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CREDIT INFORMATION SHARING AND PROFITABILITY OF BANKS IN KENYA.

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ABSTRACT

Purpose: Credit information sharing cost positively influenced the profitability of banks in Kenya. The general objective of the study was to evaluate credit information sharing and profitability of banks in Kenya.

Methodology: The paper used a desk study review methodology where relevant empirical literature was reviewed to identify main themes and to extract knowledge gaps.

Findings: The study stablished that borrower's credit history information had a positive influence on the profitability in Kenya. The study the respondents agreed that their banks collect information on the number of previous applications that a loan applicant has made, the bank collects information on the number of loans applied and declined, the bank asks for reasons that the loan applied was declined for all applicants, the bank asks loan applicants to indicate the discipline observed when repaying previous loans advanced, the bank asks clients to indicate if they have delayed in remitting their periodic loan repayment in the past, the banks collect more information about the loan applicants credit history from the CRB.

Recommendations: The study recommended that while sharing information, the banks should do a cost benefit analysis to ascertain if the sharing of such information is material or not. It should pay its attention to the administrative costs that come with sharing information. This is because the cost of information sharing as seen from the study results have a negative and significant influence on performance.

Keywords: *evaluate credit information, sharing, profitability, banks, Kenya.*

1.0 INTRODUCTION

1.1 Background of the Study

Credit risk models are applied by financial institutions such banks so as to determine losses from credit loss for a specific time scope. The approach's output is portfolio loss distribution that explains the probable losses from credit as well as their possibilities. In estimating the credit loss organization must create the value of portfolio today as well as the end period of the time scope. There usually exist two key models associated with determining the credit loss. Within the default mode paradigm, a credit loss takes place once there is a default. Loses from credit are considered costless though the existing difference between the recovery value and exposure at defaults. Under the view of the market paradigm, losses from credit are said to have occurred in case of default by borrowers. It also takes place in case of decline of the credit quality of borrowers (Braverman & Guasch, 2006). As much as there is the paradigm, it is still a tall order for banks to attain prompt payment history for various clients for use within the credit assessment process.

Riungu (2014) studied the effect of CRB on Kenya's Banks profitability. The findings obtained show that credit information systems improves risk assessment of loan applicants and enhances sharing of pertinent credit information on worthiness of a borrower amongst financial institutions. Although the study closely relates to this current study, it focused on 44 Kenyan commercial banks based in the City of Nairobi County. This shows a clear knowledge gap on the benefits of CRB on the profitability of banking institutions in one of the busiest counties in Kenya. Faced with adverse credit risk challenges and numerous losses, commercial banks are currently adopting credit Information sharing to enables credit these financial institutions to minimize risk and have confidence when offering credit because they can estimate the likely loss that they will incur if the borrower defaults on their loan obligations,(Beck, 2004). This, therefore, gives the lender the evidence and therefore the confidence that there exists the means and ability of borrowers to repay by looking at repayment and other accounts. Whereas the structure of the credit market has no effects on credit rationing, it will eventually affect the availability of credit through client-maximizing cross-subsidization. The risk is high and very costly in credit markets where the players are risk averse. In a market where there is competition, the increasing rate of cost from a higher risk is usually compensated in return by the high prices i.e. (interest rate) up to the point when equilibrium will be attained; this is when the supply is equal to demand (Bercoff, Julian, &Franque, 2002).

Several theorists have shown the pertinence of obtaining credit information before giving loans. The Adverse Selection Theory as postulated by Pagano and Jappelli (1993) shows that adverse selection is reduced by information sharing. As such, credit reference bureau can improve the capacity of banks to obtain accurate credit applicant's information. Further still, the Theory of Asymmetric Information as expounded by Auronen (2003) shows that there exists difficulty in differentiating between bad and good borrowers. In this regard, the theory argues that having the right information about a borrower can avert possible adverse effects such as loan default and delinquency (Bofondi&Gobbi, 2003; Richard, 2011). Owing to the immense benefits associated with credit information access, multitudes of scholars have endeavored to study the benefits that banks derive from credit reference bureaus. In the stack of literature on this subject, gaps subsist on the influence of selected benefits of credit referencing on commercial banks' profitability in Nakuru County. In this light, this current study investigates the nexus between borrower's credit

information history; credit information sharing cost; customer identification information as well as; collateral information and profitability of commercial banks in Nakuru County. This is particularly important since there is scanty literature on the influences of these benefits on the commercial banks profitability in the county.

In the United States of America (USA), studies such as that of Meta, Haughwout, Lee and van der Klaauw (2013) shows that giving loans without information on the credit worthiness of borrowers can lead to default and delinquency. This challenges financial sustainability for financial institutions. In Canada, Mishkin and Eakins (2007) argue that credit is referencing aids the credit evaluation processes of commercial banks and has the propensity to influence profitability in such banks. Since these studies focus on developed countries, their findings may not relate to Kenya or Nakuru County. This underlines the importance of studies such as this current one. In developing countries such as Guatemala as well as most Sub-Saharan African countries, credit references enhance borrowers credit history information sharing. In this regard, banks can gauge which customers as well as which credit products record higher default rates and vice versa. This goes on to safe banks potential losses through the meticulous provision of loans (Luoto, McIntosh, &Wydick, 2007). Since the former study did not focus on Kenya or on Nakuru for that matter, it may not cast light on the effects of information distribution on profitability of banks in Nakuru County.

In Uganda, Matovu, (2006) found out that "CRBs enable microfinance institutions to access credit risks information from borrowers. "This cautions such institutions from potential losses in cases of loan defaults. Although Matovu's study was focused on a neighboring country, it may not show the state of affairs in Kenya. This underlines the importance of local studies such as this current one that attempts to link information sharing and profitability in commercial banks in Nakuru County The Central Bank of Kenya (2012) in a report on bank supervision shows that CRBs provide immense and reliable information on the credit history of potential borrowers. This tremendously reduces transaction costs in commercial banks since the cost of associated with finding out the credit worthiness of borrowers is greatly reduced. In the same accord, Gitahi (2013) argues CRBS reduces the cost of obtaining information on the credit history of borrowers. These benefits bank immensely since, and as conceptualized by this current study reduction in such costs can have positive impacts on the profitability of the bank. First CRB was licensed in 2010 and the second CRB in 2011.

The third amendment was done in 2012, and these resulted into The CRB Regulations 2013, which now mandated Banks as well as Microfinance Banks to share both the negative and also the positive information. Currently, all the 43 Commercial Banks as well as 12 Microfinance Banks share information with the three licensed CRBs in the Kenyan market namely: Credit Reference Bureau Africa Limited, Creditinfo Credit Reference Bureau Limited, TransUnion, Metropol Credit Reference Bureau Limited. Given that CRB has been in operation for the last eight years, it's now possible to measure the CIS impact NPL of banks which impacts on the profitability of banks. 'However, the recommendations and conclusions in line with empirical results should be made with great precaution', (Mombo, 2013).

1.2 Statement of the Problem

The financial services sector in Kenya has faced quite a number of challenges ranging from high level of non-performing loans, uncontrolled competition from other players, money laundering,

regulatory requirements and penalties to use as conducted for corruption. This has led to poor performance of the commercial banks with MFIs and SACCOs taking the lead (Muriuki, 2017). The main challenge emanates from credit risk management. The credit risk approaches are applied by financial institutions in calculating the losses from credit within a certain time scope. The model's outputs involve the portfolio loss distribution that explains the potential value today and at the end period of time. There exist two conceptual approaches of assessing credit loss. Under the default mode paradigm, a credit loss only takes place once there is a really defaulter. Losses from credit reflects the underlying difference existing between recovery value and exposure default (Braverman&Guasch, 2006).

Locally, Ocharo (2013) did a research which aimed at determining the sharing of credit information effect on non-performing loans in the banks in the Kenyan market. The findings of the research were that NPL proportion has declined and the number of credit reports requested by banks had increased. Bonaya (2012) conducted a study on credit information sharing influence on loan performance in the context of Kenyan commercial banks. The study found out that the default rate of loans is negatively related to total loans. Koros (2015) study on credit information sharing effect on the credit market performance of commercial banks in Kenya. Kipyegon (2011) conducted a study on 'credit information sharing and the performance of the banking sector'. The finding of the research shows that credit information sharing and bank performance are strongly related. However, the research studies conducted on effects of credit information sharing on the profitability of commercial banks are few; yet and importantly credit information sharing provides lenders (commercial banks) with a better position to analyze the borrower's repayment capability translating to profitability through loan interest rates. Therefore, this research aims at establishing the effect of credit information sharing on profitability of banks in Kenya

1.3 Objectives of the Study

The general objective of the study was to evaluate credit information sharing and profitability of banks in Kenya.

1.4 Justification and Significance of the Study

The investors will also benefit from the findings in this study in that the Investors shall get information on loan default and profitability in commercial banks. As such, they shall be able to invest in banks with fewer default rates as well as in bank products that have fewer propensities to being defaulted. The shareholders will also be in a position to monitor the performance of their banks and whether the available information concerning the customers are well taken into considerations by the management. To the central bank of Kenya, this research will be of value as it will provide them with guidance regarding the policy areas that need to be improved when it comes to the credit information sharing.

2.0 LITERATURE REVIEW

2.1 Theoretical review

One theory that was found relevant to expound on influence of source of data, information flows and exchange platforms on level of HIS feedback in public health facilities. The theory that was found to best inform the research constructs system theory (Ludwig, 1968).

2.2.1 Theory of information asymmetry

A study by Pagano and Jappelli (1993) indicates that "sharing of information leads to the reduction of adverse selection by improving banking sources of information in regards to the applicants of credit." The theory of asymmetric information states 'that it could be hard to differentiate between the good borrowers from the bad borrower' (Auronen, 2003) in Richard (2011). This may lead to problems of adverse selection and also moral hazards. Adverse selection theory gives an explanation in the business markets, whereby the parties are in possession of more information with regards to specific items to be transacted. Therefore, the borrower is better positioned to make optimally make negotiations for transactions than other parties (the lender) (Auronen, 2003) Richard (2011). This implies that for a party that has less information on the similar items of transactions will be in a better position when it comes to making an informed decision on the transaction. It is also true that a reduction of profitability has been significantly affected by moral hazards and adverse selection (Bester, 1994; Bofondi&Gobbi, 2003). Krugman (2009)argued that "moral hazards tend to occur once an individual's increases his/her risks exposure once insured, particularly when an individual' stakes additional risks since another individual shoulders the risks costs." Problem of moral hazard can take place when "actions of a given entity or person change to the detriment of another after financial transactions have been accomplished. "An individual's decides the extent or level of risk, while the other individuals or entity suffers the consequences (costs) incase issues arise as not expected and the party isolate form the risk act differently from the way it should in case it was exposed to the similar risk. The moral hazard as well arises in principal agent issues, in which a specific entity, referred as an agent, represents another referred to as the principal.

Usually the agent will contain numerous data on the principal as the principal's usually can't completely monitor the agent. The agents usually contain the incentives of acting inappropriate in case the agent's interest and that of principal vary. In this theory, the implication is that the person borrowing is likely to default repayments, but if he is aware of the repercussions on other credit applications, they may do otherwise. The implication will be that lenders will have difficulty to assess the level of borrowers' wealth as at the dates of repayment of the debts, but not on the date the applications are made. In case lenders are not able to assess the wealth of a borrower, then the temptation of default can arise. To prevent this, banks will increase their interest rates causing the market to break down (Alary &Goller, 2001). This theory was helpful in the study in understanding the effect of borrowers' credit history on the profitability of banks. The theory of information asymmetry clearly outlines the challenges that come with one party (lender) having less information about the other party (borrower). If the bank for instance does not have adequate information about a borrower, it may end up with loan defaults which will affect their profitability. Additionally, this theory was helpful in comprehending the correlation between customer identification information and performance of banks in terms of the profitability. Proper identification of the customer can be well facilitated through credit information sharing platforms and this is vital in ensuring that the right customer with good credit worthiness is given access to banking products. Lastly, the information regarding the collaterals can also be best addressed under the theory of information asymmetry. Any information concerning the collaterals provided by the customer can be investigated to verify its authenticity.

2.2.2 The Theory of Delegated Monitoring

This theory is very critical in the literature of banks' existence in the economy. In a broad definition, when a bank closely monitors a borrower, then the bank will have to collect information before and after the loan is disbursed to the borrower. It includes a thorough screening of all the loan applications, ensuring that the borrower is creditworthy and making sure the borrower understands and abides by the terms and conditions of the lender contract. In this process, banks usually have privileged information since they have the client's records and can see the transactions in the account. For the small enterprises and medium enterprises, this is crucial to the role of banks in the system of making payments (Matthews & Thompson, 2008). Matthews and Thompson (2008), posits that the major element in the theory of delegated monitoring is an analysis of costs and benefits of monitoring. This implies that delegating monitoring will lead to new information challenges whereby parties involved in monitoring agents have information only known to them. This eventually leads to delegation costs which should be lower compared to minimum cost if not monitored and costs that are directly monitored. The Central Bank of Kenya annual report (2008), defines as "Credit information sharing is a 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". CIS is an advantage to banks because they are in a position to know if the borrowers can repay loans advanced to them commonly referred to as credit reporting. This idea of sharing information about credit report of customers was conceived after many banks were indebted by the failure of customers to repay the loan they got from the banks. This was associated with the information asymmetry that each bank had on its customers (Central Bank of Kenya, 2015). This theory was thus helpful in understanding how customer's credit information can influence the performance of banks as measured by profitability.

2.3 Empirical Review

Mbatha, (2019) conducted a study to understand the information seeking behavior of agricultural researchers and extension officers within Nairobi County, Kenya. The research objectives were understanding of agricultural researchers' and extension workers' information seeking behavior, establishing their opinion on the quality of information resources in their information centers, extent to which they use agricultural information in their information centers, and identifying challenges they faced in the retrieval of agricultural information from their information centers. Two of the major agricultural research agencies in Kenya, Kenya Plant Health Inspectorate Service (KEPHIS) and Horticultural Crops Development Authority (HCDA), were sampled as representative locations for the study. Additionally, four research objectives were proposed together with their corresponding questions in order to guide the entire research process. Suitable theoretical and conceptual frameworks were also developed from an extensive review of various literatures to help guide the researcher as well as widen his understanding of the research topic. A descriptive research design was selected as a suitable method through which the objectives of the research would be achieved. This methodology involved development and administration of semi-structured questionnaires to 97 sampled respondents. The collected data was analyzed quantitatively. The research used tables to present research findings in line with the pre-established research objectives. The study findings revealed impressive trends in the search and use of agricultural information resources among extension workers and agricultural researchers in the two sampled agencies. The two categories of agricultural information users were found to prefer

agricultural information from electronic journals and organizations' websites compared to print materials from public libraries and information centers.

Machoka,(2018) conducted a study to establish the effect of competitive information sharing, credit scoring, efficiency in the information gathering process and information accuracy on the performance of commercial banks in Kenya. This study employed a descriptive research design. The study was anchored on information asymmetry theory, moral hazard theory and financial intermediation theory. The population of this study entailed all the 43 commercial banks licensed under the banking Act as at 31 December 2015 in Kenya. The study used primary and secondary data. Primary data was collected using closed ended questionnaires administered on drop and pick method while secondary data was collected from CBK annual supervision reports and the banks specific audited accounts. Data was analyzed using both descriptive and inferential statistics. The qualitative data collected was analyzed using descriptive statistics such as mean, standard deviation, frequencies and percentages while inferential statistics including multiple regression analysis was performed to estimate the changes in performance following changes in credit information sharing variables. The study adopted the following model; $P=\alpha_0 +\beta_1CIS+\beta_2CS+\beta_3EIG+ \beta_4IA+ \varepsilon_i$ where P = Bank Performance which is measured by Return on Investment (ROI) and Return on Equity (ROE), α_0 - intercept coefficient, ε_i – error term (extraneous variables), CIS - Competitive information sharing, CS – Credit Scoring, EIG – Efficiency in Information Gathering, IA – Information Accuracy and β_1, β_2, β_3 and β_4=regression coefficients. Tables and charts were used to present the analyzed data. From the findings, competitive information sharing has significant effect on performance of Commercial banks. Credit scoring has significant effect on performance of Commercial banks. Efficiency in information gathering has no significant effect on performance of Commercial banks. Information accuracy has significant effect on performance of Commercial banks. The study recommends that the top management of all commercial banks in Kenya should strengthen their channels and systems of sharing information which shall significantly influence performance. The top management team of Credit Reference Bureau CRB in Kenya should improve on their credit monitoring role in the country to allow generate effective scores that commercial banks use for lending purposes. The top management of all commercial banks should pay little attention and emphasis efficiencies during the process of information collection. All financial institutions in Kenya need to safeguard the accuracy of their information sharing platforms for increased performance

Mugambi, (2017) conducted a study to assess the information literacy competency skills of practicing nurses at KNH with the objective of establishing, the information needs of practicing nurses, awareness of potential sources of information in nursing profession, ability to evaluate the retrieved information and establish their knowledge of ethical, legal and social-economic issues surrounding information use. The research adopted a case study focusing on single case of KNH, with a target population of 1723 registered nurses and a sample size of 347 respondents was selected. Structured questionnaires were used to collect data. Data was analyzed by use of likert scale and SPSS and presented through tables, charts, figure, graphs and percentage. The study established that information literacy program is taught at nursing schools in Kenya, four professional information needs were cited by practicing nurses at KNH; patient care, in-house presentation, presentation at a professional meeting/seminar and scholarship application/career development.

Langat, (2016) conducted a study to assess information seeking behaviour among health professionals in public health facilities in Garissa County. The specific objectives included: to establish the socio-demographic characteristics influencing information seeking behaviour of health professionals in Garissa County; to determine facility factors influencing information seeking behaviour of health professionals in Garissa County; to establish technological factors influencing information seeking behaviour of health professionals in Garissa County; to determine information needs of health professionals in Garissa County. The study used a cross-sectional study design employing mixed methods of data collection. Stratified sampling was used to select a study sample of 222 health professionals to participate in the study while purposive sampling was used to select participants for Key Informant Interviews and Focus group discussions. Descriptive and multinomial logistical regression was used to analyze quantitative data using SPSS version 20 while thematic analysis was used to analyze qualitative data from Key Informant Interviews and Focus group discussions. Results showed that mority of health professionals (86%) sought information only when and work experience (P=0.013) had a statistically significant relationship with information seeking behaviour. Among the facility factors, workload (P=0.000), and information sharing (P=0.0000) had a statistically significant relationship with information seeking behaviour. Among technological factors, computer proficiency (P=0.000), ability to search information from internet (P=0.000, ability to analyze and interpret digital data (P=0.000) and internet connectivity (P=0.001) had a statistically significant relationship with information seeking behaviour. In conclusion, there is insufficient effort made to understand information behaviour and address information needs of health professionals in Garissa County.

Gichiri,(2012) conducted a study to assess the quality (accuracy, adequacy and relevance) of the available information on HIV/AIDS, to discuss the inhibiting factors to its accessibility, assess the convenience of using this information and to establish the existing gaps in the current HIV/AIDS information service. This study established that indeed quality was lacking in the available information on HIV/AIDS, this was mainly due to lack of adequate information to address varied needs, irrelevance and inaccuracy was prevalent in the available sources. A number of inhibiting factors to accessibility of this information were also identified including: language barriers cost of information, and attitude of information providers among others. Convenience of using the available information was also lacking according to this study, this was mainly due to unfriendly information formats and also the language of presentation. This study also established that the current information service on HIV/AIDS does not address all the requirements of individuals living with HIV/AIDS and therefore there exist information gaps in the current HIV/AIDS information service in Kenya.

2.4 Research gaps

Methodological gap is the gap that is presented as a result in limitations in the methods and techniques used in the research (explains the situation as it is, avoids bias, positivism, etc.). Mugambi, (2017) conducted a study to assess the information literacy competency skills of practicing nurses at KNH with the objective of establishing, the information needs of practicing nurses, awareness of potential sources of information in nursing profession, ability to evaluate the retrieved information and establish their knowledge of ethical, legal and social-economic issues surrounding information use. The research adopted a case study focusing on single case of KNH, with a target population of 1723 registered nurses and a sample size of 347 respondents was

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Conceptual gap arises because of some difference between the user's mental model of the application and how the application actually works. Langat, (2016) conducted a study to assess information seeking behaviour among health professionals in public health facilities in Garissa County. Langat, (2016) conducted a study to assess information seeking behaviour among health professionals in public health facilities in Garissa County. The study used a cross-sectional study design employing mixed methods of data collection. Stratified sampling was used to select a study sample of 222 health professionals to participate in the study while purposive sampling was used to select participants for Key Informant Interviews and Focus group discussion. Results showed that majority of health professionals (86%) sought information only when and work experience (P=0.013) had a statistically significant relationship with information seeking behaviour .The study presented a conceptual gap as it assessed information seeking behaviour among health professionals in public health facilities in Garissa County a, while the current study is on evaluating credit information sharing and profitability of banks in Kenya.

3.0 METHODOLOGY

The study adopted a desktop literature review method (desk study). This involved an in-depth review of studies related to evaluating credit information sharing and profitability of banks in Kenya. Three sorting stages were implemented on the subject under study in order to determine the viability of the subject for research. This is the first stage that comprised the initial identification of all articles that were based on evaluating credit information sharing and profitability of banks in Kenya from various data bases. The search was done generally by searching the articles in the article title, abstract, keywords. A second search involved fully available publications on the subject on credit information sharing and profitability of banks in Kenya. The third step involved the selection of fully accessible publications. Reduction of the literature to only fully accessible publications yielded specificity and allowed the researcher to focus on credit information sharing and profitability of banks in Kenya which was split into top key words. After an in-depth search into the top key words (evaluate, credit information sharing, profitability, banks, Kenya), the researcher arrived at 5 articles that were suitable for analysis. The 5 articles were findings from Mbatha, (2019) who conducted a study to understand the information seeking behavior of agricultural researchers and extension officers within Nairobi County, Kenya. This methodology involved development and administration of semi-structured questionnaires to 97 sampled respondents. The collected data was analyzed quantitatively. The research used tables to present research findings in line with the pre-established research objectives. The study findings revealed impressive trends in the search and use of agricultural information resources among extension workers and agricultural researchers in the two sampled agencies.

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SUMMARY, CONCLUSION AND POLICY IMPLICATION FOR FURTHER STUDY

4.1 Summary

Credit information sharing cost positively influenced the profitability of banks in Kenya It was established to a significant extent the banks have subscribed to a number of CRBs, the banks share credit information of their customers with the CRBs, the banks always seek for CRB's reports on an applicant when processing the loans, the reports received from the CRBs perform key function in determining the credit history of the applicant, the banks evaluate the cost of maintaining customers credit history database in sharing information with the CRBs, the banks keep their administrative costs at an optimal level by using the CRBs, CRBs maintain updated information on credit history of all individuals in Kenya and that the CRBs update their information on a timely basis. This indicates the credit information sharing cost was low due to reliability of CRBs, updated information, timely access to the information regarding client credit record which improved bank profitability.

4.2 Conclusion

The study stablished that borrower's credit history information had a positive influence on the profitability in Kenya. The study the respondents agreed that their banks collect information on the number of previous applications that a loan applicant has made, the bank collects information on the number of loans applied and declined, the bank asks for reasons that the loan applied was declined for all applicants, the bank asks loan applicants to indicate the discipline observed when repaying previous loans advanced, the bank asks clients to indicate if they have delayed in remitting their periodic loan repayment in the past, the banks collect more information about the loan applicants credit history from the CRB. This generally indicates that most of the banks significantly assessed borrowers credit history based on other loans applied declined, reasons and discipline observed when repaying previous loans, delays in remittance and also relied on the CRB for client credit information.

4.3 Recommendations

The study recommended that while sharing information, the banks should do a cost benefit analysis to ascertain if the sharing of such information is material or not. It should pay its attention to the administrative costs that come with sharing information. This is because the cost of information sharing as seen from the study results have a negative and significant influence on performance.

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