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THE ROLE OF CREDIT REFERENCE BUREAU ON FINANCIAL PERFORMANCE OF BANKS IN KENYA

A SURVEY OF SELECTED BANKS IN KERICHO TOWN

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Abstract

Kenya's banking sector faced crisis in the past due to under capitalization, high levels of non-performing loans and weaknesses in corporate governance. Through amendment of the Banking Act and the adoption of instruments of reform, Kenyan government legislated Credit Reference Bureaus (CRBs) via legal notice No. 97 of 11th July 2008 to be used by commercial banks. The purpose was to achieve stability, effectiveness, and access to financial services. The purpose of this study was to establish the role of credit reference bureau in financial performances of banks. Objectives of the study were to determine effect of loan risks, loan lending rate, loan delinquency, and loan access on financial performance of banks. The study was carried out at Kericho town. A descriptive survey targeted 10 commercial banks and population of 100 respondents of which 80 employees were sampled in the study, 70 responded to the researched questions which were 87.5% of the population. Data was analyzed using Descriptive statistics. From findings, banks needs to manage credit risk to enable financial performance and realized its objectives, Minimize cash loss, performs better by *increasing returns on assets and better financial returns. study concluded that credit risks identification, credit scoring mechanism, credit analysis and assessment are good predictors of the model consequently those three indicators used of credit risk management have responded positively with the financial performance of banks in Kenya. The study recommends that the bank's policy recommendations are the key factor of success of financial institutions. Credit risks management is a key factor for the success of financial institution operations in Kenya and by extension pillar to financial prosperity and stability. It is therefore important for the Government of Kenya to develop policy and legal environment that is conducive to association of commercial banks.*

Keywords: Role of CRB, loan risks, loan lending rate, loan delinquency, loan access, banks

INTRODUCTION

Financial institutions are facing an enormous risk of nonperforming loans (NPLs) noting that larger loans have greater risk exposure, so the variable costs per-dollar is higher. If lenders don't take extra care, there could be more loan defaults. To overcome the challenge of NPLs, an institution is required to monitor the behavior of borrowers. Thus, the idea of establishing Credit Reference Bureau (CRB) was conceived in order to enable banks to determine credit worthiness of their borrowers, individuals, groups and enterprises; and therefore reduce the loan default risk. In this respect CRB assists in first, sharing information on default among banks; secondly, eliminating corrupt borrowers that is those with the aim of borrowing from different financial institutions with the aim of defaulting; thirdly, to provide commercial professional credit reference to say prospective foreign investors; and also to identify honest/credible borrowers based on known history and character (Schreiner,2001).

Statement of the problem

Effective credit reference bureau helps in risk management and improves decision-making by connecting information about risk to pricing, monitoring and control of loans and advances. The main causes of credit risk involve weak appraisal mechanisms, weak monitoring and control of adversely graded loans and ineffective remedial action (Rosenberg and Schuermann, 2006). Proportion of the commercial banks' credit risks results from credit default risk which arises mainly due to the inability of the banks to carry out accurate credit assessment leading to high values of nonperforming loans. This results from lack of accurate information on the credit history and current financial ability of prospective borrowers which makes it extremely difficult for lenders to assess their credit worthiness and likelihood to repay the loan (Jappelli and Pagano, 2006). This is majorly because lenders know neither the past behaviour and characteristics, nor the intentions of the credit applicants due to information asymmetry (kizito, 2013).

The financial sectors in Kenya has experienced some major failures because of inadequacies in its operation, including credit reference bureaus. given its tremendous outreach in recent years, its future growth and sustainability depends on how well it is governed, legal framework transparency etc (Yunus , 2003). If these corporate governance characteristics are not followed, it will result into collapse and closure of these institutions.

Kithinji (2010) in her research on credit risk management and profitability of commercial banks in Kenya observed that the credit information gathered will guide the bank in assessing the probability of borrowers default and price the loan accordingly, However she did not look at the role of credit reference bureaus to the overall bank financial .performance.

In her study, Gatwiri (2011) on the determinant of lending rate of commercial banks in Kenya observed that the interest of economists is to know the determinants interest rates and that there is gap in literature on the various factors that determine the interest rates among the commercial banks, there is a research gap on the level of contribution of credit reference bureaus to the determination of lending rates, and its impact on the bank financial performance of banks.

Munene (2012) studied the impact of credit reference bureaus have in accessing finance by SMEs in Kenya. the study found out that credit bureaus could alleviate firm financing constraints by providing information on individuals borrowing and bill paying habits, it enabled the lenders assess credit worthiness, the ability to pay back a loan, and this affect the interest rate and other term of loan, the study recommended further research to be undertaken to determine perceived impact of credit reference bureaus in accessing finance by others sectors in Kenya. This lead to a research question; what is the role of credit reference bureau on bank financial performance in Kenya?

Research Objectives

The main objective of the study was to determine the role of Credit reference Bureau on financial performance of banks in Kenya. Specific objectives of the study were:

i. To determine the effect of loan risks on financial performance of banks in Kericho Town
ii. To examine the effect of loan lending rate on financial performance of banks in Kericho Town

iii. To establish the effect of bank loan delinquency on financial performance of banks in Kericho Town

iv. To find out the extend of loan access on financial performance of banks in Kericho Town

THEORETICAL REVIEW

This study was guided by and grounded in Agency theory, Credit theory of money, and Moral hazard theory as discussed below.

Agency Theory

The agency theory is based on the relationship between agents and their principals. Principals, which are the shareholders of the company usually, employ managers (agents) to run business on their behalf. The possibility that agents will pursue other interest, which is not in line with the expectations of the owners of the company, creates agents costs in form of conflict of interests. Prowse (1992), in a principal-agent model, suggests that managers are less likely to engage in profit maximizing activities in the absence of strict monitoring from their principals. As far back as Adam Smith, it has been recognized that managers do not always act in the best interests of shareholders (Henderson, 1986). Therefore, if firms are controlled by, their owners are more profitable than those that are controlled by management; it means to say that concentrated ownership leads to better monitoring incentives that result in improved firm performance. However, owners may incentivize managers to pursue profit maximization through performance related remuneration.

Credit Theory of Money

Credit theories of money (also called debt theories of money) are concerned with the relationship between credit and money. Proponents of these theories, such as Alfred Mitchell-Innes, sometimes emphasize that credit and debt are the same thing, seen from different points of view Randy Wray (2004). Proponents assert that the essential nature of money is credit (debt), at least in eras where money is not backed by a commodity such as gold. Two common strands of thought within these theories are the idea that money originated as a unit of account for debt, and the position that money creation involves the simultaneous creation of money and debt.

Some proponents of credit theories of money argue that money is best understood as debt even in systems often understood as using commodity money. Others hold that money equates to credit only in a system based on fiat money, where they argue that all forms of money including cash can be considered as forms of credit money. The first formal Credit theory of money arose in the 19th century. Anthropologist David Graeber has argued that for most of human history, money has been widely understood to represent debt, though he concedes that even prior to the modern era, there have been several periods where rival theories like Metallism have held sway (Richard Werner, 2005).

The earliest modern thinker to formulate a credit theory of money was Henry Dunning Macleod, with his work in the 19th century, most especially with his The Theory of Credit' (1889). Macleod's work was expanded on by Alfred Mitchell-Innes in his papers what is Money? (1913) and The Credit Theory of Money (1914), Randy Wray (2004), where he argued against the then conventional view of money arising as a means to improve the practice of barter. In this alternative view, commerce and taxation created obligations between parties which were forms of credit and debt. Devices such as tally sticks were used to record these obligations and these then became negotiable instruments which could function as money.

Moral Hazard Theory

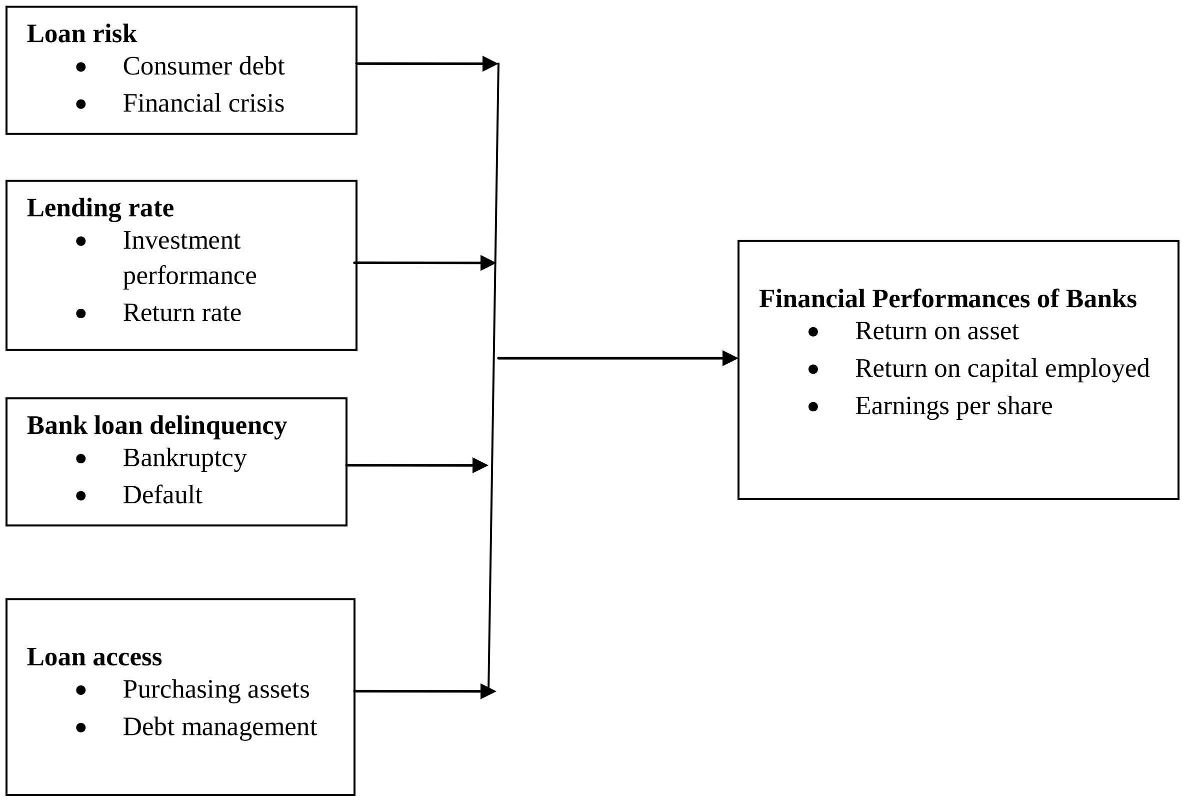
Moral hazard refers to the risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. Problems of moral hazard in banks and other financial institutions were evident at many stages of the recent financial crisis (Myerson, 2011).

As Freixas and Rochet (1997) have noted, modern microeconomic models of banking depend on advances in information economics which was not available when the traditional Keynesian and monetarist theories were first developed. So now, as economists confront the need for deeper insights into the forces that can drive macroeconomic instability, we should consider new models that can apply the microeconomic theory of banking to the macroeconomic theory of business cycles. In modern macroeconomic theory economic growth rate depends, crucially, on the efficiency of financial institutions. The financial systems themselves depend on accurate information about borrowers and the project the funds are used for (Chakraborty and Play, 2001).

Conceptual Framework

The review of the literature on role of CRB on financial performance of banks has been motivated by the curiosity to understand its role on loan risk, loan lending rate, bank loan delinquency and loan access. It is assumed that independent variables (loan risk, loan lending rate, loan delinquency and loan access) have a great influence on bank financial performance.

Figure 1: Conceptual framework



Research Gap

A number of studies have been carried out about many aspects of nonperforming assets. Kallberg & Udell (2003)found out that historical information collected by a credit bureau had powerful default predictive power. A study by Barron & Staten (21003) showed that the lenders could significantly reduce their default rate by including more comprehensive borrowers information in their default prediction model. An analysis of role of credit reference bureau on financial performance had not been taken into consideration hence need for the proposed study.

Research conducted by Galindo &Miller (2001), shows that the relationship between information sharing and access to finance is positive one. the research study used registries indices to determine the level of credit availability to firms. the study collected data from public registries from 34 countries in the world through an online survey method, 81 countries participated and 59 respond ended, Another study conducted by Brown & Zehnder (2006) concluded that the existence of public credit reference bureaus alone can help motivate borrowers to repay their loans within the required time, the study did not analysis the role of credit reference bureau.

Munene (2012) studied the impact of credit reference bureaus have in accessing finance by SMEs in Kenya, The study found out that credit reference bureaus could alleviate a firm financing constraints by providing information on individual borrowing and bill paying habits. it enabled the lenders assess credit worthiness, the ability to repay back loan, and this affect interest rate and other terms of loan, the study recommended further research to be undertaken to determine perceives impact of credit reference bureaus in accessing finance by other sectors in Kenya, this lead to research question what is the role of CRB on bank financial performance?

This study therefore filled this gap by tacking the role of CRB on bank financial performance. None of the studies done addresses the role of credit reference bureau in bank performance comprehensively. This paper attempted to fill this gap and foster research in this important area for credit reference bureau.

RESEARCH METHODOLOGY

The study used cross-sectional survey research design. Smith et al (2008) describe this design as taking a "snapshot" of a group of individuals. Oso & Onen (2005) argue that cross-sectional survey research design is suitable in carrying out research because it seeks to obtain information that describes existing phenomenon by asking individuals about their perceptions, attitudes and behaviors.

The sample comprised of 80 respondents drawn from the 10 commercial banks in kericho Town. The sample is determined according to Krejcie & Morgan (1970) table at 5% margin of error. Krejcie & Morgan as cited by Amin (2005) recommend that for a population of 100, a sample of 80 is adequate.

Table 1. Sample size

Selected Banks	Population size	Sample size
Barclays Bank	9	7
Equity Bank	11	9
Family Bank	10	8
Faulu Bank	10	8
Kenya Commercial Bank	12	10
Kenya Post Bank	10	8
K-rep Bank	8	6
National Bank	10	8
Standard Chartered bank	10	8
Trans national bank	10	8
Total	100	80

This study used quantitative data obtained from secondary sources, which were obtained from self-administered questionnaires. The questionnaires were self administered to 80 respondents from 10 commercial banks. It were structured to cover the role of CRB being investigated in the study. Subsequently, data was analyzed using descriptive statistics.

ANALYSIS AND FINDINGS

Descriptive statistics was used to discuss the findings of the study. The study targeted a sample size of 80 respondents from which 70 filled in and returned the questionnaires making a response rate of 87.5%, this was satisfactory to make conclusions for the study as Cooper and Schinder (2003) states that a response rate ranging 30-80% of the total sample size can be used to represent the opinion of the entire population.

Loan risks

Table 2. Statement on effect of loan risk on financial performance of banks

Statement	Strongly Agree	Agree	Not Sure	Disagree	Strongly Disagree	Mean%
Extent of agreeing that loan Risk Management affect Financial Performance of Banks	32	20	7	6	4	13.8
Whether it is important to manage credit risk in your bank	28	28	6	0	3	13
Whether the bank consider risk identification in credit risk management	30	25	3	2	1	12.2
On whether commercial Banks consider Credit Scoring Mechanism process in risk management	30	18	13	3	0	12.8
Whether commercial Bank consider Credit Analysis and Assessment process	23	17	14	5	1	12

From the findings, majority of the respondents at a mean of (13.8) strongly agreed that financial performance of commercial banks is affected by credit risk management. This shows that the commercial banks needs to manage effectively credit risk for a purpose of enhancing financial performance of those financial institution.

On whether it was important for commercial banks to manage risk. From the findings it was found out that the majority of the respondents confirmed that it was crucial to manage credit risk as indicated by a mean of (13) of the respondents confirmed that it was really crucial for the banks to manage credit risk. Regarding the importance of managing credit risk the study indicated that these reduce cash loss and ensures the organization performs better increasing the return on equity. It was found that it helps the organization to operate more efficiently and more effectively.

From the study majority of the respondents strongly agree that their banks consider risk identification in credit risk management at a mean of (12.2) This implied that risk identification was used as a credit risk management practices in commercial banks in the Town.

The findings further shown that majority of the respondents indicated by a mean of (12.8) that commercial banks in the town consider credit scoring mechanism in their process of risk management.

It also found out majority of the respondents at a mean of (12) indicated that commercial banks in the town consider credit analysis and assessment in their process of risk management.

Loan lending rates

Table 3. Statement on effects of loan lending rates on financial performances

Statement	**Strongly Agree**	**Agree**	**Not Sure**	**Disagree**	**Strongly Disagree**	**Mean%**
Utilization of banks' profits in following defaulters	33	19	9	5	4	14
Reduced borrowers due to fear, reduced revenue	26	30	8	0	5	13.8
Dimmed image of the organization.	35	20	5	3	2	13
Lack of support by staff	25	20	15	4	0	12.8
Unpredictable economic conditions	20	15	14	0	1	10

The Respondents admitted that indeed there were various effects of loan lending rates. Utilization of bank's profits in following defaulters at mean of (14), dimmed image of the organization (13), reduce borrowers due to fear, reduced revenue (13.8), lacked of support by staff (12.8) and unpredictable economic conditions at (10) this is an indication that majority of the respondents are utilizing bank profits in following defaulters and also unpredictable economic conditions emerged as the fear of giving out loans to their clients. The finding contradict Avery, (2004) who indicated that consumers with poor credit repayment histories will pay a higher interest rate compared with those with better past background thereby reducing credit access for those with poor repayment histories.

Table 4. Statement on effect of bank loan delinquency on bank financial performance

Statement	**Strongly Agree**	**Agree**	**Not Sure**	**Disagree**	**Strongly Disagree**	**Mean%**
Management in charge of loans is never apprehended for loans mismanaged	35	30	5	0	1	14.2
Senior management is periodically with quality reports detailing existing loan problems and possible solutions	24	12	10	0	1	9.4
Wrong timing of credit delivery	40	20	5	3	2	14
Internal controls have greatly contributed to effective loan repayments	23	15	7	8	0	10.6
High interest rates have greatly caused poor loan repayment rates	20	30	0	5	0	11

In the view of a mean 14.2 respondents agreed that Management in charge of loans is never apprehended for loans mismanaged also account for some loans becoming delinquent. Such respondents rank poor credit appraisal techniques. They explain this to mean that some loan officers lack the skills to adequately assess a credit proposition to reasonably determine their commercial viability or otherwise. In this sense, they accept some un bankable projects which eventually fail and repayment of the loan becomes sticky.

High interest rate was cited by a mean of 11 of respondents. This was not considered too strong a reason because it is only applicable to loan defaulters who have managed to pay off outstanding principal and are in default in only interest payment. If a borrower is in default of both principal and interest, then one cannot assert that high interest rate is the actually the cause of the loan default

Sometimes, because of the delays in approving loans being requested by the customers, some business opportunities are lost before the loan amount is disbursed to the customers. When this happens and the disbursement is done in cash, because money has alternative uses, the borrowers tend to misuse these funds or at best use them for wrong or unplanned business ventures which in most cases fail to perform well. In the end they are unable to repay the loan. This reason was shared by a mean of 14 of the respondents. From the above table CRB has contributed to over all bank performance. Armstrong, (2008) showed that the existence of credit registries is associated with increase lending volume, growth of consumer lending, improved access to financing and more stable banking institutions. This confirms Walsh,(2003) statement that if banks are aware of customers' good payment history, that consumer could benefit from favorable banking terms and eventual better bank performance which I concurred.

Table 5. Statements on effect of bank loan access on financial performance of banks

Statement	Strongly Agree	Agree	Not Sure	Disagree	Strongly Disagree	Mean %
Shortage of loanable funds	37	32	0	0	1	14
Lack of knowledge of loan officers	24	32	5	0	1	12.4
Poor communication on availability of grace period	45	15	0	5	0	13.2
Shortage of repayment period	42	15	6	4	0	13.4
Weak following up to utilize loan	28	25	10	3	0	13

Table 6 reveals, the selected respondents identified many problems that hinder the loan repayment process on lender side. The most frequently listed problems are the following:- shortage of loan able fund at a mean of (14), lack of knowledge of loan officers (12.4), poor communication on availability of grace period (13.2), Shortage of repayment period (13.4) and Weak in following up to utilize loan at (13).

The study findings correlate with Christen and Pearson(2005) indication that credit reports include both positive and negative information help build reputable collateral the much same way physical collaterals which may improve credit access for the poorest borrowers, the finding also conform with Anderson.(2007) indication that with credit reference bureau a culture of financial discipline will be instilled since consumers know that they will be monitored, this will directly improve bank performances.

CONCLUSIONS

From the findings, the study concludes that commercial banks in Kericho town needs to manage the credit risk in order to ensure the financial performance and meeting its objectives , Minimize cash loss and ensures the organization performs better by increasing the return on assets and helps the organization in attaining maximum financial returns.

The study concluded that credit risk identification, credit scoring mechanism and credit analysis and assessment are good predictors of the model consequently those three indicators used of credit risk management have responded positively with the financial performance of commercial banks in the town.

The study also established the banks faced several challenges in implementing the default rate in lending money to its creditors. Two of the major challengers by credit officers in banks are utilization of bank's profits in following defaulters and dimmed image of the organization due to strained relationships with customers during reposition of defaulted loans.

The study has also concluded that the client has defaulted on loan payment after more than 12 month late. The study found the approaches that are used by the banks in awarding credit to clients. From the findings, the study has concluded lack of support staff and unpredictable economic conditions are the approaches mostly used which affects loan lending rate.

The study discovered that compliance with regulatory requirements involves selected banks abiding by the rules and regulations as provided by the Central Bank of Kenya as well as its internal rules and regulations as regards to interest rate policies and portfolio management. The study revealed that regulatory requirements at Central bank were adequately followed and this was instrumental in ensuring that interest rate risk is adequately controlled under the guidance of the Central Bank.

Based on the study, the level of access to loans is low and fear of request rejection and little amount of loans explains this finding. Majority of clients that accessed the loans reported increase in sales and income and could repay loan and interest. Most of those clients that didn't access loans did not realize increase in income.

RECOMMENDATIONS

The bank's policy recommendations are the key factor of success of financial institutions. Credit risk management is a key factor for the success of financial institution operations in Kenya and by extension pillar to financial prosperity and stability. It is therefore important for the Government of Kenya to develop policy and legal environment that is conducive to association of commercial banks.

Financial specialists will be able to appreciate the challenges that may influence financial performance of commercial banks in Kenya. Many specialists may assume that all financial institutions have uniform set of factors that influence financial performance. This study offers beside four indicators of credit risk management a set of factors that can always be tested which conducting financial appraisal of commercial bank

The Proper management of credit risk is the key factor for success the regulatory institution which is central bank of Kenya should come up with uniform eligibilities in the financial institutions when it comes to the award of credit.

Banks management should enhance the construction of employee teams through providing training and seminars to improve the business knowledge this will ensure effective risk identification and assessment is carried out before disbursement of credit to creditors mitigates the occurrence of credit risk and improves financial performance.

Banks can also provide trainings to potential entrepreneurs to improve their technical capacity to utilize money lend to them. Reasonable and competitive rates can also help banks improve on loan repayment. The bank should adopt relationship management whereby the officers should keep in touch with the borrowers by visiting them at their places of work and their businesses. Close monitoring of loan repayment will assist the bank to reduce on loan default rate and thus reducing on loan provisions.

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APPENDICES

QUESTIONNAIRE

Loan Risk

On a scale of 1-5 rate the following statements

1=Strongly agree, 2= Agree,3=Not sure,4= Disagree,5= Strongly disagree

No.	Question	1	2	3	4	5
1	Extent of agreeing that loan Risk Management affect Financial Performance of Banks					
2	Whether it is important to manage credit risk in your bank					
3	Whether the bank consider risk identification in credit risk management					
4	On whether commercial Banks consider Credit Scoring Mechanism process in risk management					
5	Whether commercial Bank consider Credit Analysis and Assessment process					

Loan lending rate

1=Strongly agree, 2= Agree,3=Not sure,4= Disagree,5= Strongly disagree

No.	Question	1	2	3	4	5
1	Utilization of banks' profits in following defaulters					
2	Reduced borrowers due to fear; reduced revenue					
3	Dimmed image of the organization.					
4	Lack of support by staff					
5	Unpredictable economic conditions					

Bank loan Delinquency

1=Strongly agree, 2= Agree,3=Not sure,4= Disagree,5= Strongly disagree

No.	Question	1	2	3	4	4
1	Management in charge of loans is always apprehended for loans mismanaged					
2	Senior management is periodically with quality reports detailing existing loan problems and possible solutions					
4	Wrong timing of credit delivery					
5	Internal controls have greatly contributed to effective loan repayments					
6	High interest rates have greatly caused poor loan repayment rates					

Loan access

1=Strongly agree, 2= Agree,3=Not sure,4= Disagree,5= Strongly disagree

No.	Question	1	2	3	4	5
1	Shortage of loanable funds					
2	Lack of knowledge of loan officers					
3	Poor communication on availability of grace period					
4	Shortage of repayment period					
5	Weak following up to utilize loan					