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An Assessment of the Contribution of Credit Reference Bureau Regulation towards Mitigating Credit Risks in the Kenya`s Banking Industry

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Abstract
In Kenya, the use of Credit Reference Bureaus to mitigate credit risks is a new concept. The purpose of this study was to carry out an analysis on the contribution of credit reference bureaus in preventing credit risks in Kenya's financial sector. This study also sought to evaluate the extent to which credit reference bureaus regulation has been implemented by commercial banks and to establish any challenges facing credit reference bureaus in Kenya. In chapter three, the case study approach using descriptive design that investigated the concept of applying credit reference bureau in the prevention of credit risks was used. Questionnaires and interviews as instrument of data collection were used. Data was analyzed by SPSS computer program and presented by use of tables, percentages and figures. A regression relationship was generated to show the extent to which each dependent variable was influenced by the independent variable. This was shown by the coefficient of the independent variable in each case. A correlation analysis was also performed to find how the variables are related to each other in the model. The research findings in chapter four found out that the Credit Reference Bureaus concept contributes towards reduction of credit risks and that implementation of Credit Reference Bureaus regulation has gained general acceptance substantially in Kenya. The study also revealed that lack of awareness and non-compliance are currently the major challenges of Credit Reference Bureaus regulation in Kenya. In chapter five, the study recommends that the Credit Reference Bureaus regulation be extended to all sectors that handle credit transactions. There is need for our present Credit Reference Bureaus firms to link with other regional Credit Reference Bureaus firms in other countries. The study further recommends that membership to the Credit Reference Bureaus should be mandatory and enforceable and awareness campaigns to sensitize the public and companies that offer credit transactions should be carried out by the stakeholders.

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Key words: Credit Reference Bureaus, Credit Risk, Kenya's Banking Industry

1.1 Introduction
Historically, the concept of credit reporting agencies was born in the 1860s in the US, when merchants needed to keep track of their customers, especially those of poor credit risk. Names were usually compiled in lists; these were the first "credit bureaus." With the advance of technology and further growth of commerce, companies that

dealt with collecting credit data began to take shape. Sullivan et al, (2003), http://www.creditrepair.com. In Africa, the concept of Credit Reference Bureaus has had its practice in few selected countries by multilateral companies through private credit bureaus such as Compuscan which operates in Botswana, Namibia and Rwanda while Kutz Univar, operate in Tanzania, Kenya and Uganda. http://www.ehow.com.

In Kenya, before the publication of the Banking (Credit Reference Bureau) regulations 2008 and the licensing of the first Kenya`s credit bureau, Credit Reference Bureaus Africa Ltd in February 2010, Kutz Univar bureau was operating in the country. In Kenya, Credit Reference Bureaus concept was given a statutory basis and legal recognition by the Banking (Credit Reference Bureau) Regulations, 2008 published in July 2008 and came into operation on 2nd February 2009. According to the regulations, which provide for the licensing and supervision of Credit Reference Bureaus by the Central Bank, a closed user group for credit information sharing for institutions licensed under the Banking Act was created. A closed user group refers to clientele institutions licensed under the Banking Act, namely, commercial banks, mortgage finance companies and non-bank financial institutions. The Regulations outline the responsibilities of financial institutions and Credit Reference Bureaus as well as provide for the oversight of Credit Reference Bureaus by Central Bank of Kenya. The Regulations compel the sharing of information on both non-performing loans as well as on performing loans. Currently, Central Bank of Kenya has since licensed one Credit Reference Bureaus, Credit Reference Bureau Africa Limited, while three other applications from Metropol Credit Reference Bureau Limited, Compuscan Kenya Limited and Credit Check Limited are at various stages of being licensed. There are 44 licensed commercial banks under the banking Act in Kenya currently.

The Kenyan Banking (Credit Reference Bureau) Regulations, 2008 states that the main role of Credit Reference Bureau is to provide credit histories to financial institutions as to be able to make lending decisions in order to prevent credit risks. As a result, Jappelli and Pagano, (1999) say that credit bureaus assist in making credit accessible to more people, and enable lenders and businesses reduce financial risks. They add that credit bureaus allow borrowers to take their credit histories from one financial institution to another, thereby making lending markets more competitive and in the end, mitigate credit risks and make credit more affordable. Jappelli and Pagano, (1999, further, asserts that sharing of information between financial institutions in respect of customer borrowing behaviour, has a positive economic impact.

1.1.1 Sharing of information

According to Central Bank of Kenya, the introduction of Credit Reference Bureaus in our financial landscape is an effort to encourage sharing of information by institutions so as to reduce the incidences of serial defaults by bank customers as well as minimize the incidences of non-performing loans. Credit information sharing will allow banks to distinguish between good and bad borrowers. Information sharing will also present customers with the opportunity to negotiate a for good credit terms when one has a good credit record. This means that the introduction of Credit Reference Bureaus will inculcate a culture of observing credit terms. SMEs and individual borrowers stand to benefit greatly from the introduction of Credit Reference Bureaus since they will be able to use their credit histories as collateral unlike in the past when they were constrained from accessing credit due to lack of physical collateral. This information will be exchanged by banks on a monthly basis.

This is indicative that sharing of information between financial institutions through Credit Reference Bureau is very essential in the management of credit risks. This study therefore seeks to carry out an in-depth analysis on the contribution of credit reference bureaus in mitigating credit risks in Kenya’s financial sector with specific case study on commercial banks.

2. Literature Review

2.1 Credit Reference Bureau

According to Smith, (1998) the application of the Credit Reference Bureaus concept is enforced through Private Bureaus and Public credit registers where lenders remit information about borrower. Smith adds that timeline and truthfulness of the data reported by lenders to credit bureaus is enforced invariably by threatening deviants that they will be excluded from access to the common data base. According to Smith, (1998) private bureaus are profit oriented venture created by the initiative of entrepreneurs or a coalition of lenders. He states that credit reference agencies such as such as Duns & Bradstreet in the US, can be regarded as voluntary information sharing mechanisms, insofar as they draw a large portion of their data from lenders and suppliers, who in return obtain preferential access to their data. Alvarado, (1999) defined Public credit registers as databases created by public authority and managed by central banks. Their data are compulsorily reported by lenders, who then obtain a return flow of data for use in their lending decisions. Alvarado indicates that special public registers exist for specific classes of debt contracts or securities: for instance, in many countries lease registers record the real collateral assisting housing mortgage loans. Typically, these registers for special classes of debt have long initiated the creation of modern public credit registers managed by central banks, which record bank loans and lines of credit (Alvarado, 1999). Smith (1998) indicates that PCR differs from private bureau in that PCR universally covers all financial institutions and membership is compulsory for all lenders under regulatory jurisdiction of the CBKS. However, he says PCR does not cover all loans; there is a threshold below which they don't cover. Private bureau cover all amounts of loans but may only be patronage by lenders who join and pay membership fee.

According to Carolina, (1999), the type of information shared in both types of bureau is mainly "black" information i.e. negative information i.e. defaults or arrears and not white information i.e. positive information. In addition, the use of Credit Reference Bureaus extends to sharing information merged from other sources such as criminal records, tax records etc. Carolina adds that in some case, all these data of information is compiled together and used to assign credit scores of borrowers based on statistical risk analysis.

Trivelli, (1999) concluded that one of the challenges to effective use of credit reference bureau is the negative effects on banks' profits. He argues that giving out private information hands over potentially valuable asset to the competitors. He also says the liabilities of trans-border borrowing which account for debt owed to foreign lenders may not be captured by the local credit reference systems bureau hence posing another barrier for credit bureau application. Pagano and Jappelli (1993) suggests that this problem can be mitigated if banks share information across boarders Trivelli, (1999), also agrees and adds that the design of credit information system can mitigate adverse effect of handing over private information to competitors. Other issues such as increase in lending to safe borrowers may fail to compensate for reduction in lending to risky types of borrowers Padilla and Pagano (1997). Padilla and Pagano, (1997), found out that Credit reference bureau can have a negative effect of sharing information about borrowers' quality type. Besides, the problem of threshold amount limit as in public credit register and the threat of infinite memory by the credit reference systems has posed some challenges Bolton (1990) ,Penati (1998). According to Jappeli and Pagano (1999), the possibility of collusion of credit bureau members create barriers to new entrants. Jappali and Pagano, (2000) and Hleifer, (1998) observe that strict privacy protection laws in some countries like France, prevent development of private credit bureaus. The use of sophisticated technological systems, according to Bizer, (1992), also pause potential challenge. All in all in my view these challenges can only be mitigated by sound regulatory management of he financial sector and the use of credit reference bureau by all lenders.

In their research on Commercial Banking Crises in Kenya: Causes and Remedies, Nelson M. Waweru and Victor M. Kalani (2009) concluded that many of the financial institutions that collapsed in 90s were due to non-performing loans. On the causes, they found out that one major cause was due to lack of regulated credit reference bureaus in the country. Earlier studies done in this area limited themselves in credit risk management within the individual financial institutions and lacked the concept of information sharing found in CRB concept. This is true for research works by Ndegwa, S. (2001) on Systematic and Business risks, Mwirigi, P, K (2006) on Assessment of Credit Risk Management Techniques adopted by Microfinance in Kenya and many others which never touched on credit risk mitigation through CRBs. However, much of the previous research in CRBs is all foreign as has been observed by the reviewed literature.

2.2The need for sharing of information to mitigate credit risks

Giesecke (2004) defines credit risk as the distribution of financial losses due to unexpected changes in the credit quality of counterparty in a financial agreement. Saunders at al (2006) states that credit risk is the risk that the promised cash flows from loans and securities held by financial institution may not be paid in full. This means that borrowers may default in interest and principal payment, hence causing financial loss to the financial institutions.

According to Petersen, (1994), the data needed to screen credit applications and to monitor borrowers are not freely available to banks. When a bank does not have such information, it faces "adverse selection" or "moral hazard" problems in its lending activity.

Adverse selection arises when some information about the borrowers' characteristics remain hidden to the lender (hidden information), and can lead to an inefficient allocation of credit, Moral hazard arises instead from the lender's inability to observe borrower's actions that affect the probability of repayment. This creates the danger of opportunistic behaviour or moral hazard by the borrower and informational disadvantage by the bank leading to inefficient allocation of credit. Hogen et al (2001 258) suggest that Mitigation of credit risks is the core business in the banking business. According to Deborah Ralton and April Wright International Journal of Bank Marketing (2003) there is need to have appropriate risks management mitigation strategy in order to reduce risk of loan default because a financial institutions' viability is weakened by the loss of principal and interest. Eagles and Bosworth (1998) adds that if mitigation of credit risk are not addressed, the institution will incur financial losses, incur costs taken to recover the capital at risk and fail in its social role of providing loans to members of society to improve their living standards.

2.3 Methods of mitigating credit risks by banks

Banks have their own methods of mitigating credit risks. According to Damiano Brigo and Massimo Masetti, (2006), Banks generally charge a higher interest rate to borrowers who are more likely to default, a practice they call risk-based pricing. This is because they consider factors relating to the loan such as loan purpose, credit rating, and loan-to-value ratio. Banks may also write stipulations on the borrower, called loan covenants, which are included in the loan agreements. According to Cornett, et al, (2006), such covenants include requirements for borrowers to periodically report their financial conditions, refrain from paying dividends, repurchasing shares, borrowing further, or other specific, voluntary actions that negatively affect the company's financial position or may require the lender to repay the loan in full, at the lender's request, especially in certain events such as changes in the borrower's debt-to-equity ratio or interest coverage ratio.

Cornett, et al, (2006) adds that lenders and bond holders may hedge their credit risk by purchasing credit insurance or credit derivatives. These contracts transfer the risk from the lender to the seller (insurer) in exchange for payment. Lenders can also reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. Garp Risk Review, (July-August 2007) Related SSRN Research Paper.

De Servigny, Arnaud and Olivier Renault (2004) say that where borrowers face a high degree of unsystematic credit risk called concentration risk, lenders can reduce this risk by diversifying the borrower pool. According to Franken, Karmann and Scholtens, (2004), many governments establish deposit insurance to guarantee bank deposits of insolvent banks. Such protection discourages consumers from withdrawing money when a bank is becoming insolvent, to avoid a bank run, and encourages consumers to holding their savings in the banking system instead of in cash.

3. Methodology

3.1 Research Design

The research design adopted in this study was a case study approach using descriptive design that investigated the concept of applying credit reference bureau in the prevention of credit risks. This type of descriptive research was used because it gives a systematic collection and analysis of data in order to answer questions concerning current status of a program, proposal or activity as it is Mugenda et al (1999).

3.2 Population and sample

The population of the study consisted of all the licensed commercial banks in Kenya and the credit reference bureau under the Banking Act. According to the Central Bank of Kenya, there were 44 licensed banks and one credit reference bureau in Kenya as at 30th February 2011.

3.3 Sampling and sampling techniques

A sample of 9 banks was selected using stratified random sampling procedures based on their size category in terms of capitalization as per the Central Bank of Kenya rankings and the one and only licensed credit reference bureau then was purposively selected for the study**.** The researcher used purposive method to select 30 respondents for the research and was composed of bank managers, credit managers, credit analyses and senior staff of credit reference bureau as shown by the table 3.1 below. All these respondents were from the headquarters of their institutions based in Nairobi where they are in position to have the information needed by the study.

Table 3.1 Sample Design

Respondent's Categories	**Sample Size**
Bank managers	**9**
Credit managers	**9**
Credit analysts	**9**
CRB Africa ltd Senior managers	**3**
TOTAL	**30**

Source: Researcher, 2014.

3.4 Research Instrument (Tools)

To collect primary data, the researcher used questionnaires and interviews. Besides, secondary data and other sources like annual publications, brochures, journals, monthly publication, and library books were used. Interview schedules were also carried out with respondents and this data collection tool enabled the researcher to obtain more authentic information beyond the limitations of questionnaires.

3.5 Data Collection Procedures

With the help of research assistants the researcher visited the institutions and administered the questionnaires and conducted interview schedules. Arrangements were made with the assistance of public relations officers to administer questionnaires to top management staff. A maximum of three hours period was given to the respondents to answer the questions before collecting them.

3.6 Instrument validity

Validity is concerned with the question of whether an instrument measures what it intends to measure Nachmias, C. & Nachmias. D. (1996). To ensure validity, questionnaire was prepared in conjunction with literature review and based on the research objectives and questions. Its content validity was pre-tested by a pilot study and discussed with the supervisor, colleagues, experienced researchers and professional bankers. Completed questionnaires were collected directly from respondents which enabled any clarification of any issues that respondents needed clarified.

3.7 Reliability of instruments

Reliability is the degree to which an instrument measures accurately what it claims to measure. According to Powell, (2004) reliability is always contingent on the degree of uniformity of the given characteristics in the population. This implies that the more heterogeneous the population is in regard to the variable in question, the more reliable the instrument is likely to be. In assessing reliability of the data, internal consistency method using Cronbach's alpha was used whose alpha values obtained indicated a coefficient of approximately 0.7 and which was considered acceptable.

3.8 Data analysis

The data from the respondents was edited, coded and tallied according to their themes and analyzed into total scores, frequencies, and percentages using SPSS computer programs and results presented in tables, pie charts, bar graphs and figures.

3.8.1 Regression model

The study examined the contribution of credit reference bureaus preventing in credit risks in Kenya's financial sector. The relationship between the variables was stated using a mathematical function.

$Y = f(X_1, X_2, X_3, X_4)$

Where Y was the dependent variable and X_1, X_2, X_3 and X_4 are the independent variables

Credit risks was represented by Y

Therefore, an analytical model of a linear multiple regression equation of the form shown below was developed.

Where:

$$Y=\alpha +\beta_1X_1+\beta_2X_2+\beta_3X_3 +e_1$$

Y= Credit risks

α = Autonomous factors

X_1= Screen credit applications

X_2= Monitoring borrowers

X_3= Credit risk hedging

β_1 = Coefficient for Screen credit applications

β_2 = Coefficient for Monitoring borrowers

β_3 = Coefficient for Credit risk hedging

ε = Error term - Captures all relevant variables not included in the model because they were not observed in the data set

This regression relationship showed the extent to which each independent variable as influenced the dependent variable. This was shown by the coefficient of the independent variable in each case. A correlation analysis was also performed to find how the variables are related to each other in the model.

4. Findings

Table 4.1: Model Summary

Model	**R**	**R Square**	**Adjusted R Square**	**Std. Error of the Estimate**
1	.901[a]	.811	.798	.88195

Source: Research Data, 2014

Adjusted R squared is coefficient of determination which tells us the variation in the dependent variable due to changes in the independent variable, from the findings in the above table the value of adjusted R squared was 0.798 an indication that there was variation of 79.8% on the credit risk due to changes in screening credit applications, monitoring borrowers, and credit risk hedging at 95% confidence level. R is the correlation coefficient which shows the relationship between the study variables, from the findings shown in the table above there was a strong positive relationship between the study variables as shown by 0.901.

Table 4.12: ANOVA

Model		**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig.**
1	**Regression**	0.042	2	0.021	3.064	.018[b]
	Residual	7.824	24	0.326		
	Total	7.866	26			

From the ANOVA statistics in table above, the processed data, which is the population parameters, had a significance level of 0.018 which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%.

Table 4.13: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
	(Constant)	.510	.440		1.159	.000
	Screening credit applications	-.226	.129	-.026	-1.751	.018
	Monitoring borrowers	-.247	.125	-262	-1.976	.043
	Credit risk hedging	-.276	.185	-.183	-1.491	.042

Source: Research Data, 2014

The established regression equation was

$Y = 0.510 - 0.226\ X_1 - 0.247\ X_2 - 0.276X_3$

From the above regression equation it was revealed that holding screening credit applications, monitoring borrowers and credit risk hedging to a constant zero, credit risk in the banks would stand at 0.510. A unit increase in screening credit applications would lead to a decrease in banking credit risk by a factor of 0.226, unit increase in monitoring borrowers would lead to decrease in banking credit risk by factors of 0.247 and unit increase in credit risk hedging would lead to decrease in banking credit risk by a factor of 0.276. This shows that there was negative association between banking credit risk and screening credit applications, monitoring borrowers and credit risk hedging. The study found that all the sign value for all the variables, credit risk, screening credit applications, monitoring borrowers and credit risk hedging were found to significantly influenced by information sharing through credit reference bureaus. All the p-value for all the independent variable was found to be less than 0.05 indicating that they were statistically significant.

4.5 Conclusion

The study revealed that the concept of Credit Reference Bureau and its usage in the financial institutions contribute significantly towards credit risk mitigation. This is in line with the banking (CRB) regulation 2008, which stated that Credit Reference Bureau reduces loan default rates as borrowers seek to protect their reputation collateral. These findings also conquered with Petersen (1999) and Nelson et al (2009) who stated that Credit Reference Bureau operates as a borrower discipline device and contributes positively towards mitigation of credit risks.

The study findings showed that over 93% of the commercial banks have been registered with the Credit Reference Bureaus firm licensed so far. In addition, the study showed that 33% other players such as Higher Education Loans Board that manage credit have also registered with Credit Reference Bureaus firm, but to very little extent meaning that whereas commercial banks have to a large extent impressed the Credit Reference Bureaus regulation and joined Credit Reference Bureaus, other players that handle credit transactions have not impressed and joined the Credit Reference Bureaus. This is in line with Smith (1998) who said that implementation of Credit Reference Bureaus regulation is enforced through private credit bureaus where lenders remit information about the borrowers. There Credit Reference Bureaus regulation should extent to all sectors that handle credit transactions, such as mobile companies because it’s present application is limited to financial sector under the Banking Act. This will enable significant impact on its contribution.

That Credit Reference Bureaus firms in Kenya should link with other regional Credit Reference Bureaus firms in other countries in order to monitor loan defaulters who move from one region to another. This is due to globalization and regional blocs that are forming up like the East African Cooperation. Membership to the Credit Reference Bureaus should be mandatory and enforceable and should not be left optional to some players who handle credit transactions. The stakeholders like institute of bankers should amount awareness campaigns to sensitize the public and companies that offer credit transactions on the importance of Credit Reference Bureaus on the prevention of credit risks.

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