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ESTIMATING THE EFFECTIVE COST OF BORROWING TO MICROCREDIT CLIENTS

Abstract

This paper addresses two questions regarding microcredit in the Kumasi metropolis: What is the average interest rate on microcredit in the Kumasi metropolis? What is the effective interest rate paid by microcredit borrowers in the Kumasi metropolis? We use survey data from 33 microfinance institutions (MFIs) to answer these two questions. The results of the analysis show that the average interest rate on microcredit in the Kumasi metropolis is 4% per month generally applied using the straight-line method of loan amortization. However, due to compensating balance condition coupled with other charges mostly 3% of the principal, a microcredit borrower who contracts a loan at 4% interest rate per month ends up paying more than 4%.

INTRODUCTION

Microfinance can be defined as the provision of financial and non-financial services to the poor and financially excluded with the aim of empowering them both socially and economically. ADB (2000) defines microfinance as the extension of a broad range of financial services such as loans, deposits, payment services, money transfers, and insurance to poor and low-income households and their microenterprises. The above definitions of microfinance view the concept as pro-poor. Indeed, Aach (2008) succinctly asserts that microfinance is hailed as a “silver bullet” approach to development because of its supposed ability to renovate the poor and marginalized. Therefore, in developing countries like Ghana, microfinance programmes offering financial services to low income households specifically targeting women are vigorously pursued. The skewed pursuit of these microfinance programmes towards women is predicated on the premise that women in poor households are more likely to be credit constrained, and hence less able to engage in income-earning activities (Swain & Wallentin, 2009).

Microcredit (basically the small loans given to the poor and financially excluded for consumption and production), as an integral part of microfinance, has gained a lot of attention because of its known impact on poverty reduction or alleviation. In Ghana, in the last decade microcredit activities have skyrocketed with the quantum leap in the number of microfinance institutions (MFIs) in the country. Surmised from the promotional campaigns of these mushrooming MFIs is their microcredit methodology which is fashioned on the ‘susu’ model of microfinance. The microcredit methodology of MFIs in Ghana (save emergency, commercial and other loans) is that a prospective borrower should provide proof that they have one-third of the amount requested from the MFI as savings with the MFI. Such capital accumulation is made

possible through a 'susu' scheme in which the prospective borrower is given the opportunity to make daily or weekly small fixed contributions for a stipulated number of months. Upon making such small fixed savings for the stipulated number of months, the client is advanced a loan which is usually equivalent to three times the accumulated amount. Thus, for instance, if after the stipulated number of months the client has been able to save GH¢200 they are given GH¢600 loan. Interestingly, not until the last pesewa of the loan has been repaid the client is denied access to their savings account with the MFI. This freezing of savings coupled with other charges makes MFIs clients pay more for their loans than the interest rate stated in the loan agreement.

Concerns have been expressed over the astronomical interest rates charged by these MFIs. Unfortunately, studies on MFIs in Ghana seem to have neglected this dimension of microfinance (Adusei, 2013; Adusei and Appiah, 2012; Adusei and Appiah, 2011; Aboagye, 2009; Aryeetey, 2008; Asiana and Osei, 2007). Filling this gap is the motivation behind the current study. What is the average interest rate on microcredit in the Kumasi metropolis? What is the effective interest rate paid by microcredit borrowers in the Kumasi metropolis? Answering these two questions constitute the focus of this study.

The rest of the paper is sectionalized as follows. The next briefly reviews literature followed by the methodology section. The last section covers the conclusion and policy implications section of the paper.

BRIEF REVIEW OF LITERATURE

The change in nomenclature from microcredit to microfinance was necessitated by the realization that saving services— and not just loans—could facilitate improvement in the well-being of the poor in general and of women in particular (Vonderlack & Schreiner, 2001). This presupposes that microcredit predated microfinance.

Microcredit Summit (1997) defines microcredit programmes as "extending small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families". Guha and Gupta (2005, p.1470) refer to microcredit as "a small-scale financial service (including savings, credit, insurance, business services and technical assistance) provided to rural people who operate small or micro-enterprises, provide services, work for wages or commissions and other individuals and groups working at local levels." Swaminathan (2007) summarises the features of microcredit as (a) very small loans, (b) requires no collateral, (c) usually undertaken through formation of borrower groups, (d) beneficiaries from among the rural and urban poor, (e) the loans are for income generation through market-based self-employment, and (f) the loans are administered through the mechanism of NGO control over disbursement and determination of the terms and conditions attached to each loan.

Generally, microcredit has been pursued in many countries including India through non-governmental organizations (NGOs). In 1996, the World Bank made some recommendations concerning NGOs in Bangladesh: Integrate NGOs with commercial finance markets by: (a)

developing an appropriate regulatory framework for the financial operations of the NGO sector; (b) encouraging large NGOs to establish themselves as banks; (c) encouraging 'wholesaling' of credit to established NGOs; and (d) using smaller NGOs as brokers to mobilize self-help savings groups (World Bank, 1996). However, Swaminathan (2007) seems to have serious reservations on NGO-controlled microcredit, arguing that not only does it not offer solution to the general problems of rural credit but also lack what it takes to be an instrument for mobilizing large-scale funds for technological change in the countryside.

The value of microcredit lies in its ability to overcome three problems faced by the formal financial sector: (1) screening problem which is the difficulty in correctly estimating the extent of risk of a prospective borrower; (2) incentive problem which is the difficulty involved in ensuring that the borrower takes those actions which make repayment most probable; (3) enforcement problem which is the difficulty inherent in compelling repayment of a loan (Guha & Gupta, 2005). Basher (2007) investigates the empowerment of microcredit participants and spillover effects with data from the Grameen Bank of Bangladesh and shows that the Grameen Bank converts its participants from passive recipients of credit to more active agents who get involved in economic and non-economic activities. However, Swaminathan (2007) seems to share a contrary view, asserting that microcredit is neither a successful anti-poverty approach nor is it an sufficient answer to the gigantic unsatisfied credit needs of the rural population. There have been concerns on the possibility of microcredit exacerbating poverty among borrowers. Jahiruddin *et al.* (2011) argue that microcredit borrowers wallowing in abject poverty with little or no surplus financial capacity to absorb contingencies are susceptible to adverse effects of microcredit.

To the best knowledge of the authors no study on interest rates charged by MFIs has been done in Ghana. However, evidence from outside Ghana suggests that interest rates charged by microcredit organizations are higher than the corresponding rates charged by commercial banks or other financial institutions (Swaminathan, 2007; Chavan & Ramakumar, 2005). Harper (1998) report that the common annual interest rates fall within the range of 24 to 36 per cent. However, microcredit Self-Help Groups (SHGs) could charge as high as 50 or 60 per cent per annum (Harper 1998).

METHODOLOGY

We use survey data collected from 33 MFIs in Kumasi in the Ashanti region of Ghana. To ensure representativeness of our findings we adopt quota sampling strategy in which five MFIs from each of the categories of MFIs in the region are sampled. The categories of MFIs used for the study are presented in Appendix A. In all 33 MFIs are used for analysis. Simple random approach has been used to select cases for data collection. This presupposes that all MFIs in a particular in the region have equal chance of being selected for the study. One advantage of random sampling approach over non-random sampling approach to data collection is that it

ensures fairness to all units within the study population. The second advantage is that it makes it possible for the researcher to generalize his or her findings.

Quantitative approach to data analysis has been adopted. Tables are used to present some of the findings.

RESULTS

Table 1 presents the descriptive statistics of our data. The total number of observations used in the analysis is 33. The minimum interest rate charged by MFIs is 1.62% per month whilst the maximum is 10% per month. The average interest rate per month is approximately 4% with the standard deviation of approximately 1.62%. Of the 31 MFIs that answer the question on the method used in applying the monthly interest rate, 74.2% indicate that they use the straight line method in which a fixed amount is payable by the borrower irrespective of the existing loan balance which 25.8 indicate they use reducing balance in which the monthly installment payable by the borrower is based on the current loan balance.

Table 1 Monthly Interest Rate Characteristics of MFIs

| | N | Minimum | Maximum | Mean | Std. Deviation |
|----------|----|---------|---------|--------|----------------|
| Interest | 33 | 1.62 | 10.00 | 4.0114 | 1.62531 |

The mean interest rate of 4% per month presents prima facie evidence that the average micro-borrower pays 4% interest rate on every cedi borrowed from an MFI in the Kumasi metropolis. Going by Harper (1998)'s report that the common annual interest rates on microcredit fall within the range of 24 to 36 per cent, we can argue that 4% per month which translates into 48% per year is high. Two main factors could have accounted for this high interest rate. One is inefficiency in the operations of the MFIs. High transaction cost coupled with inefficient loan recovery strategy usually results high interest if the MFI decides to shift the inefficiency to clients. Another factor is profit incentive. MFI clients are usually the poor and financially excluded with degree of vulnerability. Thus, any MFI with an unbridled proclivity for profit can take advantage of them by demanding exorbitant interest rate from them.

The modus operandi of MFIs makes microcredit borrowers pay more than contract interest rate. Let us assume for purpose of this analysis that Mr. A has contracted a GH¢ 300 micro-loan from an MFI which has an interest rate of 4% interest per month. In line with the lending strategy of MFIs, Mr. A has saved an amount of GH¢ 100 with the MFI which is one-third of the loan value. This amount remains untouchable by Mr. A until the last pesewa of the loan has been repaid. Assuming a simple interest approach, the MFI is going to earn 4% interest rate on GH¢ 300 which is GH¢12 per month. Let us assume that other charges put together is 3% of the principal

which is GH¢9. This GH¢9 other charges plus the GH¢100 in Mr. A' s account equals GH¢109. The MFI will lend this amount at 4% per month to earn GH¢4.36 per month in addition to GH¢12 from the GH¢ 300 loan. Assuming there is a financial asset in the financial markets which pays 2% per month, Mr. A will lose this 2% income because his money is frozen pending the retirement of the loan. This 2% is the opportunity cost of borrowing which should be added to the interest rate paid by A. Thus, Mr. A' s actual cost of borrowing in this scenario is 6% (4%+2%). Thus, we argue in this paper that due to one-third compensating lending strategy of MFIs, their clients pay interest rates that are always above the stated interest rates in the loan contracts.

As can be observed from Figure 1, majority of MFIs in the Kumasi metropolis charge 4% per month interest rate on their micro-loans.

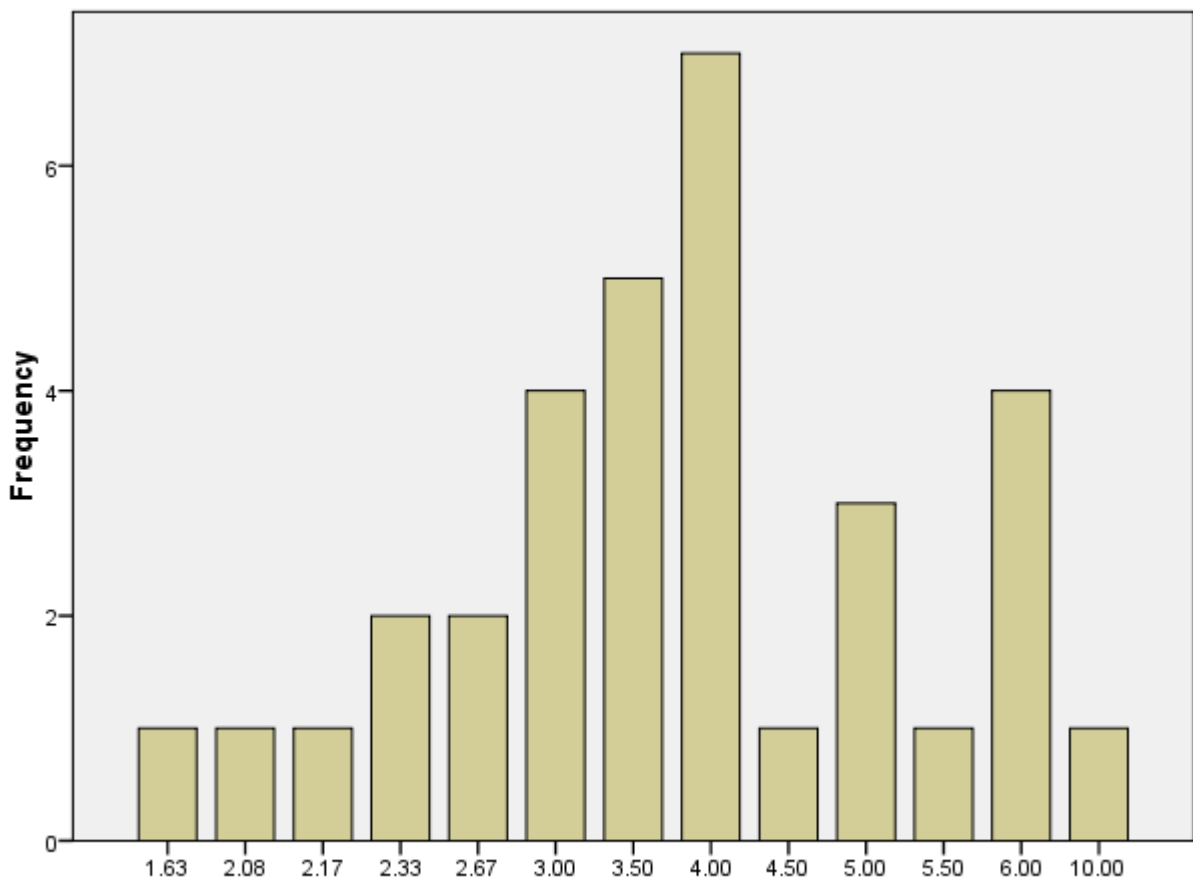


Figure 1: Interest Rate Per Month %

In addition to interest rate, 25 out of the 33 MFIs surveyed charge processing/commitment fee as a percentage of the principal. Majority of these MFIs charge 3%. Figure 2 illustrates this point.

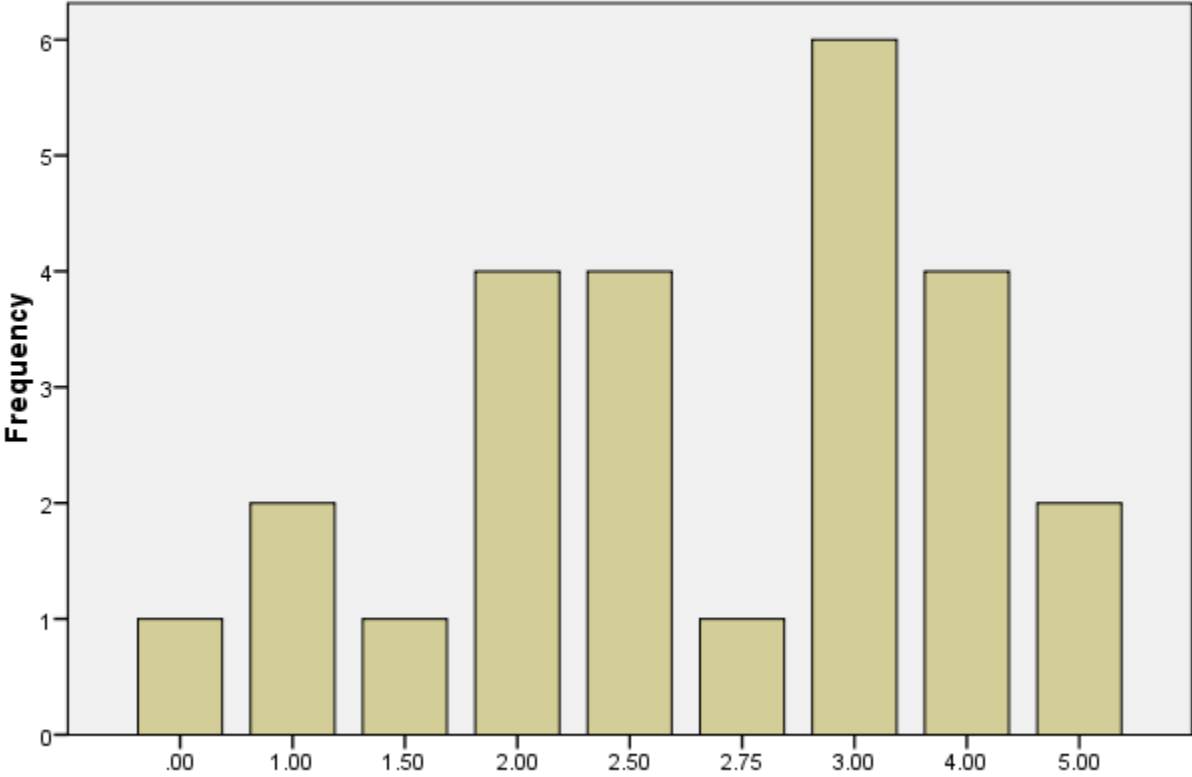


Figure 2: Processing/Commitment Fee %

Apart from the processing/commitment fee as a percentage of the principal, ten MFIs require payment of other charges which as Table 2 shows ranges between GH¢1 and GH¢ 20.

Table 2 Other Charges

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---------|----|---------|---------|--------|----------------|
| Process | 10 | 1.00 | 20.00 | 8.9000 | 6.82235 |

CONCLUSION AND POLICY IMPLICATIONS

We use survey data from 33 microfinance institutions (MFIs) to answer two questions regarding microcredit in the Kumasi metropolis: What is the average interest rate on microcredit in the Kumasi metropolis? What is the effective interest rate paid by microcredit borrowers in the Kumasi metropolis? The results of the analysis show that the average interest rate on microcredit in the Kumasi metropolis is 4% per month and is generally applied using the straight-line method of loan amortization. However, due to compensating balance condition coupled with other charges mostly 3% of the principal, a microcredit borrower who contracts a loan at 4% per month ends up paying more than 4%.

One policy implication is that Bank of Ghana should impress it upon MFIs to reduce their interest rates so as to avoid the horrors of astronomical interest rates. This is because evidence exists that microcredit can exacerbate poverty (Jahiruddin *et al.*, 2011). Charging a high interest rate could worsen the plight of the poor with concomitant social and economic costs to the state.

Another policy implication of these findings is that there is the need for Bank of Ghana to review the modus operandi of MFIs in Ghana. The compensating balance conditionality which ends up increasing the cost of borrowing should be properly regulated. It is recommended that the compensating balance should attract the prevailing interest rate in the financial markets in order to eliminate the situation where an MFI borrower effectively pays more than the stipulated interest rate in the loan agreement.

Last but not least, we recommend that Bank of Ghana and other microfinance bodies should organize periodic capacity-building programmes especially for new MFIs to equip them with modern techniques of running a microfinance business. Doing this is likely to result in effectiveness and efficiency in their day-to-day operations which may be in the best interest of microfinance clients.

In all, we expect this study to trigger microfinance reforms which will make the poor and financially excluded enjoy the full benefits of microfinance. In the future, we expect researchers to survey the remaining nine regions of Ghana for us to have a complete picture of the average interest rate charged by MFIs in Ghana. We also expect some empirical light to be thrown on factors MFIs in Ghana consider in setting their interest rates.

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APPENDIX A: LIST OF MFIs USED FOR THE STUDY

| Name of MFI | Type |
|----------------------------|------------|
| Atwima Kwanwoma Rural Bank | Rural bank |
| Bosomtwe Rural bank | Rural bank |
| Paxman | |
| Royal | |
| Trust | |
| Newways | |
| sml | |
| cedi | |
| floral | |
| Sun shade | |
| Bevaud | |

| | |
|-------------------------|------------|
| Asokore Rural | |
| Kumawuman Rural Bank | Rural Bank |
| Asante Akyem Rural Bank | |
| First national S&L | |
| Union S&L | |
| pacific S&L | |
| First Allied S&L | |
| Standard Trust S&L | |
| Ramseyer CU | |
| Oforikrom CU | |
| Tek CU | |
| Goodnews CU | |
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| Eden microfinance | |
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| Sikadwa microfinance | |
| Era | |
| Nobledream | |
| Talent | |
| Secure capital | |
| GIFS | |