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Creating value through
inclusive finance

Developing a tenant purchase scheme credit policy:

Credit risk rating tool manual

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1. Introduction

This Credit Risk Rating Tool Manual has been created as part of the Developing a Tenant Purchase Scheme (TPS) Credit Policy assignment by FSD Kenya that involves the creation of a Credit Risk Scoring Tool for TPS providers. The purpose of this Manual is to assist the users of the Credit Risk Scoring Tool to effectively use the tool to determine credit risk level of Tenant Purchase Scheme (TPS) applicants. The Tool has been developed with Mi Vida Homes as a case study, but the intention is for the Tool to be applicable to any TPS provider to analyse the TPS applicants' creditworthiness through credit risk scoring. Please note that this is a draft tool that was designed based on a proposed methodology drawing on the authors' experience and incorporating various factors that are typically considered in housing credit assessments, such as income, repayment capacity, and market conditions, to provide a best-effort approach to estimate TPS credit worthiness. Therefore, the tool is subject to future testing and validation given the lack of historical data that would be necessary for conducting thorough analysis and refining of the tool's accuracy. The tool was initially developed with the intention of testing with 50 applicants from Mi Vida's TPS, however, since the property developer decided not to move forward with the TPS, a replacement TPS will be sought for the testing.

Key considerations for use of the tool

The tool is not designed to work in isolation: A Tenant Purchase Scheme involves a long-term financial relationship between the offeror and purchaser, therefore for use of the credit tool, it is expected that the TPS offeror will have a credit department, supported by credit officers. While the credit tool allows for a systematic and standardized approach to evaluating credit applications helping to streamline the decision-making process and ensure efficiency and consistency in credit assessments, it is not a replacement for the credit department that is responsible for:

- Monitoring and Adaptation of the tool: The credit tool is dynamic and requires constant monitoring and adaptation to changing market conditions. Credit officers will need to own the tool, contribute to its refinement, ensuring that it remains relevant and effective in capturing evolving credit risk factors.
- Prudent Decision-Making: While the credit tool can provide valuable insights to support decision making, it is not a substitute for human judgment. Credit officers, through their expertise and experience, can interpret the results of credit tools in the context of unique situations, considering factors that may not be fully captured.
- Customer Relationship Management: Credit officers play a vital role in managing relationships with TPS purchasers. By understanding and owning the credit tool and other tools at their disposal, they can effectively communicate credit decisions to customers, offering insights into the rationale behind those decisions and providing guidance for improving creditworthiness.
- Compliance and Regulatory Requirements: Credit officers need to be well-versed in the applicable legal and regulatory environment to ensure that the credit tool is kept up to date and to ensure that lending practices align with legal requirements and industry standards.
- Risk Management and portfolio monitoring: The primary function of a credit department is to assess and manage credit risk. Credit tools are essential for evaluating the creditworthiness of potential TPS purchasers, identifying risks associated with lending, and ensuring the overall health of the TPS portfolio. The tool does not replace the credit department and monitoring function. Credit officers are expected to proactively manage their TPS portfolios and identify potential default risks and employ strategies to mitigate risks.

The Tool works by having a Credit Officer input preset scores against multiple qualitative and quantitative criteria depending on information provided by an applicant and supporting documentation. The Credit Officer can also select the weighting of each criterion depending on the risk appetite of the organization in question, in the initial version of the tool, all credit questions are equally weighted, and the weighting will be adjusted post real-world testing. Assessment begins at the application stage where all information required from applicants is requested and processed.

Required applicant information:

- National Identification Card (ID number, Age and Gender)
- Contact details
- KRA PIN Certificate
- Single or joint application
- Household size
- Banked/unbanked status and bank or SACCO details
- Income: Household or individual
- Income source: employment, business or other
- Years of participation in income source activity (employment, business etc., both formal and informal)
- Proof of income (both formal and informal)
- Purpose of housing unit (owner occupier or investment)
- Business registration documentation if applicable
- Expenditure details
- Sectors of employment / business/ source of income
- Assets and liabilities details

Key Considerations for Credit Assessment:

1. Support quality credit decision: The Credit Tool should categorize TPS applicants based on their credit risk level to indicate ability and willingness to pay. This is done through the inclusion of the relevant qualitative and quantitative criteria to assess and score applicants as high, medium, or low risk.
2. Fairness and inclusion: The Credit Tool should ensure inclusion of both formal and informal sector applicants by including alternative indicators of willingness and ability to pay including considering cashflows from both formal employment and informal employment such as business and farming as evidenced by 6 months of M-pesa statements, SACCO statements, bank statements, receipts, and invoices.
3. Give consideration to gender and financial inclusion, noting the composition of households and the level of ease or difficulty to access financing depending on the household adult gender composition. Gender mainstreaming is recognized as an important consideration for the credit tool: recognizing and addressing gender disparities is essential for fostering sustainable development, social equality, and economic growth ensuring that financial resources are allocated equitably, fostering economic opportunities for both men and women. By addressing gender-based economic disparities, credit providers such as TPS offerors contribute to reducing poverty and promoting inclusive economic growth. In the tool, this is implemented through the applicant questionnaire that collects information on gender, age, household composition and level of income for further analysis i.e. collecting gender-disaggregated data allows TPS providers to identify patterns and trends related to borrowing, repayment, and utilization of financial services. It is imperative to emphasize that lending practices should not be discriminatory based on gender or any other characteristic.

Discrimination undermines the principles of equality and fairness therefore the tool ensures access to the TPS is based on merit and creditworthiness.

2. Credit Risk Rating Criteria and Methodology

The Mi Vida TPS targets the segment of Kenyan's seeking affordable home ownership and will be open to formal and informal sector employees, providing a path to home ownership. The key TPS Tenant risk to be assessed is the Credit Risk: Tenants may struggle to meet the financial obligations of the purchase, including regular rent payments, fees, and eventual purchase prices, leading to potential eviction or financial strain. Credit risk assessment will consider all forms of income (formal and informal).

In developing the risk rating criteria for the TPS, applicants will be classified into three as below:

a) **Formal sector** - The formal sector comprises businesses and economic activities that are under the supervision of the government. Typically, employees working in this sector are entitled to benefits such as contributions to National Social Security Fund, some have job security and have fixed working hours. Organisations in this sector are licensed and are obligated to file and pay taxes to the government. Employees have a right to join trade unions to protect their interests.

b) **Informal sector** – he informal sector across Africa is greatly pronounced with a significant number of people engaged in small and household enterprises outside formal wage employment (World Bank – Informal Enterprises in Kenya, 2016). Close to 70% of employment outside farming is in the informal sector. In Kenya, the informal sector is large and dynamic forming close to 95% of the country's businesses and entrepreneurs. Wholesale and retail trade, hotels and restaurants continue to be the leading sectors that provide informal employment followed by manufacturing (Kenya National Bureau of statistics, Economic Survey 2023).

   The informal sector is a subset of unincorporated enterprises not constituted as separate legal entities independent of their owners. The enterprises operate on a small scale and with little or no separation between labour and capital as factors of production and have a low level of organization. The informal sector can be described using various operational criteria such as lack of registration, licensing, taxation, labour standards. Other features tend to characterize the informal sector such as firm size, income level and product standards (International Labour Organisation). The definition of informal employment differentiates three categories of a worker:

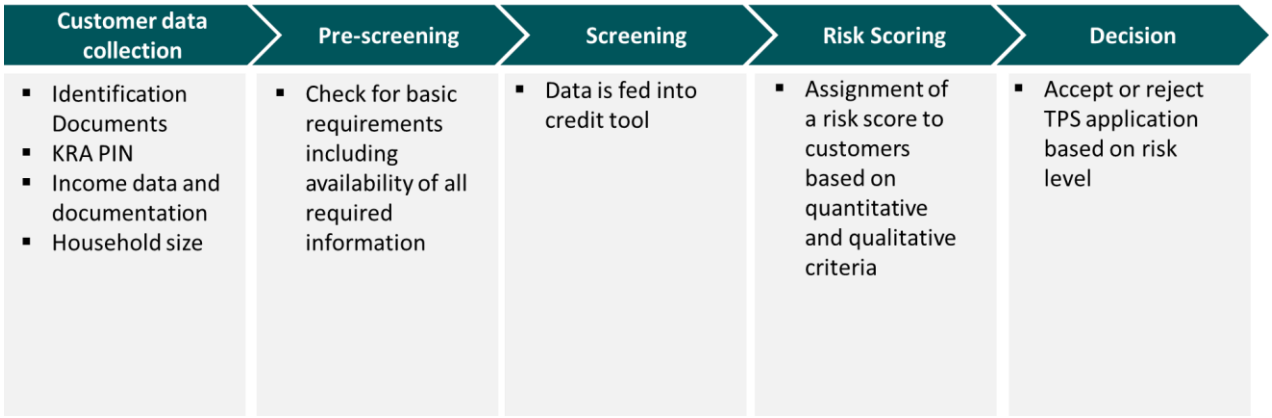
   - Employees: employees are considered to have informal jobs if their employment relationship is, in law or in practice, not subject to national labour legislation, income taxation, social protection or entitlement to certain employment benefits such as advance notice of dismissal, severance pay, paid annual or sick leave.
   - Employers and own-account workers: considered to be in informal employment when their economic units belong to the informal sector. The operational definition considers an informal economic unit or informal sector as one that is:
     - Unincorporated commercial unit,
     - is not registered under required national legislation and,
     - does not maintain a set of accounts as required by law.

     In absence of adequate data, the criteria may be extended to cover units whose employees do not contribute to social security, have no more than five workers and do not operate from fixed visible premises.
   - Contributing family workers – They are informally employed regardless of whether they work in formal or informal sector enterprises.

c) **Both formal and informal sectors**: This category comprises people who participate and derive income from both formal and informal sectors of the economy. The credit assessment tools will consolidate the criteria from the two sectors considerably to achieve fairness in credit rating.

The approach to risk assessment is summarised in Figure 1.

Figure 1: Risk assessment process summary



2.1 Pre-screening Stage

This stage involves mandatory prerequisite criteria for every applicant in the formal, informal and both formal and informal categories. The criteria have to be fully met before proceeding to the next stage.

- **Applicant personal identification** – The first step will be to obtain identification and personal tax registration information (KRA PIN) necessary for all financial transactions.

Applicant to provide relevant identification documents	Rating scale
ID, KRA pin provided	Pass
Information not provided	Fail

- **Information about current income** – Applicants will be required to provide information and proof of their income at this stage. The tool will require applicants to be able to meet monthly remittances by assessing their income levels. Applicants will need to share income supporting documents based on their formal and informal sector income sources such as contracts to supply labour and materials, employment contracts, bank, MFI, SACCO and Mpesa statements and payslips. Applicants who pass this stage will be further assessed on their income adequacy at the screening stage by observing factors like their indebtedness, their average annual expenditure, period of employment/ business operation etc.

Proof of income	Rating scale
Sufficient information available to make a decision	Pass
Sufficient information to make a decision not available	Fail

2.2 Screening stage

Applicants will be screened through a set of qualitative and quantitative criteria with each of the criteria scored against a maximum achievable score. The total maximum score achievable for all the criteria is 260 (highest credit rating). Applicants scoring below 220 will be considered high risk and applications rejected[1]. The credit risk rating tool is presented as a separate annex to this report in Microsoft Excel format.

[1] Scores will be tested and adjusted in the next phase of the assignment where 50 applicants will be scored to provide key insights into the Tool's usability and suitability. The Tool will then be updated based on the lessons learnt.

a) **Qualitative criteria**

- **Personal attributes**
  - **Applicant's age**: Age is a major factor influencing loan eligibility. It primarily affects the loan amount, cost of borrowing and the tenure. Creditors issue relatively high amounts of credit to younger people because they are deemed to have a longer productive life and can opt for longer repayment periods. They also have room to restructure their facilities if need be. Applicants beyond 50 years are at risk of reduced or no income in during the term of the TPS due to reduced productivity. Applicants below 30 are viewed as elevated risk given that they typically have fewer responsibilities and have had less time to build financial base even though they have potential to create income in future which rates them as less risky compared to the above 50 bracket.

    Younger applicants will score higher points for the TPS compared to older applicants. Information about age will be obtained from the TPS application form and verified against the ID card.

Applicant's age	Rating scale	Select Score
30 to 50 years	20	**[20]**
Below 30 years	15	
Above 50 years	10	

  - **Single vs joint application** - Joint applicants present lower risk compared to solo applicants as they have diversity in income sources which is a credit risk mitigant. Applicants will disclose this information in the TPS application form.

Single vs joint application	Rating scale	Select Score
Joint application	20	**[20]**
Single application	15	

- **Applicant's Free cash flows** – Here, the credit officer has to assess the applicant's income and take into consideration other primary and secondary needs. The key expenses to consider are food, transport, school fees, loan servicing and utilities (electricity, water, security). If free cash flows after making these deductions are above monthly TPS payments the risk of default is low. The credit manager will rely on self-reporting from applicants and spot checks on statements for verification.

Free cash flows in relation to TPS payments	Rating scale	Select Score
More than monthly TPS payments	20	**[20]**
Equal to monthly TPS payments	10	
Less than monthly TPS payments	0	

- **Purpose of the housing unit**: Owner occupiers are considered lower risk credit risk than a than those purchasing units for investment as the motivation to pay the monthly instalments will be higher. Owner occupier applicants will therefore score higher points (better credit rating) than those for investment purposes. Information on the purpose will be obtained from the application form.

Purpose of the house	Rating scale	Select Score

Owner occupier	20	**[10]**
Investment	10	

- **Period in employment/business** – Applicants with a long history of receiving income from employment or business or both are considered lower risk. The credit scoring tool will award higher scores to applicants who have been receiving income for the past 10 years and above and lower scores for less than 10 years. Employment contracts, contracts to supply materials and labour and related addenda and statements from financial institutions will aid in providing this information.

Period in employment/business	Rating scale	Select Score
10 years and above	20	**[10]**
Below 10 years	10	

- **Income consistency** – The applicants will need to demonstrate steady income streams to score higher points. Those who only work part of the year or those just getting their careers/businesses started will be lower rated (higher risk). The tool will consider income gaps as a high risk and therefore such applicant will score less points compared to those with no gaps. Employment contracts, contracts to supply materials and labour and related addenda and statements from financial institutions will aid in providing this information.

Income consistency	Rating scale	Select Score
In employment/business consistently over the past 24 months	20	**[10]**
In employment/business consistently over the past 12months	10	
In employment/business consistently for less than 6 months	5	

- **Extent of formality** – The more formal, the higher the score, the lower the risk. Relevant business permits and tax compliance certificates for both formal and informal sector applicants will provide proof that the applicant is registered and filing returns and paying applicable taxes.

Extent of formality	Rating scale	Select Score
Tax compliance certificate	20	**[20]**
Single business permit	10	
None	0	

- **Credit history:** The credit risk rating tool will consider the scores assigned by other credit rating agencies in Kenya. Because the rating scores from the different providers differ, the risk rating tool will standardise the scores based on the risk level. See appendix for credit score standardisation. In cases where the rating agencies have no information about an applicant for the reason of not taking any facility in their lifetime, the tool will consider this as high risk and issue zero score.

Credit history	Rating scale	Select Score
Very Low Risk	20	**[15]**
Low Risk	15	

Moderate Risk	10	
Risky	5	
Very risky	0	
Not rated	0	

b) Quantitative criteria

- **Income growth** – Income growth shields individuals against adverse and volatile macro-economic factors like inflation, purchasing power, interest rates and currency depreciation. Applicants with a positive income trend will, therefore, score higher points as they demonstrate increase earning potential. The growth can be observed by reviewing contract letters, statements from financial institutions and tax returns filed with Kenya Revenue Authority.

Income growth	Rating scale	Select Score
Income growth > 10%	20	**[20]**
Income growth of 5% - 10%	15	
Income growth < 5%	5	

- **Costs** – This will be measured in relation to income using the Cost to income ratio. The ratio compares the operating costs to operating income; a lower ratio would imply higher operational efficiency. The ratio allows lenders to assess borrowers' current financial health and they can use it to make estimated prediction of the borrowers' future financial situation with other factors held constant. Lower ratios translate to higher credit scores. Applicants will disclose their average monthly and annual costs, and these can be traced to their customer statements from financial institutions and from financial statements.

Costs	Rating scale	Select Score
40% and below	20	**[15]**
21% to 40%	15	
41% and above	5	

3. Risk scoring and decision making

The criteria in the screening stage are converted into aggregate numerical scores that then categorize applicants into high risk, medium risk and low risk categories which are then used to make a credit decision to accept or reject applicants based on the TPS provider's risk appetite. Table 1 illustrates the risk levels and score thresholds for the Credit Rating Tool.

Table 1: Risk levels based on aggregate scores

Risk level	Upper threshold	Lower threshold
Low risk	100%	80%
Medium risk	79%	41%
High Risk	40%	0%

Based on an applicant's total score and the risk thresholds, the Credit Tool allocates a risk rating and resulting decision. Table 2 shows an example of the credit decision.

Table 2: Risk Rating Tool Output: Credit Decision based on risk level

Maximum possible score	100%
Minimum possible score	0%
Minimum score allowed	41%
Total score by applicant	68%
Risk level	Medium risk
Decision	Accept

4. Appendix: CRB standardisation of Kenyan 3 rating agencies

The 3 licensed Credit Reference Bureaus in Kenya have different scoring metrics. To enable the tool's users to utilize credit scores from any one of them, the tool uses a standardised risk level enabling comparison of risk across the tools as shown in Table 3.

Table 3: Standardized Risk Levels derived from CRB scores

Metropol Scores and Risk levels		Credit Info Scores and Risk Levels		Transunion Scores and Risk Levels		Consolidated Risk Level Used in the Credit Tool
850-900	Lowest risk	743 to 900	Very low risk	781-850	Excellent	**Very low risk**
800-849	Lowest risk	731-742	Very low risk			
		713-730	Very low risk			
750-799	Low risk	701-712	Low risk	721-780	Good	**Low risk**
	Low risk	689-700	Low risk			
		677-688	Low risk			
700-749	Moderate risk	665-676	Average risk	661-720	Fair	**Moderate risk**
	Moderate risk	653-664	Average risk			
		641-652	Average risk			
600-649	High risk	620-640	High risk	601-660	Poor	**High risk**
		604-619	High risk			
		574-603	High risk			
500-599	Highest risk	530-573	Very high risk	300-600	Very poor	**Very high risk**
		251-529	Very high risk			
Below 500	Substandard	250	Very high risk			