

STRATEGIC ROLE OF CREDIT REFERENCING BUREAU ON CREDIT RISK MANAGEMENT IN MICROFINANCE INSTITUTIONS IN KERICHO COUNTY

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Abstract: The need for establishment of CRB services in any financial system arises because of information asymmetry between lenders and borrowers. The study aims to assess the strategic role of credit referencing bureau on credit risk management on microfinance institution in Kericho County. It was guided by four objectives: To determine the influence of credit information sharing on the credit risk management on microfinance institutions in Kericho county; To establish the effect of credit scoring on microfinance institutions in Kericho county; To analyze the role of the reduced moral hazard on microfinance institutions in Kericho county; To establish the effect of loan portfolio diversification on microfinance institutions in Kericho county. The study was guided by four theories namely; Theory of Asymmetric Information; Adverse Selection Theory; Moral Hazard Theory; Information Theory of Credit; Power Theory of Credit. The study adopted a descriptive research design and the researcher targeted the 10 microfinance. The study targeted employee of microfinance in the county. This study adopted Cluster sampling technique. Both descriptive and inferential statistics were adopted for the study. The quantitative data was analyzed by using descriptive statistics which includes frequency distribution tables and measures of central tendency (the mean), measures of variability (standard deviation) and measures of relative frequencies. The inferential statistics included a regression model which established the relationship between variables. Data was analyzed by the use of a statistical software SPSS version 20. Data was presented in the form of tables and charts. Looking at the variables collectively, it's evident from the table that 59.2% of variance in the credit risk management practices by Commercial banks. 59.2% of the variations in the credit risk management practices by Commercial banks can be explained by the identified independent variables: Credit Information Sharing, Credit Scoring, Reduced Moral Hazard, and Loan Portfolio Diversification.

Keywords: financial system, credit risk management, microfinance institutions in Kericho county.

1. INTRODUCTION

Back Ground to the Study:

Development and growth of any economy depends largely on a financial sector success. The primary function of financial institution is mobilizing deposits from surplus units to deficit units in the form of loan and advances to various sectors such as agricultural, industry, personal and governments. As noted by Wandera (2013) financial institutions play a vital role to emerging economies where most borrowers have no access to capital markets. Thus, they are considered as an intermediary between the depositors and borrowers. However, in recent times, there have been an increased number of significant problems both at matured and emerging economies Tendia et al (2012).

While there are several reasons that can lead to Mfis' sectors performing poorly like inefficient management and low capital adequacy, nonperforming assets remain the single largest cause of irritation of the sector sectors Sontakke and Tiwari (2013). Deterioration in asset quality is much more serious problem of Mfi's unless the mechanism exists to ensure the timely recognition of the problem. It is a common cause of Mfi's failure. Poor asset quality leads to nonperforming loan that can seriously damage a Mfis financial position having an adverse effect on banks operation Lafuente (2012). Some institutions like microfinances have become very cautious in extending loans due to non-performing assets Sontakke and Tiwari (2013).

Microfinance institutions generate their revenue from credit extended to low income individuals in the form of interest charged on the funds granted (Central Bank Annual Report, 2010). In many case the loan repayments may be uncertain since many of the loans extended end up being bad loans. The success of lending out credit depends on the methodology and information applied to evaluate and to award the credit Ditcher (2003). To overcome the challenge of NPLs, Microfinance is required to monitor the behaviour of borrowers and get as much information as possible about borrowers' financial habits and credit worthiness before making any decision to advance credit Schreiner (2001). The idea of establishing credit referencing mechanism was conceived in order to enable lenders to monitor the behaviour of borrowers and determine credit worthiness and therefore reduce the loan default risk or bad loans Sullivan and Sheffrin (2003).

Despite recent growth in the Microfinance sector in Kenya, the sector is faced with challenges of loan repayment defaults by clients. The issuance of credit reference bureau licences by the Central Bank of Kenya to Credit-Info Credit Reference Bureau Limited, Credit Reference Bureau Africa Limited and Metropol Credit Reference Bureau Limited has been viewed as progress in the right direction especially in aiding borrower assessment. There has been a heightened general interest in the credit rating industry in the country. Many have begun asking who the industry's firms are; what they do; how they do it; and what the consequences of their actions would have on the players and consumers within the financial industry in Kenya.

Locally, few aspects relating to Credit Reference Bureau have been reviewed in Kenyan context. (Mumi, 2010) reviewed the impact of credit reference bureau in financial institutions in Kenya; (Sigei, 2010) researched on evaluating the effectiveness of credit reference bureau in Kenya. The case of KCB; (Nganga ,2011) carried out a study on stakeholder perception of credit reference bureau service in Kenya credit market and finally (Gaitho,2010) reviewed the role of credit reference bureau on credit access, a survey of commercial banks in Kenya.

This study was therefore attempted to fill the gap by examining the strategic role of CRB on the credit risk management on microfinance institutions in Kericho County.

2. LITERATURE REVIEW

Information Asymmetry Theory:

According to Jensen and Meckling (1976) Information asymmetry occurs when one group of participants has better or timely information than other groups. Typically, the source of the information asymmetry is the superior knowledge that one party have about some prospects or decision, while the other party may comprise the uninformed group. This may lead to uninformed group end up making uniformed decisions.

Information asymmetry under credit management happens when one party, borrower or lender has superior information. In case of potential loan default, the borrower has information on their ability to repay the loan amount, while the lender may be disadvantaged. Credit referencing Help Bridge the gap created by information asymmetry by enabling lenders to access and assess the character of the borrower and there make informed lending decisions. Jensen and Meckling (1976).

Decision Theory:

Decision theory is the part of probability theory that is concerned with calculating the consequences of uncertain decisions. This can be applied to state the objectivity of a choice and to optimise decisions. Several aspects of decision theory exists, these may include the following under the lending decision: risk appetite, risk attitude, expected value, expected utility, loss aversion and information availability Kahneman and Tversky (1979).

The definition of risk appetite is the amount of risk, on a broad level; an entity is willing to accept in pursuit of value (COSO, 2004). Utility is used as a measurement of satisfaction. This can also be used in decision theory, as a means of expressing the satisfaction of a particular choice. When indifference is reached, the satisfaction that the options carry is the same. People in general would rather take a decent sized certain gain than gamble for a potential large gain and in contrast are willing to take a gamble to avoid a certain loss Kahneman and Tversky (1979).

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 borrower's wealth properly, maybe because of lack of information or inability to do a proper assessment of the same, 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)

The Credit Theory:

States that, "a sale and purchase is the exchange of a commodity for a credit". From this main theory springs the sub-theory that the value of credit or money does not depend on the value of any metal or metals, but on the right which the creditor acquires to „payment,“ that is to say, to satisfaction for the credit, and on the obligation of the debtor to „pay“ his debt, and conversely on the right of the debtor to release himself from his debt by the tender of an equivalent debt owed by the creditor, and the obligation of the creditor to accept this tender in satisfaction of his credit." Mitchell (1914).

In this sense Mitchell (1914) argued that it is a credit that redeems a debt. He further argues that payment is, in the end, the promise to "cancel our debt by an equivalent credit expressed in terms of our abstract, intangible standard."

Adverse Selection Theory:

Stiglitz and Weiss (1981) originate the paper of adverse selection theory of credit markets. The theory rests on two main assumptions: that lenders cannot distinguish between borrowers of different degrees of risk, and that loan contracts are subjects to limits (i.e. if project returns are less than debt obligations, the borrower bears no responsibility to pay out of pocket).

This analysis is restricted to involuntary default, i.e., it assumes that borrowers repay loans when they have the mean to do so. In a world with simple debt contracts between risk-neutral borrowers and lenders, the presence of limited liability of borrowers imparts a preference for risk among borrowers, and a corresponding aversion to risk among lenders. This is because limited liability of borrowers implies that lenders bear all the downside risk. On the other hand, all returns above the loan repayment obligation accrue to borrowers. Raising interest rates then affects the profitability of low risk borrowers disproportionately, causing them to drop out of the application pool.

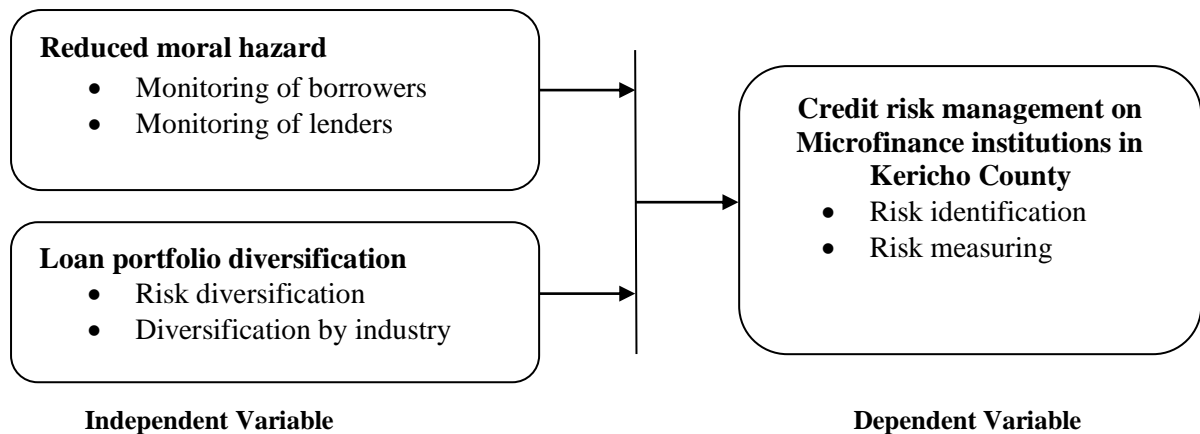
This leads to an adverse compositional effect higher interest rates increase-the riskiness the average riskiness of the applicant pool at a very high Interest rates, the only applicant are borrowers who could potentially generate very high return (but presumably with small probability). Since lenders' preference over project risk run counter to those of borrowers, they may hold interest rates at levels below market-clearing and ration borrowers in order to achieve a better composition and lower risk in their portfolio. Excess demand in the credit market may persist even in the face of competition and flexible interest rates.

In the adverse selection theory, the interest rate may not raise enough to guarantee that all loan applicants secure credit, in times when loanable funds are limited. In general, the volume of credit and level of effort is less than the first-best. Borrowers who have greater wealth to put as collateral obtain cheaper credit, have incentives to work harder, and earn more income as a result. Existing asset inequalities within the borrowing class are projected and possibly magnified into the future by operation of the credit market, a phenomenon that may cause the persistence of poverty. By exchange information about their customers' accounts can improve their knowledge of applicants' characteristics and behavior. In Principles, this reduction of informational asymmetries can reduce adverse selection problems in the lending, as well as change borrowers' incentives to repay, both directly and by changing the competitiveness of the credit market. Information asymmetries are the main obstacle for MFIs to provide loans to clients Nawai (2010).

According to Silwal (2003) to minimize these problems financial institutions usually requires business project, borrower past credit information and collateral before approving the loan. MFIs also offer credit through group-based lending method to mitigate adverse selection and to replace the collateral requirement. Pagano and Jappelli (1993) show that information sharing reduces adverse selection by in improving MFI's information on credit applicants. In their model, each institution has private information about local credit applicants, but has no information about nonlocal applicants.

If MFIs exchange information about their client's credit worthiness, they can assess also the quality of non-local credit seekers, and lend to them as safely as they do with clients. Information sharing can also create incentives for borrowers to perform in line with MFIs' interest. Klein (1982) shows that information sharing can motivate borrowers to repay loans, when the legal environment makes it difficult for financial institution to enforce credit contracts. In his model borrowers repay their loans because they know that defaulters will be blacklisted, reducing external finance in future.

Conceptual Framework:



3. RESEARCH FINDINGS AND DISCUSSIONS

Reduced Moral Hazard:

The study sought to determine the role of the moral hazard on credit risk management on Microfinance institution in Kericho County. The respondents were presented with statements with factors that affect the credit information sharing and the responses are presented on the Table below

The Reduced Moral Hazard:

Statement	n	Mean	Standard Deviation
Moral hazard on credit officers and borrowers arises when loans are not subjected to normal objective credit assessment before disbursement.	168	4.12	0.591
Mfi must have in place written guidelines on the credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions	168	4.47	0.213
Clear established process for approving new credits and extending the existing credits has been observed to be very important while managing Credit Risks in banks	168	4.88	0.528
Related party transactions should be reviewed by the board of directors under due processes of good governance	168	3.76	0.488

The responses on the role of moral hazard are presented above table. The respondents agreed Moral hazard on credit officers and borrowers arises when loans are not subjected to normal objective credit assessment before disbursement with a mean of 4.12 and standard deviation of 0.591. The respondents agreed that banks must have in place written guidelines on the credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions with a mean of 4.47 and standard deviation of 0.213. The respondents strongly agreed that Clear established process for approving new credits and extending the existing credits has been observed to be very important while managing Credit Risks in banks with a mean of 4.88 and standard deviation of 0.528. The respondents agreed that related party transactions should be reviewed by the board of directors under due processes of good governance with a mean of 3.76 and standard deviation 0.488.

Relationship between Credit Risk Management Practices and the Reduced Moral Hazard:

		Reduced Moral Hazard
Credit Risk Management Practices	Pearson correlation	0.457
	Sig.	0.004

Table above presents there is a positive significant relationship between credit risk management practices and the reduced moral hazard at 95% confidence interval as indicated by the P-value of 0.004. Moral hazard models imply that information sharing should reduce default rates and interest rates and increase lending, either because credit bureaus foster competition by reducing informational rents (Padilla and Pagano, 1996) or because they discipline borrowers (Padilla and Pagano, 1997).

Loan Portfolio Diversification:

The study sought to determine the influence of loan portfolio diversification on credit risk management of commercial banks in Kenya. The respondents were presented with statements with factors that affect the credit information sharing and the responses are presented in table below Loan Portfolio Diversification

Loan Portfolio Diversification:

Statement	N	Mean	Standard Deviation
Preference for group financing	168	2.95	1.083
Sectorial orientation	168	4.02	0.499
Portfolio performance	168	4.71	0.152
Review of funding priority orientation	168	4.31	0.526
Portfolio concentration	168	2.16	0.324
Portfolio return to cost measurement	168	3.95	0.258
Portfolio integration with other risk types	168	4.61	0.848

Table presents the findings on loan portfolio diversification. The respondents disagreed with the statement they preferred group financing with a mean of 2.95 and standard deviation of 1.083. The respondents however agreed that the portfolio had Sectorial orientation with a mean of 4.02 and standard deviation of 0.499 and strongly agreed Portfolio performance affected the loan portfolio diversification with a mean of 4.71 and standard deviation of 0.152. The respondents agreed that the Review of funding priority orientation highly affected the loan portfolio diversification with a mean of 4.31 and standard deviation of 0.526. The respondents however disagreed with the statement Portfolio concentration affects diversification but agreed on Portfolio return to cost measurement and Portfolio integration with other risk types with a mean of 3.95 and 4.61 respectively.

Relationship between Credit Risk Management Practices and Loan Portfolio Diversification:

		Loan Portfolio Diversification
Credit Risk Management Practices	Pearson correlation	0.890
	Sig.	0.000

Table presents there is a positive significant relationship between credit risk management practices and the loan portfolio diversification at 95% confidence interval as indicated by the P-value of 0.000. Michael et al (2006) emphasized that loan portfolio affect operational efficiency which in turn affects the profits of the bank, liquidity position and solvency position of banks. Batra, S (2003) noted that diversification also affect the psychology of bankers in respect of their disposition of funds towards credit delivery and credit allocation.

4. FINDINGS, CONCLUSION AND RECOMMENDATIONS

Introduction:

The data was analyzed and presented in form of tables and charts. The relationship between the factors (Independent variables), the policy implications from the findings and areas for further research are also presented. The study recommended to the various stakeholders in the Microfinance institution in the county is also presented. Areas for further study have also been presented.

Summary of major Findings:

In conclusion most of the respondents were female .The respondents who were between 41-45 Years made the highest percentage while those between 46-50 years in age made the least percentage.The officers who formed part of the respondents were mostly graduates and a less than half of the respondents had ether postgraduate or other qualification. When the respondents were presented with how long they have worked in the organization. Majority of the respondents had between 11-15 years in experience, while the other respondents had between 16-20 years in experience, majority of the respondents had between 26-30 Years in experience while the respondents had less than 5 years in experience.

Reduced Moral Hazard:

There is a positive significant relationship between credit risk management practices and the reduced moral hazard. The respondents agreed Moral hazard on credit officers and borrowers arises when loans are not subjected to normal objective credit assessment before disbursement. The respondents agreed that banks must have in place written guidelines on the credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions. The respondents strongly agreed that Clear established process for approving new credits and extending the existing credits has been observed to be very important while managing Credit Risks on the microfinance institutions in Kericho County. The respondents agreed that related party transactions should be reviewed by the board of directors under due processes of good governance.

Loan Portfolio Diversification:

There is a positive significant relationship between credit risk management practices and the loan portfolio diversification. The respondents disagreed with the statement they preferred group financing. The respondents however agreed that the portfolio had Sectorial orientation and strongly agreed Portfolio performance affected the loan portfolio diversification. The respondents agreed that the Review of funding priority orientation highly affected the loan portfolio diversification. The respondents however disagreed with the statement Portfolio concentration affects diversification but agreed on Portfolio return to cost measurement and Portfolio integration with other risk types.

Conclusion:

Looking at the variables collectively, it's evident from the table that 59.2% of variance in the credit risk management practices by microfinance institutions in Kenya .59.2% of the variations in the credit risk management practices by microfinance institution in Kericho can be explained by the identified independent variables: Reduced Moral Hazard, and Loan Portfolio Diversification. CRB allows for credit information sharing in the microfinance institution. Credit information sharing undoubtedly plays a pivotal role in reducing the information asymmetry that exists between banks and borrowers. The major benefit that the microfinance receive from CRB is that they are able to get credit information on prospective borrowers that will facilitate assessment of credit requests to mitigate risks of bad debts (Sullivan and Sheffrin 2003).

Recommendations:

Reduced Moral Hazard:

Clear established process for approving new credits and extending the existing credits should be observed to be very important in managing Credit Risks in banks. Monitoring of borrowers should be done in monitoring current and potential exposures change with both the passage of time and the movements in the underlying variables

Loan Portfolio Diversification:

The bank should establish a framework is established that helps determine the amount to offer to different customers. The banks should identify various products that make up portfolio to extend the reach of different borrowers.

Areas for Further Research:

The researcher recommends further studies to be carried out on other factors that affect credit risk management other than the mentioned ones like risk identification. The study recommends that further research be done in other factors affecting CRB in other counties and establish the role credit referencing bureaus to SACCOs and other revolving funds in the counties.

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