CREDIT REFERENCE BUREAU EFFECT ON FINANCIAL PERFORMANCE OF NON-DEPOSIT TAKING MICRO FINANCE INSTITUTIONS IN KENYA

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DECLARATION

STUDENT DECLARATION

I Edwick Onyango Orengo, declare this project to be my original work and has not been presented to any other college, institution or university other than the University of Nairobi for academic credit.

Signature …………………………………………. Date ………………………………..

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D61/61066/2011

SUPERVISIOR DECLARATION

This research project has been submitted for examination with my approval as the University of Nairobi supervisor.

Signature …………………………………………. Date ………………………………..

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DEDICATION

I dedicate this project to the Almighty for his abundant wisdom, my loving wife Elizabeth and my two children Tamara and Trevin who are my source of joy and strength, all my sisters for the moral support and my parents Moses and Beatrice for their prayers and support.

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ABSTRACT

The constant challenges that confront local NDT MFIs have brought into focus the survival and sustainability of NDT MFIs in Kenya. With the coming of Credit reference bureau, we have witnessed better credit market, lower bad debts, reduced interest rates, increased profitability, general financial performance and improved competition within the sector. However, no empirical research have critically examined the relevance of credit reference bureaus and its impact on financial performance of NDT microfinance institutions in Kenya. The study sought to establish the effect of credit reference bureau service on financial performance of NDT microfinance institutions in Kenya. This study employed descriptive design by use of questionnaire.Target population was four (4) non deposit microfinance institutions registered by AMFI Kenya as at Dec 2012 namely ECLOF, AAR Credit, MUSONI and Juhudi Kilimo. The study used closed ended questionnaires which were administerd to 21 respondants drawn from the 4 NDT MFIs. When asked whether in their opinion, CRB information translated into a decrease in non-performing loans, fifty seven of the respondents think that the impact is of a low extent, but twenty-nine percent think that the impact is greater. The standard deviation of 1.10 suggested a consensus from the respondents on this issue. This study recommends that the Association of Microfinance Institutions strengthening of the Non deposit taking MFIs to come up with mitigation measures to control the external factors that interfere with the credit ratings of their customers; with a possible measure to cushion non deposit taking MFIs from weak laws that could lead to blind loaning or borrowing. From the study and subsequent conclusions, the researcher recommends a further research on the factors prohibiting NDT MFIs from using CRB information to solve moral hazard problem in Kenya.

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ABBREVIATIONS

AMFI	Association of Microfinance Institutions
CBK	Central Bank of Kenya
CRB	Credit Reference Bureau
MFIs	Microfinance Institutions
NDT	Non-Deposit Taking
NGO	Non-Governmental Organizations.
NPL	Non performing Loans
ROA	Return on Asset
ROE	Return on Equity
USAIDs	United States Agency for International Development
CIS	Credit Information Sharing

CHAPTER ONE: INTRODUCTION

1.1 Background

Banks and Microfinance Institutions (lenders) play a pivotal role in the financial market by availing surplus cash to those who have a deficit (borrowers) to carry out a desired economic activity (CBK, 2016). Financial institutions in Kenya face an uphill task in determining the credit worthiness of borrowers due to weak legal/judicial enforcement in case of loan defaults, inadequate information on the potential borrowers' ability to repay their credit facilities, and the unsecured nature of most of the loans offered to personal customers (Njungiri, 2012).

Schreiner (2001) asserts that financial firms are facing a big risk of non-performing loans (NPLs), he observes that bigger debts have higher risk exposure, so the variable cost per shilling is greater. If creditors don't take caution, there could be more bad debts. To solve NPLs, institutions are called to track the behaviour of lenders. Thus, the notion to establishing Credit Reference Bureau (CRB) was comprehended to allow banks to decide credit worth of their debtors and consequently reduce the loan evasion hazard.

Information Sharing by CRB enables information flow in the financial market. Sharing of Credit information holds a critical role in reducing information asymmetry existing between lenders and partakers of credit. With CRB in place, lenders are in a position to get credit information on potential debtors that will enable evaluation of credit application to diminish risks of non payment. CRB similarly enable borrowers with good credit record to obtain loan facilities at lower rates than the prevailing market rates and

waiver of certain loan conditions such as collateral requirement before issuance of loan. This promotes competitive pricing of loan services. Thus credit information sharing compensate and stimulates good credit track record. Additionally, credit sharing helps reduce credit cost and aptly scrutinising and valuing risks (CBK 2016).

On the flip side, financial institutions have been blamed for using adverse CRB reports as intimidation to those falling behind their settlement timetables while diminishing credit requests of those recorded, barring them from accessing credit. The financial institutions have not been giving incentive to clients with high credit score by availing loan facilities at a lower interest rate thus discouraging repayment. Banks have also faced lawsuits because of wrongful listing of clients as defaulters with CRB (CBK, 2016).

1.1.1 Credit Reference Bureau

Credit Reference Bureau is a firm that gathers data from numerous sources and offers customer credit information on individual consumers for many uses. It offers data on their personality, loan account, insolvency and late repayments and recent inquiries. Additional information shared are: forgeries and frauds; receiverships, bankruptcies; credit default and late payments; falsification of securities; and mis-use of funds borrowed. (CBK, 2016).

This enable credtitors evaluate credit worth, ability to service credit, and can move the interest capping. Would be creditors buy this information only when they have acceptable reason as defined in regulations, to determine the borrower's creditworthiness (Sullivan

and Sheffrin, 2003). Information gathered by CRB is availed at a charge to clients for use of credit scoring, assessing credit risk or any other requirment, apartment leasing, employment application etc. CRB allows creditors avail credit to less risky customers (eliminating defaulters). CRB also reduce cost of getting loan facility by making lenders be more favourable with credit terms to lenders with good history of repayment. Lastly, credit bureaus decrease moral hazard through moulding a credit culture where debtors are aware of their credit rating and rewards or punishes them accordingly (Sullivan and Sheffrin 2003).

In Kenya, the laws regulating the registration and operations of CRB are set out in The Banking, Act Cap 488, and The Microfinance Act, Laws of Kenya, Credit Reference Bureau Regulations, 2013. (CBK, 2016). The CRB regulations, 2013 gives a Bureau licensed under the Act right to engage in obtaining and receiving client data, pile, manage, assess, bring up-to-date and broadcast the client information to buyers in compliance with the CRB rules, 2013, amass and keep database and produce reports from client databank and credit scoring.

As at September 2015, the Central Bank has licensed Credit info CRB Ltd, CRB Africa Limited and Metropol CRB under the Act to engage in the above activities. Njuguna Ndung'u, (2012) noted that the present mechanism of sharing information is restricted to banks and, to a smaller degree, to Deposit Taking Microfinance Institutions. Thus the risk of this financial institutions creating "Silo" database, called "segmented" sharing of information. Credit reports produced through such schemes give an imperfect and

deceptive image. “Comprehensive” schemes, on the other hand, allow a comprehensive client credit profile.

The use of non-financial data in credit files offers the possibilities of a varied information resources that will enable giving of low-priced loans to borrowers accessing formal credit for the first time. Ndungu, (2012) also observed that sharing of both positive and negative information of clients is key this allows risk based pricing via credit scoring.

1.1.2 Non-Performing Loans

Investopedia defines non-performing loan (NPL) as the total of loaned amount to which the borrower is yet to make his arranged repayments for more than 90 days. A nonperforming loan is one which is defaulted already or near to being defaulted. After a credit is nonperforming, the likelihoods of its repayment in full are deliberated to be significantly low (IMF, 2016). The problem of banks’ non-performing credits is attributed to economic, political, technological, social, technological, environmental and legal and factors (Bhide, et.al, 2003). Research demonstration that increased NPL levels considerably impact on banks’ economic recovery, lending, and ultimately on fiscal development (N. Klein, 2013). G.Mpavido (2012) assets that the effects of NPL are two fold, one, banks burdened with NPLs might be unable to give new credit. Two, overstretched lenders are met with decreased enticements to invest and resourses are locked under them rather than being transferred to more industrious users.

A high rate of NPLs has adverse effect on economic progression. Competent tackle of NPLs requires the joint effort of international financial institutions,Private sector and governments. It is imperative that countries undertake a all-inclusive analysis of its regulatory and legal frameworks to establish all important roadblocks that obstruct successful NPL solution. Countries should not fail to notice legal and regulatory restrictions that stop a transfer of NPLs and dampen the development of a market for distressed loans, in particular (Franc Cmok 2016).

1.1.3 Impact of Credit Reference Bureau on Non Deposit Taking Micro Financial Institution

MFI- Hopping or "Credit Hopping" describes a behaviour of lenders who are customers of multiple MFIs at the same time. This behaviour leads to a number of problems. On an individual basis MFI - Hopping poses the high risk of over-borrowing which can lead rapidly to impoverishment of the already vulnerable part of society. Furthermore, not only MFI - Hopping is a danger to individuals but also the possibility that a lender can access multiple credits via banks, MFIs as well as SACCOs. The borrowed amount can increase dramatically, as a consequence seriously endangering financial stability of the individual but also of the financial institutions. All financial institutions depend on the repayment of the credits at the very least, to provide constant cash-flow. If default rates increase dramatically due to access to multiple loans, the solution has to aim at restricting this access (CBK 2012).

Christine Lagarde, (2014) pointed out that accessability of finance is a mojar connection between economic prospect and outcome. She asserts that by building individuals and families to persue economic opportunities, financial inclucivity can be a powerful agent for fast growth. Increasing access to finance, which translates into provision of financial services to so-called "unbanked", can only be possible with a development of a strong and sustainable financial infrastructure. The backbone of which is a well-functioning credit information sharing mechanism. That theory has been proved by various papers prepared by international organizations like the World Bank Group as well as practical case studies from many different parts of the world. There is correlation between economic development and the advancement of the financial sector and its credit information sharing system.

A key part of financial sector infrastructure is the establishment of an effective mechanism for credit information sharing (CIS) to improve the flow of information between borrowers and lenders. In 2008 Kenya's financial sector regulatory framework was amended, mandating the sharing of negative credit information among banks. (CBK, 2016).

Recognizing the role of a functioning credit reference system in reducing transactions costs for small and medium enterprise (SME) lending FSD established a project to support the establishment of CIS in Kenya. A number of NDT MFIs have become members of CIS including ECLOF Kenya, MUSONI, Transunion, Jubilant Kenya, Pesazetu and Jumo. This institutions have immensely benefited from CRB reports by

being able to advance credit to increased and less riskier customers and lower the bad loan stretch needed to offset unticipated losses of credit to good payers. Additionally, CRB minimise the cost of credit by making lenders to give reasonable rates for good debtors hence benefiting NDT MFIs clientele thus enabling this institutions offer loans at even lower rates. Lower credit price for those with good credit rating stimulate debtors to become more willing to repay loans enabling NDT MFIs to reach more beneficiaries with their cheap loan services. Last but not least, Moral hazard is reduced by CRB in that they develop a credit traditions in the market as debtors become conscious of the monitoring by lenders of their credit history, punishing or rewarding them accordingly (Sullivan and Sheffrin, 2003).

1.1.4 Non Deposit Taking MFIs

The World Bank defines microfinance institutions as institutions engaging in micro financial dealings through different methods to give service to small scale farmers, low income household, microenterprises and those without access to main stream banking services. They engage in micro credit or micro-finance. Microfinance is based on the premises that the poor have skills which remain unutilized or underutilized (Yunus, 2003).

Non-Deposit Taking Microfinance Institution can be defined as firms with a Certificate of Registration, barring the acceptance of cash deposits from public as set in the Microfinance Act, 2006 and the Microfinance (Deposit Taking Institutions) Regulations 2008. The majority of the NDT MFIs obtain their funding from commercial banks,

government agencies, Churches, NGOs and Aid Agencies such as USAID. They include Vision Fund, ECLOF, AdokTimo, SISDO, Platinum Credit, Ngao among others.

Their primary focus being development and provision of affordable, innovative, accessible and poor focused credit and other business development services to their clients who would want to start and grow their enterprises, while maintaining a profitable venture operating on sound business ethics. This is aimed at changing their member's lives from poverty to that of dignity, influence, and purpose. (https://kenyaloans.com/weso/).

Microfinance Act (2006) applies to NDT MFIs. Credit services offered by NDT MFIs are majorly unregulated. None the less, several NDT MFIs are regulated by sectorial laws, minimally. These firms do not fall under the watchful eye of the CBK's microfinance regulation and are thus not subject to the strict regulations. They are self-regulated by the Association of Microfinance Institutions (AMFI) which is a member-based institution formed in 1999 by leading microfinance institutions.

The inclusion of Non Deposit-Taking MFIs into the regulatory framework is presently being considered by the CBK and a variety of industry stakeholders. Hopefully NDT MFIs will be governed through Microfinance Act (2006). Section 2(b) of this Act empowers the Cabinet Secretary, Finance to draft laws that will control the activities of the individual non deposit-taking MFIs. The laws are still being drafted by the CBK. Because of lack of legal framework to operate in, NDT MFIs have not been very

attractive to investors since they fail to give surerity of economic probity to clients. Further, the imperfect guideline exposes the organizations to possible big losses.

1.2 Research Problem

Lending to the poor among the poorest is always a brave bet by the NDT MFIs as their chances of servicing the loans is never guaranteed. The Kenya Financial Sector Deepening (FSD) programme asserts that credit provision is a key element of financial intermediation. The burden thus fall on policy drafters to periodically review the credit market to eliminate barriers to faster economic growth. Non-Performing Loans, even though reducing, is a worry to the value of creditors assets in Kenya's financial market especially for the NDT MFIs. Additionally, those with good credit rating have been deprived by unreasonable interest rates and strict security requirements, as NDT MFI cover against the danger of elevated Non Performing loans. The challenge has been because of information asymmetry, which has led to the denial of applicants of borrowers with good credit rating since the credibility can not be assertained. Again, continuous defaulters negatively affected NDT MFI profitability, unstabilised the sector and stanted credit growth to the NDT MFI.

A big number of the local NDT microfinance institutions in Kenya started as NGOs, with donor funding as their main source of income. While such donations have made an enormous contribution to microfinance development, attempts to scale up funding from these traditional sources have been an uphill task given the dwindling interest of donors in Kenyan organizations after her elevation to a middle income country. The constant

challenges that confront local NDT MFIs have brought into focus the survival and sustainability of NDT MFIs in Kenya. This in no doubt has brought into question the role of CRB in providing relevant information to help reduce the default rate among borrowers in this sector.

A number of empirical researches have been done on CRB but most of them have not focused on its effect on financial performance especially of NDT MFI. Gitahi (2013) studied the impact of CRB on the level of non-performing loans by the commercial banks, Sigei (2010) evaluated the effectiveness of credit reference bureau in Kenya, case study of KCB, Nganga (2011) studied shareholder view of CRB facility in Kenya loan market. Kago (2014) did study the impact of CRB on deposit taking MFI. The above research work have not shifted their effort on the effect of credit reference bureaus on financial performance of NDT microfinance institutions in Kenya.

The existence of credit reference bureau leads to a better credit market, lower default and interest rates, improved profitability, general financial performance and increased competitiveness within the industry. None of the above studies have critically examined the relevance of credit reference bureaus and its effect on financial performance of NDT microfinance institutions in Kenya. This research work attempts to fill this noticeable gap in literature by answering the research question; what is the effect of credit reference bureau service on financial performance of NDT MFIs in Kenya?

1.3 Research Objective

To ascertain the effect of credit reference bureau service on financial performance of NDT microfinance institutions in Kenya.

1.4 Value of the Study

The research offers a chance to NDT MFI in Kenya to learn how to fully operationalise Credit Reference Bureau services. It also helps firms re design loan facilities and will assist to fasten the decision making process. It also builds up the available literature on CRB in NDT MFI in Kenya.

This study helps regulators and stakeholders to ascertain the role of CRB on profitability of NDT MFI, this will assit the NDT MFIs to evolve into deposit taking MFIs. Additionally, the study helps to highlight the successes and challenges of Credit Reference Bureau in NDT MFIs and thereby helping policy makers in formulation of policies for regulation.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

Chapter two discusses theories and literature review on research that have been done on financial performance and credit reference bureau. This chapter begins with theoretical framework which consists of theories of financial performance in relation to credit reference bureau.

2.2 Theoretical Literature

In an attempt to ascertain effects of CRB service on financial viability of NDT microfinance institutions in Kenya, this study will be guided by adverse selection theory, moral hazard theory, information sharing theory and credit rationing theory.

2.2.1 Adverse Selection Theory

Stiglitz and Weiss (1981) asserted that loan providers have difficulty differentiating between good and bad borrowers, he further state that credit contacts are subjects to limited ability of borrowers i.e. if borrowed funds are invested in unprofitable venture then debtor has no consciousness to pay from other sources of income. The above observation assume the loanee will service the credit should they have the resources to repay. Todays world with straight forward debt interactions among risk-neutral debtors and creditors, the existence of restricted liability of debtors gives a preference for risk among debtors, and an equivalent aversion to risk among creditors. This is because restricted liability of debtors means that creditors shoulder all the negative risk.

Again, all profits over the loan settlement responsibility accumulate to debtor. Increase in interest rates will affect the profit of low risk debtors unreasonably, making them fall out of the application pool. This leads to an adverse compositional effect. Higher interest rates increase the average riskiness of the applicant pool, increased Interest rates, the only applicant are debtors who could produce abnormal retun. By exchanging information relating to clients, NDT MFI can advance their awareness of applicants' behaviour and features. In Principle, the decrease of informational asymmetries can lessen adverse selection challenge in lending and change debtors' motivation to settle, by altering the fairness of the credit market.

Information asymmetry is a major challenge for NDT MFIs to avail credit to customers. This finally result credit risk which is the one that negatively affect the performance of MFIs (Nawai 2010). According to Silwal (2003), to minimize these problems financial firms mostly request for proposal of business credit history of customer and security prior to authorising the credit facility. NDT MFIs also advance loans via members group-based lending scheme to diminish adverse selection and lift the security requirement.

Pagano and Jappelli (1993) proves that information sharing decrease adverse selection by building NDT MFI's information on loan applicant. In the model, every firm has confidential information on existing customer loan applicant, but lacks information about non-existing customer applicant. By NDT MFIs exchanging information about their customer's credit merit, they can gauge the rating of non-existing customer credit seekers, and advance credit to them as securely as they do with clients. Information sharing can

also motivate debtors to act as per NDT MFIs' interest. Klein (1982) proves that information sharing can stimulate debtors to service credit, when the legal system makes it hard for firms to follow provisions of credit contacts. The model has debtors service loans for fear of being listed with CRB in future.

2.2.2 Moral Hazard Theory

Moral hazard can be defined as the danger that a party to a contract has not entered into the agreement in good faith, has given wrong information regarding his credit ratio, liabilities or assets, or has an enticement to take every risks ventures in a frantic endeavour to increase profit margins before the contract is completely executed. Moral hazard problems in business firms were evident at many stages of recent financial crisis. (Myerson, 2011).

Economists believe the ineffectiveness is as a information asymmetry. If NDT MFIs can monitor the activities of customers, they can block credit to customers with risky characteristics, enabling them have a shield against debtors with risky behaviours thus discouraging risky behaviours. Since NDT MFIs have no means to flawlessly scrutinize their customers' deeds, they are not provided the amount of safeguard that would be provided in a world with perfect information (Hansen, 2004).

(Alary, 2001), argues that Moral Hazard problem means that debtors have motivation to default if the market does not provide consequences for his action. He state that should

the creditor not be in a position to access debtors wealth, debtor will have temptation to default. Preventing this, creditor will hike interest rates, causing the market to fall.

Nyman (2010), proposes existence of two types of moral hazard exist: inefficient and efficient moral hazard. Efficient moral hazard holds that over utilization of credit advanced by NDT MFIs does not always create a welfare loss in the community. Rather, people achieve improved wellbeing through the bigger utilization of healthcare, thus becoming more industrious and realising an overall benefit to communal welfare.

2.2.3 Information Sharing Theory

Past papers scrutinized the consequence of information sharing in a market with asymmetric information, either adverse selection or moral hazard (Gehrig, 2005). In moral hazard set-up, information sharing provide debtors with higher motivation to service; since information is accessible on the loan products in the market and cost implications, debtors are able to achieve better loan terms since monopoly of creditors is no longer a barrier to them. (Padilla, 1997). Additionally, debtors will be unwilling to default, given that it will be in the public domain and when this information is eventually shared, cost of credit will go up for them and access to credit will go down. (Padilla, 2000), called the effect disciplinary effect.

Information sharing treats adverse selection problems by providing financial institutions with information advantage, Padilla (2000) and Pagano (1993). By information sharing, financial institutions know customer credit rating of the competitor financial institutions

especially those who move from one provider to the next. Gehrig and Stenbacka (2001), talk about negative effect of information sharing. Their model on adverse selection looks at a two-period antagonism with symmetric information in period one. They postulate that firms are less willing to gather data for the many clients in period one, knowing very well they will have to surrender this information to competitors in period two. They argue that if client information is shared with other firms, second-period fight will be higher and first-period credit cost will increase, leading to welfare losses. Hauswald and Marquez (2003) prove that information processing, gives NDT MFIs informational advantage, protecting it from competition enabling them to receive rents. Improvement in the screening knowledge, will boost profits. Availability of that information, will level the playing field for all firms and decrease profit because of increased competition.

2.2.4 Credit Rationing Theory

Credit Rationing theory was advocated by Freimer and Gordon (1965) and comprehensively by Stiglitz and Weiss (1981). Stiglitz and Weiss (1981) proposed unfulfilled agents are debtors. Asymmetric information result in credit rationing, because creditors have no means of differenciating credit rating of debtors. De Meza and Webb (1987) criticised the above position. They think asymmetric information can result in over provision of credit.

Allen and Santomero, (1998) argue that financial institutions because they screen and monitor borrowers more efficiently than other investors can ratio credit. (Freixas and Rochet, 1999), is of the view that financial firms are expert in gathering private

information and scruitinising it. NDT MFIs own very tactical data on clients income statement, as well as development stategy of the firm (Diamond and Rajan, 2001). Despite this overabundance of credit history, relations involving NDT MFI and clients are not as it should be and as a result NDT MFI experience informational asymmetries (Freixas and Rochet, 1999) making it difficult to evaluate interest rate in the market.

Equilibrium rationing refers to a state in which the market has completely adjusted to all publicly existing information and where request for credit for a given market interest rate is bigger than supply. Stiglitz and Weiss (1981) stated that credit rationing happens when firms levy uniform interest rate to all debtors, because of inability to measure credit rating and screening debtors completely is very costly. The above assumptions are too straight forward to be present in the current market. NDT MFIs have the capability to screen clients with a small degree of success. NDT MFI levy different interest rates to clients depending on the prevailing market rates. Debtors with low credit rating presumably pay greater interest rate and credit rationing is less likely. Nevertheless, NDT MFI lack capabilty to differenciate clients perfectly because perfect screening is impossible allowing for credit rationing.

According to Stiglitz and Weiss (1981) credit rationing also occur when firms ask for security against credit. They observe that debtors with low credit rating generally have low rate of return thus are less wealthy. They will not be in a position to provide adequate security and will thus not qualify for large loans. Security provision will result in the same negative impact as sky rocketing interest rate. Instead Bester (1985) advise

firms to only present loan agreements with flexible clauses on security requirement and interest rate capping. He assumes that with the correct mixture of security requirement, credit rationing will not occur.

2.3 Non-Performing Loans Determinants

Macroeconomic factors are forces swaying NDT MFI results. Financial providers reason that in times of recession, clients will bump into liquidity problems, increasing the probability of the firms meeting their loan repayment obligations. (Jimenez and Saurina, 2006). Fofack (2005) looked at factors giving rise to NPLs and revealed that growth in economic, exchange rate increase and interest rate feed to increase NPLs. Jimenez and Saurina (2006) presented same findings. Warue (2013) added his voice by acknowledging a positive relation between lending interest rates and NPL in firms. Al-Smadiand Ahmad (2009) was of a different view, he presented contradictory result of negative relationship between market interest rate and credit risk.

Salas and Saurina (2002) showed that increase in GDP explain changes in NPLs. Jimenez et al. (2005) convinced us that NPLs are influenced by factors such as high interest rates, Economic GDP and relaxed credit clause. Previouse research tend to prove a positive relationship between unemployment rate and NPLs. Louzis et al. (2010) gave unemployment as a major cause of NPLs.

2.3.1 NDT MFI-Specific Determinants

Distinctive characteristics of the NDT MFI segment and strategy choices of individual NDT MFI, exercise a crucial way to increase NPLs. Literature reviews revealed the link between NDT MFI-specific factors and NPLs. Keeton (2003) presented a positive connection between increase in credit and impaired assets.

Weak governance in NDT MFI can result in non monitoring of credit quality of customers and operating costs, resulting to investment loss. Peristiani (1996), Berger and DeYoung (1997) all argued that cost efficiency to be directly proportional to governance structure of the firm. Berger and DeYoung (1997), present a theory that firms with poor governance, risk assessment and controle is not undertaken when advancing credit to new clients. Kwan and Eisenbis (1997) show that increased inefficiency leads to increased loan ratio. Profit margins also influence the risk appetite of firms. Firms performing well are not under pressure to generate profit hence less likely to engage in risky lending.

Misra and Dhal (2010) paper reflect those of Das and Ghosh (2007). They have pointed to a positive effect with firm size. They hold the position that big firms are apt to have quite large NPLs, because of the balance sheet restraint. Hu et al. (2006) found that size of bank is not connected to NPLs. Hu et al. (2006) stressed firm risk profile.

The above review presents a picture that NPLs is experienced by firms worldwide. However, NPLs is more evident in developing countries. Literatures gave clue that NPLs is affected by firm-specific factors such as governance structure, market share, credit

policy, risk appetite and macroeconomic factors such as rate of employment, interest rate capping, Monetary policy, fiscasl policy, political environment.

2.4 Empirical Review

No study has been undertaken to identify and validate the consequence of credit reference bureau service on financial performance of NDT microfinance institutions but according to Angulin and Scapens (2000), there has been no pattern of defining and adopting indicators and constructs for the credit reference bureau service on financial performance.

2.4.1 International Evidence

Numerous studies have pointed how all-inclusive information assist creditors better foretell debtors default. Herausgeber (2001) observed that the use of credit information systems has become a subject of study and support with Kenyan government and international community. Herausgeber (2001) holds that lack of risk level information is a barrier to access of credit by microenterprises. NDT MFI need to make speedy strides to gather and analyse credit information of clients before making loan decisions.

Barron and Staten (2003) hold that creditors can reduce NPL by adding debtor information in the prediction model for defaulters.

2.4.2 Local Evidence

Ng'ang'a (2011) carried out a study on shareholder view of CRB products in Kenya. The research methodology was by constructing a Lerner index based on loan repayment, efficiency and financial performance. The empirical investigation is based on data from

thirty six Microfinance Institutions for the period 2010-2011. The study revealed that many of the borrowers do not want to be listed by credit reference bureaus and could try as much as possible to service their credit facilities so as to protect their reputation.

Wanjiku (2012) carried out a study on the consequence of financial regulation on profitability of deposit taking microfinance institutions (DTMs) in Kenya. The study concludes that the supportive Deposit Taking Microfinance Regulations of 2008 led to the improvement in financial performance of DTMs. Regulations led to increased loan uptake and improved profitability of the firms. The negative effect of the regulation were increased transformation cost, introduction fo license fee and increased competition from other financial players who have been in the industry longer.

A study by Gitahi (2013) showed the effect of credit reference bureau on the level of non-performing loans in the commercial banks in Kenya by analysing data from financial statements from these banks for a period of six years (2007 – 2012), by adopting an event study research design and use of regression analysis method. The target population consisted of all commercial banks in Kenya. The research found that CRB have reduced NPL by about 4%, upon the birth of CRB, that is, 2010-2012. His conclusion was that, there exist an inverse connection between NPL and frequency of checks on clients by firms to CRB.

On examining the relevance of credit reference bureaus and its effects on the financial performance of banks in Kenya Alloyo (2013), found that during the period before

introduction of CRB , firms performance were majorly not growing. This changed with coming on board of CRB.

2.5 Summary of Literature Review

Credit reference services from above studies reviewed, remains an important tool to reduce risk of defaults for financial institutions and it has been highlighted clearly that it is a good tool for managing risk in financial organizations. From the review literature most studies have focused their research on banks as major lending institutions but none has focused on the consequence of credit reference bureaus on financial performance of NDT MFI.

All these studies give credit to CRB for the improvement of the credit market, decrease in interest and default, better rate of return on investment, general financial performance and increased competitiveness within the industry. None of the above studies have critically examined the relevance of credit reference bureaus and its effect on financial performance of NDT microfinance institutions in Kenya. Credit reference bureaus have an effect on non-performing loans in that there was an average reduction of 4% on the level of non-performing loans, in the years after birth of credit reference bureaus. The study revealed that many of the borrowers do not want to be listed by credit reference bureaus and could try as much as possible to service their credit facilities so as to protect their reputation.

From the review literature most studies have focused their research on banks as major lending institutions but none has focused on the effect of credit reference bureaus on financial performance of microfinance institutions. This research seeks to establish the effect of credit reference bureaus on financial performance of NDT microfinance institutions in Kenya to fill the gap left on this sub-sector which greatly contributes to the growth of the Kenyan economy. The knowledge of this information shall be used in data collection so as to meet the objective of the study.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the methods used in this study to get answers to the objective of this research. Research methodology is presented in this order, research design, target population, sampling procedure, data collection methods, instruments of data collection and finally data analysis. The following sections provide a detailed description of the methodology that was used in this study.

3.2 Research Design

This study employed descriptive research design. Descriptive research design outcome is a description of the collected data using tables designed to fit the work, words, charts or pictures. It shows statistical relationships of the data or a mere descriptive relationship. A questionnaire was developed to facilitate data collection.

Questionnaires was analyzed by use of descriptive statistics. The main objective of the study was to evaluate the effectiveness of CRB on the financial perfomanace of non-deposit taking mirinania institution in Kenya. Descriptive research enable a researcher describe the given problem and establish relationship between the factors. It is specifically investigated effect of CRB (Credit Reference bureaus) on performance of NDT MFIs.

3.3 Population

Target population refers to whole set of items, people or animals with general noticeable character of a given nature different from any other population. Mugenda and Mugenda (1999), defines population as a distinct set of services, people, events etc that are of interest to an investigator.

Target population was four (4) non deposit microfinance institutions registered by AMFI Kenya as at Dec 2012and members of Credit Information Sharing Association of Kenya (Appendix I), The target population comprises of branch managers, credit administrators, credit analysts and loan officer working within the four institutions. The target population thus was 26 comprising of 4 branch managers, 10 credit administrator, 8 credit officers, 4 loan officers .

3.4 Data Collection

Questionnaires was the only gear used to collect data. The selection and design of questionnaires was influenced by the characteristic of data, population size, available time and the objectives of the study.

The data that was collected was aimed at providing answers to the research question as to the consequence of credit reference bureau service on financial performance of NDT MFIs in Kenya. Questionnaire was used because they were advantageous since they enabled the researcher save time, maintain confidentiality, and added access to population, and eradicated interviewer bias (Cooper& Schindler, 2004).

The questionnaire was developed and designed on the foundation of the research questions, what is the effect of credit reference bureau service on financial performance of NDT MFIs in Kenya. Data was analyzed using Spreadsheets to produce suitable tables for presentation of data. The research was consequently taken to be a suitable avenue for getting results of the study.

3.5 Data Analysis

Data analysis refers to the organization, accounting and explanation of data, giving meaning to response received relating to situation definations, noticeable patterns, categories etc (Mugenda and Mugenda, 2003). Data analysis entails data preparation, meaning that the data is cleaned for errors, edited and coded to enable processing. Content analysis technique was used to capture the respondent’s concerns, ideas, attitudes and feelings about credit bureaus and its influence on financial performance of NDT MFIs.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

The objective of this research was to deduct the consequence of CRB service in the performance of NDT micro finance institutions. This was done through a perception survey; twenty six (26) questionnaires were sent out to employees of the 4 NDT MFIs namely ECLOF, AAR Credit, MUSONI and Juhudi Kilimo, twenty one (21) were received back, a response rate of almost 80 percent.

This chapter presents the findings of the research and discussions taking into account the results of the pre-stated objective of the study. The findings of the study and the analysis of the results established from the interview guides sought to determine the impact of credit reference bureaus on the performance of NDT MFIs.

The chapter further discusses findings in relation to relevant theory and literature as established by other authors in the same field of study. The data was collected through structured interview specifically designed to generate data relevant to the research objective and analyzed through content analysis to improve quality of data collected. Close ended questions were administered requiring respondents to express their feeling and thinking about the impact of credit reference bureaus on the performance of NDT MFIs in Kenya.

4.2 Discussion of Findings

4.2.1 Profile of Respondents

From the literature review, we established that the respondent could be the branch manager, Credit administrator, credit analyst or loan officer. Table one show that most of the respondents were the credit administrators at 48 percent. The assumption is that credit sharing information supplied to CRB plays a critical role in reducing asymmetry between lenders and borrowers. This would imply that a certain level of information is pre conditioned for effective CRB. All the twenty are respondents (see Table 1) agree that there is information sharing.

Table 1: Position of the respondent in the organization

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Branch Manager	1	4.8	4.8	4.8
	Credit Adminstrator	10	47.6	47.6	52.4
	Credit Analyst	8	38.1	38.1	90.5
	Loan Officer	2	9.5	9.5	100.0
	Total	21	100.0	100.0	

When asked how long they have shared information, 43 percent of respondents say they have shared information with CRB between three years to five years, and 33 percent have

shared the information for a period of over the one year to two years (see table three). The logic of this question was to establish whether the sampled exams are experienced enough to determine the benefits of sharing information.

Table 2: Does your organization share credit information with CRB

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Yes	21	100.0	100.0	100.0

Table 3: How long has your organization shared information with CRB

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Less than 1 year	3	14.3	14.3	14.3
	Between 1-2 years	7	33.3	33.3	47.6
	Between 3-5 years	9	42.9	42.9	90.5
	Over 5 years	1	4.8	4.8	95.2
	5.00	1	4.8	4.8	100.0
	Total	21	100.0	100.0	

4.2.2 Financial Perfomance of NDT MFIs due to Credit Reference Bureau

In this sections respondent's opinion or perception was sought on the extent to which the performance of their institutions is influenced by the information sourced from CRB. The results are presented in table 4 below. Close-ended questions were used, and a likert scale was labeled as follows:

1=Very low extent

2= Low extent

3= No effect

4= Great extent

5= Very great extent

When asked whether in their opinion, CRB information translated into a decrease in non-performing loans, fifty seven of the respondents think that the impact is of a low extent, but twenty-nine percent think that the impact is greater (see Table 4). The standard deviation of 1.10 suggested a consensus from the respondents on this issue. The result to a less degree agree with finding by Gatahi (2013) who reported that CRB indeed reduced NPL.

Table 4: Financial Performance of NDT MFIs due to credit reference bureau

	Very Low Extent	Low Extent	No Effect	Great Extent	Very Great Extent	Total	Std. Dev
Q4.CRB led to decrease in NPL	5	57	5	29	5	100	1.10
Q5.CRB increase no. of debtors	5	43	14	33	5	100	1.09
Q6.CRBs reward customers with good credit rating	5	24	29	43	0	100	0.94
Q7.CRB help gain insight of client intent on loan provision	0	14	57	29	0	100	0.65
Q8.CRB help NDT MFI differentiate good from bad borrowers	0	48	29	14	10	100	1.01
Q9.CRB help lower search cost of loan applicant	0	14	19	43	24	100	1.00
Q10.CRB eliminate collateral	24	24	10	33	10	100	1.40

The response (Q5) on the question, whether CBR translated into an increase in borrowers show that forty-three percent of respondents think the impact might not be significant; however, thirty-three percent of them think that CBR impact is great. At least fourteen percent of the respondents think that CBR has no impact. This does to a small extent confirm the effect disciplinary effect propelled by (Padilla, 2000). Wanjiku (2012), also asserted that regulations led to increase in loan uptake by MFI, thus should CBK draft

laws to regulate NDT MFI, then it is expected that an increase in number of loan applicants will be observed.

The CBR is expected to discriminate between good and bad borrowers and the response to question six in table 4 was to establish that fact. In this regard, forty-three percent think that they do but substantial number, twenty-nine percent, think CBR is not effective in separating good borrowers from bad borrowers. Standard deviation confirmed agreement CRB is of little help in gaining insight of potential borrowers' intent on the loan provision, as far as fifty-seven percent of respondents [see question7] are concerned. Therefore, CBR might not be solving the moral hazard problem. This confirms Stiglitz and Weiss (1981) assertion that loan providers have difficulty differentiating between good and bad borrowers The response to question eight confirmed the response in question seven.

It is the respondent's opinion that CBR has lowered search cost for lending firms (Q9) as sixty-seven percent of respondents [43% + 24%] score great extent and above on this item. On whether the CBR has eliminated the need for collateral for low income borrowers (Q10), there is lacked of agreement the standard deviation is a way above one that is 1.40. Forty-eight percent of respondents think it is a low extent, and ten percent think of has no impact. The finding challenges Hauswald and Marquez (2003) who urgued that information processing, gives NDT MFIs informational advantage, protecting it from competition enabling them to receive rents. Improvement in the screening knowledge, will boost profits. Availability of that information, will level the playing field

for all firms and decrease profit because of increased competition. Results of (Q10) also support Silwal (2003), who proposed that to minimize the problems of adverse selection financial firms mostly request for proposal of business credit history of customer and security prior to authorising the credit facility.

4.2.3 Credit Reference Bureaus and Sharing of Borrowers Information

The objective in this section was to find the extent to which CRB enhanced the sharing of information between borrowers and lenders. The responses are in Table 5. The responses in question 4 in this section suggest a negligible impact of CRB on the market as a whole [see questions 11 to 16]. It appeared the respondents had difficulty responding to questions in this section. They seem not to agree with Padilla (2000) and Pagano (1993), argument that information sharing treats adverse selection problems by providing financial institutions with information advantage.

Table 5: Credit reference bureaus and sharing of borrowers information

	Very Low Extent	Low Extent	No Effect	Great Extent	Very Great Extent	Total	Std. Dev
Q11.Firms shares positive and negative info to CRB	0	29	67	0	5	100	0.98
Q12.Weakening perfomance due to complex credit processes	5	5	62	24	5	100	0.81
Q13.CRB improves credit and market performance	0	62	38	0	0	100	0.50
Q14. NDTMFI lack data to screen credit applications	0	52	24	19	5	100	0.94
Q15. Lack of information has contributed towards adverse selection or moral hazard problems in lending activity of the NDTMFI	0	57	10	29	5	100	1.03
Q16.Information asymmetry makes it difficult differenciate good and bad credit risks	0	10	10	52	29	100	0.89

4.2.4 Credit Reference Rureau on Non Perfomance Loans

In this section, respondents were asked whether, low level of default translated into improved performance and in this section respondent, opinion was sought as to whether CRB impact on default rates; the results are summarized in table 6. When asked whether information from credit reports (Q17) helps identify defaults in terms of credit history,

seventy one (71) percent of respondents say they do and a low standard deviation confirms agreement among respondents on this issue. Since the introduction of CRB borrowers' concern to protect their reputations has increased to a great extent, (see question 18); at least sixty-two percent of respondents say so. In question nineteen, we confirm that CRB provides balanced information, whether negative or positive, which is not harmful to borrowers. However, most of the interviewees are not of the school that NDTMFI use CRB information [question 20] for risk identification through risk mapping and/or scenario analysis. Barron and Staten (2003) advice that NDT MFI can reduce NPL by adding debtor information in the prediction model for defaulters. In question 21 and 18, there is confirmation that CRB reports help instill culture of financial discipline.The results in question 21 tie with the results of he studie done by Ng'anga who found that customers will usually struggle to pay loans to avoid being listed by CRB. In this section, nearly all standard deviations are below one, confirming agreement among respondents on these issues. The above results agree with Gatahi (2013) who found out that CRB has aided reduce NPL for firms.

Table 6: Credit Reference on Non Performance Loans

	Very Extent	Low	Low Extent	No Effect	Great Extent	Very Great Extent	Total	Std. Dev
Q17. Credit report Information aid defaulter identification		0	5	5	19	71	100	0.81
Q18. CRB decreased default rates as debtors aim to protect reputation		0	24	10	62	5	100	0.93
Q19. CRB credit report provides include positive and negative information		0	10	29	62	0	100	0.68
Q20. NDTMFI use credit report information for risk identification		10	52	14	24	0	100	0.98
Q21. Credit reports instill culture of financial discipline		0	10	14	76	0	100	0.66

4.2.5 Provision of Credit by NDT MFIs

When asked whether CRB has improved provision of credit by NDT MFI, the respondents are of the opinion that the impact is low [67 percent of respondents think so- see question 22]. In fact 62 percent of respondent assert that they have not gained much from information supplied by CRB. However, Alloyo (2013) in his study reported a growth in business performance as a result of introduction of CRB.

Table 7: Provision of Credit by NDT MFIs

	Very Low Extent	Low Extent	No Effect	Great Extent	Very Great Extent	Total	Std. Dev
Q22.CRB has improved provision of credit by NDTMFI in Kenya	5	67	24	5	0	100	0.64
Q23.NDTMFI increased profits by lending base on CRB reports	5	29	62	5	0	100	0.66

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter provides a snap shot of the findings. It also gives finding and result with main on the research objective, question. Additionally it recommends on areas of focus for future research.

5.2 Summary of Findings

The respondants were of the opinion that CRB information does not translate into decrease in performing loans, (see Table 4). Additionaly, the respondents think that CRB is of little help in gaining insight of potential borrowers thus not solving the moral hazard problem. It is the respondent's opinion that CBR has indeed lowered search cost for lending firms bringing down operational cost, this will help push profit margin up thus increasing profitability of the firm.

The respondants could not agree on whether CRB has eliminated the need for collateral for low income borrowers. The study reveledthat sinceintroduction of CRB borrowers' concern to protect their reputations has increased to a great extent, however, the respondants confirmed that the institutions do not use the information for risk identification through risk mapping and/or scenario analysis.

5.3 Conclusions

This paper attempts to determine how CRB services affect viability of NDT MFI. An important finding is that CRB servises results in the direct influence on performance of non deposit taking MFIs in Kenya. The paper also provides empiricalevidence regarding the relative influence of CRB services on performance of non deposit taking MFIs in Kenya. Specifically, the findings show that a CRB service is indeed an influential variable affecting performance of Non-deposit taking micro-finance institutions.

5.4 Recommendations for Policy and Practice

This study recommends that the Association of Microfinance Institutions to strengthen the Non deposit taking MFIs to enable them come up with mitigation measures to control the external factors that interfere with the credit ratings of their customers; with a possible measure to caution non deposit taking MFIs from weak laws that could lead to blind loaning or borrowing. It is also recommended that CIS should amend its regulations to allow inclusion of non-financial data in credit files to offer a more diversified information capital.

The study further recommends the creation and strengthening of an independent unit within each non deposit taking MFIs to enhance oversight and monitor performance.
Conclusively, CRBs should adopt modern methods that focus more on core competencies targeting clients in order to prevent financial deepening and to enhance good performance of non deposit taking MFIs. The tight work schedule of most of the staff of non-deposit taking MFIs and sensitivity of giving information on CRB services posed a slight

challenge to the study. This is because the respondents that were approached were reluctant in giving information demanding written permission to be interviewed.

5.5 Limitations of the Study

The major challenge was reluctant of the NDT MFI staff to agree to undertake the study, the researcher was faced with bureaucracy and numerous approvals to administer the questionnaire, this forced the researcher to delay the response analysis.

Additionally, the study was carried out within time and resource constraints. Adequate time was required to book and collect data from the NDF MFIs. This was not exhaustively done as some of the schedules of the MFIs could not fall within the research timelines. The researcher faced financial constraints. Funds were required to cover travelling, communication, stationery, research, internet and other incidental costs of the project.

5.6 Suggestions for Further Research

From the study and subsequent conclusions, the researcher recommends a further research on the factors prohibiting NDT MFIs from using CRB information to solve moral hazard problem.

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APPENDIX

APPENDIX I: QUESTIONNAIRE

SECTION A: BACKGROUND DATA

1. Position in the organization

   Branch manager [ ]

   Credit administrator [ ]

   Credit analyst [ ]

   Loan officer [ ]

2. Does your organization share credit information with CRB?

   Yes [ ]

   No [ ]

   Not sure [ ]

3. How long has your organization shared information with CRB

   Less than 1 year [ ]

   Between 1-2 years [ ]

   Between 3-5 years [ ]

   Over 5 years [ ]

SECTION B: FINANCIAL PERFORMANCE OF NDT MFI DUE TO CREDIT REFERENCE BUREAU

4**.** To what extent has the adoption of credit reference bureau influenced the following activities in your institution. Use a scale of 1-5. Where 1-very low extent; 2-low extent; 3- No effect 4-Great extent 5- very great extent

SECTION C: CREDIT REFERENCE BUREAUS AND SHARING OF BORROWER'S INFORMATION

To what extent has credit reference bureaus affected sharing of borrower's information in your institution. Use a scale of 1-5. Where 1-very low extent; 2-low extent; 3-No effect 4- Great extent 5- very great extent

	Variable	**1**	**2**	**3**	**4**	**5**
5	Institution shares both positive and negative credit of its customers to CRB					
6.	Weakening performance of the sector is due to complex credit processes in the markets					
7.	CRB improves credit market performance and credit access for the poor					
8.	NDT MFI lack data needed to screen credit applications and to monitor borrowers					
9.	Lack of information has contributed towards adverse selection or moral hazard problems in lending activity of the NDT MFI.					
10.	Information asymmetry has caused difficulty in differentiating good and bad credit risks					

SECTION D: CREDIT REFERENCE BUREAU ON NON-PERFORMANCE LOANS IN THE LENDING MARKET.

	Variable	**1**	**2**	**3**	**4**	**5**
11.	Information from Credit reports helps identify defaulters in terms of credit history as risky clients					
12.	CRB decreased default rates as borrowers aim to protect their “reputation collateral” by fulfilling their obligations in a sensible manner					
13.	CRB provides credit reports that include both positive and negative information which help elevate or destroy “reputation collateral”					
14.	NDT MFI use information from Credit reports for risk identification through risk mapping and/or scenario analysis					
15.	Credit reports help instill culture of financial discipline due to monitoring of borrowers					

SECTION E: PROVISION OF CREDIT BY NDTMFI IN KENYA

	Variable	**1**	**2**	**3**	**4**	**5**
16.	CRB has improved provision of credit by NDT MFI in Kenya					
17.	Has the institution gained more profits as a result of issuance of credit based on CRB reports?					

Thank you for taking your time to answer this Questionnaire.