

Credit Reference Bureau as the Factor Influencing the Profitability of Commercial Banks in Kenya: A Case of Standard Chartered Bank, Kenya

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Abstract: The Kenyan banking sector was in the 1980's, 1990's and early 2000 riddled with numerous Non-Performing Loans (NPLs) portfolio which reduced the bank's profitability profoundly and led to the collapse of many banks Imperial Bank of Kenya being the latest to be liquidated. One of the catalysts in this scenario was serial defaulters who borrowed from various banks with no intention of repaying the loans. Undoubtedly these defaulters thrived well in the information asymmetry environment that prevailed due to lack of a credit information sharing mechanism. The objective of this study was to establish the effect of the credit reference bureau on the commercial bank's profitability in Kenya with specific objective, to evaluate the impact of the CRBs on the bank's loan advances. The study used Standard Chartered Bank Kenya Limited as a case study because it is listed on the Nairobi Stock Exchange and thus its financials are in the public domain. Purposive sampling was used whereby secondary data from the bank's quarterly reports of net profits from the year 2000 to 2014 was considered with a target population of 55. Secondary data was used from the bank's website to collect profitability ratios of the bank for the years under study. Microsoft excel was used to derive the descriptive statistics relevant for this study. Data was presented in tables, pie charts and bar graphs. The study concludes that the bank puts greater emphasis on the credit information obtained from the bureaus that is CRB Africa and Metropol in determining who to extend their credit to.

Keywords: Bank's profitability, Credit information, Credit reference bureau, Defaulters, Information sharing, Liquidated, Non-Performing Loans, Portfolio.

1. INTRODUCTION

The Kenyan banking sector was in the 1980's and 1990's riddled with a momentous Non-Performing Loans (NPLs) portfolio. This invariably led to the collapse of some banks. One of the catalysts in this scenario was serial defaulters, who borrowed from various banks with no intention of repaying the loans. Undoubtedly these defaulters thrived in the information asymmetry environment that prevailed due to lack of a credit information sharing mechanism. As a result in Kenya, 2 local banks and 10 non-bank financial institutions were closed or taken over between 1984 and 1989. A further 5 local banks and 10 non-bank financial institutions (NBFIs) were closed or taken over in 1993 to 1994 and 2 more local banks in 1996. Brownbridge (1998) suggests that the reason for the many failures was the lack of adequate expertise to screen and monitor their borrowers and therefore distinguish between good and bad risks.

The Kenya lending market is quiet competitive with forty three commercial banks. In a highly competitive market, lenders may not be so willing to share information for fear of losing out to competition. On the other hand, through adverse selection caused by information asymmetry, good borrowers are locked out due to high interest rates and the moral hazard aspect of information asymmetry, may lead to a higher rate of default by bad borrowers who are not deterred by the high interest rates (Atieno, 2001). Japelli and Pagano (2005) noted that the credit markets have been faced with adverse selection and moral hazard problems attributed to information asymmetry among lenders and borrowers. It is therefore important that lenders supplement their information about borrowers with that of other lenders. A credit information system, of which a credit bureau is an important aspect, is therefore a necessity in a functioning credit market. South Africa has one of the most efficient credit reporting systems in sub Saharan Africa characterized by fixed data retention periods that is correlated with the predictive value, presence of competing private bureaus, use of sophisticated credit scoring models that incorporate high quality data, full file reporting including both positive and negative information, information is gathered on both individuals and entities and a proper regulatory framework that facilitates efficiency and effectiveness in credit reporting.

1.2 Statement of the Problem:

The Banking (Credit Reference Bureau) Regulations 2008 were adopted to provide a framework for the governance of licensing, operation and supervision of Credit Reference Bureaus (CRBs) by the Central Bank of Kenya. The CIS initiative in Kenya is, however, threatened by the risk of litigation arising from information shared by lending institutions, particularly in cases where adverse reports have led to decisions unfavourable to a customer seeking credit facilities, such as denial of the facilities sought.

1.3 Research objectives:

To establish the effect of the credit reference bureau on the commercial bank's profitability in Kenya.

1.3.1 Specific objective:

To evaluate the impact of the CRBs on the bank's loan advances

1.3.2 Research Question:

What is the effect of CRBs on bank's loan advances?

1.4 Significance of the study:

The study will help the credit managers in commercial banks to understand the impact of information on credit history and through use of the same enable them to make better credit decisions. The managers will not only use negative but will also be able to rely on positive credit reports to be able to negotiate favourable terms for those borrowers with a good credit history. This information will enable credit managers be able to better manage their debtors.

Being aware of their credit ratings will make them more disciplined in terms of not borrowing from multiple institutions and thus not being able to meet their obligations when they fall due. This study will also help borrowers with good credit reports to use this to their advantage in terms of negotiating for better interest rates, loan amounts and payments.

This study will contribute knowledge on the credit information sharing and the impact it has on efficiency in the credit market. It will open avenue for exploration of other viable sources of information on credit worthiness of a borrower. It will also open up discussion on how to ensure the credit information sharing is managed to achieve accessibility and price viability of credit facilities by lenders in general.

2. LITERATURE REVIEW

2.1 Adverse Selection Theory:

Pagano et al (1993) showed that information sharing reduces adverse selection by improving banks information on credit applicants. The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the borrower) is in a position to negotiate

optimal terms for the transaction than the other party (in this case, the lender). The party that knows less about the same specific item to be transacted is therefore in a position of making either the right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of non-performing loans in banks (Bester, 1994; Bofondi and Gobbi, 2003).

2.2 Moral Hazard Theory:

The moral hazard problem implies that a borrower has the incentive to default unless there are consequences for his future applications for credit. This result from the difficulty lenders have in assessing the level of wealth borrowers will have accumulated by the date on which the debt must be repaid, and not at the moment of application. If lenders cannot assess the borrowers' wealth, the latter will be tempted to default on the borrowing. Forestalling this, lenders will increase rates, leading eventually to the breakdown of the market Alary and Goller (2001).

2.3 Financial Sustainability Models:

Classic microeconomic theory suggests that financial sustainability can be modelled through a 'Marginal-Revenue-Marginal-Cost' approach (Jackson & McConnell, 1980). The means for determining the behaviour, including viability, of a competitive entity is to calculate and compare, at each price level, amounts that each additional unit of output would add to total revenue on the one hand, and to total cost on the other. That is, in comparing the marginal revenue and the marginal cost of each successive unit of production, any unit whose marginal revenue exceeds marginal cost should be produced and any unit marginal cost whose exceeds marginal revenue should not. The equilibrium point where marginal revenue equals marginal cost is the key to the output-determining rule that suggests the entity will maximize profits or minimize losses by producing at that point where marginal revenue and marginal cost equals (Jackson & McConnell, 1980).

2.4 Review of Empirical Studies:

2.4.1 Credit Information Sharing:

Pagano and Jappelli (1993) defines credit information sharing as the process where banks and other credit providers submit information about their borrowers to a credit reference bureau so that it can be shared with other credit providers. This enables banks to obtain information on how borrowers have been servicing their loans. It is also known as credit reporting (CR). CIS enables banks to distinguish between bad and good borrowers. This means that defaulters will not be able to walk into a bank and get credit. This process in the long run will mean better information on borrowers resulting in accessible and cheaper loans. Under the Banking (Credit Reference Bureau) Act, 2008 banks are required to relay negative information to CRB on a monthly basis. The bureau gets updated on any eventual (positive) changes to the information as they occur. The credit report forms a basis for making lending decision by banks. Information is data that has been processed or transformed so that they are meaningful. The quality of information often impacts on the decision that is made using the information. Bocij et al, (2008) argue that the difference between good and bad information can be identified by considering whether or not it has some or all of the attributes of information quality. Further, they explain that attributes of information quality can be divided into three basic categories: time characteristic such as timeliness, currency and frequency which are related to time of collection and review; content characteristic such as accuracy, relevance and conciseness which are related to the scope and content of information and form characteristic which is related to how the information is presented to the recipient. Other qualities include reliability, confidence in source, appropriateness, correct recipient and use of correct channels to transmit the information (Bocij et al, 2008).

The four variables chosen in the conceptual framework highlight some of the qualities of good information as outlined above.

2.4.2 Impact of Credit Information Sharing:

Theory predicts that information sharing institutions will alleviate the problem of information asymmetry in the following ways: Countering adverse selection through elimination of information asymmetry between lenders and buyer by credit reference bureaus which ensure that loans are extended to good borrowers who had been priced out of the market,

Countering moral hazard made possible by increasing the cost of default by the credit information sharing institutions leading to an increased repayment, Countering information monopoly in the sense that it reduces monopoly a lender has on its borrowers (Pagano and Jappelli, 1993). Banks with long relationship with a borrower have information on the credit history of that borrower that other lenders don't and hence they can charge high interest on high quality borrowers and reducing over indebtedness which is made possible by the fact that sharing information among lenders reveals the debt exposure of a borrower to all potential participating lenders and thus those highly exposed receive less credit.

2.4.3 The Credit Reference Bureaus:

In Kenya, the credit reference bureaus are licensed and regulated by the Central Bank of Kenya under The Banking (Credit Reference Bureau) Act 2008. They collect and combine credit information on individuals from different sources and provide the information in the form of a credit report. Currently, the banks are required to submit negative information to the credit bureaus. This information includes; dishonour of cheques other than for technical reasons, proven cases of cheque kiting, proven cases of fraud and forgeries, false declarations and statements, receiverships, bankruptcies and liquidations, credit defaults or late payments on all types of facilities, tendering of false securities and misapplication of borrowed funds. There are currently only two credit reference bureaus licensed in Kenya. They are Credit Reference Bureau Africa Limited licensed on 9th February 2010 and Metropol Credit Reference Bureau Limited licensed on 11th April 2011. The credit report does not contain information on race, religion, medical history, personal lifestyle, political preference, criminal record or any other information unrelated to credit.

2.4.4 Importance of Credit Reference Bureaus:

Central Bank of Kenya (2009) highlights that Credit bureaus act as financial intermediaries within the financial infrastructure, facilitating information exchange among lenders, allowing lenders to supplement their information with that from other lenders so that credit decisions are made from the best possible information. Secondly, credit bureaus make available comprehensive information about a borrower by assembling public records and credit account details to help lenders identify good borrowers. This in turn leads to improved risk management, increased amount of lending, reduction of defaults and enables borrowers to develop credit profiles. Thirdly, credit histories do not only provide information for credit decisions but also allows borrowers to take their credit information from one financial institution to another hence making the credit market more competitive. Fourthly, through information sharing, credit bureaus help prevent the borrower from taking credit from multiple guarantors at the same time leading to over indebtedness. This is through ensuring that at the time of application the lender is aware of the debt exposure of the borrower. Finally, advanced scoring and statistical methods of risk assessments developed using credit information, which categorizes credit applicants according to risk classes; prevent lenders from making bad credit decisions or turning away business by helping them assess the probability of repayment expeditiously. Scorecards indicating probability of risk enable lender to determine the cut off level depending on the risk the lender is willing to take (the lenders' risk appetite).

2.4.5 Credit Risk/ Default Risk:

Jordan et al (2004) define credit risk as the possibility of default. When credit is extended to a borrower, the expectation of the lender is that the terms of agreement will be fulfilled, interest will be paid as due and principal will be repaid as scheduled. Unfortunately, it is not uncommon for events to occur during the life of the debt agreement that make it impossible for the borrower to meet the terms of agreement. If payment is never made, the loss to the lender is obvious, if merely delayed, there is loss since lenders cannot invest the funds and earn interest during the period of the delay. As a result, the interest return actually realised by the lender is less and in many cases substantially less than the agreed on in the loan agreement. This is what is described as the default risk.

2.5 The Conceptual Framework:

This conceptual framework seeks to capture the relationship between access of CRB information, the nature of the information, timeliness of the information and accuracy of information on the banks' profitability.

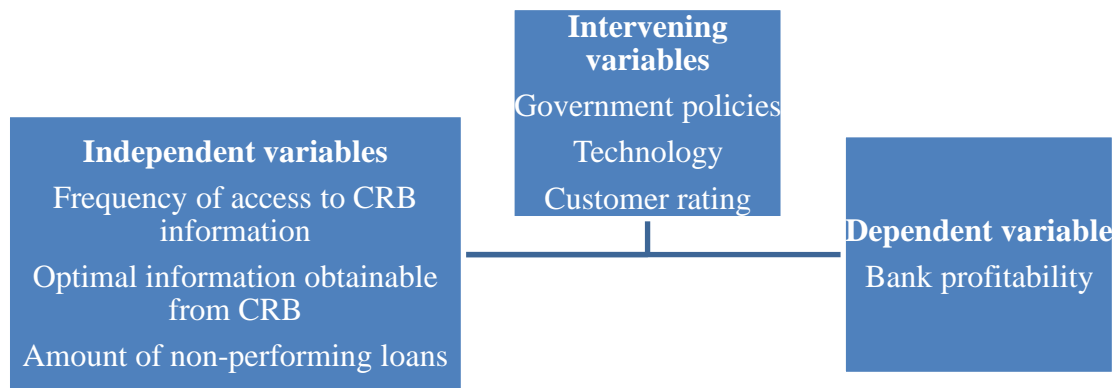


Figure 2.1 conceptual framework

At a given rate of interest, the study seeks to find out if the above mentioned four independent variables impact on the ability of a bank to grant or deny credit on determining the default risk of a borrower.

3. RESEARCH METHODOLOGY

This study used a Case Study of Standard Chartered Bank Kenya to determine the effect of CRB on bank profitability. Standard Chartered Bank Kenya Limited was purposely used. Self-administered semi structured questionnaires was used to collect data from 55 bank officials. Moreover secondary data from the bank’s quarterly financial records was also used in the study to check the bank’s profitability for the periods under study, that is years 2000 to 2014 so as to capture pre and post CRB inception information relevant to the study in Kenya since CRB Act was entrenched in our constitution in the year 2008. Regression model was used to analyze the data with the help of Microsoft excel. The output of analysed data was used to determine the relationship that exists between the dependent and independent variables. Model

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \mu$, Where: Y is the profits after tax, β_0 is the intercept, β_1 and β_2 are parameters of loan advances and non-performing loans respectively, X_1 and X_2 are loan advances to customers and non-performing loans respectively.

4. DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Frequency of requesting for credit reports:

The researcher wanted to know when does the bank request for credit reports from CRB about their borrowers. The results were as follows:

Table 4.1: CRB requests by the bank

Response	Frequency	Percentage
For all credit applications	54	100
For some credit applications	0	0
Not at all	0	0
Not sure	0	0
Total	54	100

From the figure above, 98% of the respondents who were the majority indicated that the bank was requesting for credit reports for all credit applications while 2% said that the request was for only some selected credit applications. This shows the emphasis to which the bank is putting on the credit score information of its potential borrowers.

4.2 Analysis on the loan processing period:

The researcher also sought to know the time it takes for the loan to be processed and drawn into customers’ account in order to know if CRB information has had any impact in processing time. The responses were as shown in the table below.

Table: 4.2 Response on the loan processing time

Response	Frequency	Percentage
1-3 days	35	65
4-7 days	7	13
Moer than 7 days	12	22
Total	54	100

From Table 4.2 above majority of the respondents at 65% indicated that loan processing took 4-7 days, 22% said it took more than one week while 13% indicated that it took 1-3 days to process a customers' loan. This shows that 78% of the respondents agreed that it took less than a week to process a loan as long as the customer meets all the vetting requisites and thus borrowers do not wait for longer periods to be liquidated. Figure 5 shows that credit information of customers took one day when requested by the bank and therefore since all loan applications needed credit scores for processing, then this leads to shorter loan processing periods.

4.3 Findings on the relationship between credit information and loan recovery:

In determining the relationship between credit information and loan recovery of banks the researcher used regression model with the aid of excel spread sheet. The R square, p- value and t-value were used to establish the degree of relationship that exists between credit information and profitability as follows.

Table 4.3: Regression output showing relationship between after tax profits, Non- performing loans and Loan advance to customers

SUMMARY OUTPUT

<i>Regression Statistics</i>					
Multiple R		0.977234422			
R Square		0.954987115			
Adjusted R Square		0.942126291			
Standard Error		660645.5838			
Observations		45			

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	2	6.48E+13	3.24E+13	74.25551	1.93E-05
Residual	7	3.06E+12	4.36E+11		
Total	9	6.79E+13			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>
Intercept	827921.4949	493375.8151	1.678075	0.13723	-338726.922
L.A X1	0.055643232	0.007576734	7.34396	0.000157	0.037727103
NPLs X2	0.567623309	0.21063764	2.694786	0.030871	0.069544437

R square value of 0.95 indicates that there is a strong relationship between profitability, NPLs and loan advances to customers. Therefore 95 % of variations in profitability of the bank are explained by variations in NPLs and loan advances to customers. Moreover t- value statistic and p- value statistic for both loan advance and NPLs indicate that they are significant in the model, that is $t > 2$ and $p < 0.05$ thus indicating that the bureaus are significantly important in influencing the profit levels of the bank under study.

5. SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary:

5.1.1 *How the extend of access to information from CRB influences default rate:*

It was established that the banks level of interaction with CRB applies for all credit applications as indicated by respondents who all noted that the bank must request for customers credit information before applying for any form of credit. This clearly pointing out that frequent and constant interaction will ensure comprehensive information in an attempt to reduce the rate of loan default and at the same time avoid unnecessary excuses from borrowers that they were not aware of credit history.

5.1.2 *The timeliness of CRB information and its effect on loan default:*

Findings showed that all the respondents (100%) agreed that banks received information on time from CRB. This is due to the fact that the information can be accessed online using restricted passwords and the emphasis that the bank has put on the credit score determination for all potential clients.

5.1.3 *How accuracy of information influences loan default rate (nonperforming loans):*

Findings indicated there is a strong positive relationship between accuracy of information and loan recovery. Majority of the respondents at 88% indicated that the bank does not verify the CRB information and uses them as they are to determine customers' credit worthiness. This means that banks have confidence in the CRB information they obtain about their borrowers. The findings on the other hand revealed that apart from the application forms which are not comprehensive enough to cater for all attributes of credit screening, there is no formal trust assessment mechanism in place this compromises the accuracy of information given by the reference bureaus.

5.1.4 *The relationship between profits, loan advances to customers and non-performing loan (NPLs):*

From the regression output it is clear that R Square of 0.95 indicates that 95% of variations in profits of the bank are explained by NPLs and loan advances to customers. This shows the reason why the bank is taking seriously the screening of customers credit information from CRBs before applying for any credit since this will impact heavily on their profitability. Parameters $\beta_1=0.05564$ indicates that 5.56% of the variations in loan advances explains variations in profitability while $\beta_2 =0.567$ shows that 56.7% of the variations in NPLs explains variations in the profitability. Thus NPLs impacts more on the profit levels of the bank than the amount of loan advance.

5.2 Conclusions:

Credit bureaus make available comprehensive information about a borrower by assembling public records and credit account details to help lenders identify good borrowers. The information that can be found in the bureaus about borrowers include: full names, date of birth, national identity card number, passport number, all postal addresses, contact details, employment, employment identification number, profession, income/business history, credit history, loan amounts and securities taken or proposed to be taken. This in turn has led to improved risk management, increased amount of lending, reduction of defaults through reduced nonperforming loans, increase in profits and enabling borrowers to develop good credit profiles.

5.3 Recommendations:

To make clients appreciate the credit policies and recovery procedures banks need to educate their customers on the importance of meeting their credit obligations to avoid being listed in the credit reference bureaus. On the other hand, to avoid inaccuracies in credit reporting banks and regulators should device a way of verifying credit scores since at the moment the banks are using unverified data from the bureaus to either grant or deny a customer any credit facility. This has led to a rising number of litigations in court by customers against their bankers for wrongful listings in CRB.

5.4 Areas for further research:

Studies should be carried out on other factors such as customer service, mobile banking and agency banking to determine their effects on profitability of banks. Moreover the current precedent set by customers suing the bureaus for wrongful listing and its impact in the banking industry should also be studied.

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