NON- PERFORMING LOANS: ARE CREDIT REFERENCE BUREAUS THE SOLUTION?

BY

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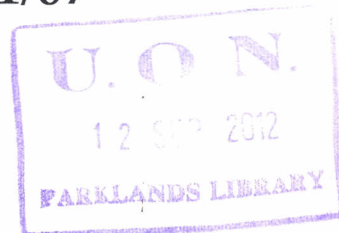

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DECLARATION

This Thesis is my original work and has not been presented for a degree in any other university.

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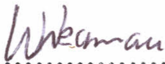
This Thesis has been submitted with my approval as University of Nairobi supervisor.

Signed : .................................... Date : 28/11/2008

DR. WINNIE KAMAU

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DEDICATION

To my dear nephews Ken, Njeru, Stevey-Wonder and young Steve and my sweet nieces Jane, Sally, Poly and Juliet. May you find this valuable when you become of age.

ACKNOWLEDGEMENTS

I am grateful to God for all, His grace, and unfailing love and for granting me strength to pursue this Masters programme and above all good health and peace of mind.

To my supervisors Ms. Jacqueline Nyaga and Dr. Winnie Kamau for their support, guidance and training.

To Mr. Mereka for granting me an opportunity to utilize the resources at his chambers and for allowing me time out of the office in pursuit of this LL.M Programme.

To all my precious and invaluable friends, colleagues and family. Thanks for your love, support and encouragement.

GOD BLESS YOU ALL!

ABBREVIATIONS

No.	Short Name	Full Name
1.	CRB	Credit Reference Bureau.
2.	DFI	Development Finance Institutions
3.	DPFB	Deposit Protection Fund Board.
4.	FI	Financial Institutions.
5.	MFI	Micro-Finance Institutions.
6.	NPL	Non-Performing Loans.
7.	SACCOs	Savings and Credit Co-operative Societies.

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1. Anti-Corruption and Economic Crimes Act, Act No. 3 of 2003
2. Banking Act (Cap.488 Laws of Kenya).
3. Banking (Credit Reference Bureau) Regulations, 2008 – Legal Notice No. 97/08.
4. Banking (Exchange of Information) Regulations, 2004 (Now repealed).
5. Central Bank of Kenya Act (Cap. 491 Laws of Kenya).
6. Companies Act (Cap. 486 Laws of Kenya).
7. Evidence Act (Cap 80 Laws of Kenya).
8. Finance Act, Act no. 10 of 2006.
9. Income Tax Act (Cap 470 Laws of Kenya).
10. Prudential Guidelines for institutions licensed under the Banking Act.

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CHAPTER 1

INTRODUCTION

1.0 Background Of The Study

The post independence period in Kenya was one of tremendous economic growth characterized by conscious Government policy to transfer economic activity into the hands of indigenous Kenyans and the banking sector was no exception[1].

Twenty years after independence in 1983, several indigenous banks developed acute liquidity problems[2]. In spite of Treasury and Central Bank efforts to bail out the ailing institutions, one institution was closed in December 1984. This bank failure exposed the inadequacy of safety-net and failure resolution mechanisms existing at the time. This in effect, precipitated amendments to the Banking Act in 1985 to expand the safety-net and improve the bank failure resolution mechanism.[3] However, in the ensuing period two more institutions collapsed in August 1986 followed by a third one in January 1987 and these institutions were placed under liquidation by the Official Receiver, a Government office under the Attorney General's Chambers.

In 1989 seven institutions were found to be experiencing acute liquidity and drastic collective action needed to be taken. A consolidation scheme was crafted by the Government whereby a new entity Consolidated Bank of Kenya was formed to take over the assets and liabilities of

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[1] Observation made by the Research Department of the Central Bank of Kenya on the history and establishment of the Deposit Protection Fund Board (DPFB). Available at www.centralbank.go.ke. Last accessed on 21.9.2008

[2] Ibid

[3] The Deposit Protection Fund Board (DPFB) was established by the said amendment to the Banking Act through an Act of Parliament, the Banking (Amendment) Act no. 17 of 1985, as a deposit insurance scheme to provide cover for small depositors and act as liquidator to banks which could not be salvaged. The same amendments gave Central Bank of Kenya the responsibility of risk minimization through prudential regulation, supervision and surveillance.

the seven institutions.[4] The scheme was supervised by the Treasury which also funded the seed capital for the new bank through the DPFB.

The early 1990s were characterized by intensive political activity with the resurgence of multi-party politics. An unfortunate by-product of this activity was a mushrooming of 'politically correct' banks licensed for political exigencies. During 1993, fourteen institutions were placed under liquidation. Other subsequent bank failures, occurred as follows two in 1994, three in 1996, one in 1997, five in 1998, one in 1999, one in 2001, two in 2003 and one building society in 2005.[5]

The banking crisis, failures and closures experienced were largely due to the problem of non - performing loans (NPLs).[6] Poor loan quality has its roots in the informational problems which afflict financial markets, and which are at their most acute in developing countries, in particular problems of moral hazard and adverse selection.[7] Lack of information on the creditworthiness of the borrowers places them at a high level of default in payment. The

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[4] The Consolidated Bank of Kenya Limited was incorporated on 7th December, 1989 under the Companies Act (Cap 486 Laws of Kenya) and is licensed under the Banking Act (Cap 488 Laws of Kenya).

[5] The information is available from the central bank of Kenya website at www.centralbank.go.ke. But even from its supervision report of 2006, the Central Bank does not disclose the names of the institutions which have been liquidated. These banks however include but are not limited to Trust Bank, Prudential Bank, Trade Bank (Aug, 93), Euro Bank, Rural Urban Credit Finance Limited , Delphis Bank. Daima Bank (05), Prudential building society, Thabiti Finance Company Limited, Pioneer Building Society, Jimba Credit Corporation, Continental Finance Union Bank etc.

[6] A non-performing loan has been defined to mean a loan that is in default or close to being in default. Many loans become non-performing after being in default for three (3) months, but this can depend on contract terms.

[7] Martin Brownbridge: The Causes of Financial Distress in Local Banks in Africa and Implications for Prudential Policy, March 1998. UNCTAD/OSG/DP/132.Palais des Nations, CH-1211 Geneva 10, Switzerland. *Moral hazard* attenuates incentives on bank owners to act in ways which are contrary to the interests of the bank's creditors, by undertaking risky investment strategies such as lending at high interest rates to high –risk borrowers which, if unsuccessful would jeopardize the solvency of the bank. *Adverse selection* means that the borrowers with the highest chances of default are chosen for a loan.

lenders not having properly evaluated the borrowers have no fall back position when they begin to default.[8]

Non-performing loans are an undesirable phenomenon that hurts the bank's liquidity (and thus the danger of depositors not being able to get their money as and when they require it) which impacts negatively on its earning. They also affect adversely the asset quality of a bank since all loans, whether bad or good constitute an asset to the bank and when the quality of this vital asset is affected, a bank might suffer loss[9].

Asymmetry of information problems have long been at the fore of analysis of credit markets. Indeed, one rationale for banks is that, as institutions they gather information and establish relationships with borrowers in an effort to surmount the information asymmetric problems. In a model with adverse selection, Jappelli and Pagano[10], show that exchanging information on borrower type decreases default rates and reduces average interest rates. In a related paper, Padilla and Pagano[11] show that information sharing among borrowers would lead to lower interest rates and increased lending. There is also a growing body of empirical evidence that suggests that the existence of credit information sharing is associated with deeper credit market and that there is value in the existence of private credit bureau reporting services[12].

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[8] Gerard Caprio Jr. & Daniela Klingebiel: Bank Insolvency: Bad luck, Bad policy or Bad banking, 1996. Department of Economics, Williams College. They observe that the reasons why banks become insolvent points to a number of other causes such as bad luck, bad policy and bad banking emanating from excessive lending to un-creditworthy borrowers. Consequently, the banks suffer ending up in liquidation. The study does not investigate bank insolvencies but this is an illustration that apart from non-performing loans other factors do contribute to bank failures.

[9] What adds to a bank's bottom line is the quality of assets it owns.

[10] Jappelli T. and M. Pagano: Information Sharing in Credit Markets, December 1993. The Journal of Finance Vol. 43(5), 1693-1718.

[11] Padilla A. J. and M. Pagano: Endogenous Communication among Lenders and Entrepreneurial Incentives, 1997. The Review of Financial Studies 10 (1),, winter, pp 205-236.

[12] Andrew Powell, Nataliya Mylenko, Margaret Miller and Giovanni Majnoni: Improving Credit Information, Bank Regulation and Supervision: On the Role and Design of Public Registries, November 2004. World Bank

However, it is not clear that banks will voluntarily share information even when it is in a broader social interest to do so. There is no theoretical analysis regarding the organizational structure of private credit bureau industry and an important question is whether there should be public sector intervention to enhance credit information sharing and, if so, what form that intervention should take.

In jurisdictions where credit reference bureaus have taken root, public intervention does indeed take place. First, private sector credit bureaus are frequently regulated and the regulation normally takes the form of monitoring privacy. For example, a consumer who receives a regular paycheck, pays credit cards in full and other bills on time is normally considered a better credit risk than one that does not. The second form of intervention that has taken place is the direct (and frequently forced) provision of credit information sharing services by central banks or banking supervisors known as public credit registries (PCRs).[13]

Armed with the most comprehensive consumer payment histories, creditors in United States apply statistical scoring models to estimate an individual's repayment risk[14]. Credit bureau data has made a wide range of credit products available to millions of households who would have been turned down as too risky a generation ago.[15] However there has recently been an

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Policy Research Working Paper 3442. Policy Research Working Papers are available online at http://econ.worldbank.org

[13] Ibid

[14]Today Americans hold more than 1.4 billion credit cards, use them to spend $1 trillion a year, and maintain balances in excess of $600 billion. Information provided by credit bureaus is an important ingredient in the vast expansion of unsecured consumer credit in the U.S. over the last century. This information is used to decide who is offered credit and on what terms. Credit bureau data on consumer borrowing and payment behavior has therefore become the cornerstone of the underwriting decision for consumer loans in the United States.

[14] Barron J., and M. Staten: The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience, 2003. In Credit Reporting Systems and the International Economy ed. Margaret Miller. Boston: MIT Press.

economic crisis in the United States as a result of credit defaults and this probably reflects the weaknesses embedded in the credit market that even credit bureaus can fully resolve.

The full benefits of comprehensive credit reporting have yet to be realized in most other countries. The credit-reporting environment varies widely around the globe. Limits on consumer payment histories may be government imposed (perhaps as a result of concerns about consumer privacy, but often due to lobbying for such restrictions by incumbent lenders wishing to limit competition), or may simply occur as a result of underdevelopment of the legal and technological infrastructure necessary to sustain a comprehensive credit-reporting market[16].

Credit references are used to help lenders quantify the risk of lending to a given applicant, or to determine overall creditworthiness. For example, if an applicant's credit history indicates proper, timely payments on all outstanding obligations, a lender may judge it more likely that the applicant will make timely payments on the requested loan.

In Kenya, there are three credit reference bureaus (CRBs), namely, Credit Reference Bureau Africa Limited, Metropol East Africa Limited and Quest Credit Bureau Limited. The bureaus are emerging in our economy and they may be seen as one way to curb the menace of non-performing loans by possible assessment of future credit performance based on past performance with credit. But this does not mean that credit reference bureaus necessarily maximize social welfare. They may make mistakes such as leaking a client's information to unauthorized persons such as journalists. The regulatory regime adopted should balance the social welfare.[17]

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[16] Ibid

[17] Supra note 12

For a long time the lending laws in Kenya focused on remedies available to a lender upon default by a borrower. These include sale of the security or collateral for loan which in some instances may not be good for realization, for instance where land placed as security has undergone sub-division. On recognition that sharing of information is vital in a credit market, the Banking (Exchange of Information) Regulations, 2004[18] were enacted that allowed the banks willing to share information about their customers to do so. This was under Regulation 2 thereof. The same Regulations also provided for the setting up of the credit reference bureaus as institutions through which information can be exchanged. This was under Regulation 3 thereof. These Regulations have however been repealed by the enactment of the Banking (Credit Reference Bureau) Regulations, 2008.[19] The current Regulations provides for the operations of the credit reference bureaus which will be companies registered under the Companies Act[20] and licensed under the Banking Act[21]. The Central Bank will have the mandate to supervise and undertake surveillance of the bureaus.[22] These Regulations while aiming at forming a platform for setting up of CRBs and allowing exchange of credit information necessitate the re-thinking of the old banker's duty of confidentiality.

Confidentiality is established in the Banking Act[23] and is extended to loans in default as well as loans in good standing. It is understandable that a loan arranged by a bank for one of its customers should be treated confidentially so long as both parties are honouring the loan agreement. When a loan is in default, however, the right to make the default public may stimulate repayment or renegotiation of the loan agreement and encourage new applicants for loans to ensure that their applications are bona fide.

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[18] Legal Notice No. 80 of 2004 (Now repealed)

[19] Legal notice No. 97 of 2008

[20] Cap 486 Laws of Kenya.

[21] Cap 488 Laws of Kenya.

[22] See Regulation 25 (1) of the Banking (Credit Reference Bureau) Regulations, 2008

[23] Section 31 of the Banking Act, Cap 488 Laws of Kenya.

The conditions under which borrowers are allowed to hide under the umbrella of confidentiality merit very careful review and should be modified. An important break in the confidentiality barrier has been considered under which banks will be able to share information on non-performing loans so that a bank being approached by a prospective client for a loan can clear with other banks that the client is or is not in arrears on loans the client had earlier arranged with other banks in the net[24]. This is in my view a promising development. Fear of disclosure should encourage potential borrowers to avoid seeking loans with little, if any, intention of repaying, and strengthen management's ability to refuse doubtful loan applications.

Credit information systems act as information brokers that increase the transparency of credit markets. However, in many developing countries credit information systems are still in their infancy and information sharing between lenders remains insignificant. As competition in microfinance lending intensifies in these countries, borrower information becomes all the more important. Micro-Finance Institutions (MFIs) are increasingly utilizing their services to address a fundamental problem of all credit markets: asymmetric information between borrowers and lenders that can lead to adverse selection and moral hazard. Motivated by industry survival amidst increasing competition, a wide array of lending institutions in developing countries are becoming increasingly aware of the essential role that credit information systems play towards the creation and maintenance of an efficient financial system[25].

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[24] The issue of a bank's right to disclose its business dealings with a customer to a third party can be addressed by the bank including in its new account opening documentation and loan application documentation a consent from the customer that the bank may disclose at its sole discretion information concerning its business dealings with the customer. The information to be disclosed should include both 'positive' and 'negative' information about a customer.

[24] Anna Dorbec : Credit Information Systems: Theoretical and Comparative Analysis. Working Paper AED-EAL-2006-2 WP-AED-dorbec_EN06-09-06.doc. EconomiX, University of Paris X-Nanterre

1.1 Statement Of The Problem

The credit market operates under substantial asymmetries of information. Indeed, when a borrower applies for a loan, the lender most likely does not know many personal and professional features of the borrower that may be crucial for an appropriate risk assessment. The study will investigate whether the entrenchment of credit reference bureaus in the law, will arrest the information asymmetric problem and subsequent reduction of non-performing loans.

Essentially, unless gold ore is excavated, its existence deep in the earth is of no essence. CRBs are of eminent importance to both financial institutions giving credit and individuals taking financial loans and mortgages. Few people know about the existence of CRBs hence they fail to tap from their services. The study will analyze and document the legal and regulatory framework that provides for exchange and/or sharing of information.

There is need to amend our laws so as to allow *ex-ante remedies*[26] on credit default. Reliance on remedies that are *ex-post*[27] may pose a great threat to the liquidity of our economy. The ex-post remedies while not only archaic and outdated, they come late in the day to salvage an ailing bank. The study will analyze the Kenyan lending laws and assess their adequacy or lack thereof.

1.2 Theoretical/Conceptual Framework.

The theoretical and /or conceptual analyses on lending and exchange of information are derived from economics since the nature of the topic under study which assesses the nexus between non-performing loans and credit reference bureaus is itself economic in nature. Some writers while discussing the same ideas of lending and exchange of credit information

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[26] These are remedies available before the fact of lending.

[27] These are remedies available when uncertainty embedded in the entrepreneur's investment project is resolved.

use the term "theoretical models' while others use the term "conceptual models" while referring to the two problems of moral hazard and adverse selection experienced in the credit market. Thus the use of the two terminologies above.

Information asymmetry gives rise to conceptual framework of *moral hazard* problems on the side of borrowers and *adverse selection* on the side of banks. The two theories focus on involuntary and voluntary default risks and associated borrower incentives. In the first model, default arises involuntarily, owing to adverse income, changes in interest rates and/or wealth shocks that make borrowers unable to repay their loans. The second model contrast stresses problems with contract enforcement: borrowers may not repay their loans even if they have the means to do so[28].

Moral hazard is an asymmetric information problem that occurs after the transaction. The lender is subjected to the hazard that the borrower has incentives to engage in activities that are undesirable from the lender's point of view because they make it less likely that the loan will be paid back. It could also be that banks engage in high risk investment activities or charges higher interest rates that makes it difficult for borrowers to repay. Moral hazard arises out of information asymmetries because information flows between savers (borrowers) and bankers (lenders) are not efficient in the economic sense.[29] Moral hazard may be ex-ante or ex-post.

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[28] Parikshit Ghosh: Credit Rationing in Developing Countries: An Overview of the Theory, December 1999. University of British Columbiap.3

[29] A case in illustration is where a borrower charged a title that had been prepared for a sub-division. With the connivance of his lawyer, a sub-division scheme was drawn up and approved by the Ministry of Lands and separate titles somehow issued for four separate plots. The original title, which the lending bank had, was accordingly rendered worthless even though it was still physically there. Efforts to enforce such a title when the lender tried to sell the security proved futile. A system of property rights which cannot stand up in a court of law creates an extreme case of moral hazard and must seriously inhibit the ability of lending institutions to advance money to borrowers in those areas.

Ex-ante moral hazard: The borrowers may find it more favourable not to communicate the entirety of the information to potential lenders, especially when this information is negative.

Ex-post moral hazard: The borrower client who is able to repay his debt can declare default of payment or make the choice of entering into a more risky activity than the one presented to the lender.

Government intervention is needed because moral hazard model shows that, the presence of credit bureaus generally increases borrowers' incentives to repay, and if appropriately designed can lead to welfare gain(i.e. borrowers' effort to perform is closer to the socially optimum level). Therefore, if credit bureaus fail to arise spontaneously (say, because of coordination problems), one can make a case for the creation of a PCR. Viewed as a policy instrument to protect creditors and discipline borrowers. This disciplinary role can be expected to be particularly important where creditors' rights are otherwise poorly protected and enforced.

On the other hand, adverse selection is an asymmetric information problem that occurs before the transaction. This theory rests on the assumptions that the lender cannot distinguish between borrowers of different degrees of risk, and that loan contracts are subject to limited liability (i.e. if project returns are less than debt obligations, the borrower bears no responsibility to pay out of pocket). This problem thus occurs when people who are most likely to produce an undesirable (adverse) outcome are the most likely to be selected for a loan. Borrowers who want to take big risks (in expectation of equally large return) are most eager to borrow because they know that they will be unable to repay the loan if things go wrong. Lenders also like large loans because, the loans are less expensive per transaction than many smaller loans and also because lenders are likely to realize considerable returns in

monetary terms if the project is successful. However if the loan is unpaid, it produces a lethal adverse selection problem[30].

The adverse selection argument embodies the intuition about why better information makes lending markets work more efficiently. Better information allows lenders to more accurately measure borrower risk and set loan terms accordingly. Low risk borrowers are offered more attractive prices, which stimulate the quantity of loans demanded, and fewer higher risk borrowers are rationed out of the market because lenders can offer them an appropriate price to accommodate them, rather than turn them away.

Adverse selection problem is most likely to be more severe in 'public Government banks' where external control, even by the monetary authority, may be weak or ineffective. The taxpayers becomes the biggest losers since they must underwrite the cost of loans not paid (through higher taxes) and direct subventions to the affected institutions in order to prevent their collapse.

Government intervention is needed because adverse selection model shows that, information sharing increases the screening ability of banks. If banks have monopoly power (from sources other than priviledged information), a credit bureau increases their profits and welfare of safe borrowers but reduces the welfare of risky borrowers. If there is competition between banks, the gains from information sharing are rebated back to their customers, reducing the incentive to establish a credit bureau and thus perhaps leaving information sharing up to public intervention. A PCR helps banks to analyze risks, enhance loan quality and improve pricing and allocation. This can ultimately increase the stability of the banking system.[31]

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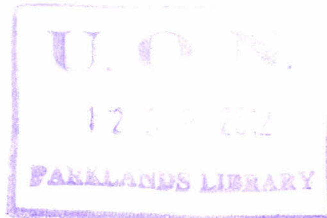
[30] Supra note 28 at p.11

[31] Japelli T and M. Pagano: Information Sharing in Credit Markets: International Evidence, June 1999. CSEF Working Paper No. R-371 University of Salerno at p.24


PARKLANDS LIBRARY

1.3 Hypothesis.

This study will be premised on the hypothesis that increased use of credit reference bureau services by lending institutions will reduce levels of loan repayment defaulters in Kenya due to enhancement of credit rating of borrowers.

1.4 Objective Of The Study

a) To determine the major functions and/or the role played and usage of CRBs in a growing economy such as Kenya and to evaluate the importance of the services they offer to those who heavily rely on such information.

b) To determine the extent to which the Kenyan legal framework on lending is apt to the task of credit rating and to identify any gaps or weaknesses.

c) To make recommendations for reform.

1.5 Justification Of The Study

When one bank goes under there are wide reaching macro-economic ramifications and there is need for a critical analysis of the banking sector with regard to non-performing loans. The bad debts are a reality and every year financial institutions make provision for bad or doubtful debts. However, credit reference bureaus (CRBs) have been used in developed economies such as the United States of America, UK, Canada as well as developing countries such as South Africa, India and Nigeria and they have been very instrumental in offering a platform for assessment of credit worthiness of borrowers before granting credit and thus assuage the problem of bad debts.

The study will be useful to policy makers on the need for and the role of the credit bureaus, exchange of information and guiding literature on operations of the newly enacted Banking (Credit Reference Bureau) Regulations, 2008 in a developing economy such as Kenya.

1.6 Literature Review

There is paucity of literature in this field locally. This is because the field of study is relatively new in our jurisdiction. Most commentators are from the international experience of other countries that have particularly embraced the services offered by credit reference bureaus.

Mark Furletti (2002) [32] in his article, *An Overview and History of Credit Reporting*, states that the first "bureaus," as they were called then, were small and community based. They often tracked the behaviors of consumers in a specific county or town and primarily focused on serving one kind of creditor bank, finance company, or retailer. These early credit reporting companies represented cooperative efforts among creditors in a specific region and were operated solely for the benefit of its members. They typically limited their credit-related reporting to negative or "derogatory" information. In addition to capturing name, address, and some loan information, these early agencies would scour local newspapers for notices of arrests, promotions, marriages, and deaths. These notices would then be clipped and attached to a consumer's paper credit report.

Using a pure adverse selection model, Jappelli and Pagano (1993) analyze the factors that lead to endogenous communication between lenders in a credit market. They find that information sharing is more likely to occur when the mobility of households is high, the pool

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[32] Mark Furletti: An Overview And History Of Credit Reporting , June 2002. Federal Reserve Bank of Philadelphia

of borrowers is heterogeneous, the credit market is large and the cost of information exchange is low. When some lenders begin to share information, it creates an incentive for other lenders also to share information.

John M. Barron and Michael Staten (2003)[33], in their article, *The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience Summary,* observe that credit availability is hindered when the amount of information in personal credit histories is restricted. Privacy legislation that curtails the collection and use of factual credit history data has a direct cost in terms of higher prices and restricted access to credit. Consumer credit will be less available in countries where credit reporting omits categories of variables that would provide a more complete picture of a consumer's borrowing and payment history. The negative impact is greatest for those who are young, have short time on the job or at their residence, have lower incomes, and are more financially vulnerable.

Stiglitz J. and A. Weiss (1981) [34], in their article, C*redit Rationing in Markets with Imperfect Information*, offers a rigorous theoretical explanation of the existence of credit rationing in which some applicants obtain loans and some of them are rejected. They argue that banks should ration credit rather than increase the interest rates due to adverse selection and moral hazard problems. If banks increase interest rates high risk projects will be preferred over low risk projects by the borrower who receives loan, decreasing the expected return for the bank (moral hazard effect). Since the behavior of banks cannot be monitored costlessly, the bank will take this into account when setting the interest rate.

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[33] Barron J., and M. Staten: The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience, In Credit Reporting Systems and the International Economy ed. Margaret Miller. Boston: MIT Press2003

[34] Stiglitz J. and A. Weiss: Credit Rationing In Markets With Imperfect Information. 1981. American Economic Review 71 (3) 393-410

Innesa Love and Nataliya Mylenko (2002)[35] in their article, *Credit Reporting and Financial Constraints,* on the empirical study of CRB impact on credit markets found that the presence of private registries is associated with lower financial constraints and higher share of bank financing. Small and medium firms tend to have higher share of bank financing in countries where private registries exist and stronger rule of law is associated with more effective private credit registries. Existence of a private credit registry is associated with lower incidence of severe financing constraints (i.e. lower probability of firms rating finance as a major obstacle) and higher average share of bank financing.

Vercammen, James A (1995)[36] in his article, C*redit Bureau Policy and Sustainable Reputation Effects on Credit Market,* observes that welfare stemming from reputational effects will diminish with time as private information of borrowers is revealed to lenders in the form of lengthening credit histories. Policies that can restrict the flow of information from borrowers to lenders may be desirable from a social efficiency perspective because such policies can sustain reputational effects.

Njoya W.N (1996)[37], in her dissertation, Innovations *in Banking Practice and Credit Provision: The Legal Framework* observes that recent innovations (such as credit cards, ATMs etc) in banking practice globally posses potential and actual problems to unregulated banking acts and provision of credit. Other jurisdictions have kept the law in synch with banking practice and thus a need for an improved law in Kenya. Innovations designed to

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[35]Innesa Love and Nataliya Mylenko: Credit Reporting And Financial Constraints, 2003. A World Bank Policy Research working paper 3142, Policy Research Working Papers are available online at http://econ.worldbank.org

[35] Vercammen, James: A Credit Bureau Policy And Sustainable Reputation Effects On Credit Markets. 1995 Economical 62 (248) (November) 461-478

[36] Njoya W.N: Innovations In Banking Practice And Credit Provision: The Legal Framework, 1996 Dissertation. University of Nairobi LL. B

facilitate provision of credit and other ordinary consumer banking services are vital. Banks sell credit thus the desire for innovation and numerous advertisements.

Waki A.M.M (2003)[38] in her dissertation, *Why Banks Divulge: A Case for the Proper Delimitation of the Bankers' Duty of Confidentiality,* explores the banker's duty to confidentiality. She enthusiastically sides with the exception thereof such as protection of banks interest, compulsion of law, public interest and consumer consent. Her observations are that the duty lacks clear delimitation. Authorities are scanty and vague. Judgments are not pivoted on the issues of confidentiality and thus few non-committal remarks by a court end up being the locus classicist on a fundamental issue. Extent of divulging confidential information has not been determined; how much information? to whom? This is left to court's discretion. The bankers' duty to confidentiality is inadequate and recommendations to resolve the apparent problem are a must. She encourages disclosure. This therefore paves way for sharing of information in the credit market.

Anita Campion[39] in her article, *Client Information Sharing in Bolivia,* observes that, as the microfinance industry becomes more competitive, microfinance institutions (MFIs) increasingly seek access to credit bureaus and credit information agencies. The growing number of microfinance providers in the market results in borrowers having more access to loans, which can lead to client over indebtedness and default. By sharing client information with each other and by using credit bureau information on client history and indebtedness, MFIs facing competition can reduce their credit risk and avoid unnecessary losses.

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[38] Waki A.M.M: Why Banks Divulge: A Case For The Proper Delimitation Of The Bankers' Duty Of Confidentiality, 2003 Dissertation. University of Nairobi LL. B

[39] Anita Campion: Client Information Sharing in Bolivia, A Journal of Micro-finance Vol. 3 No. 1

Kimani James Njenga, (2005)[40], in his dissertation, *Non-Performing Loans: Does the Law Protect the Bank,* observes that the CRBs, an idea mooted in 2002 involving obtaining clients' details impedes on a bankers duty for confidentiality. However he seems to be advocating for disclosure since he advocates for Micro-Financial Institutions (MFIs), Development Finance Institutions (DFIs), building societies, hire purchase companies all to be able to access a common information sharing mechanism as opposed to the current regulation which limits participation to such mechanisms to only institutions which are licensed under the Banking Act[41]. I agree with his observations to the extent that high levels of non-performing loans in the banking sector are among other factors due to inadequate credit risk analysis in extending loans.

Mbiuki Jasper Micheni (2007)[42], in his dissertation, *Defaulters Beware: Finally a Cure for Non-performing Loans is here, Thanks to Credit Reference Bureaus,* observes that prudent and efficient financial intermediaries cannot operate without reliable information about borrowers. He encourages sharing of positive information by the lenders so as to allow borrowers to build credit history and be able to access credit with ease. This is what I would call, building up of 'reputation collateral" on part of the borrowers and do not have to used the commonly know securities as collateral while accessing credit.

Robert B. Avery, Paul S. Calem, and Glenn B. Canner (2003)[43], in their article, *An Overview of Consumer Data and Credit Reporting,* are of the view that, credit reporting companies endeavor to maintain high-quality data, but the degree to which consumer credit reports are

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[40] Kimani James Njenga: Non-Performing Loans: Does The Law Protect The Bank, 2005 Dissertation. University of Nairobi LL. B

[41] Cap 488 Laws of Kenya.

[42] Mbiuki Jasper Micheni: Defaulters Beware: Finally A Cure For Non-Performing Loans is Here, Thanks To Credit Reference Bureaus, 2007 Dissertation. University of Nairobi LL. B

[43] Robert B. Avery, Paul S. Calem, and Glenn B. Canner: An Overview Of Consumer Data And Credit Reporting, 2003. Working Paper No. 02-21, Federal Reserve Bulletin.

accurate, complete, or consistent across companies is in dispute. Research and creditor experience has indicated that credit reporting company information, despite any limitations that it may have, generally provides an effective measure of the relative credit risk posed by prospective borrowers. Nonetheless, the industry and its critics alike recommend that consumers review their credit reports periodically, especially if they are in the market for new credit, if they have been denied credit, or if their creditor has changed the terms of an account on the basis of credit reporting company information.

Most of the writers have not written on the causal connection between NPLs and CRBs. Lack of information on cash flow of borrowers means that to be based more on collateral than on credit risk assessment or the profitability of potential investment. Better reporting of financial probity of the applicants and the establishment of CRB would enable more prudent financial interceding between banks and borrowers.

1.7 Limitations For The Study.

Although I believe that my study adds to the recent literature, it has some obvious limitations. The major limitation is a lack of evidence for causality between creation of the reference bureaus and their consequent effect on non-performing loans. It is possible that other unobservable elements of financial markets are responsible for the relationship. It is plausible that in a country with greater use of bank finance and excellent information technology, the establishment of credit bureaus is more likely unlike in Kenya. Accessing information from bureaus and central bank was difficult and lack of awareness on populace made it difficult to get their views.

1.8 Research Methodology

The research was primarily library based. Primary sources included statutes, government surveys and reports while secondary sources included textbooks, articles and internet sources. I also used questionnaires (see Appendix) and personal interviews from officials of Credit Reference Bureaus to supplement the data I had from library sources.

1.9 Chapter Breakdown.

Chapter One consists of background, theoretical framework, objectives and scope of the study.

Chapter Two elaborates on non-performing loans, the credit reference bureaus, and the nexus between credit reference bureaus and nonperforming loans.

Chapter Three is an evaluation of the adequacy (or lack of it) of the legal and regulatory framework on exchange of information in Kenya. The chapter gives a critical analysis of these laws by pointing out their strengths and weaknesses in their current form.

Chapter Four contains conclusions and recommendations based on the data analysis. Potential areas of future research are also suggested.

CHAPTER 2

NON-PERFORMING LOANS, THE CREDIT REFERENCE BUREAUS AND THE NEXUS THERETO

2.0 Introduction

What are non-performing loans and what causes them? How can non-performing loans be monitored? Is there a measure of curbing the menace of non-performing loans? Non-performing loans hurts a banks liquidity (and thus the danger of depositors not being able to get their money as and when they require it) which impacts negatively on its earning. They also affect adversely the asset quality of a bank since all loans, whether bad or good constitute an asset to the bank and when the quality of this vital asset is affected, a bank might suffer loss. The credit reference bureaus have been said to be vital towards finding a solution to the problem of non-performing loans. But do the credit bureaus perform this role perfectly? Well, the question is what exactly are credit reference bureaus? What is their historical evolution and growth across the continents: America, Europe, Asia and Africa? How do credit bureaus emerge and operate? What benefits do the bureaus offer and what problems do they pose, that is, are they always a desirable phenomenon in a credit market. These are the question that this chapter seeks to answer. The balance between privacy rights and creditors need for payment history is also discussed, need for regulation of the operations of the bureau and two profiles of bureaus operating in our jurisdiction are also highlighted. The analysis of the nexus between the question of non-performing loans and credit reference bureaus points out to both strengths and shortcomings of the bureau operations. The conclusions tend to suggest that credit reference bureaus are one way to curb the menace of non-performing loans by helping in assessment of credit performance by credit rating. However they are not a super solution. Other measures need to be adopted to check on other externalities that may affect bank failures such as political instability and inflation.

2.1 Non-Performing Loans

2.1.1 Definition Of Non-Performing Loans

Currently, there is no internationally accepted definition of the term non-performing loans, also known as bad or doubtful debts, though the bottom line in the international manuals seem to be that loans are good unless there is absolute certainty that a loan is not going to be paid under the existing arrangement[44]. A non-performing loan has been defined by some to be a loan that is in default or close to being in default. Many loans become non-performing after being in default for three (3) months, but this can depend on contract terms. "A loan is non-performing when payments of interest and principal rates are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days or overdue, but there are other good reasons to doubt that payments will be made in full" (IMF)[45]

Central Bank of Kenya: Prudential Guidelines for Institutions Licensed under the Banking Act, defines non-performing loan as a loan that is no longer generating income or when it comes to the institution's knowledge that a credit facility will no longer generate income. For the purposes of the regulation, loans are non-performing when:

- Principal or interest is due and unpaid for 90 days or more: or
- Interest payments for 90 days or more have been re-financed, or rolled-over into a new loan.

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[44] Adrian M. Bloem and Cornelius M. Gorter: Selected Issues on the Treatment of Non-Performing Loans in Macro-Economic Statistics. IMF Working Paper 2001, comments prepared by Ralph Kozlow, U.S. Bureau of Economic Analysis (BEA)

[45] Central Bank of Kenya Prudential Regulations for Banking Institutions Licensed under the Banking Act. The Guidelines are issued under Section 33(4) of the Banking Act (Cap. 488 Laws of Kenya), which empowers the Central Bank of Kenya to issue guidelines to be adhered to by institutions in order to maintain a stable and efficient banking and financial system. They can be accessed through the internet at www.centralbank.go.ke

Current accounts (overdrafts) and other credit extensions not having pre-established repayment programs are considered "non-performing" when any of the following conditions exists:

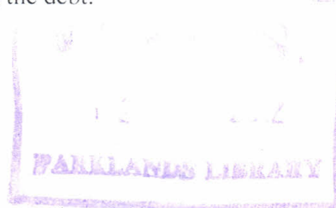
- Balance exceeds the customers approved limit for more that 90 consecutive days;
- The customers borrowing line has expired for more than 90 days;
- Interest is due unpaid for more than 90 days;
- The account has been inactive for more than 90 days, or credits are insufficient to cover the outstanding interest during the period.

This includes all loans classified under the substandard, doubtful and loss categories. The balance outstanding as at the time when the account is identified as non-performing (not just the amount of delinquent payments) is used in calculating the aggregate amount of 'non-performing" loan.

According to the guidelines, a ***substandard loan*** is one that is not adequately protected by the current sound net worth and paying capacity of the borrower[46]. In essence, the primary sources of repayment are not sufficient to service the debt and the institution must look to secondary sources such as collateral, sale of fixed assets, refinancing, or additional capital injections for repayment.

Further ***doubtful loans*** have all the weaknesses inherent in a substandard loan plus the added characteristic that the loan is not well secured. These weaknesses make collection in full, on the basis of currently existing facts, conditions, and value, highly questionable and improbable. The possibility of loss is high, but because of important and reasonably pending mitigating factors, the actual amount of loss cannot be fully determined. A loan that is due for more than 360 days may retain a 'doubtful' classification if it is backed by realizable security.

[46] This implies that the security fir the loan cannot adequately cover the amount in default even if the bank were to realize the same and that the borrower is not financially capable of repaying the debt.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If pending events do not occur within 360 days and repayment must again be deferred pending further developments, a loss classification is warranted upon realization of securities held. ***Loss*** occurs when loans which are considered uncollectible are of such little value that their continuance recognition as bankable assets is not warranted[47].

Non-performing loans have been a big problem to banks operating in Kenya, and are said to be the most important threat that a bank can face. Non- performing loans negatively affect banks' profit efficiency and bad debts reflect low levels of profit efficiency.[48]

There are different quality assessment parameters one can use to know whether a bank has a sound financial base. One is the non-performing loans provision to operating income. This ratio measures a bank's asset quality. When loans become non-performing, a bank is expected to make a provision for the eventuality that they may not be repaid. This ratio measures how far the bank's operating income cover the provisions. If provisions suck up the entire operating income i.e. 100% and above, such bank is in trouble.

The other parameter is the net non-performing loans to total loans. This is a measure of how much of the total loans portfolio is non-performing. It tells you whether a bank is investing prudently or not. A high percentage reflects poor performance.

2.1.2 The Causes of Non- Performing Loans

Many of the bad debts are attributed to moral hazard: the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at high interest rates to borrowers in the most risky segments of the credit markets.[49]

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[47] Losses are taken in the period in which they are identified.

[48] Boaz W. Meso & Donatilla K. Kiano, Financial Liberalization and Bank Efficiency:The Case of Commercial Banks in Kenya.

The problems of poor loan quality faced by local banks are also compounded by macroeconomic instability. Periods of high and very volatile inflation occurring in a country such as the 1990's,[50] macroeconomic instability would have two important consequences for the loan quality of the local banks. First, high inflation increases the volatility of business profits because of its unpredictability, and because it entails a high degree of variability in the rates of increase of the prices of the particular goods and services which make up the overall price index. The second consequence of high inflation is that it makes loan appraisal more difficult for the bank, because the viability of potential borrowers depends upon unpredictable developments in the overall rate of inflation, its individual components, exchange rates and interest rates.

Poor risk assessment in the lending practices of commercial banks has led to high non-performing loan portfolios.[51] This is as a result of information asymmetry between lenders and borrowers.

2.1.3 Chronology Of Banking Crisis.

It has been argued that, although every banking crisis is a unique historical event, a product of specific circumstances, it usually follows three-phased script.[52] The first phase is the *speculative boom*, sparked by over optimism. It is characterized by a high investment, a sting demand, rising asset prices and a percolation of growing personal wealth. Next comes the

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[49] Supra, note 7 pg.16

Non-performing loans are caused by a myriad of causes most of which are not related to each other. They range from imprudent decisions to sheer bad luck, bad policy and bad banking emanating from excessive lending to un- creditworthy borrowers, change in commodity prices so on.

50During the 1990's inflation reached 46 per cent in Kenya.

[51] Africa Economic Outlook: AfDB/OECD 2004

[50] Andress Blanchi, Former President of Chile's Division of Credit Lyonnaise, December 1995. Inter-American Development Bank.

loss of confidence and the first signs of distress in some banks. Interest rates, wages, foreign exchange rates and inflation hit unsustainable levels. As confidence drops, *an open crisis* ensues, loans become non-performing and then difficulties to recover. Depositors and asset holders step up demand, interest rates rise, bank fail and credit tightens. Finally "distress permeates all economic sectors".[53]

2.1.4 Monitoring The Problem of Non-Performing Loans.

It has been argued that the key objective should be to remove non-performing loans from the balance sheet so that banks do not have to continue making provisions for them. Several options have been suggested for warehousing these non-performing loans. In several countries, including Kenya, Japan, South Korea and Mexico, the function is added to the mandate of the Deposit Protection Fund (DPF) Board.[54]

A second option is to form a special Remedial Unit as a separate Profit and Loss Center and Warehouse for the NPLs. Once placed in this Unit such NPL would cease to accrue interest and the Unit would ensure that adequate provision is taken against each NPL. The Unit's sole function would be to initiate a satisfactory and reliable repayment stream or to dispose of collateral security, relying heavily on alternative dispute resolution techniques.

A third option is to enter into a partnership with an outside contractor having specialist skills and experience in dealing with NPL. Such an arrangement would remove the process from the usual debt collector/attorney/judicial arena and introduce new skills and resources to the process. Compensation in this case would be performance related.

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[53] Ibid

[54] Andrew Mulei, the former central bank of Kenya Governor in his speech on the central bank and its role in promoting economic recovery in Kenya at Nairobi Safari Club on 3rd December 2003

2.2 Credit Reference Bureaus

2.2.1 Definition Of Credit Reference Bureaus

A **credit reference** is information, the name of an individual, or the name of an organization that can provide details about an individual's past track record with credit. Credit rating agencies typically fill this role in the case of consumer credit. Potential lenders consult the credit rating agency for information on an applicant as part of their process for deciding whether or not to grant credit to the applicant[55].

Other letters of credit reference might be written by banks which would provide basic information about how long the applicant has held an account, what type of account it was, and whether or not there were any overdrafts or late payments noted.

A **credit bureau** (U.S.) or **credit reference agency** (UK) is a company that provides consumer credit information on individual borrowers. This helps lenders assess credit worthiness, the ability to pay back a loan, and can affect the interest rate applied to loans. Interest rates are not the same for everyone, but instead are based on risk-based pricing, a form of price discrimination based on the different expected costs of different borrowers, as set out in their credit rating.[56]

Credit bureaus collect and collate personal financial data on individuals and businesses from data furnishers with which the bureaus have a relationship. Data furnishers are businesses, utilities, debt collection agencies, public institutions, and the courts (i.e. public records) that a consumer or business has had a relationship or experience with. Data furnishers report the experience with the consumer or business to the credit bureaus. The data provided by the data furnishers as well as collected by the bureaus are then aggregated into the credit bureaus data

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[55] www.answers.com/topic/credit-bureau

[56] Ibid

repository or files. The resulting information is made available on request to contributing companies for the purposes of credit assessment and credit scoring.

Lenders commonly exchange data about past defaults or arrears. Sometimes they also share data about customers' outstanding liabilities, maturities, and details about borrowers' credit history. One element that distinguishes one credit reporting company from another is its inquiry data[57]. Credit reporting companies also differentiate themselves by the degree to which they can process inquiries and loan data quickly. Given the risk implications of making a lending decision with information that is weeks or months old, issuers have pressed credit reporting companies to maintain files that are as up-to-date as possible.[58]

2.2.2 Historical Background And Development Of Credit Reference Bureaus

The motives for establishing a credit reporting system have varied throughout history as they have appeared in different areas of the world. The first appearance of a formal arrangement for credit information sharing was in the *United States* in the 1830s, when the creation of the first credit registries was a response to the problem of information asymmetry in trade markets. The history of credit bureaus in the United States has allowed them to evolve and adapt via experimentation and innovation over time. In addition, evolution of the institutions coincided with the advancement with US commercial and bankruptcy laws, allowing for their embedment into US business culture. Recently the credit reporting industry in the United

[57] This is classified either as hard and soft data.

[58] Mark Furletti: An Overview and History of Credit Reporting, June 2002. Federal Reserve Bank of Philadelphia

States has been marked by rapid consolidation into three major credit information providers: Trans Union, Equifax, and Experian[59].

In the U.S., most of the early credit bureaus were cooperatives or non-profit ventures set up by local merchants to pool the credit histories of their customers and to assist in collections activities. Others were established by local finance companies or the local Chamber of Commerce. The next step for this industry was the formation of a mechanism to share consumer credit information in different cities and regions of the country. This was accomplished through a trade association established in 1906. For most of its existence this organization was known as Associated Credit Bureaus, Inc., or ACB. ACB developed the procedures, formats, and definitions that enabled the sharing of credit files between agencies across the country. ACB even introduced a form of scrip, which members purchased from the association, which was used as a currency to pay for credit reports obtained from fellow members in other cities.[60]

Membership in ACB grew rapidly from fewer than 100 bureaus in 1916 to 800 in 1927, and doubling again by 1955. According to ACB, its members collectively attained universal coverage of consumer borrowers by 1960. But even in that year, the largest of the credit bureaus maintained files on consumers in at most a handful of cities. At a time when the technology was limited to filing cabinets, the postage meter, and the telephone, American credit bureaus issued 60 million credit reports in a single year. [61]

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[59] Jill Luoto, Craig McIntosh and Bruce Wydick: Credit Information Systems in Less-Developed Countries: Recent History and a Test, September 2004.

[60] Robert M. Hunt: The Development and Regulation of Consumer Credit Reporting in America, November 2002. Working Paper No. 02-21., Federal Bank of Philadelphia.

[61] It is worth noting that Credit Bureaus respond to economic and technological change.

Credit bureaus emerged at a time when the primary source of consumer credit was offered by retailers; the other important sources were pawnbrokers, small loan companies, and, of course, friends and family. One reason that retailers were so dominant in this period was that state usury laws made it difficult to earn profits on small loans lent at legal rates.

Europe, like the United States, has a substantial history of credit reporting, yet the high value that European law places on individual privacy limits the depth of credit reporting relative to that allowed in the United States. In 2003, while most credit bureaus in Europe were privately owned, seven of fifteen member countries of the European Union operated a public credit registry.[62] Credit reporting in Europe is in the midst of a transitional state currently as the 25-member European Union struggles to harmonize individual differences in order to achieve full cross-border information sharing, trying to balance values of individual privacy with financial market efficiency.

Africa remains the region of the world with the least developed credit information systems. However, both private and public credit-reporting institutions operate in the formal sectors of many African countries. African countries with a public credit registry include Angola, Burundi, Madagascar, Mozambique, Nigeria, and Rwanda. Additionally, a public credit registry operating in western Africa is overseen by the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO), a central bank representing the West African nations of Benin, Burkina Faso, Cote D'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. As of 2002, private credit bureaus existed or were in the process of development in Mali, Niger, Nigeria, Burkina Faso, Kenya, Benin, Senegal, The Gambia, Cote D'Ivoire, Ghana, Uganda, Tanzania, Botswana, South Africa, Swaziland, Namibia, Rwanda, and Togo. [63] The topic of

[62] Supra, note 59. This and other institutional and cultural differences between European countries have made intra-European information sharing between financial institutions difficult.

[63] World Bank (2002).

borrower information sharing was a major subject of discussion at the 2003 annual conference in Gambia of AFMIN, the African Microfinance Network, a regional association of African microfinance institutions.

The *Asian* financial crisis during the late 1990s led to an urgent call for transparency in credit information throughout Asia. After the crisis, a great number of local and foreign- based credit bureaus were created. Before the 1997 economic crisis, there had been plans under the Financial System Master Plan to implement a nation-wide public credit registry, but in the chaos of the financial sector bankruptcies of mid-1997, these plans were aborted. After the dust of the economic crisis settled in 1998, the Ministry of Finance and the Central Bank established the Thai Credit Bureau, which began operating in 2000, under government guidelines and requirements for both negative and positive information sharing. At virtually the same time, the Central Credit Information Services in Thailand, a private credit bureau, was formed by 12 local commercial banks, Trans Union International, and Business Online[64].

2.2.3 Rise Of Credit References Bureaus Credit References Bureaus And Their Mode Of Operation:

Credit Reference Bureaus are instrumental when assessing lending risks *ex ante* that is, before the act of lending takes place. They operate on the principle of reciprocity, that is, banks that wish to enlist the services of a certain CRB must also be willing to let that CRB obtain information about the banks customer.

Improved information flow enhances the efficiency and stability of the entire financial system yet because of the public good characteristics of credit information system, their natural emergence in the credit market is not always guaranteed. CRBs emerge where people are

[64] The example of *Thailand* is representative of the booming demand for credit information systems in the region.

relatively mobile[65]. Exchange of information in these bureaus can either be voluntary or be imposed by legislation. In some countries exchange of information occur via public credit registries managed by credit bureaus armed with powers to force compulsory reporting, take the information from lenders, process it and return it to lenders. In other countries, lenders themselves own CRB. There is potential conflict of interest.

CRB have emerged in the consumer credit markets and small business loans characterized by large number of applicants whose desired loans are not large enough to warrant individual assessment. CRB pool data from many lenders and for several years, own an ideal database for estimating statistical models of risk management.

Incentives for lenders to share information about borrowers (about payment experience, current obligations and exposure) are positively related to the mobility and heterogeneity of borrowers, to the size of the credit market, and to advances in information technology. Whereas discouraging the sharing of information about borrowers is the fear of competition from additional entrants. Mobility and heterogeneity of borrowers reduce the feasibility of a lender relying solely on its own experience to guide its portfolio management. Thus, these factors increase the demand for information about a borrower's experience with other lenders. The need for information to supplement a lender's own experience grows with the size of market. In addition, any declines in the cost of sharing information boost the net gains from sharing.[66]

Mode of operation:

In a number of countries, lenders (banks, finance companies, credit card companies, retailers, suppliers extending trade credit) routinely share information on the creditworthiness of their

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[65] Jappelli T., and M. Pagano: Information Sharing in Credit Markets, December 1993. The Journal of Finance Vol. 43(5), , 1693-1718

[66] Supra note 12

borrowers through credit bureaus, information brokers that in some cases are set up and owned by the lenders themselves and in others operated independently for profit by a third party. Lenders supply the bureau with data about their customers. The bureau collates this information with data from other sources (courts, public registers, tax authorities, etc.) and compiles a file on each borrower. The lenders that have contributed data can later obtain a return flow of consolidated data about a credit applicant by requesting a 'credit report' from the bureau.[67]

Lenders who provide their private information to credit bureaus are granted access to the common database insofar as the data provided are timely and accurate. Credit bureaus are exposed to a potential conflict of interest, especially when they are owned by the lenders themselves: each lender would like to exploit the information provided by other lenders without disclosing his own. This explains why sanctions are invariably threatened to any credit granter who fails to supply data or provides inaccurate information.[68] In other words, credit bureaus are based on the principle of reciprocity, which is generally stated in the contractual agreement between the bureau and credit grantors.[69]

2.2.4 Benefits Of Credit References Bureaus

Benefits occur at three levels: institutional level, the client level and the market level.

a) Institutional benefits:

Lenders can choose whether to lend or not if they know about a potential clients credit history. Bad track records indicate one is not a good credit candidate. A client with two or more outstanding loans may be unable to furnish another one. This helps institutions

[67] This two-way flow of data between lenders and the bureau is better effected electronically.

[68] Sanctions range from fines to loss of membership and hence denial of access to the bureau's files

[69] Mark Furletti An Overview And History Of Credit Reporting, June 2002. Federal Reserve Bank of Philadelphia

minimize their risks. CRB report can also reduce transaction costs for an institution. A poor report will alert the loan officer of a potentially bad credit risks and will serve as basis for declining a loan. It saves time. Credit officer will not waste time on a bad credit subject freeing the loan officer's time for a review of less risky client.

b) Client benefits:

With good reports, clients are able to get quicker, preferential services and access other products. Savings from reduced transaction costs should eventually be passed on to borrowers through lower interest rates. Increased efficiency in the evaluation of loan applications can result in faster loan processing. Default prone clients are not enthused about CRB reports but it encourages them to pay their bad debts.

c) Markets (both goods and services)

Benefits from a healthy flow of information without a large defaulting clientele, Financial Institutions (FIs) are more profitable and can expand their services. Real property dealers are willing to enter the market and offer services aided by a better understanding of their clients. A fair, transparent information system helps promote confidence among vendors and consumers resulting in greater volumes of transactions.

2.2.5 Problems Of Credit Reference Bureaus (The Fear of Social Stigmatization).

Fear of competition may inhibit information sharing. When lenders agree to supply data to a credit bureau they lose the monopoly power attached to exclusive customer information, unless they are well protected by other barriers to entry.

Apart from providing information to banks the standard raison d'être of a CRB is to share information across financial institutions. Moreover, there remains the important question as

to what information to share. In particular, banks are more likely to voluntarily share negative information. Hence some private credit bureaus essentially work with negative information only. Consequently, as their negative credit history dogs them, such borrowers have little incentive to perform better on loans.

When lenders share information about past defaults, borrowers do not wish to damage their credit rating because a default will signal future lenders that the borrower is high-risk. Thus, information sharing here has a positive disciplinary effect on borrower behavior. However, suppose an incumbent lender shared so much additional information about a borrower's characteristics that future lenders knew with certainty that a borrower was indeed low-risk. The future lenders would compete for such borrowers and offer them better loan terms. Consequently, such borrowers would have no more incentive to perform well on the current loan than if no information was shared. Thus less sharing could be better, and that lenders will seek to fine-tune the amount of information disclosed to some level below "perfect" so as to maximize the disciplinary effect.[70]

2.2.6 The Balance Between Privacy Rights And Creditors Need For Payment History.

Although quite sensitive to the threat of invasion of privacy, U.S. policy toward the collection of personal information also recognizes that consumers necessarily must reveal some information about past behavior in order to obtain credit. When a consumer applies for credit, he/she voluntarily trades away some privacy in exchange for goods or services. Loss of some privacy is the price of participating and enjoying the benefits of an information-intensive economy.

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[70] Barron J., and M. Staten: The Value of Comprehensive Credit Reports: Lessons from the U.S. Experience, 2003. In Credit Reporting Systems and the International Economy ed. Margaret Miller. Boston: MIT Press.

In the context of a single loan transaction a consumer faces a straightforward task of weighing the gains vis a vis the costs of revealing some personal information. Presumably, for some types of transactions, the potential benefits aren't worth revealing personal financial information and the customer refuses to continue. For other transactions, such as applying for a loan, the customer gives up much information but places even greater value on obtaining the loan, and so willingly sacrifices some privacy. However, since personal information about consumers can be stored and subsequently transferred, the consumers lose some control over its use subsequent to the transaction. Thus, a key element of U.S. regulatory policy regarding the use of credit bureau data is to preserve the consumer's right to authorize release of the information.

Credit bureaus are information-sharing arrangements that help to reduce the problems of adverse selection and moral hazard in credit, insurance, and other markets. The flip side of information sharing is necessarily a loss of consumer privacy. It is likely that sharing a little information about borrowers, such as their payment history, generates benefits that exceed the losses associated with any loss of privacy, especially if consumers are aware that such information is being shared and access to the information is limited. When access is less well regulated, consumers are less well informed, or information is used for purposes not envisioned by consumers, this case becomes harder to make[71].

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Privacy protection

The disclosure of information on borrowers, especially when it is not voluntary, necessarily raises the problem of privacy and therefore of individual freedom. Even though economical studies reveal that sharing of financial information can be favourable to the development of

[71] Robert M. Hunt: The Development and Regulation of Consumer Credit Reporting in America, November 2002. Working Paper No. 02-21, Federal Bank of Philadelphia

credit, the same information can be used for other purposes. In particular, it can reinforce exclusion of some categories of the population from certain rights, which can be harmful from the social point of view. Therefore, specific regulation for financial information flows, in particular, when it concerns individuals, becomes imperative. However we should notice that its enforcement largely depends on the general effectiveness of institutions. Thus, in the case of developing countries, wherein institutions are often weak, the problem related to the respect of privacy becomes more complex.[72]

2.2.7 The Need For Regulation

Do we expect CRB to attain the socially efficient degree of accuracy? We need a system that protects borrowers from unscrupulous people who may access confidential information illegally. CRB do make mistakes and customers should be protected. The problems associated with CRB may among others include; failing to report accurate data, changing credit rating based on erroneous data and often 'mix up' of customer information. Thus a strong case to establish a legal regime may monitor the activities of CRB. Law would be an attempt to refine the balance between the obvious benefits of CRB generally and consumers legitimate concerns over accuracy and privacy. The law should create obligations for CRB, users of credit reports and CRB members.

The presence of regulations does not automatically signify their enforcement. The quality of institutions in the matter of law enforcement differs with the level of development of the country. The organization of the credit information system should be adapted to the institutional context. The decrease in the number of agents holding information of a private nature and the ban on the circulation of some types of information are the instruments to reduce the risk of fraud. Thus, the implementation of a public registry system (with restricted

[72] Supra note 65

access) appears to be better suited in the case of countries with low ability of control of private firms (this is often the case of developing countries). In countries with more effective rule of law (developed countries), private bureaus can operate without excessive risks. The issue of the degree of public intervention in the credit information system however remains strongly debated.

In my view a good practice that need to be followed by CRB include an open system membership; allowing collection of both positive and negative information; enabling maintenance of data for a reasonable period of time; the borrowers should have access to their own data, it should indicate who has accessed the data as part of the reports and it should clearly establish a private policy.

2.2.8 Profiles of Credit Reference Bureau in Kenya.

Credit Reference Bureau Africa Limited (CRBAfrica Ltd) is a multi-national organisation that compiles and distributes credit information. It is headquartered in Nairobi, Kenya and it specializes in credit reference bureau operations which include accounts receivable management and debt management outsource services across the African Continent. CRBAfrica is currently established in Kenya, Tanzania, Uganda, Ghana, Botswana, Mauritius, Zambia and Egypt with further planned expansion into other African countries[73]. Credit Reference Bureau Africa (CRBAfrica Ltd) is found to operate as follows: -

[73]The information found in the discussion on the profile of Credit Reference Bureau Africa is a combination of information accessed though the internet at www.crbafrica.com coupled with information obtained from questionnaire administered and ensuing interview conducted with the country director of the said bureau Mr. Wachira Ndege who is the Chairman of the credit bureau association.

- **Regional and International Network**

CRB has entered into a partnership with the umbrella body for bankers associations in the COMESA region, the COMESA Bankers Association, for the establishment of a regional network of credit bureaus. Through an affiliate in the UK and association with international credit bureaus, CRB has a global reach and is able to meet requests from its subscribers for credit reports and debt recovery in over 104 countries worldwide.

- **Core Services**

CRB services seek to provide a long-term solution to the systemic weaknesses of credit based commerce in African economies through globally - applied credit bureau operations. CRB's comprehensive solution to the problem of credit risk is through the provision of a credit referencing, accounts receivable management, and debt management outsource service. In addition, CRB provides consultancy services and training in proactive credit risk management and professional debt collection techniques.

- **Financial Sector Bureaus**

CRBAfrica specialises in the establishment and operations of "closed user group" credit information sharing mechanisms for the financial sectors in Africa, carefully designed to comply with the relevant confidentiality regulations. CRBAfrica has been able to build strong relationships across Africa with numerous local and international banks, credit card companies, and financial institutions by converting their non-performing loans, recovering their bad debts and reducing future credit risks, through the provision of verifiable, proactive credit report information.

- **Commercial Sector Bureaus**

Through uniquely designed software systems, CRBAfrica electronically sub-divides commerce into individual 'trade sector bureaus' such as insurance, medical, and petroleum etc, to create 'closed user groups' for the different sector stakeholders. This enables each sector stakeholder to share their credit experiences in total confidence to prevent debtors migrating amongst their members.

- **Professional Services**

CRBAfrica conducts in-depth audits of companies' existing credit management systems and procedures. The examination reviews the sales process, the customer service, accounting and credit control functions, and the role of personnel in these functions. Following an independent review, recommendations for credit management improvements are offered to reduce the risks associated with extending credit.

Metropol East Africa Limited (Metropol) is a limited liability company incorporated in Kenya in 1996 to provide risk management services with particular emphasis on credit rating, business information reports, debtor administration services and debt collection and to help clients produce bankable business Plans. Metropol's target business activities are Commercial Banks, medium, and large scale Manufacturing and Trading companies. The company acts as the strategic one-stop-office linking national and overseas firms, which carry out business in the region. This is made easier by using Dun &Bradford specialised software. Metropol handles an average of 180 inquiries every month, and the number is increasing with the ever changing and growing complexity of the business environment.[74].

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[74] The other information found in the discussion on the profile of Metropol East Africa Limited is a combination of information accessed though the internet at http://www.kenya.info/view.asp coupled with

2.3 Nexus Between Non-Performing Loans And Credit Reference Bureaus

The causal connection between non-performing loans and credit reference bureaus is not a one-to-one correlation that has fully been established. However, the study reveals that exchange of borrower type credit information in a credit market has a certain level of impact on both lending and default as discussed herein below.

2.3.1 The Effect of Information Sharing on Lending and Defaults

The research on the topic under study suggests the following effect of lenders' exchanging information on the credit history of borrowers.

2.3.1.1 Improving Bank's Knowledge About Applicant's Characteristics/ Transparency

Credit bureaus improve banks' knowledge about applicants' characteristics and permit more accurate prediction of repayment probability. This allows lenders to target and price their loans better, easing adverse selection problems. In this respect the benefit of establishing a credit bureau is greatest where each bank is confronted by a large number of customers on which it has no previous information, that is, borrowers are very mobile. Credit information systems further helps build an efficient financial system by promoting transparency in lending thus lowering the overall default and interest rates and improving the pool of borrowers in formal credit markets.

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information obtained from questionnaire administered and ensuing interview conducted with the Managing Director of the said bureau Mr. Sam Mukhokho.

2.3.1.2 Reduction of Information Asymmetry.

Credit bureaus reduce the informational asymmetry between banks and their customers. They tend to level the informational playing field within the credit market and force lenders to price loans more competitively. Lower interest rates increase borrowers net return and augment their incentive to perform. The value that the debtor attaches to his or her good credit history or "reputation collateral" makes it easy for such a debtor to access credit in the future. The greater the value "reputation collateral" is to borrowers, the harder borrowers will work to maintain good standing.

2.3.1.3 Borrower Discipline Device.

Credit bureaus work as a borrower discipline device: every borrower knows that if he defaults his reputation with all other potential lenders is ruined, cutting him off from credit or making it much more expensive. This mechanism also heightens borrowers' incentive to repay, reducing moral hazard. The disciplinary effect of credit bureaus arises from the exchange of negative information. Information about past defaults generates fear of social stigma. Borrowers have greater incentive to perform if only negative information is exchanged to continue and argue that sharing positive information can have negative impact of default and mitigate the disciplinary effect of CRB[75].

Whereas it should be said that the reference bureaus are not the ultimate solution to all baking problems in Kenya; studies have shown that, credit reference bureaus by improving banks knowledge about the applicant's characteristics, permit more predictions about payment probability. This allows the lenders to price their loans better. Where there is no system of

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[75] Sharing positive information, i.e. data on borrowers' characteristics, while attenuating adverse selection effects, may actually reduce the disciplinary effect of information sharing.

sharing information about credit worthiness of potential clients, the information playing field is rendered uneven and the costs of appraising loan applications are considerably high.

2.3.2 Shortcomings

The credit reporting industry may generate a poor reputation in the eyes of consumers. To some degree, credit bureaus are victims of their own success. Few people stop to think about the role a credit bureau played in their successfully obtaining credit, insurance, or even employment. But when they are denied such things on the basis of information contained in a credit report, the credit bureau often gets the blame. Consumers are also concerned about the potential loss of privacy that may result from the sharing of sensitive financial information. Credit bureaus are concerned about these issues too, but it's unlikely they weigh the benefits and costs of greater accuracy, or greater privacy, in the same way most consumers do. The challenges facing the industry in Africa are said to include unstructured and informal addresses, swapping of first name and surname, lack of historical credit data, validating and ensuring integrity of data received by the subscribers and poor information technology[76].

2.4 Conclusions

The industrialized regions of the world tend to have much more expansive information-sharing systems than the developing economies for several key reasons. First, the sheer volume and density of lending within the industrialized countries augments the demand for credit bureaus. Second, the industrialized countries typically have stronger legal infrastructures. A country with strong legal and regulatory frameworks is able to more successfully enforce information-sharing rules, and deal appropriately with concerns over issues such as consumer protection rights and individual privacy. Third, more sophisticated communications technology, such as the more widespread level of Internet access in

[76] Research done by Gillian McMeekin, the general manager of South Africa-based XDS credit bureau

industrialized countries, lowers the cost of information exchange. Fourth, developed countries typically have greater levels of borrower mobility and heterogeneity, making the services of credit bureaus of greater importance. Borrowers in developing countries are thus able to carry a credit rating with them that is independent of their geographical location.

By its nature, credit reference bureau makes the environment more conducive for consumer lending, and when you have more consumer lending, it makes people have access to buying things that they don't have to wait for years to save in order to buy them.

Improved information flows enhance the efficiency and stability of the entire financial system. Yet because of the public good characteristics of credit information systems, their natural emergence in the credit market is not always guaranteed. The developing countries are worst hit.

CHAPTER 3
LEGAL AND REGULATORY FRAMEWORK

3.0 Introduction

Kenya is a developing country and the credit reference bureaus are at their nascent stage of development. A subsidiary legislation, the Banking (Credit Reference Bureau) Regulations, 2008[77] has been enacted by the Minister of Finance that banks do subscribe to a credit reference bureau, an arrangement that would result in banks obtaining information about their client's credit worthiness in reference to that client's past performance. The question remains, is this solution towards curbing the menace of non-performing loans in our economy? The measure is aimed at reducing the non-performing loans percentages for the banking and the lending sector, but such measure does not seem to impede on the banks duty of confidentiality to its clients. This chapter is an analysis of the legal framework under which the banks and other money lending financial institutions operate in Kenya. The chapter will evaluate the legislation touching on sharing/exchange of information while analyzing the efficiency thereof.

The law provides for disclosure of information as the legal and regulatory framework herein below highlights.

Since the duty of confidence is a contractual duty it is subject to the general law. The overriding duty is to comply with the law. Dipplock LJ. stated in the case of **Parry Jones Vs. Law Society**[78] that: -

> "Such a duty of confidence is subject to, and overridden by the duty of any party to that contract to comply with the law of the land. If it is the duty of such party to a

[77] Legal Notice No. 97 of 2008.

[78] (1968) 1 ALL ER 177

contract whether at common law or under statute, to disclose in defined circumstances confidential information, then he must do so, and any express contract to the contrary would be illegal and void, for example in the case of the banker customer, the duty of confidence is subject to the overriding duty of the banker at common law to disclose and answer questions as to his customer's affairs when he is asked to give on them a court of law'[79]

The dictum indicates that there are circumstances when disclosure may as of necessity or legally be allowed. The compulsion to disclose private information may take the form compulsion by act to disclose or compulsion in the form of a valid request from an official.

3.1 Evidence Act[80].

In Kenya the power of the court to compel disclosure is found in section 179 of the Evidence Act which gives courts powers to order disclosure on the application of any party proceedings. On such application the court may order that such party be at liberty to inspect and take copies of any entries in banker's book for any of the purpose of such proceedings. A bank may be compelled by law to disclose the state of its customer's account in legal proceedings. And unlike an advocate a bank cannot refuse to answer questions concerning its relationship with a customer on the ground of priviledge. This Act do provide for disclosure which disclosure is quite wide in scope of information that can be disclosed in evidence.

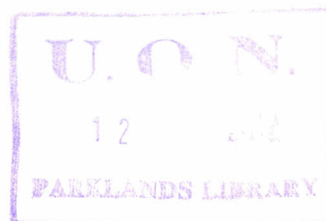
3.2 Income Tax Act[81].

The Income Tax Act provides for further grounds under which courts of law can order disclosure. For example under section 120 of the Income Tax Act, a bank may be required to disclose to a commissioner of income tax information on the state of the account of the

[79] Ibid p. 180

[80] Cap 80 Laws of Kenya.

[81] Cap 470 Laws of Kenya.



customer. This information sharing may be done so as to avert fraud and mis-representations on submission of tax returns.

3.3 Companies Act[82]

Section 232 of the Companies Act provides that where an Administration Order is made in relation to a company and receiver is appointed, the court has power to summon before any person, whom the court thinks capable of giving information concerning the promotion, formation, business, dealing affairs or property of the company. The court can require such person to submit an affidavit to court containing an account of his dealings with the company and produce any books, paper and other records in his possession or under his control relating to the company.[83] The section has been used against banks to require inside information to be disclosed for example the commissions of inquiry have ordered disclosure of affairs of institutions engaging in 'dirty deals'. For example the investigation ordered against (now under receivership) Delphis Bank and Trust Bank as being behind the operations of the Goldern Berg scandal.[84]

3.4 Anti-Corruption and Economic Crimes Act[85]

Section 27 (3) of the Anti-Corruption and Economic Crimes Act provides that Kenya Anti-Corruption Commission may require any person to provide any information or documents in the person's possession that relate to a person suspected of corruption or economic crime. The only persons exempted thereon are advocates. This disclosure is aimed at curbing corruption.

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[82] Cap 486 Laws of Kenya.

[83] Section 232 cap 486 Laws of Kenya.

[84] The commission though not a court of law perse operates under the law as a tribunal does.

[85] Act No. 3 of 2003

Also discovery orders can be used to coerce banks to reveal their customers details.[86]

3.5 The Banking Act[87]

section 27 of the Banking Act, while mandating the Central Bank of Kenya to undertake supervision and surveillance of commercial banks, gives it power to collect such data as may be necessary to enable it to maintain the affairs of the institutions and the protection of their depositors. The Central Bank may require institutions to submit statistical and other returns on a periodic basis in addition to any other returns required by law which is in itself disclosure.

The Central Bank may require to be furnished with information by commercial banks as well as the Minister of Finance. This is disclosure by the law which banks must comply with while ordered so to do. The nature of information to be furnished is however not described and this creates a lacuna. It would be important to outline the scope of such information for certainty[88].

Section 31 is at the core of sharing of credit information. It provides for the establishment of credit reference bureaus as the discussion herein below will show. Section 31 actually provides for publication of the information so obtained under sections 27, 28 and 30. There is however a proviso to the effect that the information so furnished shall not be published if it would disclose the financial affairs of any person, unless the consent in writing of that person has first been given. This is a protective provision. The question then that comes to mind is – is this contrary to exchange of credit information about persons and financial institutions?

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[86] See the case of Bankers Trust Vs. Shapira (1980) WLR 1274.

[87] Cap 488 Laws of Kenya.

[88] See sections 28 and 30 of the Banking Act, Cap 488 Laws of Kenya.

On recognition that credit reference bureaus are instrumental when lending risk ex-ante, section 31(3) of the Banking Act provides for exchange of information and the establishment of credit reference bureaus[89]. To be specific, section 31(3) (a) allows

> *"Central Bank to disclose any exchange referred to in sub-section (2) to any monetary authority or financial regulatory authority, within or outside Kenya, where such information is reasonably required for the proper discharge of the functions of the central bank or the requesting monetary authority or financial regulatory authority".*

Section 31(3) (b) states that

> *"Central Bank and institutions licensed under this Act may, in the ordinary course of business in such manner and to such extent as the Minister may, in regulations prescribe, exchange such information as is reasonably required for the proper discharge of their functions."*

The recent amendment to the Banking Act provides for exchange of information touching on non-performing loans[90].

Section 31(4) states that,

> *"without prejudice to the generality of sub-section (3) (b), regulations under that sub-section may provide for the establishment and operation of credit reference bureaus, for the purpose of collecting prescribed credit information on clients of institutions licensed under this Act, and disseminating it amongst such institutions for use in the ordinary course of business, subject to such conditions or limitations as may be prescribed"*

This section forms the platform for establishment of credit reference bureaus.

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[89] These amendments were made in 2006
[90] The Banking Act as amended in 2006: Kenya Gazette Supplement No. 94 Act No.10 of 2006.

Section 33 (5) provides that

" *No duty to which an institution or its officers may be subject, shall be breached by reason of the disclosure, in good faith, of any information under subsection (2) to*

(a) the Central Bank or another institution or

(b) A Credit Reference Bureau established under subsection (4)

In the course of the performance of their duties and no action shall lie against the institution or any of its officers on account of such disclosure.

Lack of information sharing mechanism enable weak borrowers to borrow from one bank after another, leaving a trail of bad debts in their wake and hence the main cause of the build up of non-performing loans in financial sector.[91]

It is important here to indicate that the Banking Act does not apply to the Kenya Post Office Savings Bank, Agricultural Finance Corporation and Societies registered under the Co-operative Societies Act, other than the Co-operative Bank of Kenya Limited.[92] This in itself limits the applicability of credit reference bureaus and the exchange of credit information in the financial market.

3.6 The Central Bank of Kenya Act[93].

The main objective of the Central Bank of Kenya is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices. The bank should foster the liquidity, solvency and proper functioning of a stable market-based financial system. The Central Bank of Kenya Act is silent on sharing of information and even on the establishment of reference bureaus. Central bank deals with supervision of commercial banks which role should be strengthened. Banking supervision department needs to be strengthened to enhance closer surveillance aimed at detecting banking problems early enough so as to

[91] Supra note 45
[92] Section 54 of the Banking Act Cap 488 laws of Kenya
[93] Cap 489 Laws of Kenya

take preventive action. There should be proper and clear guidelines for risk classification of loans to facilitate better credit risk assessment.

3.7 The Prudential Guidelines For Institutions Licensed Under The Banking Act-

The Prudential Guidelines for Institutions Licensed under the Banking Act[94], offers the definition of non-performing loans as a loan that is no longer generating income or when it comes to the institution's knowledge that a credit facility will no longer generate income. For the purposes of the regulation, loans are non-performing when the principal or interest is due and unpaid for 90 days or more or interest payments for 90 days or more have been re-financed, or rolled-over into a new loan. The guidelines also outline the differences between sub-standard, doubtful and loss loan categories[95].

The guidelines further provides a guideline on loan classification and advances, treatment of collateral, reporting requirements, minimum provisioning allocations for loans, the format of calculating the different loan loss provisions, format of loans and advances performance report remedial measures and administrative sanctions to be employed by Central Bank. The guidelines prohibit insider unsecured loans and sets out the need for liquidity statements by institutions. These guidelines are good. However, they are quasi legal and strict compliance may not be adhered to. Though penalties are as provided under the Banking Act, the

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[94] Supra note 45.

[95] A ***substandard loan*** is one that is not adequately protected by the current sound net worth and paying capacity of the borrower. I.e. the primary sources of repayment are not sufficient to service the debt and the institution must look to secondary sources such as collateral, sale of fixed assets, refinancing, or additional capital injections for repayment. A ***doubtful loan*** has all the weaknesses inherent in a substandard loan plus the added characteristic that the loan is not well secured while the ***Loss*** occurs when loans which are considered uncollectible or of such little value that their continuance recognition as bankable assets is not warranted. Losses are taken in the period in which they are identified.

guidelines are of persuasive nature. They need greater force of law for total adherence by banks and other financial institutions.

The guidelines are silent on exchange of credit, borrower type information. This is a big loophole. They should be amended to provide a guideline on what information to be exchanged in the credit market.

3.8 The Banking (Credit Reference Bureau) Regulations, 2008[96]

The Finance Act[97] by amendment of section 31 of the Banking Act[98] established credit reference bureaus which opened a new chapter in Kenya's banking industry. The banks can share information regarding non-performing loans, thus the high levels of non-performing loans that had in the past crippled the sector, wiping out profits, frustrating shareholders and causing collapse of several banks would probably be no more[99].

"If you must lend, know your borrower" is in line with the new banking practice being adopted popularly know as "Know your Customer (KYC)"[100] slogan cum obligation. Before approval of a loan or any other credit facility, a person's borrowing trends and credit history will be verified by the credit bureau.

The now repealed Banking (Exchange of Information) Regulations, 2004[101] provided for optional exchange of information by the banks if they so wished.[102] The approach many

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[96] Legal Notice No. 97/08

[97] Act No. 10 0f 2006 by Gazette Supplement No. 94

[98] Cap 488 Laws of Kenya.

[99] www.crbafrica.com

[100] This a practice being adopted by most if not all financial institutions to enable them know their customers better.

[101] The Regulations were repealed by the enactment of Banking (Credit Reference Bureau) Regulations, 2008 Legal Notice No. 97 of 2008.

banks adopted was to include in new account opening documentation and loan application documentation a consent from the customer that the bank may disclose at its sole discretion information concerning its business dealings with the customer to a third party. This advancement did set the stage for setting up of credit reference bureaus and in addition provided an opportunity for the re-thinking of the banker's duty of confidentiality[103].

Mandatory exchange of information was brought about by the amendment of the Banking Act, section 31 thereof. Section 31 (3) (b) implies that every sector player must take part in the information exchange. The motivation is so as to seal off the loophole of serial defaulters invading institutions that do not engage in information sharing and heavily borrower from them leaving a trail of debts in their wake that they are not ready and willing to repay.

The Honourable Minister for the Finance, Hon. John Michuki launched the Banking (Credit Reference Bureau) Regulations, 2008 on 22nd September 2008. The Minister had formally gazetted the said Regulations on July 11, 2008. These regulations sets out the framework for the establishment and operation of Credit Reference Bureaus (CRBs) in Kenya to facilitate credit information sharing among all credit providers licensed under the Banking Act. These regulations will become operational from 1st February 2009 and allow the Central Bank of Kenya (CBK) to license and supervise the bureaus. The Bureaus will collate credit information on loans of customers of institutions licensed under the banking Act namely commercial banks and mortgage finance companies[104]. These Regulations are in the nature of Subsidiary Legislation. CRB Regulations set out the framework for the establishment and

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[102] Regulation 2

[103] Regulation 3 provided for the setting up of the credit reference bureaus.

[104] The Central Bank in conjunction with the Kenya Bankers Association has set up a Taskforce that will work with development partners and other market players to ensure that the prerequisite infrastructure is in place before these regulations become operational from 1st February 2009.

operations of the credit bureaus. In order to facilitate information sharing among credit providers licensed under the Banking Act.

These regulations are expected to enhance the credit risk appraisal process by banks that will have access to more information on prospective borrowers. It has been argued "that credit referencing provides one of the key solutions to the information asymmetry problem that has existed in the Kenyan banking sector between banks and their customers. Information asymmetry gives rise to moral hazard problems on the side of the borrowers and adverse selection on the side of banks. This state of affairs provides a fertile environment for the flourishing of 'serial defaulters' who borrows from various institutions with no intention of repaying. The Kenyan Banking sector as a result has been saddled by a substantial portfolio of non-performing loans"[105].

Key to note here is that CRBs to be licensed under the regulations will initially collate credit information only from institutions licensed under the Banking Act. However, there are a host of other credit providers in the economy such as Microfinance institutions, SACCOs, utility companies, hire purchase companies and retail stores. The full benefits of credit referencing can only be realized if it is extended to these other credit providers in future.

The operations of the bureau are set out in Regulation 13 as follows: -

(a) *to obtain and receive customer information;*

(b) *to store, manage, evaluate, update and disseminate the customer information to subscribers;*

(c) *to compile and maintain database and generate reports from customer information database;*

[105] This observation was made by Prof. Njuguna Ndung'u, the Central Bank of Kenya Governor during the launch of the Banking (Credit Reference Bureau) Regulations, 2008 on 22nd September, 2008.

(d) *to assess the creditworthiness of a customer;*

(e) *to sell to institutions specialized literature and other informational material related to its activities;*

(f) *to carry out market and statistical research relating to matters set out under the regulations.*

(g) *To carry out any other activity as may be approved by the Central Bank from time to time in accordance with the Act.*

The nature of information to be shared is any customer information concerning a customer's non-performing loans as well as performing loans (that is, both positive and negative information) and may include details such as the name of the person, date of birth, national identity card number, personal identification number, passport number, driving license number, past and current addresses and other contact details. And in case of non natural persons it shall include its name, registration number, personal identification number, names of directors, shareholders or partners, past and current address plus other contact details.
Other information that can be exchanged include the customer's credit history, including the nature and amount of loans or advances and other credit facilities granted to a customer, amounts outstanding thereof and related matters.

The regulations will provide for the licensing and establishment of credit bureau operations in the country. The regulations also make it mandatory for financial institutions to report non-performing loans, and provide for the protection of consumers by defining their rights. Credit reference bureau regulations would lead to reduction of non-performing loans and increase the number of potential market entrants whose information can be processed. The regulations would enhance the credit risk appraisal process by banks that will have access to more information on prospective borrowers.

Regulation 25 gives Central Bank the powers to regulate and supervise all bureaus licensed under the Regulations. Under sub-rule (2) the Central Bank may issue directions, guidelines or rules generally for the better carrying out of its supervisory functions under the Regulations.

Information to be exchanged concerns the nature and details of security or securities taken or proposed to be taken by an institution as security for loans, advances and other credit facilities. Also details of patterns of payment of credit facilities or default in payment by the customer, debt restructuring and actions taken by the institution to recover unpaid amounts including realization of securities, legal proceedings and related matters. I feel these are good provisions however, the regulations being a subsidiary legislation can be altered with ease, 'hard' legislation would be a better option. These regulations will however, strengthen earlier amendments to the Banking Act by making it mandatory for banks to share information.

The problem with the operations of the credit reference bureau is there are that they have been operating without a legal framework in the past. The CRBs in our jurisdiction have been operating as profit-making companies. The mistakes they could have caused are not addressed by the legal regime in place and no remedy is available to aggrieved parties.

The new Regulations are likely to pose difficulties to the bureaus when they become fully operation from 1st February 2009. The bureaus will be forced to adjust their operations so as to make them strictly legal. In the first place the bureaus must seek licensing from the Central Bank and there is no guarantee that they will actually be licensed to continue with their operations or not. They will be forced to change some of their operations so as to be in line with the legal framework in place which may pose serious difficulties as they adjust to comply with the requirements of the new law. It is also purely speculative as to what the regulations will actually achieve. It is yet to be seen if the credit reference bureaus will

achieve the highly desired role of reducing the high levels of non-performing loans once their operations are fully operational.

Customers' Right of Access and Correction.

As an individual, under the Banking (Credit Reference Bureau) Regulations, 2008 you are entitled to have incorrect information held within your credit reference corrected.[106] If the file contains mistakes, the bureau must correct them and confirm any changes, in writing within fifteen days. If it refuses, or you are not satisfied with the amendment, you can send it a Notice of Resolution or an amendment notice of up to one hundred words, which it must add to your file and send out whenever information about you is supplied in the future.

Credit reference bureaus must add a Notice of Resolution to a person's 'credit file' and supply the notice to any lender who makes enquiries. This ensures that any future application for credit is 'referred' when being processed – in other words the Notice of Resolution must be read and taken into account by a lender. Someone may default on credit agreement or incur a Court Judgment or Decree against them because of a sudden change in circumstances – for example redundancy or a personal tragedy. If the actual information held by credit reference agencies is factually correct, despite the circumstances, it cannot be altered as it is a true account of a person's credit history and this is where a Notice of Resolution is especially useful.[107]

There is an absolute need for fair credit reporting to ensure that there is balance between the benefits credit reference bureaus offer and consumers' legitimate concerns over accuracy and privacy. Good legislation should encourage consumers to correct errors in their reports.

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[106] Regulation 20 of the Banking (Credit Reference Bureaus) Regulations, 2008

[107] It is advised to use a Notice of Correction to explain any special circumstances, which led to financial difficulty, and if required, you should take professional advice about how notice should be worded to best effect.

A legislation on consumer rights should also be enacted that should include among other the following: -

a) Right to be told if information in their file is used against them.
b) Right to be able to find out what is in their file.
c) Right to dispute inaccurate information and have inaccurate information corrected or deleted.
d) Right to have outdated information excluded from the consumer report.
e) Right to consent to disclosure required for reports provided to employers.
f) Right to request that their names be excluded from lists for unsolicited and insurance offers.

3.5 Conclusions

The track record acts as personal collateral in accessing credit. Credit bureau operations are vital in building confidence of the banking sector, and facilitating access to finance for big and small businesses. However, from the above discussion, it appears that the legal and regulatory framework in our jurisdiction has been lacking in clear formulation of what information to be exchanged in the credit market. For example the Central Bank of Kenya Act is totally silent on the whole question of establishment of credit reference bureaus as well as the exchange of credit information. It can only derive from the mandate and objectives of the Central Bank as stated in the Act. The Regulations states that a bureau that shall run and operate the services of credit referencing shall be a limited liability company licensed under the Banking Act and the Central Bank is mandated to supervise, and undertake surveillance of the bureaus. The Banking Act sets out the framework for the establishment of the credit bureaus while the Banking (Credit Reference Bureau) Regulation 2008, provides for their operations. The Central Bank of Kenya Act seems to come from behind the Banking Act and the Regulations. The Central Bank Act therefore needs to be amended to be in synch with the

Banking Act and the Regulations. The lending laws in the present form do not offer sufficient penalties to defaulters. There has been a laxity in implementation of the lending laws by the financial institutions. The supervisory role of the Central bank has also not been fully carried out accordingly. The new Regulations are a positive move towards reform of our lending laws. However they need to be translated into an Act of Parliament to make them 'hard' legislation and to give them a greater force of law. The Government should not rest and should continue with formulation of the appropriate requisite legal and regulatory framework to extend credit referencing beyond the banking sector.

We should also have a good and efficient legal and judicial environment. A transparent and efficient court system provides better protection of creditor rights and may improve the amount of time spent prosecution for loan recovery. Lawyers play a critical role in speeding or slowing down the cases. They should endeavour to ensure that the cases are prosecuted as quickly as possible by avoiding employing delay tactics in conduct of court cases.

CHAPTER 4
CONCLUSION AND RECOMMENDATIONS

4.0 Conclusions

One of the problem that this stubby sought to investigate was an analysis of the Kenyan lending laws and to establish whether they are adequate as they are or not. Kenyan lending system has been riddled in adequacies. Most of the laws on lending and/ or borrowing do not adequately provide for remedies in cases of credit default. Even the law are in place suffers from lack of enforce. The judicial system does not help either in faster dispensation of cases touching on lending and default. There are numerous applications under Certificate of Urgency in our courts to stop any attempts by creditors to realize the security placed as collateral in case of loan, mortgage or other credit default. In line with the circumstances of a contemporary world, there is need to recognize and implement through legislation the legal provisions that takes care of the creditors to protect them from eminent failure when borrowers default and banks have o follow back position. Criminal remedies such as criminalizing bouncing cheques have equally done little to protect the creditors. Lenders are the ultimate sufferer when loans become non-performing and have finally to be written off.

The study further sought to analyze and document the legal and regulatory framework that provides for exchange and/or sharing of information. Several legislations as discussed in chapter three herein above discussed the legal and regulatory framework for sharing of information. This is either optional or mandatory. The courts or other specialized tribunals and commissions of inquiry can order disclosure of certain information. However this disclosure is limited to a certain extent and in particular circumstances especially where it is ordered that the said disclosure is to be done in camera. This in itself is an indication that discosure of private and sensitive information is not absolute. Under the Anti-Corruption and

Economic Crimes Act discussed above, the lawyers are exempted from disclosing information under privileged. Our legal framework does not provided for total and absolute sharing of information. Additionally, most of the legislation that we have do not clearly set limits of what kind of information can be disclosed or shared. This becomes a big loophole and individuals and institutions fail to disclose because no legal provisions on such needed disclosures.

The newly enacted Banking (Credit Reference Bureau) Regulations, 2008[108] are seen to be one solution to exchange of credit information in the financial market. They will become operational as from 1st February, 2009 and right now their effectiveness or not lies on the willingness of banks to share information. Though mandatory in their construction, their enforcement is something we are yet to see and any comments on how successful they will be or not in facilitating sharing and exchange of information is all but speculative.

The study further sought to is investigating whether the entrenchment of credit reference bureaus in the law, will arrest the information asymmetric problem and subsequent reduction of non-performing loans. An important reason for high level of non-performing loans in the banking sector is inadequate credit risk analysis in extending loans. Lack of information on the cash flow of borrowers means that prudent lending has to be based more on collateral than on credit risk assessment or the profitability of potential investment. Better reporting of financial probity of applicant and the establishment of credit reference bureaus is believed will enable more prudent financial interceding between banks and borrowers. With the enactment of Banking (Credit Reference Bureau) Regulations, 2008 it is felt that the portfolio of non-performing loans held by Kenya's commercial banks are expected to reduce.

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[108] Legal Notice No. 97 of 2008

At the moment there are three credit reference bureaus in the country. The lead being Credit Reference Bureau Africa Limited, located in Nairobi's Westland's suburb. It has tens of thousands records in its files and issues more than 3000 credit reports per month. Most of its subscribers are commercial banks.[109] It normally has data on defaulters and business reports. Other companies engaging in credit referencing activities are Metropol East Africa Limited and Quest Credit Bureau Limited.

To benefit from the services of Credit Reference Bureau Africa Limited, firms subscribe to the bureau at an annual fee of Ksh12,000 and pay another Ksh500 - 7,500 each time they want information on an individual or firm. However, the amount charged in the later part depends with the volume of the files one want to check on.[110]

Efficiency of Credit References.

Credit reporting companies serve as sources of information about consumers' use of credit as reported by those from whom consumers borrow. Lenders use this information to supplement whatever data they have already directly acquired about a borrower's creditworthiness to make lending decisions. As part of this system, lenders have incentives to report their own experiences with borrowers so as to gain access to other creditors' data in the future.

Credit reference bureaus give insights into a consumer's past behavior with credit, similar to the ways in which an insurance company might use a driving record or a prospective employer might use a college transcript. These insights can be used to make decisions about his or her stability and his or her ability and willingness to repay debt. Without such information, borrowers would likely be required to provide far more information about

[109] The information was obtained from questionnaire administered and ensuing interview conducted with the officials of credit reference bureaus operating locally.

[110] Ibid

themselves when applying for any type of credit and pay more for access to credit. In fact, in countries that do not have a well-developed credit reporting system, creditors can make the mistake of lending to consumers who are already overextended or in default with another creditor. These mistakes result in a higher cost of borrowing for all consumers.[111]

When an application for a loan, credit card, bank account or mortgage is made, the chances are that the company responsible for extending the line of credit will run a check with a credit reference bureau. These bureaus check the register to verify details such as addresses, any bad debts, and bankruptcies and perhaps on how reliably repayments of existing loans are made. It is essential that the information making up the reference is accurate and up to date; otherwise the consequences could be very damaging for both or either parties.

If one is about to apply for mortgage or other major loan it may be worth checking in advance to see exactly what information credit reference bureaus hold on them. Correcting any errors in advance could help one avoid problems at a later stage, when one may not be able to get things put right in time.

The breadth of credit markets is associated with information sharing. The consumer credit market is broader in countries where credit bureaus operate, especially if they have been active for a long time. Total private debt scaled by Gross National Product is also larger in countries where information sharing is more solidly established and intense. These relations persist even when one controls for other economic and institutional variables, such as country size and growth rate, and variables capturing respect for law and the protection of creditor rights. Defaults are mitigated by public and private information sharing although this

[111] Mark Furletti An Overview And History Of Credit Reporting June 2002, Federal Reserve Bank of Philadelphia

evidence is weak, perhaps owing to the other externalities such as inflation and political chaos.

The mobility of borrowers, the degree of banking competition, the stringency of privacy laws and the degree of protection of creditor rights all play a role, in determining the emergence of credit reference bureaus. The historical evidence from the United States, Japan, Spain and Italy suggests that credit bureaus tend to be created in the wake of consumer credit booms.

Another important finding is that private credit bureaus are positively related to availability of bank financing for small and medium firms. Stronger rule of law is associated with more effective private credit bureaus. This finding has obvious policy implications and highlights the necessity of strong legal system for the operation of credit markets as a whole and credit bureaus in particular.

I regard this paper no more than a first step in the empirical analysis of the effects of information sharing on credit markets. The pervasiveness and intensity of this information exchange warrants much more thorough inquiry into its effects on the lending policies of banks and the conduct of borrowers. There is still no solid microeconomic evidence on this issue. There are inadequate accounts of the impact of these arrangements in developing countries, where in many cases they are just being established. It is ironic that private credit bureaus and public credit registers know so much about us while we still know so little about them.

4.1 Recommendations

Now that we have Banking (Credit Reference Bureau) Regulations, 2008, then a platform for credit referencing has been established. However, key to note here is that credit reference bureaus to be licensed under the regulations will initially collate credit information only from institutions licensed under the Banking Act.

This study makes the following recommendation: -

1. **Expanding the range of financial institutions that can access services offered by Credit Reference Bureaus.**

While it is gratifying that an enabling legal and regulatory framework is now in place for credit information sharing in the banking sector, more remains to be done. There are a host of other credit providers in the economy such as Microfinance institutions, SACCOs, utility companies, hire purchase companies and retail stores, Higher Education Loans Board that would greatly benefit from the services of the credit bureaus but which are not covered under the current Regulation. The full benefits of credit referencing can only be realized if it is extended to these other credit providers in future.

2. **Translating the Regulations into an Act of Parliament.**

Once the first recommendation herein above is achieved, then the next to follow suit should be an immediate translation of the Regulations (Banking (Credit reference Bureaus) Regulations, 2008), into an Act of Parliament. This will give them a greater force of law and avoid the danger that subsidiary legislations face of blatant and constant amendments.

3. Enacting data protection and/ or fair credit reporting legislation.

With the enactment of legislation touching on exchange of information, then we need to look at the other side of the coin. The Regulations are aimed at protecting the credit rights. But what about the debtor's rights?. Our Parliament should definitely enact an Act of Parliament aimed at protecting the debtor's right. In any case it should be modeled in the format of the United Kingdom's Data Protection Act XXVI of 2001 as amended by Acts XXXI of 2002 and IX of 20003 and/ or the United States' Fair Credit Reporting Act of 1970.

4 Curing the problem of multiplicity of laws and regulations:

The registration of the credit reference bureaus is under the Companies Act, the establishment and licensing is provided for under the Banking Act, the operations of the bureas is provided for under the Banking (Credit Reference Bureaus) Regulations, 2008 while the supervision and surveillance is under the mandates of the Central Bank as provided for under the Central Bank of Kenya Act. There is possible conflict if this is not properly checked. The Government may consider having a single legislation with provisions touching on all these areas. Further the said Act should prescribe stiff penalties to those who disclose confidential information blatantly without authority injuring ones reputation. Compensation should be offered to any wrongly injured party be such unlawful disclosure just like operates the laws on defamation.

5 Shifting focus on collateral.

The management must shift emphasis away from reliance on collateral to viability of projects in assessing credit. This approach would entail changing over-reliance on the security that a borrower can offer but on past credit history. This is the so called "reputation collateral" that the credit reference bureaus seeks to offer. A person will good credit repayment history will

get a preferential treatment ahead of one who has a bad credit history and/ or a serial loan defaulter for that matter.

6. Centralization of loan approvals.

Centralization of loan approvals of business proposals to loan officers who specialize in specific economic sectors is said to increases the quality of loans and reduces the incidence of NPLs. Such a management structure requires prompt access to extensive data and the quick transmission of questions and decisions. The computerization programme is therefore a vital link to this

7. Raising awareness.

Raising awareness will ensure that more people, financial and lending institutions are aware of the operations of the bureaus and then they will start to embrace the services offered by the bureaus from a point of knowledge. This will go a long way in credit assessment and eventual reduction levels of credit default.

All said and done, the legal heritage of credit reference bureaus will be better understood and appreciated after the legal structures and regulatory framework are fully in place and operated for some reasonable time in our jurisdiction.

4.2 Suggestions For Further Research.

To overcome the above mentioned limitations further research would be needed to study dynamic relationships between events leading to the establishments of credit reference bureaus, their creation, and subsequent improvement in financial development and reduction in a firm's non-performing loans.

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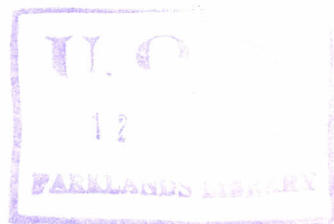

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APPENDIX

APPENDIX

Questionnaire Administered To ....

Questionnaire directed to private credit reference bureaus

Aim of the survey

This questionnaire is directed to managers of credit bureaus and is part of the research project on *"Non-performing Loans: Are Credit Reference Bureaus the Solution?"*. A masters degree thesis at the University of Nairobi]. The project aims at understanding the establishment, mode of operations and the basic functions of the bureaus and their consequences on non-performing loans in credit markets.

Confidentiality

The researchers carrying out this project guarantee complete confidentiality in the use of the data collected in the survey. Data and results based on the survey will always be presented in tabular form and at a level of aggregation that will safeguard the confidentiality of individual banks.

PLEASE ENCLOSE ANY PUBLISHED OR OFFICIAL MATERIAL THAT YOU FEEL WOULD BE RELEVANT TO UNDERSTAND THE OPERATION OF CREDIT BUREAUS IN OUR COUNTRY.

1. DESCRIPTION OF YOUR CREDIT BUREAU

Town where headquarters is located: ____________

The credit bureau is owned by:

a group of banks

a group of other financial intermediaries

individual share-holders

foreign-owned (majority stake foreign-owned)

The credit bureau is

a company run for profit

a cooperative enterprise or consortium of lenders

a semi-public institution

other (please indicate)

Indicate who originally started the credit bureau:

private entrepreneurs

consortium of lenders

government agency

other (please indicate)

The credit bureau operates:

at multinational level

at national level

at regional or provincial level

2. SCALE OF OPERATIONS

	Personal sector	Business sector
Year started operating		
Number of records in your files in 1990s'		
Number of records in your files in 2000-2007		
Credit reports issued in 1990s'		
Credit reports issued in 2000-2007		
Number of records in your files in 2008		
Credit reports issued in 2008		

Pease supply information on credit reports and number of records in the first year of the operation of the credit bureau and the current year of operation.

3. SOURCES OF INFORMATION

Please rank the importance of the following as sources of information for your credit reports on a 1 to 3 increasing scale: 1 = not used or rather unimportant, 2 = important; 3 = crucially important.

	Personal sector	**Business sector**
Banks		
Other financial institutions		
Credit card companies		
Central Credit Register		
Public records		
Tax files		
Other: (please indicate)		

4. DATA SUPPLIED BY LENDERS

Which type of data is provided by lenders to your credit bureau?

	Personal sector	**Business sector**
Defaulted loans		
Arrears		
Total loan exposure		
Characteristics of borrowers*		
Other: (please indicate)		

* For households: employment status, marital status, age, income, assets, etc.; for firms: line of business, balance sheet data, personal information about directors, share-ownership structure, etc.)

5. RECIPROCITY

Do you apply a principle of reciprocity with your clients (i.e., do you supply information only to those who supply it to you)?

YES NO

If yes, is there an explicit agreement between you and lenders to exchange information?

YES NO

What happens if lenders do not comply with the reciprocity agreement (i.e. supply late or incorrect information)?

6. CREDIT BUREAUS IN OUR COUNTRY

Please list the other main credit bureaus that operate in our country:

Please describe briefly the evolution of the credit bureau industry in the last 10 years in our country (growth and problems of the industry, process of concentration, etc.)

7. PUBLIC CREDIT REGISTERS

Please indicate if a Public Credit Register exists in our country and, if so, how it affects your operations. (By a P.C.R. I mean a publicly managed database, which forcibly collects data about loans from banks to supply it under request from other banks.)

8. PRIVACY LAWS

If laws protecting consumer privacy exist in our country, what do they require?

How do these laws affect the operation of your company?

How much do you charge: subscription and annual fees?

Any relevant comment.

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