regulatory capital and is correlated to the economic activity of a country. A brief overview of the Zimbabwean economy is now provided. The state of the economy presents credit risk management challenges. Credit risk is composed of three underlying risks according to Bessis (1998). These are Default risk, Exposure Risk and Recovery Risk.

**Financial sector background**

In 1980 the banks the following banks were in operation; Rhodesian Banking Corporation (now ZB Bank), Barclays Bank, Standard Bank (now Standard Chartered), Merchant Bank of Central Africa (MBCA), Bank of Credit and Commerce International latter becoming Bank of Credit and Commerce Zimbabwe and now CBZ Holdings, Grindlays Bank (now Stanbic), Beverley Building Society, Central Africa Building Society (CABS) and Post Office Savings Bank (now the People’s Own Savings Bank). The financial sector was relatively closed between 1980 and 1999. The signs of a financial crisis started in 1998 as the United Merchant Bank (UMB) collapsed as a result of bad loans, mismanagement and high exposure to CSC bills. Zimbabwe Building Society also nearly went bust in 1988 and was placed under corrective order in 2004 and eventually rescued by a merger with First Bank in 2006. Universal Merchant Bank (Unibank) was placed under curatorship before it was rescued by CFX. In 2002 Genesis Investment Bank was placed under corrective order due to capital inadequacy and poor corporate governance. First National Building Society (FNBS) was put under curatorship in February 2003 and is currently under liquidation.

The deteriorating economic environment of high inflation of 599% in 2003 forced some financial institutions (mostly indigenous banks) into an asset-liability mismatches as well as speculative activities that led to a liquidity crunch which precipitated into the currency crisis of 2003. This dampened public confidence especially in the indigenous banks resulted in a run on deposits and switches to the foreign international Banks such as Standard, Stanbic and Barclays. Due to high inflation and a weakened economy caused largely by
the destruction of agriculture sector the asset quality of banks deteriorated.

A defining moment in Zimbabwe occurred in 2003/2004 with a financial crisis. The coming in of new Governor in late 2003, ushered changes in the banking sector as the Central Bank sought to realign financial institutions to a sound financial footing. As a result of tighter bank supervision the number of banking institutions declined from forty (40) as at 31 December 2003 to twenty-nine as at 31 December 2004. The result was the placing of Trust Bank, Time Bank, Barbican Bank, Royal, Century Bank and Discount House, Rapid Discount House and Intermarket subsidiaries under curatorship.

The monetary policy of 21 April 2004 identified the following as the causes of the 2003/4 financial crisis:

- Extensive diversification
- High prevalence of insider loans
- Weak corporate governance as a result of an undiversified shareholding structure
- Imprudent credit risk management framework caused by loan concentration
- Evasion from core banking activities and speculation
- Underhand foreign currency dealings to fund off-shore dealings
- Inadequate board oversight
- Weak control, guidelines, procedures and bank wide risk management frameworks

**Concessionary Funding and Bank Lending**

Agricultural lending has unique characteristics that influence capital requirements. Agriculture has a lengthy production cycle and is depended on weather which often leads to less frequent, seasonal payments of loans. It is also capital intensive with 80% of the total assets consisting of farm real estate and machinery (Bliss 2005). The financial performance of farms is highly correlated, especially for farms in the same geographic region. Because financial institutions, especially agricultural lenders, usually do not hold random portfolios of loans, geographic and industry correlations lead to higher correlations in default and losses (Bliss 2005). Between 1980 and 1999 lending to agriculture was on the increase from about 20% to around 90% before nose-diving to below 18% in 2000 hence the justification of subsidized lending by the RBZ.

In January 2004 the RBZ introduced concessionary funding under Productive Sector Facility (PSF) at 20% per annum later reviewed to 50% in July 2004. The major objectives were to avoid company closures due to high cost of borrowing, stimulate productivity and increase capacity utilisation. Much of this facility was however utilized for debt financing and restructuring with minimal impact of productivity and GDP. In January 2005 the Z$13 trillion (old currency) Parastatals and Local Authorities Reorientation Program (PLARP) was launched due to their contribution of 40% to GDP. Agricultural Productivity Enhancement Facility (ASPEF) was launched in May 2005 to provide support specifically for farmers and 20% interest later revised to 50% in 2006. In addition The Export Facility that was letter phased out was availed to some exporters. In July 2006 the 16 trillion (old currency) SMEs facility was introduced with concessionary rate of 70% per annum. The low interest rates offered present opportunities for arbitrage that has downstream effects on the economy. A credit subsidy is costly and inflationary, and to a large extent ineffective, as it was difficult to ensure that the cheap credit is being used for the intended purposes. These
facilities have an impact on credit risk management.

The hyperinflationary environment during the period 2003-2008 and recessionary economy has had an impact on interest rate risk and loan book balances. Loans are the largest contributor to the balance sheets hence the need to be vigilant on credit risk management. Furthermore, the introduction by the RBZ of concessory funding through PSF and ASPEF may have an effect asset quality and portfolio design hence credit risk. The increased expectation of exchange rate depreciation increases default risk and therefore calls for an increased understanding of credit risk. In Zimbabwe and like any other developing nation exchange rate risk transforms into credit risk. Credit Risk has to be managed to avoid financial crises-Brownbridge (1998)

**Methodology**

A methodology is defined by Borroso (2003) as a process to produce a result. Nachamius et al (1996) add that it is a system of explicit rules and procedures upon which claims of knowledge are evaluated, providing rules for communication and reasoning. The qualitative approach was used to provide a better understanding credit risk practices in the banking sector. Quantitative research provided the fundamental connection between empirical observation and mathematical expression of quantitative relationships-Saunders et al., (2003). Statistical variables such as the mean, variance, coefficients of variation standard deviation, and ketosis were used in the analysis of risk management practices and applicability and use of frameworks.

The research focused on commercial banks in Zimbabwe as the sampling frame and according to RBZ there were 14 commercial banks operating in Zimbabwe. With n = 14 the target sample i.e. was 10(71%) of the population size. However the sample size was reduced to 6 owing to failure by some of the commercial banks to respond to the questionnaires. The following commercial banks participated in the survey-Stanbic, Standard Chartered, Barclays, NMB, Kingdom and ZB Financial Holdings. The banking sector is guided by a code of ethics on disclosure of information. In addition any information released can be highly sensitive and be a source of business risk. The area of research also evoked on business strategy.

**Data Collection Instruments**

Kotler (2000) identifies four major tools for collecting primary data as observation, focus groups, surveys and experiments. The sample survey method was used. The survey technique was used to allow for the collection of primary data basing on questionnaires distributed to the employees of the bank. A combination of open ended and closed ended, were used. The questionnaire was divided into four sub-sections:

1. The first section was designed to credit risk issues and background
2. The second Section was designed to capture credit risk modeling techniques
3. The third section was designed to understand compliance to international best practices
4. The forth section covers RBZ concessory funding.

**Data presentation and analysis procedures**

The information was converted into some usable data. Both the qualitative and quantitative data were utilized and converted into general characteristics that were then presented in the form of tables, simple bar graphs, histograms, and pie charts. Analysis of quantitative data was achieved through...
the use SPSS (Statistical Package for Social Scientists) package.

Results and discussion

Most banks were aware of the Basel recommendations and in particular Basel II to be implemented of 2008. The table below shows the descriptive statistics on the most important source of risk (risk rating) in the commercial banks.

<table>
<thead>
<tr>
<th>Source: Research data (run anova)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1 Risk rankings</td>
</tr>
<tr>
<td>Min</td>
</tr>
<tr>
<td>-----</td>
</tr>
<tr>
<td>Operational</td>
</tr>
<tr>
<td>Credit</td>
</tr>
<tr>
<td>Liquidity</td>
</tr>
<tr>
<td>Legal</td>
</tr>
<tr>
<td>Interest</td>
</tr>
<tr>
<td>Reputation</td>
</tr>
<tr>
<td>Strategic</td>
</tr>
<tr>
<td>Forex</td>
</tr>
</tbody>
</table>

The mean ranking for the risks shows that on the overall banks recon that operational and credit risks are the most important. The cumulative ranking showed that operational risk was rated number one and two by 4(66.7%) of the banks and credit risk was rated number one and two by also 4 (66.7%) of the banks. The ranking on forex risk was consistent with all banks as reflected by the lower standard deviation. This confirms the risk avoidance by banks to dealing in foreign currency truncations as a result of the RBZ exchange rate operating during the period under review.

Due to the challenging operating economic environment strategic and reputational risks were sited to be also crucial. Examples sited include the human capital flight in the banking sector that saw top bankers who include, Julias Makoni(NMB), William Nyemba(Trust Bank) and Ntuli Ncube(Barbican) among others as having taken away visionary leaders are pioneers of these banking institutions. A strategic and reputational vacuum was created has the potential for causing bank failures.

Bank examiners from RBZ interviewed (Supervisors) through in depth interviews concluded that the three most important business risks are operational, credit and market risk. The other risks were viewed to be of lesser importance as the good management of these will actually mean less strategic and legal and compliance risk.

All banking institutions were found to have a formal risk reporting structure. This structure however depended with the organizational organogram. International financial institutions had risk reporting structures that linked to other regional and international offices. For local banks the risk structure involved to a large extend the risk department reporting to the Board of Risk but administratively to the Chief Executive Officer. There were clear separation of risk issues in international banks compared to the local banks were limited risk portfolios were offered. It also emerged that indigenous commercial banks also utilized treasury managers as risk managers for liquidity and foreign currency risks. Credit committees are available and functional in all banks for approving loan facilities. The Reserve Bank through the corporate governance guideline and the risk management guideline outlines the principles for setting up the risk management structure. These are as governed by banking regulations statutory instrument 205 of 2000.

The following credit risk reports were drawn up within financial institutions:
**Table 2**  
Credit risk reports

<table>
<thead>
<tr>
<th>Type of credit report</th>
<th>Frequency</th>
<th># of banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess report, arrears</td>
<td>Daily</td>
<td>4</td>
</tr>
<tr>
<td>Facilities management report,</td>
<td>Monthly</td>
<td>5</td>
</tr>
<tr>
<td>Guarantees report</td>
<td>Monthly</td>
<td>6</td>
</tr>
<tr>
<td>Insider loans reports/Board reports</td>
<td>Monthly / Quarterly</td>
<td>2</td>
</tr>
<tr>
<td>Inspection reports</td>
<td>Prompt</td>
<td>6</td>
</tr>
<tr>
<td>Early alert</td>
<td>Monthly</td>
<td>6</td>
</tr>
<tr>
<td>Underwriting standards</td>
<td>Yearly</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: Research data

The table above shows that a wide variety of credit reports are drawn up within financial institutions. Due to the differing loan policies some reports are drawn up and dropped in other banking institutions. The Supervisor expects quarterly credit risk reports and monthly/weekly for banks under corrective order.

The RBZ introduced in 2004 that all commercial banks in Zimbabwe should be subject to international credit rating. To that end effective January 2005 the Global Credit Company provides credit ratings for commercial banks. However International banks operating in Zimbabwe have been subject to credit rating attributed to their Head offices outside the country. While all risk managers appreciated the need for global rating for market confidence building only two of risk managers had their ratings. The appreciation did not translate into knowing the grades hence the perception of lack of relevance to Zimbabwean economic conditions. The major challenges on credit ratings included the lack of a comprehensive manual by the Global Credit Rating Company on the procedure and a manual that detail; for example risk weights for each credit grade. The need to bring these ratings in line to the widely used standards such as Moody’s, Standard and Poor and Fitchers ratings was also pointed out. A side by side scale for comparing with would increase the appreciation of GCR ratings. In addition the availability of a variety of rating scales, i.e. short term debt rating, long term debt rating (investment and non-investment grade) and claims paying ability rating scale resulted in a weakened appetite for GCR ratings. The Supervisor uses the CAMELS (capital, asset quality, management, earnings, liquidity and sensitivity to market risk) as a way of measuring the performance of banks on a scale of 1-5 for the above parameters. Banks that are downgraded are a sign of weakness calling for tighter monitoring.

Risk managers saw the macro-economic environment as presenting challenges. High nominal interest rates mean that the induplum rule could be reached within three months for huge borrowings. Though risk managers agreed that the ratio of doubtful and non-performing loans might have increased no figures could be provided. As confirmed by the RBZ there has been reduced lending with banks minimizing as far as possible exposures to especially the agriculture sector (RBZ, 2004) Also banks have been unable to support manufacturing, mining and tourism sectors due to capacity underutilization. This has increased the growing indicators of business failure. In addition the following were listed by banks as consequences of the hyper inflationary-economic environment; reduction in client base, underemployment of resources (capital, labour, land), parallel lending, erosion of savings, higher default rates, increased prudential lending, difficulty in credit pricing, asset price inflation, over-borrowing and collateral risk. An unstable economic environment was seen to be having a destabilizing effect on credit creation process.
Common Sources of Credit Risk

The graph below indicates the common sources of risk in banking institution in Zimbabwe. A 100% indicates that the risk is inherent in all banks.

**Figure 1: Source of credit risk**

<table>
<thead>
<tr>
<th>Source</th>
<th>% Availability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>83</td>
</tr>
<tr>
<td>Overdraft</td>
<td>100</td>
</tr>
<tr>
<td>Bankers Acceptances</td>
<td>100</td>
</tr>
<tr>
<td>Interbank Trans</td>
<td>16.7</td>
</tr>
<tr>
<td>Trade Finance</td>
<td>33.3</td>
</tr>
<tr>
<td>Forex Trans</td>
<td>0</td>
</tr>
<tr>
<td>Derivatives</td>
<td>33.3</td>
</tr>
</tbody>
</table>

Source: Research data

Loans, overdraft facilities and interbank transactions were identified as major sources of credit risk in Zimbabwe. This is consistent with the depth of the financial sector where few financial products are available compared to more developed countries. As expected no risk from derivatives is available in the banking sector. However risk managers likened credit derivatives/future contacts to trade by financial institutions on the stock market directly or through special purpose vehicles that could be a possible source of risk. Some financial institutions were inflation indexing their credit portfolios as a way of hedging. Only one commercial bank reported to be trade financing for export products.

The pie chart below shows the average relative weights for the sources of credit risk.

**Figure 2: Risk weights**

<table>
<thead>
<tr>
<th>Source</th>
<th>% Weight Source of Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>80%</td>
</tr>
<tr>
<td>Overdraft</td>
<td>20%</td>
</tr>
<tr>
<td>Bankers Acceptances</td>
<td>6%</td>
</tr>
<tr>
<td>Interbank Trans</td>
<td>5%</td>
</tr>
<tr>
<td>Trade Finance</td>
<td>3%</td>
</tr>
<tr>
<td>Forex Trans</td>
<td>0%</td>
</tr>
<tr>
<td>Derivatives</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: Research data

Loans and overdrafts constitute 80% of the credit banking risk with the rest of the risks constituting 20% of the perceived credit risk weight. This was in line with the Supervisors perception that loan, overdraft facility constituted over 70% risk source.
Measurement of Credit Risk and Modeling

In all the commercial banks interviewed it was agreed that both the qualitative and quantitative risk measurement methods are used. The qualitative approach is based mainly on managerial judgment. To that end the role of relationship managers in commercial banks was emphasized by all banks. The CAMPARI (character, ability, margin, purpose, amount, repayment and insurance) model is used to guide risk measurement. A wide variety of modeling techniques are available for quantitative analysis. The graph below reflects the frequency of use of the credit risk models in commercial banks in Zimbabwe.

![Credit risk models](image)

Source: Research data

From the sample Credit Risk Portfolio Model (CRPM) is the most common and used credit model. However respondents claimed also to use other credit models such as the Moody’s and Credit + models compromising the validity of responses. Further during probing it was evident except in one bank that the use of the models was fully appreciated and applicable in the organizations. The validity of the answers use of risk models is therefore in doubt. Risk managers for local banks concurred that it was easier for international banks to use these models because of the skills transfer from their Head-Offices. Stress testing and loss forecasting was said to be an ongoing event but done monthly within commercial banks. However three banks are still in the process of building up stress testing models and back-testing these models for validity. The use of scorecards differed among banks. Two banks use the traditional score card, with two using the electronic scorecard while the score cards are not available for two banks. The reason for unavailability centered mainly on the banks concentrating more on corporate sector borrowing.

Weights attached to the 5Cs differed among organizations. The table below shows the factor weights as provided for by the banks.

<table>
<thead>
<tr>
<th></th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Industry Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>20.00</td>
<td>35.00</td>
<td>24.1667</td>
<td>24</td>
</tr>
<tr>
<td>Character</td>
<td>20.00</td>
<td>30.00</td>
<td>23.3333</td>
<td>23</td>
</tr>
<tr>
<td>Capacity</td>
<td>15.00</td>
<td>35.00</td>
<td>23.3333</td>
<td>23</td>
</tr>
<tr>
<td>Collateral</td>
<td>.00</td>
<td>30.00</td>
<td>15.0000</td>
<td>15</td>
</tr>
<tr>
<td>Condition</td>
<td>.00</td>
<td>15.00</td>
<td>11.6667</td>
<td>12</td>
</tr>
<tr>
<td>Other</td>
<td>.00</td>
<td>10.00</td>
<td>2.5000</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: Research data

The results show that capital is weighted heavily in credit assessment. This is slightly above character and capacity. Capital adequacy of the borrower was reported to reflect on the capacity of the business to go on as a going concern. The importance of character is emphasized by the relationship management framework employed by
banks. Thus banks recognize the central role of managerial judgment and intuition in granting credit. This is reflected in the pie chart below.

**Figure 1** Industry weights

![Pie Chart](image)

Source: Research data

It was established that commercial banks lend mainly on the basis of capital. The fixed as well as working capital of the organization will provide a clue as to whether the project will be successful or not. As such financial ratios especially the leverage ratios play an integral role in credit assessment. While from a Zimbabwean customer point of view a project is turned down due to perceived inadequacy of collateral commercial banks view collateral to constitute 15% of the decision to grant credit. All risk managers alluded to the fact that collateral is the last requirement after due diligence on the project proposal reflecting on the lesser importance of the factor. For large institutions such as Delta, Meikles or Anglo, collateral is hardly an issue in credit granting decisions. Thus it is possible for banks to lend without collateral. Also risk managers noted that some collateral e.g. hospital deeds have a high social and political cost to enforce in the event of default. In any case the marketability of such is difficult owning to asset fixity.

Score cards are reviewed quarterly, in one bank, monthly in another with the remainder of the commercial banks reporting to be reviewing them as and when economic fundamentals change. All banks acknowledged that the concepts of the 5Cs of managing credit can be utilized for corporate sector. The graph below shows the additional methods used by the organization.

**Figure 2** Corporate sector assessment methods

![Bar Chart](image)

Source: Research data

Financial ratio analysis and industry concentrations are the widely used corporate sector credit risk assessment methods. Stock market analysis is crucial as it impacts on the market capitalization of the company hence all organizations utilize them. In that respect risk economic research departments are being set by two international commercial banks in order to track borrower’s performance as well as stock market price movement. Due the less involvement in off-shore financing agency rating, are also employed by one of the financial institutions interviewed. The prohibitive costs of agency ratings results in the limited use.
On Sovereign credit exposure all banks interviewed are indirectly exposed to the government of Zimbabwe through parastatals and government controlled companies. However no commercial bank reported to be exposed to another sovereign country other than Zimbabwe. This is linked mainly to the weakened domestic economy.

In line with the RBZ prudential guidelines for providing for bad loans, all banks responded positively to the RBZ directive. Commercial banks also reported that problem loans are quarantined and in some organizations this is done by sending the loan to the recoveries section for constant monitoring. The RBZ guideline has the loan classifications and provision as outlined in the table below.

**Table 1 Loan classifications**

<table>
<thead>
<tr>
<th>Loan classification</th>
<th>Provision</th>
<th>Loan classification (b)</th>
<th>Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pass/regular book(A)</td>
<td>1%</td>
<td>F</td>
<td>20%</td>
</tr>
<tr>
<td>Special mention/Early alert(B)</td>
<td>3%</td>
<td>G</td>
<td>50%</td>
</tr>
<tr>
<td>Sub standard(C)</td>
<td>20%</td>
<td>H</td>
<td>100%</td>
</tr>
<tr>
<td>Doubtful (D)</td>
<td>50%</td>
<td>Y</td>
<td>50%</td>
</tr>
<tr>
<td>Loss (E)</td>
<td>100%</td>
<td>Z</td>
<td>50%</td>
</tr>
</tbody>
</table>

One institution however reported to be using a different classification indicated in column b and the rationale of these provisions could not be established.

All banks reported a high risk of default losses as a result of the macro-economic environment. However actual defaults have been minimal due to the higher lending via the concessionary facilities provided by the RBZ. Also the lower lending book reduces actual default. Commercial banks have also managed to benefit from the asset bubble that has minimized the actual losses as collateral values have been increasing. In addition borrowers were able to repay the loans, thanks to inflation. Banks were not adhering to the RBZ guideline of limiting credit to an individual or company to at most 25% of bank capital and 75% to a group of companies.

A wide toolkit is available for risk mitigation. However managers use only techniques that either work best for them or are better known to them. The table below shows that the most effective strategies are collateral and downgrade triggers/early warning system.

**Figure 3 Mitigation techniques**
Source: Research data

The results contradict with the earlier result on importance of collateral. Collateral thus remains a core in managing credit in Zimbabwe. Risk managers also lamented on the difficulty of enforcing lending limits especially in hyperinflationary environments. In all banks a good project is likely to be financed even if the limit or industry concentration has been exceeded with rules having to be adjusted to suit these circumstances.

Insider loans and lending are said to be in line with RBZ guidelines for all banks. An independent credit assessment board approves loans for insiders in local banks. However one international bank and one local bank interviewed have no facility for insider loans. The argument for this being, if it is a bankable project then the insider should be able to obtain a loan from another commercial bank. This is done to minimize the moral hazard problems.

Principles of credit management are contained mainly in the Basel papers on credit risk. With the imminent implementation of Basel II it was important for Zimbabwean banks to be acquainted with components of this paper. In addition beginning 2008 the IMF and World Bank made it mandatory for economies requiring funding from the Briton Woods Institutes to be compliant with Basel II. Papers such as Principles of credit risk Basel (1997) outline the roles of management and the role of the supervisor in credit management. The table below outlines the papers that commercial banks interviewed utilize in managing credit risk.
As evident from the results there is no consensus on banks for the utilisation of the Basel recommendations. Interesting to note is also that not all banks are utilizing the RBZ Risk management framework as it was said to be a duplication of Basel papers and not applicable to shallow financial markets. International banks were found to be better positioned for implementation of Basel II with training offered by parent companies being done. Staff from Zimbabwe was reported to be in Singapore, UK and South Africa for Basel training. The skills transfer will facilitate a smooth transition to Basel II. Indigenous banks are considering utilizing expensive outside consultancy for the adoption of the guidelines. The lack of financial depth i.e. unavailability of many financial instruments was reported to be limiting the applicability of these papers.

All commercial banks interviewed had clear documentation on internal credit management procedure. The review of the procedure was regular in international banks and while in indigenous banks it was irregular. The product was understood to be a product of senior management.

The October 2006 guideline by RBZ on loan concentrations had the effect of directing lending into sectors as required by the RBZ. The directive increased competition for banks not traditionally in agriculture. It was also reported to have compromised asset quality as banks try to conform to the directive. For example a commercial bank that has been averse to lending to micro projects are now forced to provide 10% of the loan portfolio to SMEs. Similarly and in particular the Land Bank is now being forced to finance areas such as mining, were they have no competitive advantage. The average ASPEF proportion in relation to the overall loan portfolio for the researched banks is 35,267%(.....). There are 50% of banks reported that reported improvement in asset quality as a result of the concessionary funds largely due to the low interest rates that reduced default risk. In addition the rollover of the facilities reduced the real value of the borrowed money as a result of inflation. The other 50% reported no effect on credit quality as the same due diligence is followed irregardless of concessionary facility or not. The following challenges in administering the ASPEF facility were
identified: no loan limit on ASPEF borrowing, cross borrowing of facilities using different names in different banks, gap between approval and funding, influence of politics on lending-Banks not approving concessionary funds seen as anti-government. Thus some banks were requesting a large number of proposals as proof of support for concessionary funds and only approve a few projects due to the uncertainty of land tenure in approving agricultural projects and increased concentration on agriculture.

Conclusion

The responses given by the risk managers show that all business risk have to be managed in a holistic manager. Foreign currency risk is the least important risk in commercial banks in Zimbabwe. There is need for the RBZ to provide a framework for risk management structure to increase independency and segregation of duties. The involvement of treasury managers in risk management will increase rather than reduce business risks. Global Credit Ratings (GCR) are not universally understood by commercially banks. The adverse macroeconomic environment has reduced lending. Greater involvement of the economics and research department is required in risk assessment. Loans, overdraft facilities are the greatest source of credit risk. Sources of credit risk depend on the degree of financial depth. Credit score cards and scoring are still an effective way of managing risk. Relationship management is crucial in credit granting process. There is strong evidence that Credit risk models are not employed with equal velocity in commercial banks. The difficulty in application of models stems from the unavailability of suitable quality data as well as unavailability of financial products on the market. Application of models depends on credit risk data for input into. Thus value at Risk, default probabilities and Monte Carlo simulations are not done by indigenous banks. Therefore credit risk is hardly quantifiable in Zimbabwe. Collateral and credit triggers/early warning system are the most effective mitigation techniques for the commercial banks. Few risk mitigation techniques are used by the banks. The policies on insider loans differ with organizations. Concessionary funding resulted in a general improved asset quality. The RBZ October 2006 directive on lending concentration has created pressure to lending in areas were banks have no competitive and comparative advantage. Concessionary funding presented political challenges and pressures to local bank and increased credit risk. The three international banks are already operating fully under Basel I while there is significant progress towards implementing Basel II. Further Basel II implementation is depends on five year quality data but preferring longer series that are not available in most financial institutions. Indigenous banks are still working on modalities of both Basel I and II. Foreign owned banks have better credit risk practices than locally owned banks. The study only focused on commercial banks. However within the financial services sector, discount houses, insurance companies, Building societies, Asset management companies, microfinance houses, POSB and Merchant Banks all face credit risk. Such a research will provide insight to the state of credit risk in the whole financial sector. There is need also to fully understand the actual preparedness of banks in Zimbabwe in the implementation of Basel II. Such a study will be revealing.
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