

# The Impact of High Lending Rates on Borrowers' Ability to pay Back Loans in the Tamale Metropolis

Oteng Evans

School of Business, Valley View University-Techiman Campus  
PO box 183, Techiman Brong Ahafo, Ghana  
E-mail: [evansoteng@yahoo.com](mailto:evansoteng@yahoo.com)

Luthur Ntim Adjei

School of Business, Valley View University-Techiman Campus  
PO box 183, Techiman Brong Ahafo, Ghana  
E-mail: [evansoteng@yahoo.com](mailto:evansoteng@yahoo.com)

## Abstract

The main purpose of the research was to find out the impact of high lending rates on borrower's ability to pay back loans in the Tamale Metropolis. Cross-sectional survey method was adopted. Structured questionnaires were distributed to respondents within Tamale Metropolis to solicit their views concerning lending rates. 200 questionnaires were distributed but 101 respondents were drawn for data collection. Non-probability sampling method basically random sampling and convenience sampling were used. At the end of the study, it was found out that the lending rate that is deemed acceptable by both borrowers and lenders was 25%. On the other hand, the respondents (borrowers) were also of the view that the current lending rate was rather too high. It was also found out that high lending rates affected borrowers' ability to pay back because they cannot make enough returns from their businesses to service their loans. Based on this notion, the borrowers further said that high lending rates affected their businesses negatively in the sense that they are not able to make enough profits to grow their businesses which is the primary reason why they opted for the loan facility. It can be concluded that lending rates impact on the operations of businesses whether high or low. Central Bank as well as all financial institutions that have the ability to lend money should adopt Interest Rate Reduction Refinancing Loan (IRRRL) into their business operation so that borrowers can invest to yield enough profit to service their loans and also make some profit for growth.

**Keywords:** Lending Rates, Loan Facility, Financial Institutions and Interest Rate Reduction Refinancing Loan (IRRRL)

## 1. Introduction

Banks are in business to make profit. Banks across the country are following increasingly differentiated pricing strategies aimed at maximizing profits since this is the ultimate goal of any business organization. These strategies are more or less dependent on the Bank of Ghana's Monetary Policy Committee (MPC) directives regarding inflationary trends and prime rates. In their bid to attract customers, increase market shares and to stay competitive as well as operate within the ambiance of laws governing banking, Banks in Ghana then come out with attractive products and services such as giving of loans that intend to attract the customers (borrowers) and charge certain fees and commissions. Lending rates are the charges made to borrowers when they take loans from the bank. The Lending rate affects or impacts on customers (borrowers) and the banks differently. Bank customers, investors, government and all those affected by lending rates and the banks themselves have in recent times reacted variedly to changes in prime rate and base rate, fees and commissions.

While some argue that Lending rates are high and scare away borrowers and other investors, banks also argue that operational cost and cost of providing efficient services are exorbitant and need to recover these costs in order to stay in business. Thus the total revenue must be greater than the total cost ( $TR > TC$ ). Banking Act 2004 (Act 673) Section 23 (1) emphasized that, every bank is supposed to create awareness to the customer on the amount of charges made, either in real values or percentages as well as interest to be debited on borrowers account's 14 days in advance. The full list of charges and lending rates are to be displayed at bank's branch offices or must be provided to customer on demand. Due to the increase in number of banks, there has been a keen competition among banks to gain a proportion of the market share, Ghana Banking Survey, (2009).

## 2. Literature review

Cost of doing private business in Ghana is increasingly becoming more expensive as the days go by. Financial institutions are increasing rates they charge on borrowed amounts and unfortunate for private businessmen and customers in general, the government is competing with them when it comes to borrowing. Most banks find lending to private customers risky and therefore they increase the threshold of service charges that are associated with borrowing to sieve the kind of clientele that can qualify for such loans (Paget, 2007).

Customers find it difficult to pay back their loans due to high lending rates and charges. Untamed inflation is also devaluing the currency and presenting borrowers with more debt servicing problems considering the fact that they have to put these borrowed monies to profitable use before they can pay back. This study therefore seeks to find out from an academic lens and from customers' point of view, the impact that lending rates have on their private business and the extent to which it impedes their growth.

According to Mankiw (2002), the quantity theory of money states that the central bank, which controls the money supply, has the ultimate control over the inflation rate. If the central bank keeps the money supply stable, the price level will be stable. If the central bank increases the money supply rapidly, the price level will rise rapidly.

The central bank can also strongly influence market interest rates through its open market operations; there are two paths through which this influence works. First, open market operations have a direct impact on the market rate on the government securities, which will in turn impact on other market rates. Second, the central banks open market operations change the level of reserves available to the banking system, directly affecting the amount of money banks have to lend out, and therefore the rate banks charge on loans. For example, an open market sale of securities by the central bank will tend to increase rates on Government securities and will reduce the amount of reserves in the banking system; with fewer reserves, banks have less money available to lend and there is a tendency to raise loan rates. The total effect of such a policy action is therefore a reduction in money and credit availability and upward pressure on market interest rates. (Leisenring 1980)

## 2.1 Demand for credit

The role of credit in a society is to bridge the gap between financial requirements of businesses and the financial assets of businesses. It can also be seen as an important instrument for improving the welfare of the poor directly (consumption smoothing that reduces their vulnerability to short term income shocks) (Binswanger and Khandker 1995; Heidhues 1995; Nwanna 1995) and for enhancing productive capacity through financing investment by the poor in their human and physical capital. According to Aryeetey et. al (1994), demand for credit can be categorized into three, namely; perceived demand for credit, potential demand for credit and revealed demand for credit. Perceived demand for credit is represented by a situation where enterprises that assume to be in need of cash, mention finance as the constraint. Potential demand is characterized by a desire for credit which is not actualized due to market imperfections and institutional barriers. Revealed demand is characterized as written application for financial support at a given rate of interest.

The theories of the demand for assets such as the transaction, precautionary, and portfolio model may be applied to model the demand for credit to the private sector. At the theoretical level, most studies of demand for credit include an economic activity variable such as real GDP or industrial production, financing cost (bank lending rates) and expected inflation.

There is some disagreement in literature with regards to how economic activity affects credit demand (Calza, Gartner and Souza, 2001). A number of empirical findings confirm a positive relationship between economic activity and demand for credit based on the theoretical underpinning that strong economic growth would have a positive effect on expected income and profits and, thus, on the overall financial conditions of households and corporations.

Kashyap et al. (1993), argue that economic growth provides an opportunity to private sector agents to support higher levels of indebtedness and consequently, to finance higher consumption and investments through credit. Thus, in periods of boom, with businesses keen to expand output and consumers keen to spend in anticipation of rising incomes, this situation is likely to culminate in high demand for bank loans. Besides, expectations of higher activity and productivity can lead to a larger number of projects becoming profitable in terms of expected net present value and, hence, to a higher demand for credit to fund them.

By contrast, some empirical studies conducted on the US do not support the existence of a stable relationship between credit and some activity. Some writers even argue that the relationship between the two variables may be negative if it existed (Bernanke and Gertler, 1995; Friedman and Kuttner, 1993). These writers argue that an increase in contemporary productivity leads to a rise in output and ultimately profits. Based on this argument, during boom periods, companies might prefer internal financing by ploughing back of profits and reduce the relative proportion of external financing. This argument is supported by the pecking order theory which states that profitable firms which generate cash internally may have less need for external financing. On the other hand, in recessions, when both disposable income of households and the profitability of firms are likely to decline, households and corporations may increase their demand for bank credit in order to smooth out the impact of lower income and profits (Calza et al., 2001). Thus, the relationship between demand for credit and economic activity is an empirical question.

## 2.2 Interest Rates

The cost of loans which is represented by bank lending interest rates is another variable that influences the

demand for credit. Although, there is consensus on the use of bank lending rates as an argument in the demand for credit model, some studies argue that the cost of loans should be adjusted to reflect the opportunity cost of bank loans. For instance, Friedman and Kuttner, (1993) asserted that the demand for loans will depend not only on the own price of the borrowed funds, but also the price of funds obtained from other internal or external sources. There is however a divide on the relationship between the cost of loan (interest rate) and demand for credit. While some argue that the relationship is negative, (Weiss, 1981; Stiglitz, 1989; and Besley, 1994) others consider it to be neutral. Those who argue for the negative relationship between demand for credit and the interest rate advocate that high interest negatively affect demand for credit because only limited borrowers with high risk projects may have their demand satisfied. Prominent among those who hold this view are Stiglitz and Weiss (1981), Stiglitz (1989) and Besley (1994). Their argument is based on the fact that high interest rates encourage adverse selection of loan seekers. Those who take high risk and get their loans approved are those with high default rates. Nehman (1973) in his work on the analysis of demand for rural credit among farmers in Sao Paulo, Brazil, observed that borrowing costs strongly affect the willingness of the rural poor to seek loans from the formal sector. Although the work by Aryeetey et. al. (1994), on the supply and demand of finance of small enterprises in Ghana, did not make any explicit relationship between the interest rate and demand for credit, it did acknowledge implicitly that demand for credit at 30% interest rate was somewhat weaker among medium-sized firms.

### 2.3 Inflation

Inflation expectation of borrowers is another important variable that affects the demand for bank credit. The effect of expected inflation on demand for credit could be positive or negative depending on the basis of argument. If it is expected that increase in the rate of inflation will be greater than the increase in the rate of interest, then the demand for credit would increase by offsetting the effect of increase in nominal interest rate. This implies that the demand for bank credit is directly related to the rate of inflation. Another source by which the impact of inflation on demand for credit can be determined is through the private business sector. If high inflation is associated with the highly variable rate of interest, it may increase the risk associated with the return to investment. This leads to the negative impact of the rate of inflation on the demand for bank lending.

There are some other important factors that affect the demand for credit. These are supply - side factors, such as requirements for collateral or certain procedural specificities, which lead to rationing in the financial market and restrict some people from using one service or the other. Zeller and Sharma (2002) point out that many of the Ghanaian households which do not apply for formal loans are indeed discouraged by such constraints.

### 3 Methodology

The study was based on a cross-sectional survey method by taking a sample of the target population through questionnaires and interviews to determine the relationship between the two variables, lending rate and borrowing.

The target population of this study was based on borrowers (customers of banks) in the Tamale Metropolis. A total of 200 questionnaires were distributed but 101 respondents were drawn for data collection. However, random sampling was used to give each member of the population an equal and known chance of being selected. Since there are several banks in Ghana with large populations of customers, this method helped in getting an unbiased sample. Also, convenience sampling was used since the interest was in getting an inexpensive approximation of the truth. As the name implies, the sample was selected because they are convenient. This non-probability method was chosen to help get the experts on technical issues that the public domain could not provide.

Quantitative data was used in this research study. Qualitative information including bank lending rates was also used. Qualitative data is a form of data that places premium on the quality of the data instead of the quantity of the data.

Primary source of data was used in the form of questionnaire administration to respondents within the Tamale metropolis. The questionnaires were designed to reflect the objectives of the study. Other forms of secondary data such as average interest rates, journals and academic literature were also used in the study. The questionnaire is structured with a mixture of open and closed ended questions, designed to enable us conduct an in-depth investigation on the customer's view on the research topic. All customers respond to the same set of questions in the predetermined order. The questionnaire is devised to poll the awareness and the views of the customers on the issue of lending rate and how it affects them. The main instrument for data collection was questionnaire and it was pre-tested on a smaller group of respondents as a pilot basis. Through this method, errors were corrected until the questionnaire became valid and objective for general distribution.

#### 4 Analysis

Customers of banks and other financial institutions borrow for a number of reasons and their ability to pay back their loans can be attributed to a number of factors which include inflation and lending rates at which they borrowed the loans. Inflation can be described as the instability or frequent change in the prices of goods and services over a period of time within an economy while lending rate is the rate at which customers are lent money by banks and other financial institutions. This section seeks to analyze and explain behavioural pattern and trend for the variables inflation and lending rate (average base rates) 2005-2012. Over the years, there have been changes in inflation and lending rates and it is depicted in the graph below;

From fig 1.1 it could be seen that at the end of 2005 the rate of inflation stood at 15.1% and fell by 4.2% to 10.9% in 2006. In 2007 it decreased slightly by 0.2% to 10.7%, while at the end of 2008 it rose to 16.5% which represented an increase of 5.8%.

In December 2009 it increased to 19.3% which represented an increase of 2.8%. Also the end of December 2010 experienced a substantial fall from 19.3% to 10.9% which represented a decrease of 8.4%. In 2011 it fell marginally by 2.2% to 8.7% and finally in 2012 it rose slightly to 9.5% representing an increase of 0.8%. The volatility in inflation rates could be attributed to the high rate of instability in the Ghanaian economy of which the Tamale metropolis is a part of. (Note 1)

From fig 1.2 end of year average lending rate for the selected banks in 2005 was 22.24% and fell to 19.24% in 2006 with a change of 3%. At the end of 2007 it rose to 19.49% with a slight increase of 0.5%. At the end of 2008 it increased significantly to 27.70% a change of 8.21%. At 2009 year end it remained at 27.70% with zero change. 2010 showed a drop of 5.7% to 22% and finally sustained a drop to 16.96% for 2011 and 2012 respectively. This shows the level of volatility of the average base rates of the various banks and the borrower is also affected due to the high instance of instability. (Note 2)

From fig 1.3, it could be seen that the two variables moves together to the right. It shows that the two variables are positively skewed to the right. The scatter graph above shows that there is a strong positive correlation between the two variables. (Note 3)

From fig 1.4, it could be seen that; in the first instance the two variables fell, became constant, rose again, attained a maximum, fell and became slightly constant. Hence the line graph of the two variables has similar features, with inflation rates deviating slightly from average base rates. From the graph the movement of the two variables is very similar which support the alternative hypothesis. (Note 4)

From table 1.1 below the mean values were 12.7 and 21.535 for inflation and lending rates respectively. The degree of error is 1.33951 and 1.512623 respectively depicting that average lending rates have a high degree of error than inflation rates. The median for both variables are 10.9 and 20.745, while the mean is 10.9 and 27.7 respectively. The standard deviation recorded was 3.788705 and 4.278344 which depicts that the data for average base rates is more spread from the mean than the data for inflation. The data for both variables are positively skewed to the right with values of 0.83974 and 0.623382. The minimum and maximum values for both set of data are within the range 8.7-19.3 and 16.95-27.7 respectively. (Note 5)

Out of the One hundred and one (101) respondents, ninety-nine (99) of them are account holders; this makes 98% with only 2% not having an account of any form. Table 1 shows the frequency and percentages of those who are account holders and those not.

(Note 1)

The information in Table 2, show how customer feel about bank charges in general. 32.7% think in general all bank charges are too high while 47.5% think it is high. The respondents on the lending rate of Ghanaian banks reveal that, the bank lending rates are too high or just high. These people were mainly bankers and customers with deposit account. (Note 2)

In Table 3 the opinion on the effects of present lending, it is very clear that bank lending rate affects customers so much with 5.9% having no problem with the charges. (Note 3)

#### 5 Summary of Findings, Conclusion and Recommendations

Finding out people's ability to pay back loans they have taken from the bank cannot be discussed outside the scope of major external factors such as inflation and the lending rates as authorized by the Central Bank of Ghana.

In the course of the study, it was found out that inflation rates have not been that stable for more than seven years now as can be seen from figure 1.1. The volatile nature of inflation contributed one way or the other to the lending rates of the individual banks which were selected for consideration in this study. It was found out that 2009 was the year in which the inflation rate was at its peak at a rate of 19.3% and this could partly explain the reason why the average lending rates for that same year was pegged at 27.7%. Likewise the inflation rates which has been quite unstable, it was also found out that there was some close connection between inflation and average lending rates of the banks because in the event of an increase in inflation rates, average lending rates also rose with it and this relationship can be described as direct. This direct relationship also has some



consequence on the amount of money that customers can borrow from the bank, the interest that is charged by the banks and customers' ability to honour such debts when the time is due.

In the findings, it was realized that more than eighty percent of the respondents think that the interest rates that their banks charge are way too high and this has affected their demand for bank loans. The very few who had the courage to go for loans also default at some time indicating the difficulty they have in repaying loans to the banks. The respondents therefore suggested to the banks possible ways through which they can attract customers to come for loans and most of these recommendations centered on the reduction in interest rates by their respective banks in the Tamale metropolis.

### Conclusion

From the above findings, a number of conclusions can be drawn and they include the following:

There are other external factors which trigger the increase in the demand for loans by customers. Some of the major factors that contribute to the high lending rates by banks in the Tamale metropolis are due to the fact that the Bank of Ghana places high interest rates on loans that the commercial and merchant banks go for and these banks also eventually pass on the cost to the customers for the sake of profits. This contributed to the soaring of interest rates to the tune of 27% in 2009 and 2010.

The respondents to whom questionnaires were administered expressed their displeasure with the high lending rates of the various banks. However, irrespective of their displeasure with the lending rates charged, they are in some way forced to go for these loans in order to make sure their businesses survive. The impact of these high lending rates on customers is not favourable and the recurrent effects that it has on the economy as a whole is rather adverse. There will be less people showing interest in the demand for loans and this will shrink private sector development which is very critical for the development of a young nation like Ghana.

### Recommendations

During the research, majority of customers had suggestions on how banks can improve their charging policies to benefit both stakeholders. Some of these recommendations are contradictory because, what suited one customer, did not suit the other. These suggestions are listed below:

The customers suggested that an incentive that banks can give their customers is to decrease the interest rate on lending. Most economists advocate independent central banks to limit the influence of politics on interest rates, Bernanke (2007). An example of such a product is the Interest Rate Reduction Refinancing Loan (IRRRL). This will encourage more people to borrow and increase the clientele base of banks.

According to Leisenring (1980) some countries and states in the United States of America, usury laws are used to encourage the allocation of credit away from certain types of borrowers. Usury laws put ceilings on the rates that lenders can legally charge on loans; usury ceilings are most frequently applied to mortgages and consumer loans. When market rates rise above the legal ceilings, there is a profit incentive for banks and other lenders to allocate scarce credit to other types of loans. Ghana can practice the usury laws to monitor the lending rates happening in the economy.

### References

- .Bank of Ghana. Annual Report 2009 Banking Act 2004 (Act 673) Section 23 (1) [www.bog.gov.gh](http://www.bog.gov.gh)
- Ghana Banking Survey (2009)
- Paget, J. S. (2007) *Paget's Law of banking* (SBN: 1405712988, ISBN13: 9781405712989, hardback .Published by Lexis Nexis Butterworths, 13th edition.
- Mankiw Gregory N., (2002) *Macroeconomics* 6th Sixth Edition Publisher: Worth Publishers;
- Leisenring, C. A. (1980). *High interest rates*. Library of Congress, Congressional Research Service in [Washington, DC] .
- Binswanger, H.P. & Khandker, S.R. (1995). The impact of formal finance on the rural economy of India. *Journal of Development Studies* 32(2): 234-262
- Aryeetey, E., Baah-Nuakoh A, Duggleby T, Hettige H and Steel, W.F (1994), "Supply and Demand for Finance of Small Enterprises in Ghana", World Bank Discussion Paper, No. 251, African Technical Department Series, World Bank, Washington D.C.
- Calza, A., Gartner, G. & Sousa, J (2001) Modelling the demand for loans to the private sector in the euro area. April 2001.
- Kashyap, A. K., and J.C. Stein and D.W. Wilcox (1993) 'Monetary Policy and Credit Conditions: Evidence from the Composition of External Finance', *American Economic Review*, 83, 78-98.
- Stiglitz, J. E., and A. Weiss, 1981 "Credit Rationing in Markets with Imperfect Information", *American Economic Review*, Vol. 71, No. 3.
- Bernanke, B.S. and M. Gertler (1995). 'Inside the Black Box: The Credit Channel of Monetary Policy Transmission' *Journal of Economic Perspectives*, 9, 27-48.

Friedman, B. and K. Kuttner (1993) ‘Economic Activity and the Short-Term Credit Markets: An Analysis of Prices and Quantities’, *Brookings Papers on Economic Activity* 2, 193-266.

Stiglitz, J. E., 1989 “Financial Markets Development”, *Oxford Review of Economic Policy*, Vol. 5, No. 4, p. 55-68

Besley, T., (1994) “How do Market Failures Justify Intervention in Rural Credit Market”, *Research Observer*, Vol. 9, No. 1, p. 27-47

Nehman, G. I., 1973. “Small Farmer Credit in a depressed Community of Sao Paulo, Brazil” PhD dissertation, Department of Agricultural Economics and Rural Sociology, Ohio State University, U.S.A.

Zeller, M. and Sharma, M. (2002). ‘Access to and demand for financial services by the rural poor: A multicountry synthesis’. In: Ma. Zeller and R. L. Meyer (Eds.), *The Triangle of Microfinance: Financial Sustainability, Outreach, and Impact* (pp.19-45). Baltimore, MD and London: Johns Hopkins University Press.

Notes

Note 1.

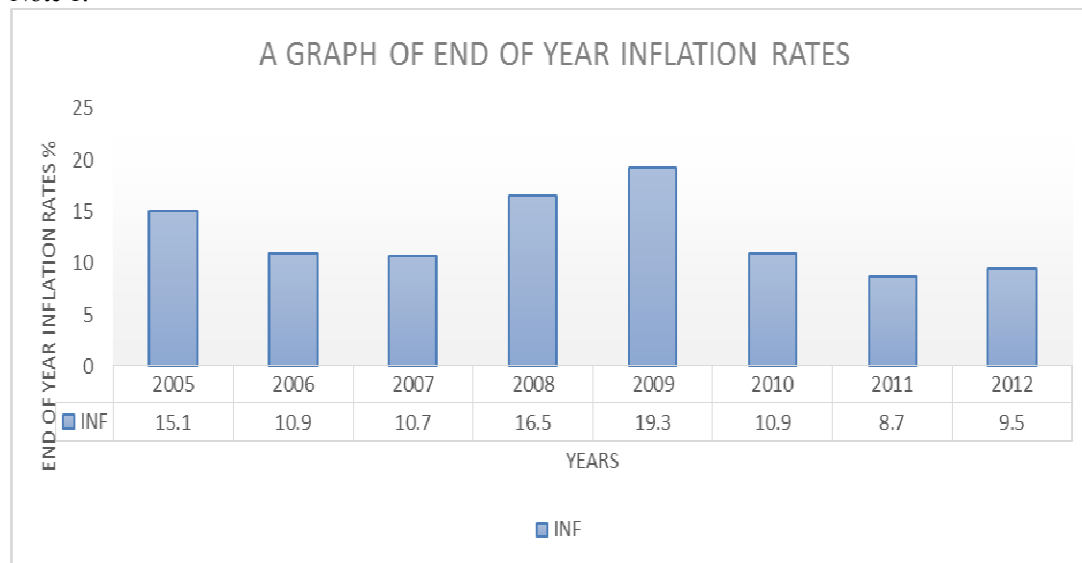


Fig 1.1 A Graph of End of year Inflation Rates

Note 2

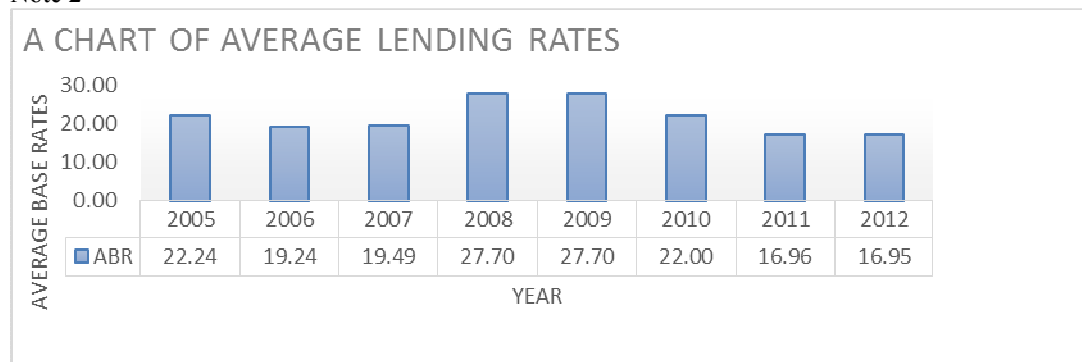


Fig. 1.2 A Graph of Average Base rates

Note 3

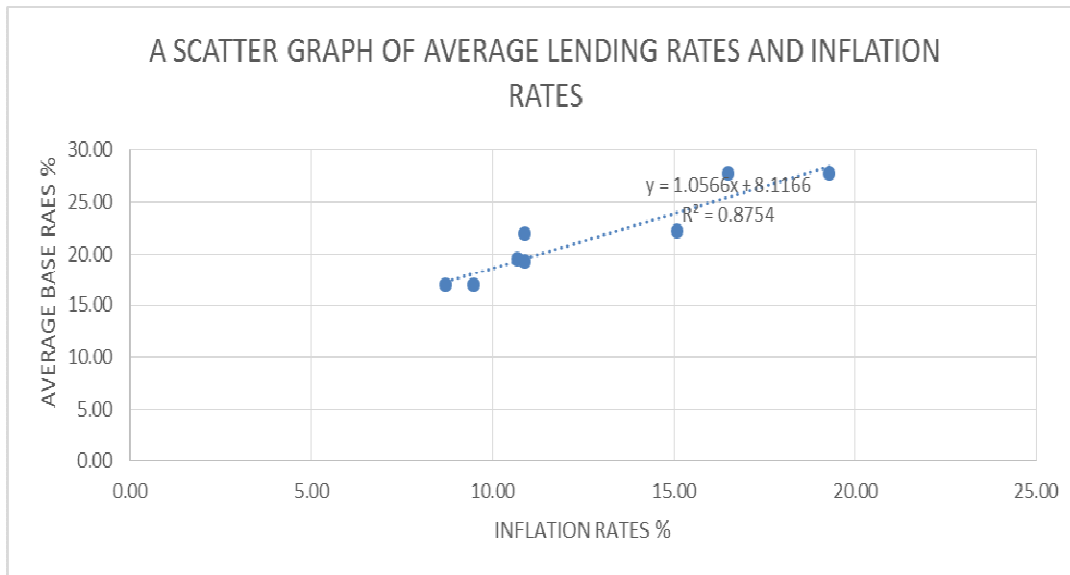


Fig 1.3 A Scatter Graph of inflation and lending Rates

Note 4: Table 1 showing summary of Inflation and Lending Statistics

<i>INFLATION</i>		<i>LENDING RATES</i>	
Mean	12.7	Mean	21.535
Standard Error	1.33951	Standard Error	1.512623
Median	10.9	Median	20.745
Mode	10.9	Mode	27.7
Standard Deviation	3.788705	Standard Deviation	4.278344
Sample Variance	14.35429	Sample Variance	18.30423
Kurtosis	-0.67843	Kurtosis	-0.9964
Skewness	0.83974	Skewness	0.623382
Range	10.6	Range	10.75
Minimum	8.7	Minimum	16.95
Maximum	19.3	Maximum	27.7
Sum	101.6	Sum	172.28
Count	8	Count	8

Note 5

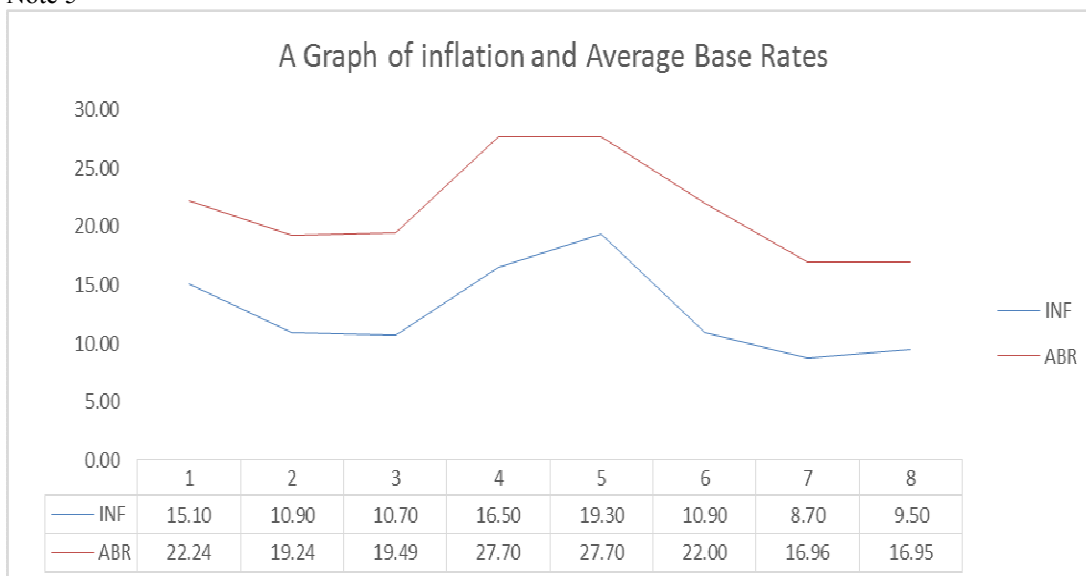


Fig 1.4 A Graph of Inflation and Average lending rates

Note 6. Table 2. Account Holders

Response	Frequency	Percent	Cumulative Percent
Yes	99	98	98
No	2	2	100
Total	101	100	

Source: Survey Data

*Table 2. Customers' Impression on Interest Rates*

Note 7. Table 3

Rating of Interest Rate Charges	Frequency	Percent	Cumulative Percent
Too High	33	32.7	32.7
High	48	47.5	80.2
Just Right	14	13.9	94.1
Low	4	4	98
Too Low	1	1	99
No Opinion	1	1	100
Total	101	100	

Source: Survey Data

Note 8. Table 4

Opinions	Frequency	Percent	Cumulative Percent
Not At All	6	5.9	5.9
Little	7	6.9	12.9
Normal	35	34.7	47.5
Much	36	35.6	83.2
Very Much	15	14.9	98
Unbearable	2	2	100
Total	101	100	

Source: Survey Data



The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:  
<http://www.iiste.org>

## CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

**Prospective authors of journals can find the submission instruction on the following page:** <http://www.iiste.org/journals/> All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

## MORE RESOURCES

Book publication information: <http://www.iiste.org/book/>

## IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digital Library, NewJour, Google Scholar

