

# **CREDIT INFORMATION SHARING AND LEVEL OF LOAN DEFAULT IN DEPOSIT TAKING SACCOS IN MERU COUNTY, KENYA**

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## **Abstract**

*The study aimed at assessing credit information sharing influence on level of loan default in deposit taking SACCOS. The study adopted a descriptive research design. Descriptive statistics and multiple linear regression were used in data analysis. The study revealed that there exist a strong relationship between credit reports, credit scoring and level of loan default in SACCOS. However, the study concluded that credit information sharing significantly influenced level of loan default. The study recommends operationalization of regulations that can govern SACCOS on sharing information on non-performing loans to aid in risk mitigation. There is also need to*

*extend credit information sharing to all other SACCOS including the non-deposit taking and utility service providers to increase data for borrowers' profiling.*

*Keywords: Deposit taking SACCOS, Credit information sharing, loan default, non-performing loans, Kenya*

## **INTRODUCTION**

Saving and credit cooperative societies are a self-governing association of persons which are organized and operated under the principles of cooperatives to meet their common financial and social needs (ICA, 2005). The essential aim of a SACCO is to promote the financial and social welfare of its members by granting loans to cover their financial needs, supporting the spirit of initiative in agricultural or industrial work and careful use of the saving produced locally (WOCCU, 2005).

The history of cooperatives started with the Rockdale Society of Equitable Pioneers, founded in 1844. However, Africa has a membership of 16 million making it third in membership size after North America and Asia which have 102 million and 36 million respectively. Compared to other continents Africa mobilizes only 0.4% of the global savings which is USD 1.1 trillion and 0.4% of global loans provided to the membership standing at USD 912 billion. North America, generally consisting of Canada and United States are the major players with savings and loans up to 83% and 84% of the statistics respectively (WOCCU, 2009). In Kenya, the first cooperative society in Kenya was organized by Europeans settlers in Rift Valley in 1908. The society was supposed to market cereal crops, fruits and dairy products. That time there was no Co-operative Law to govern it until 1931. In 1966, the cooperative societies Act was enacted which introduced control measures to counteract mismanagement and misappropriation of funds. The savings and credit cooperative societies were formed in late 1970's. SACCOS have grown significantly and they play a major role in providing financial services to majority of Kenyans particularly in the rural areas for example between 1985 and 2006 the number of registered SACCOS rose from 1285 to 4876 (Ministry of Co-operative Development and Marketing, 2007). Co-operatives remain one of the best vehicles through which the perceived unbankable population can access savings and credit facilities (Kioko, 2014).

SACCOS offer small sized loans to their members compared to others financial institutions in Kenya, but still experience a high level of loan default (Karumuna & Akyoo, 2011). SACCOS have a high exposure to credit risk; the risk that borrowers are unable to pay or risk of delayed payments as well as operational risks (Alfred, 2011). There has been massive fraud of funds by SACCOS' leaders (Mugisa, 2010) and level of loan default in SACCOS have

increased. Credit information sharing is expected to create an incentive for defaulters to make payments against the defaulted debts (Kairu & Amandi, 2014). Institutionalized information sharing through private bureaus or public credit registers is utilized in more than 100 countries in the world (WorldBank, 2009). Credit information sharing undoubtedly plays a pivotal role in reducing the information asymmetry that exists between lenders and borrowers.

Credit information sharing started recently in Kenya through Banking (Credit Reference Bureau) regulations 2008 that oversee licensing, operation and supervision of credit bureaus by Central Bank of Kenya which were gazetted and operationalized in 2009(Loannidou & Penas, 2010). Credit reference bureaus try to solve the moral hazard and adverse selection problems by acting as brokers of information through collection, filing and distributing the information voluntarily supplied by their members. The Central Bank of Kenya (CBK) has licensed three credit reference bureaus i.e. Credit Reference Bureau Africa Limited, Metropol Credit Reference Bureau Limited, and Credit info Credit Reference Bureau Limited (CBK, 2015)

Enhanced usage of credit reports by SACCOs are anticipated to curb information search costs and as a result offer sound terms of borrowing to clients with good credit track record (CBK, 2012). Credit reference bureaus gather information on the payment history and accounts of borrowers. They gather and dispense two major types of data i.e. white and black information. Black information usually refers to negative client data, such as information about defaults on payments, delays, delinquencies, bankruptcies and other information with a negative connotation on the payment history. White information on the other hand is positive client data on payment history and the financial behavior of the data subject. A credit report depends on the amount of detail of the information (La Porta, Florencio, Andrei, & Robert, 2007).

### **Problem Statement**

Financial intermediation is the main business of financial institutions and loans are generally the main source of revenue for SACCOs (Kwambai & Wandera, 2013). Nevertheless, many SACCOs have collapsed in Kenya since 1986 due to loan defaults which have resulted from national economic downturn, failure by loan applicants to disclose vital information during loan processing and lack of an aggressive debt collection policy (Waweru & Kalani, 2009). This deters the essential aim of a SACCO of promoting the financial and social welfare of its members by granting loans to cover their financial needs so as to help members achieve their standard of living (Lagat, Mugo, & Otuya, 2013).The issue of bad debt can fuel credit crisis and result in the collapse of some of these institutions hence the economy as a whole. Locally few studies have been done on credit information sharing, among them includes Kioko (2014) on Credit information sharing influence on performance of licensed deposit taking SACCO

businesses in Kenya and Kisenge (2014) on impact of credit information sharing on the level of non-performing loans of commercial banks in Kenya. The researcher therefore sought to assess credit information sharing influence on level of loan default in deposit taking SACCOs.

### **General Objective**

The general objective of this study was to assess the influence of credit information sharing on level of loan default in deposit taking SACCOs in Meru County.

### **Specific Objectives**

The study sought to determine the influence of credit report and credit scoring on level of loan default in deposit taking SACCOs in Meru County, Kenya.

## **LITERATURE REVIEW**

### **Asymmetric Information Theory**

Information asymmetry refers to a situation where enterprise owners or manager know more about the risks facing their business, than do the lenders (PWHC, 2002) cited in Eppy (2005). Information asymmetries arise when gaining information on the characteristics or behavior of the borrower and it's costly for the financial institution. Information asymmetries generate problems of allocation of loans to borrowers with undesirable characteristics such as a high level of risk or inability to take advantage of the loan (Lown & Morgan, 2003). The theory describes a situation in which all parties involved in an undertaking do not know relevant information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with an enterprise for which the funds are earmarked. The lender on the other hand does not have sufficient information concerning the borrower (Edwards & Turnbull, 1994). Perceived information asymmetry poses two problems for the SACCOs; moral hazard and adverse selection (Binks & Ennew, 1992). Credit information sharing improves borrowers' incentives to repay the loans and helps overcome moral hazard of borrowers (Padilla & Pagano, 2000). It also allows loans to be extended to safe borrowers who had previously been priced out of the market, resulting in higher aggregate lending.

### **Transaction Cost Theory**

Transaction costs theory involves the design of efficient mechanisms for conducting economic transactions (Frino & Romano, 2010). Transaction cost theory is essential in explaining the growth of the financial sector. Transaction costs make the presence of credit approval

decisions costlier which means risk-averse lenders could deny credit access (McIntosh & Wydick, 2009). Williamson (1985) states that transaction costs is the resultant resistance that arises in undertaking transactions among exchange parties. The resistance linked with transactions is mainly caused by opportunistic actions that usually arise when two parties in an exchange fail to fulfill their duty of being trustworthy. Transaction costs of intermediation between the lenders and borrowers are a crucial challenge for both the lender and borrower since transaction costs lending decisions would not be taken with lack of information from the transaction participants(Bag, 2013). In an increasingly competitive atmosphere, financial institutions may not share information among themselves and this could worsen the problem of adverse selection, moral hazard and the transaction costs in borrowing. The lack of trust associated with rising loan default and increased bad debts affect the quality of lending. With the growth of credit market and increased competition, the necessity for sharing of information to reduce transactions costs is critical (Bag, 2013).

### **Credit Rationing Theory**

This theory was introduced by Freimer and Gordon (1965) and expounded by Stiglitz and Weiss (1981). The theory states that asymmetric information leads to credit rationing, as lenders cannot distinguish between good and bad borrowers. Asymmetric information in credit markets may lead to over-lending. Financial institutions screen and monitor their clients before approving a loan. They are specialized in gathering private information, treating it (Freixas & Rochet, 1999) and own highly strategic information on borrowers' receipts and expenditures as well as the way they develop (Diamond & Rajan, 2001). Nevertheless, the bond between lenders and borrowers is not ideal. Lenders suffer from informational asymmetries (Freixas & Rochet, 1999). Stiglitz and Weiss (1981) proved that credit rationing occurs if lenders charge the same interest rate to all borrowers, because they cannot distinguish between borrowers and screening borrowers perfectly is too costly thus, credit rationing may occur. According to Stiglitz and Weiss (1981) argue that low-risk borrowers expect a lower rate of return on average. Thus, they are less wealthy than high-risk borrowers on average after some periods. Low-risk borrowers are therefore not able to provide more collateral. Increasing collateral requirements may have the high adverse selection effect. Lenders only offer contracts in which they simultaneously adjust interest rates and collateral requirements (Owino, 2014).

### **Empirical Review**

Furletti (2002)in his study on the overview and history of credit reporting was of the view that credit reports give businesses insights into a consumer's past behavior, 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, which include a consumer's record of meeting financial obligations, 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 more information about them 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 over extended or in default with another creditor. These mistakes result in a higher cost of borrowing for all consumers.

Turner and Varghese (2007) in their study on factors influencing loan default observed that credit bureaus help to solve a problem that is inherent in lending: imprecise knowledge of a borrower's likelihood of repaying. The lender must instead infer the risk profile of the borrower. Incorrect assessments result in two symmetrical problems. Low-risk borrowers are mistaken as high-risk and high-risk borrowers are mistaken as low-risk. Consequently, low-risk borrowers face high interest rates that act as subsidies for high-risk borrowers. High-risk borrowers receive subsidies and are hereby drawn into the market. Average prices go up to reflect the disproportionate presence of high-risk borrowers, and delinquency rates are higher. In response, lenders ration loans in a way that given two individuals with identical risk profiles and preferences, one will receive a loan and another will not. The study concluded that credit referencing drastically reduces the levels of default. A research study carried out by Brown and Zehnder (2006) showed that information sharing increases repayment rates, as borrowers anticipate that a good credit record improves their access to credit. This incentive effect of information sharing is substantial when repayment is not third-party enforceable and lending is dominated by one-shot transactions.

According to a survey carried out by Cowan and Cowan (2006) on financial institution use of credit scoring for small business lending established that effectively developed and managed credit scoring would help meet their needs in a variety of ways. Some of the ways that credit scoring would meet their needs included: the reduction of reliance on collateral, risk-based pricing that may lower their interest rates and greater credit availability for higher-risk customers, who, without risk-based pricing, would simply be denied loans. In addition, turn-around times from application to approval and funding would likely decrease. Finally, as lenders become more confident in scoring's accuracy, risk-adjusted approval rates may increase. Aduda, Magutu, andWangu, (2012) stated that SME's lack the collateral necessary for financing their loans and are also subjected to higher interest rates. The average loan amount issued to SME's in Kenya is 5 Million. Credit scoring reduces informational dullness and improves the

quality of lending for SME's looking to access long term financing. Credit scoring increases the access of credit for SME's because the banks can quantify risk. However despite the availability of credit scoring in the U.S., relationship lending is still a dominant factor as relationships and loan purpose were considered more important than credit scoring regardless of whether a bank used credit scoring or not (Cowan & Cowan, 2006).

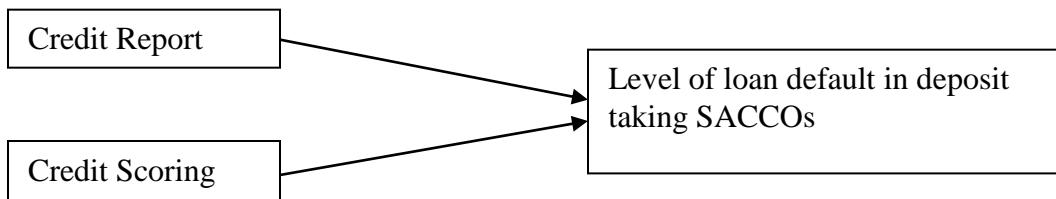
Bhardwaj and Sengupta (2011) in their study on credit scoring and loan default stated that lenders evaluating an application for credit either collect information from the applicant first-hand or receive this information from credit agencies or bureaus. Such information primarily includes the prior credit history of the borrower. Credit scoring is an outline measure of information set on the borrower in terms of a single metric or score that is viewed as a measure of future credit risk. Information sharing lessens the problems of adverse selection (Jappelli & Marco, 1993), moral hazard (Padilla & Marco, 2000) and over lending (Bennardo, Marco, & Salvatore, 2009) that affects the credit markets. Information sharing leads to decreasing number of borrowers defaulting in paying their loan (Brown & Zehnder, 2010).

In the study carried out by Nasieku and Ngugi (2016) on credit information sharing and credit risk reduction in Kenya commercial banks recommended that banks to ensure that they incorporate credit information sharing to reduce loan defaults. The study also recommended CBK to put into place policies to ensure that it is mandatory to use credit reports for every borrower. Commercial banks and other financial institutions should also use the information provided by CRB already licensed in Kenya to effectively lend to potential borrowers. The government through the relevant agencies to publish credit information sharing regulations and create awareness to the public on the services available from credit reference bureaus so that borrowers can submit the relevant information to the lending institutions. Credit information sharing is the exchange of information on client financial histories (Jappelli & Pagano, 2010). Sharing of credit information can make an important contribution to the development of the financial system which is an essential determinant of economic growth (Doblas-Madrid & Minetti, 2009). Credit scores have enormous benefits to both lenders and borrowers. Borrowers are able to negotiate with lenders on better terms. Highly rated borrowers with good credit history can convincingly negotiate for lower interest rates or even waiver of collateral (Nasieku & Ngugi, 2016).

## **Conceptual Framework**

The conceptual framework as shown in Figure 1 illustrates the hypothesized relationship between the independent variables (credit report and credit scoring) and the dependent variable (level of loan default).

Figure 1: Conceptual Framework



## METHODOLOGY

The study used a descriptive survey research design. Descriptive research design was used since it provides insights into the research problem by describing the variables of interest. It was used for defining, estimating, predicting and examining associative relationships. This helped in providing useful and accurate information to answer the questions based on who, what, when, and how. The study was conducted in Meru County, Kenya owing to its being cosmopolitan in various SACCOs. The target population consisted of all the 9 deposit taking SACCOs in Meru County. The respondents were the 57 credit officers of these deposit taking SACCOs. The study used census study methodology which enabled the researcher to gather more information to assist in analysis and arriving at accurate results. The 57 credit officers or respondents who were more than the threshold of 30 participated in the study. Data was collected from primary sources. Self-administered questionnaires were issued to the respondents. Descriptive statistics was used to analyze the data. Data was edited, coded, classified and summarized into categories. Multiple linear regression was also used to link the relationship between independent variables (credit report and credit scoring) and dependent variable (loan default) and was guided by the following model:

$$LD = \beta_0 + \beta_1 CR + \beta_2 CS + \epsilon$$

Where, LD is the dependent variable (Level of loan Default),

$\beta_0$  is the intercept

CR =Independent variable Credit Report.

CS =Independent variable Credit Scoring.

$\epsilon$  is the error term.

## ANALYSIS AND RESULTS

### Credit Report Influence on Level of Loan Default

The first objective was to find out the influence of credit report on the level of loan default. 100% of the respondents stated that credit report for customer is requested on all loan applications. Only 41.2% of the respondents said that credit report contain demographic information of a

client while 58.8% said they don't contain. Majority of the respondents (85.3%) said that credit report contain payment profile information, 23.5% of the respondents said that credit report contains account information while 38.2% said they contain enquiries made on customers account. The respondents stated that customers are entitled to one credit report yearly. 76.5% of the respondents were in agreement that credit report is used for approving or declining the loan. From the findings the researcher found that 61.8% of the respondents disagreed that credit report is used for charging high or low interest and for deciding what amount to give the customer. Majority of the respondents (50%) rated the influence of credit reporting on level of loan default as being high.

### **Credit Scoring Influence on Level of Loan Default**

The Second objective of the study was to establish the influence of credit scoring on the level of loan default. Credit referencing advisories were found to provide credit score of customers. Majority of the respondents i.e. 44.1% were of the view that score attained from credit referencing advisory was extremely important to issuance of credit to a customer 32.4%, 20.6% and 2.9% of the respondents stated it as being very important, important and less important respectively. 35.3% of the respondents were in agreement that access to accurate credit scores reduces the value of relationship lending 14.7% were uncertain while 50% disagreed. The researcher found that risky customers receive loans with high interest rates and less risky customers receive loans at a lower interest rate. Credit scoring influence on level of loan default was highly rated by majority of the respondents who were 61.8%.

### **Regression Analysis**

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.906 <sup>a</sup>	.821	.811	.215

In reference to table 1 above, the two independent variables that were studied, explain 81.1% of credit information sharing influence on level of loan default in deposit taking SACCOs in Meru County as represented by the adjusted R<sup>2</sup>. This therefore means that other factors not studied in this research contribute 18.9 % of the credit information sharing influence on level of loan default in deposit taking SACCOs in Meru County. Therefore, further research should be

conducted to investigate the other influencers (18.9%) of credit information sharing on the level of loan default.

Table 2: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	7.454	2	3.727	80.252	.000 <sup>a</sup>
	Residual	1.625	35	.046		
	Total	9.079	37			

Table 2 above shows the significance value is 0.000 which is less than 0.05 thus the model is statistically significant in predicting how credit report and credit scoring influence level of loan default in deposit taking SACCOs in Meru County. The F critical at 5% level of significance was 2.32. Since F calculated is greater than the F critical (value = 80.252), this shows that the overall model was significant.

Table 3: Coefficients

Model	B	Std. Error	Sig.
1	Constant	.499	.201
	Credit Report	.712	.121
	Credit Scoring	.132	.076

The researcher conducted a multiple linear regression analysis so as to explain the influence of credit information sharing on level of loan default. The two variables as per the SPSS generated, the equation: LD= 0.712CR + 0.132CS + 0.499. To assess the significance of each independent variable on the dependent variable, the researcher established that credit report and credit scoring were significant and influenced level of loan default as their P values were less than 5%. The model revealed that there exists a significant relationship between credit report and level of loan default. This concurs with Furletti (2002) in his study on the overview and history of credit reporting who affirmed that countries that do not have a well-developed credit reporting system, creditors can make the mistake of lending to consumers who are already over extended or in default with another creditor. These mistakes result in a higher cost of borrowing for all consumers.

It also revealed that there exists no significant relationship between credit scoring and level of loan default in deposit taking SACCOs which is in agreement with the study of Cowan and Cowan (2006) on financial institution use of credit scoring for small business lending which stated that relationship lending was still a dominant factor as relationships and loan purpose were considered more important than credit scoring regardless of whether a bank used credit scoring or not. However, the study differs with Nasieku and Ngugi (2016) who stated that credit scores have enormous benefits to both lenders and borrowers. Borrowers are able to negotiate with lenders on better terms.

## **CONCLUSIONS**

The study concludes that credit information sharing and level of loan default are indeed related. Credit information sharing, increases transparency among financial institutions, helps the SACCOs lend prudently, lowers the risk level to the SACCOs, acts as a borrowers discipline against defaulting and it also reduces the borrowing cost i.e. interest charge on loans. Credit referencing bureaus has come of age and has helped the financial institutions to lend with care. The effect of it therefore has led to reduced level of loan default.

## **RECOMMENDATIONS**

Based on the findings of this study, the following recommendations have been made:

- i. The credit referencing advisories to expand their field and ensure that they gather more financial history data from other sources such as county offices, the Kenya Revenue Authorities, utility providers and other service providers so that one's credit worthiness is viewed wholly.
- ii. Financial institutions are also advised to utilize the information gathered for the intended use as it was noted that the use of credit scores hasn't greatly reduced the occurrence of relationship lending.
- iii. The public also to be sensitized on the importance of getting to know what is contained in one's credit report early enough. Each individual is entitled to one free credit report per year.
- iv. To operationalize regulations that can govern SACCOs on sharing information on non-performing loans to aid in risk mitigation.
- v. There is need to extend credit information sharing to include the whole SACCO subsector including the non-deposit taking SACCOs to increase data for borrowers' profiling.

- vi. Credit referencing bureau information to be applied to all members without discrimination of whether one is in the board of directors or an ordinary member. This would create the importance of using credit reports and credit score in reducing level of loan default.

## LIMITATIONS OF THE STUDY

The credit information sharing is only limited to commercial banks and deposit taking SACCOs in Kenya and therefore the findings of the study may not be beneficial to other financial institutions like SACCOs which offer only back office activity services. Credit reporting is currently limited to negative (black) information which is retained by the bureau for seven years after it is repaid. The study was therefore limited to the negative information influence as opposed to full reporting.

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