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ESTIMATING THE EFFECTIVE COST OF BORROWING TO MICROCREDIT CLIENTS IN GHANA

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ABSTRACT

This study estimates the effective cost of borrowing to microcredit clients in Ghana. A simple open-ended questionnaire is administered to 35 microfinance institutions. The study finds that the major costs of borrowing are interest rates and processing fees. The study also finds that the minor costs of borrowing are registration fees, commitment fees, insurance and compulsory savings. In terms of effective cost of borrowing, the study finds that microcredit customers effectively pay at least 8.0 percent interest rate in excess of the stated interest rate.

JEL: E43, E51

KEYWORDS: Effective Cost, Microcredit, Ghana

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 progarmmes 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 make 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; Afrane and Ahiable, 2011; Aboagye, 2009; Aryeetey, 2008; Asiama 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? The effective interest rate takes into account certain financial charges the client pays in addition to the stated interest rate which is frequently announce. This highlights the actual cost of borrowing. Therefore, answering the above questions constitute the focus of this study.

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 wellbeing 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) summarizes 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 nongovernmental 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 anti-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) reports 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 35 microfinance institutions in Kumasi in the Ashanti region of Ghana in the year 2013. The institutions are selected such that there is a fair representation of each category of institutions providing microfinance was captured (see Table 1). Simple random approach has been used to select cases for data collection. This presupposes that all MFIs in a particular in the study area have equal chance of being selected. 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 is makes it possible for the researcher to generalize his or her findings.

Data are collected using an open-ended questionnaire which allows the institutions to indicate actual interest rates charged. To estimate the effective interest rate on a microloan, we adopt the Christen (1990)' model. The new model is given as:

$$\text{Effective Interest Rate (EIR)} = \frac{Total\ interest\ payable}{Net\ principal \times time}$$

Where,

1. Net principal = original principal less commission charged
2. Time = the term of loan
3. Total interest payable = $(P \times T \times R)$
   Where P = original principal, T = time (3 months), R = rate charged

RESULTS

The analyses dealt with the categories of the institutions and loan products, cost of borrowing and methods of computing interest rate, and computations of effective interest rates.

MFIs and Products

Table 1 shows the categories of financial institutions studied. As evident in the table, 40 percent of the respondents are 'susu' companies; 14.3% are savings and loans companies; 17.1% are rural banks; 17.1% are credit unions whilst 11.4% are financial NGOs. It is obvious that the "susu" companies dominate the sample. This is because they are considered as traditional MFIs and their number in the metropolis outweighs other MFIs.

Several innovative loan products have been developed by these institutions to meet different needs. For purposes of this study, the various products are classified into four: personal, group loans, small and medium enterprises or commercial loan, and emergency or special loan, including funeral loans (see Table

2). Not all the financial institutions provide loans under each category. For instance, Financial NGOs consider all loans as either personal or group loan. No differentiation is made regarding what the loan is used for.

Table 1: Financial Institutions Providing Microfinance Services

	Frequency	Percent
'Susu' Companies	14	40.0
Savings & Loans Companies	5	14.3
Rural Banks	6	17.1
Credit Unions	6	17.1
Financial NGOs	4	11.4
Total	35	100.0

This table provides the breakdown of the sample for the study. Source: Field Survey, 2013

MFIs and Cost of Borrowing

There are several financial cost elements associated with borrowing from microfinance institutions. The survey of 35 MFIs in Kumasi revealed the following costs: interest rate, processing charges, commitment fees (including cash lien, compulsory savings), application or registration fees, insurance charges. Not all the institutions charged each of these costs of borrowing. The predominantly charged costs of borrowing are interest rate and processing fees, where all institutions charged at least one of them.

Interest rates: For effective loan recovery, most microloans are usually on short-term basis, and as such the interest rate is charged on monthly basis. The survey has shown that different interest rates are charged for different loan products as shown in Table 2. For each loan product, the minimum, maximum and mode interest rates charged by each category of institutions providing microfinance have been presented.

Table 2: Interest Rate by Institution and Product (in % per Month)

Institutions	Personal/Normal Loan (N=30)			Group Loan (N=18)			SME Loan (N=19)			Emergency/Special Loan (N=16)		
	Min	Mode	Max	Min	Mode	Max	Min	Mode	Max	Min	Mode	Max
'Susu' companies	3.2	4.0	6.5	3.3	4	6.5	4.0	4.0	10	4.0	10.0	20.0
Savings & Loans	3.0	3.5	4.0	3.0	3.5	3.5	3	3.5	4	6	6	8
Rural banks	2.3	2.3	2.6	2.3	2.3	2.8	-	-	-	2.5	2.5	2.5
Credit unions	1.6	3.0	5.0	-	-	-	2.3	2.5	3	3.5	3.5	10
Fin. NGOs	4.5	4.5	5.5	4	4	6	-	-	-	-	-	-

This table summarizes the interest rate by institution and product per month. Source: Field Survey, 2013

In all, 30 out of the 35 institutions covered in this study offer personal loans. The key feature of this loan is that it is granted on individual basis and the requirements include being a member of the institution for a certain timeframe. With this type of loan, the minimum interest rate charged among all the institutions is 1.6 percent, which occurs among the credit unions. The maximum interest rate charged is 6.5 percent which relates to the MFIs. It can be seen that the rural banks have the smallest maximum interest rate charged of 2.6 percent. Group loans, which appear to be more secured (apparently due to 'group monitoring) than the personal loans has interest rates not too different from the former in terms of average and maximum rate charged. Among the loan products, emergency or special loans attract relatively high interest rates. The rate can rise as high as 20 percent depending on how urgent the loan is needed and the risks involved. The exception is rural banks which maintain low interest rates of 2.5 percent. The "Susu" companies, savings and loan companies, and credit unions which grant such loans apply relatively high interest rates.

Method of calculating interest: Another dimension of borrowing cost to clients is the method of calculating interest rates. The survey has shown that the methods of computing interest rates among the institutions are the straight line and reducing balance. In all 72.7 percent of the institutions surveyed use the straight line

method (see Table 3), more than half of which are the "Susu" companies. In fact, only one of such institutions applies the reducing balance method. Interestingly, all the credit unions use reducing balance apparently because such institutions are owned by members who collectively contribute the funds, and as such are not-for-profit making; therefore, they do not intend to take too interest from members. There are two out of the savings and loans companies which use both methods.

Table 3: Methods of Computing Interest Rates

Institutions	Straight Line		Reducing Balance		Both		Total	
	Frq	%	Frq	%	Frq	%	Frq	%
'Susu' companies	13	39.4	1	3.0	0	0.0	14	42.4
Savings & Loans	3	9.1	0	0.0	2	6.1	5	15.2
Rural banks	4	12.1	2	6.1	0	0.0	6	18.2
Credit unions	0	0.0	4	12.1	0	0.0	4	12.1
Fin. NGOs	4	12.1	0	0.0	0	0.0	4	12.1
Total	24	72.7	7	21.2	2	6.1	33	100

This table shows the methods used by MFIs in computing interest rates Source: Field Survey, 2013

Other financial charges: Apart from the interest rate, there are other charges which are normally deducted from the principal loan amount before disbursement. The study finds processing fees, commitment fees, application or registration fees, insurance, as well as a certain proportion of compulsory savings in order to qualify for loan. Some of the institutions charge these extra costs as a proportion on the principal loan amount, whiles others charge a fixed amount.

More than 70 percent of the institutions interviewed charge processing fees as a proportion on the principal loan amount. Among all the institutions, the minimum processing fees is 1 percent with the maximum being 5 percent as shown in Table 4. It is also realized that one microfinance institution charge GH¢5.00 for whatever loan applied as processing fees. It is noteworthy that only one credit union charges processing fees. Majority of them charge only the interest rate since they do not exist with profit motive.

Table 4: Processing Charges (in %)

Institutions	Freq	Processing Fees		
		Min	Mode	Max
'Susu' companies	11	1.0	3.0	5.0
Savings & Loans	5	2.0	2.5	3.0
Rural banks	6	3	4	5
Credit unions	1	2.6	2.6	2.6
Fin. NGOs	2	1.5	1.5	2.0
ALL	25	1	3.0	5.0

This table shows the processing charges of MFIs. Source: Field Survey, 2013

Response rate for commitment, registration/application fees and insurance fees is relatively low with 8 percent, 37 percent and 20 percent respectively. Thus, these charges are not predominant among the MFIs. However, it is important to note that commitment and application fees can be fixed at as high as GH¢50 per each loan applied. In terms of proportion on principal loan amount, commitment and application fees are 3 and 5 percent respectively. For insurance, the maximum charge is 1.3 percent.

Effective Interest Rates

Effective interest rate is the actual rate of borrowing when all other financial charges are factored into the calculation of the interest rate. It expresses the relative cost of borrowing arrangements with different conditions (Christen, 1990). One purpose of this study is to calculate effective interest rates of microcredit and that clarifies the broader discussion of cost of borrowing of microfinance clients.

For purposes of computing the effective interest rate, the mean, minimum and maximum rate of each loan product is derived as shown in Table 5. As stated above, the institutions charge several fees such as processing, application, registration, commitment, insurance, etc. in addition to the interest rate. In this analysis, however, only the processing fees is applied since more than 70 percent of the institutions surveyed charge it. The response rates of the remaining types of fees are below 40 percent and it is disproportionate to apply in all cases. The minimum and maximum processing fees charged are 1 and 5 percent respectively. The mean processing fees is 3.0 percent, with a standard deviation of 0.9 percent.

For purposes of this computation, the following typical loan conditions are used. The loan size is taken to be GH¢ 1000.00 with six (6) months term, amortizing monthly using the straight line method. Applying a simple method for calculating effective interest (see Appendix) as given in Christen (1992), the rates charged by the institutions are given in Table 5.

Table 5: Effective Interest Rates

Institutions	Interest Rates/Other Chargers (%) Per Month				Effective Interest Rate (% Per Month)		
	Min	Max	Mean	Stdv	Min	Max	Mean
Personal/Normal Loan (N=30)	1.6	6.5	3.8	1.2	1.8	7.7	4.4
Group loan (N=18)	2.3	6.5	4.0	1.3	2.5	7.7	4.6
SME loan (N=19)	2.3	10.0	4.1	1.8	2.5	11.4	4.7
Emergency/Special loan (N=16)	2.5	20.0	8.1	4.6	2.7	21.9	8.9

This table shows the effective interest rates. Source: Field Survey, 2013.

The above table indicates that when a client takes a personal loan of GH¢1000 payable monthly for six (6) months with an interest rate of 3.8 percent monthly for instance, he will effectively be paying about 4.4 percent (GH¢44.0) as effective interest rate, which is about 15.8 percent more than what he should have paid (GH¢38.0). The difference is as a result of the up-front deduction 3.0 percent processing fee. Similarly, an amount obtained under the SME loan product with a minimum interest rate of 2.3 percent, will end up attracting 2.5 percent effective interest rate, which is also about 8.5 percent more. In fact, comparing the stated interest rate to that of effective interest, in all cases, the customer pays at least 8.0 percent more. On the high side, a client who takes a loan with stated interest rate of 6.5 percent monthly for six months, effectively pays 7.7 percent, which is about 18.5 percent more. The point clearly is that effective interest rates show that the borrowers pay relatively higher interest rates than the stated interest rates regularly reported by these financial institutions.

It must be stressed that this analysis takes into consideration only the processing fees. However, there are other charges some of the institutions apply. For instance, in addition to the processing fees, an institution may charge application or registration fee of about GH¢20, which will further result in increase in the effective interest rate. This is because the principal actually disbursed will be reduced further by this amount. Another significant cost which result in even higher effective interest rate is the compulsory savings before a client qualifies for a loan. Also, there are transactional costs such as the transport cost to and from the MFI's office, opportunity cost of time spent in training programs organized by the institution, etc.

Although the survey does not specifically capture such data, there is a particular institution which requires that the client save an amount equal to 30 percent of whatever loan intended to be applied. Thus for instance, before a loan of GH¢100 can be granted, the client must have saved GH¢20 to the financial institution within a specific time span, usually three months. This amount does not yield any interest to the client. However, when the loan of GH¢100 is granted, the interest is computed on the total sum as if there were no savings supporting the loan. Besides, the amount in the savings account (compensating balance) is frozen pending repayment of the loan.

DISCUSSIONS

The above results call to question whether microfinance is indeed pro-poor concept in the Kumasi metropolis. We have grounds to argue that microcredit is becoming increasingly expensive for clients, who are undoubtedly the poor, not only in terms of the high stated interest rate, but also the method of computing the interest. Although the main reason for microcredit charging commercial interest rates is to ensure sustainability of the MFIs (Yunus, 2003), the interest rates of these institutions as observed from this study are certainly very high. Harper (1998) reports that the common annual interest rate of microcredit ranges from 24 to 36 percent. Contrary to this, our results show that, depending on the loan type, the average monthly interest rate ranges between 3.8 and 8.1 percent a month translating into 45.6 and a hooping 97.2 percent per annum respectively. Ironically, commercial banks that have been tagged as anti-poor due to their unfriendly lending standards charge average market interest rate of 30% per annum. This has raised concerns as to whether the plight of the poor is not worsened by microfinance (Jahiruddin *et al.,* 2011; Khan, 2008). However, this has been countered with the argument that "what really matters to the poor people is not the interest rate but access to credit" (Varley, 1995). As old as this argument in favour of microfinance may seem, it still appears valid because first, the number of MFIs keeps increasing and yet each has appreciable client base to support its operations; and second, the greater proportion of the informal sector still needs access to credit; and third, there are emerging frontiers of microfinance such as water and sanitation infrastructure provision where microfinance has proved viable (Afrane and Adjei-Poku, 2013).

CONCLUSION, POLICY IMPLICATION AND LIMITATIONS

The aim of this study to explore the effective cost of borrowing to microfinance clients with data from 35 MFIs in the Kumasi metropolis. The study has shown that microfinance institutions charge interest rates depending on loan products that interest rates of microcredit have become higher than commercial rates. The study finds that the effective interest rates range from 45.6 percent to a hooping 97.2 percent depending on the loan product. The study shows that cost of borrowing is higher than what the MFIs frequently state. In fact it has been shown that the clients effectively pay at least 8.0 percent or more than the stated interest rate.

This study recognizes the immense contributions of microfinance in poverty reduction; therefore, our adverse findings do not negate relevance of the microfinance concept. Instead, our findings draw attention to the high interest rates and other associated costs of borrowing presently charged by MFIs which obviously require immediate policy intervention. Our candid position is that the fact that the poor needs access to credit cannot justify worsening their plight with that same credit.

One limitation of this study is that it uses data from one administrative region in Ghana. Thus, the findings may not be representative of Ghana. It is, therefore, recommended that future research should investigate the effective cost of borrowing to microcredit clients in other regions so as to present a broader picture of effective cost of borrowing to microcredit clients for policy formulation. Another limitation of the study is that it relies on data provided by MFIs. Therefore, the validity of its findings depends on the extent to which these data are valid. Notwithstanding these shortcomings, it is the belief of the authors that the publication

of the results of the study will renew the interest of both researchers and policy makers in the modus operandi of MFIs in Ghana.

APPENDIX

Appendix: Computation of Effective Interest Rate

Loan Conditions:

Loan size: GH¢1000
Loan term: 3 months
Interest rates are shown in the table below
Method of calculating interest: Straight line method

Up-front commission (Processing fees):
Maximum = 6.5% on loan size
Minimum = 1.0% "
Average = 3.0%
Assumption: a maximum interest rate matches with maximum processing fees charged

Method applied for Effective Interest Rate (EIR) = $\frac{Total\ interest\ payable}{Net\ principal \times time}$

Where:
1. Net principal = loan size less commission charged.
2. Time = the term of loan
3. Total interest payable = $(P \times T \times R)$
   Where P = original principal, T = time (3 months), R = rate charged, and C = Processing fee charged.

Illustration

1. Calculating minimum EIR for personal/normal loan using the above information
   Interest payable = 1000 x 6 x 1.6/100 = GH¢96.00
   Processing fees (use minimum) = 1/100 x 1000 = GH¢ 10
   Therefore EIR = $\frac{96+10}{990\times6}$ = 0.01953 = 2.0% 0.0178 = 1.8%
   Repeat this process for minimum interest rate for all loan products

2. Calculating maximum EIR for personal/normal loan using the above information
   Interest payable = 1000 x 6 x 6.5/100 = GH¢390
   Processing fees (use minimum) = 5/100 x 1000 = GH¢50
   Therefore EIR = $\frac{390+50}{950\times6}$ = 0.0772 = 7.7%
   Repeat this process for maximum interest rate for all loan products

3. Calculating average EIR for personal/normal loan using the above information
   Interest payable = 1000 x 6 x 3.8/100 = GH¢228
   Processing fees (use minimum) = 5/100 x 1000 = GH¢30
   Therefore EIR = $\frac{228+30}{970\times6}$ = 0.044 = 4.4%

Repeat this process for average interest rate for all loan products

Table 6: Total Results

Institutions	Interest Rates/Other Chargers (%) Per Month				Effective Interest Rate (% Per Month)		
	Min	Max	Mean	Stdv	Min	Max	Mean
Personal/Normal Loan (N=30)	1.6	6.5	3.8	1.2	1.8	7.7	4.4
Group loan (N=18)	2.3	6.5	4.0	1.3	2.5	7.7	4.6
SME loan (N=19)	2.3	10.0	4.1	1.8	2.5	11.4	4.7
Emergency/Special loan (N=16)	2.5	20.0	8.1	4.6	2.7	21.9	8.9

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