Original Research Paper

Interest Rate and Loan Default in Financial Institutions

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Abstract: The study was carried out to examine the relationship between interest rate and loan default in Pride Microfinance in Ishaka-bushenyi municipality, Bushenyi District, a case of Pride Microfinance Ishaka branch. This study was guided by a mixed research design. Questionnaires and interviews were used as data collection instruments. A purposive sampling technique was used to sample 50 respondents. It was found out that there are high costs of getting business loans by borrowers because of a lack of collateral. The high interest rate level on the borrowers leads to loan default among business borrowers because the profit margin is very low. It was also found out that the possible solutions to reduce loan default were proper loan assessment, motivating good loan clients, reducing interest rates and proper loan monitoring. Also, financial institutions should tighten and follow the possible solutions to minimize high interest rates to favour business borrowers for greater productivity. It was recommended that though the availability and accessibility of loanable funds is very important, the Institution could consider lowering interest rates to enhance loan on time loan repayment. The Institutions could consider the establishment of micro insurance to protect customers. There should be increased monitoring of loan to ensure that funds are not diverted, loans are used for the intended purpose and repayment made on time. The study concluded that financial Institutions have to reduce the costs of getting business loans and interest rate which would encourage borrowers to obtain business loans to effectively operate their business activities and as well as repaying the loans.

Keywords: Business, Financial Institutions, Interest Rate, Loan.

1. Introduction

Interest rates can be classified as either short-term or long-term. For example, you can take out a home loan with the interest rate fixed for 20 years. This is considered a long-term interest rate. You make the same payments over these years, regardless of whether interest rates rise or fall. Alternatively, when you use your credit card or take out a personal loan you are borrowing money at an interest rate that can change in the short term. As a general rule, short-term interest rates tend to be higher than long-term interest rates [1].

Traditional finance theory argues that as the size of a loan expands, the interest rate on that loan rises to accommodate the increased risk associated with the loan. However, utilizing firm-level data of the Barbadian banking industry, it is observed that the smaller the loan's size, the greater the interest rate applied, and vice versa. Yet, using a fixed effect panel data framework, this article also shows that the interest rate differences among loan sizes can be mainly explained by the borrower's characteristics for local banks while for foreign banks, its operating characteristics that are the most important factors [1] [2] [3].

International organizations are coming to the realization that micro finance Institutions (MFIs) are veritable and effective channels to ensure programme implementation effectiveness, particularly in poverty alleviation projects and firsthand knowledge of the needs and interest of the poor [4]. According to [4], the World Bank Sustainable Banking with the Poor project (SBP) in mid-1996 estimated that there are more than 1,000 microfinance institutions in over 100 countries, each having a minimum of 1,000 members and with 3 years of experience.

The chance that finance institution in Nigeria may not receive its money back from business borrowers (plus interest) is the most common and often the most serious vulnerability in Finance institution [5]. According to her since most finance loans are unsecured, default can quickly spread from a handful of loans to a significant portion of the portfolio. This contagious effect is worsened by the fact that finance portfolios often have a high concentration in certain business sectors [6] [7].

2. Literature Review

In Rwanda after the 1994 Genocide, Rwanda started rebuilding its economy, peace and political stability, re-established sound macroeconomic and structural policies backed by substantial donor assistance. As a result, the impressive macroeconomic stability has led to per capita gross domestic product (GDP) nearly double from $336 in 2006 to $625 in 2011 [8]. The Financial sector reforms in Rwanda started in 1994 with the establishment of five banks after the genocide, the main areas of reform were that the central bank of Rwanda embarked on strengthening prudential supervision and regulation of the financial sector. In 2007, the Government of Rwanda developed a comprehensive and detailed financial sector assessment plan based on the 2005 financial sector assessment program [8].

The developments were supported by the Central Bank of Uganda within the framework of systemic stability as supervision and regulation with efforts to ensure that only fit and proper institutions were granted banking licenses. The lack of an efficient financial services industry has held back, many would-be entrepreneurs including business borrowers with viable business plans from realizing their own potential [9] [10] [1]. Women in agriculture, in particular, have been excluded as loan candidates in developing communities. Therefore, it is against this background that the researcher conducted a study on the relationship between high interest rate and loan default in financial institutions in Uganda with reference to business borrowers in Ishaka-bushenyi municipality, Bushenyi District.

It was observed from the reviewed papers that there are so many drawbacks in Interest Rate and Loan Default in Financial Institutions a case of Pride Microfinance Ishaka Branch. the Interest rates are ordinarily the drivers of financial institutions' financial performance [8]. They are the ones that determine the size of the profit margin for every transaction between a financial institution and its customers. Yet, there are many reported cases of defaults in loan repayment in Microfinance Institutions (MFIs). When business borrowers' default in repaying the credit facilities advanced to them, the MFI concerned will be negatively affected. There will be limited finances to run its operations and also to loan out to other potential borrowers. The challenge of non-repayment of borrowed loans for a long time by the client will lead to the untimely collapse of the financial institution [11] [12] [13]. The MFIs play a huge role in enhancing the accessibility of financial services especially to the poor and low-income earners mostly business borrowers in the society. This implies that any challenges affecting these institutions are bound to have far reaching impact on the

society and the country's economy at large [14] [15] [2]. These drawbacks form the bedrock at which this research reckons on and further explains why it is necessary to examining the relationship between interest rate and loan default in financial institutions with reference to business borrowers in Ishaka-Bushenyi municipality, Bushenyi District.

This research will significantly be of great importance to the banking sectors in Uganda as it will give appropriate information about loan improvement, recovery and security. It will also help in educating the financial institutions and their clients on the prone and corns of lending and borrowing.

3. Methodology

This is a case of pride microfinance management staff ishaka branch in Uganda. The methods that were used to collect and analyze data are:

- Research design
  The researcher employed mixed design which was based on quantitative and qualitative approaches in order to establish the extent and rate of the problem. Emphasis was put on collecting data from top management and other staff members. Questionnaires and interview guides were employed for data collection from the targeted populations.

- Study Population and Sample
  The study involved 50 people from Ishaka-bushenyi municipality, Bushenyi District including; the management staff of Pride Microfinance Ishaka branch; Loan officers, auditors, cashiers as well as managers.

- Sample size and Sampling Techniques
  A purposive sampling method was used to sample 50 respondents which included the top 5 administrators of pride microfinance and 45 other staff were all purposively selected to highlight issues relating to high interest rates and loan default in financial institutions.

- Instruments for Data Collection
  Researcher formulated questionnaires and Interview guide were used as instrument for data collection in this study. The researcher designed an interview guide for the top management staff and a questionnaire for other staff of pride Microfinance.

- Validity of Research Instruments
  The validity of the instruments was ascertained by subjecting the initial draft to face and content validation. Two experts from the Department of Business Administration option in microfinance management, Kampala International University were used. The experts examined the items in relation to language clarity and appropriateness of the items in eliciting the required information from the respondents and made appropriate corrections. The items were modified based on the observations and corrections of the experts before the final instrument was administered.

- Reliability
  Reliability was done by administering the test to an appropriate financial institution administrator, then after, two weeks, the same test was administered to the same group of subjects, and the two sets of scores were correlated using Pearson product-moment correlation and results evaluated. The coefficient was above 0.7 and the instrument was reliable.

- Data Analysis
  Both quantitative and qualitative data analysis was used. After the researcher had collected the required data from the respondents, it was organized into groups, coded and analyzed. The researcher analyzed quantitative data using tables, coding, frequencies and percentages to facilitate easy presentation, analysis and interpretation.

4. Finding and Discussion

In this section, the findings of the study are presented, analyzed and interpreted.

4.1. Demography

In this section, the researcher asked the respondents to indicate their sex, age, marital status, and level of education. Table 1 summarizes the respondents' sex characteristics.

Table 1 indicates that the majority of the respondents 29 (58%) were males while the least 21(42%). This means that there are many males working in Pride Microfinance than females.

Table 1. Sex of the Respondents

Sex	Frequency	Percentage (%)
Male	29	58
Female	21	42
Total	**50**	**100**

Table 2 shows the responses about the age of respondents. Table 2 indicates that the majority of the respondents 16 (32%) were aged between 30-34 years while the minority were between 40 years and above with a frequency of 07 giving 14%. From the table above it was observed that the workers of Pride Microfinance were mainly in their early adulthood which means they are still vibrant and active in services.

Table 2. the Age of the Respondents

Age	Frequency (F)	Percentage (%)
25-29	13	26
30-34	16	32
35-39	14	28
40 & above	07	14
Total	**50**	**100**

Table 3 shows the marital status of the respondents in Pride Microfinance. Findings in table 3 indicate that the majority of the respondents were married (56%) while the minority (44%) were single. This implies that most of the employees from Pride Microfinance had additional social responsibilities and were capable of performing the financial activities with commitment.

Table 3. Marital Status of Respondents in Pride Microfinance

Status	Frequency (F)	Percentage (%)
Married	28	56
Single	22	44
Total	**50**	**100**

Table 4 shows the summary of responses from respondents about their respective levels of education. Table 4 indicates that majority of the respondents 22(44%) were bachelor degree holders, followed by the diploma holder 17(34%) while the minority had certificates represented by a frequency of 5(10%).

Table 4. Level of Education of Staff of Pride Microfinance

Level of Education	Frequency	Percentage (%)
Certificates	05	10
Diploma	17	34
Bachelor Degree	22	44
Post graduate & above	06	12
Total	**50**	**100**

The staff with diplomas and postgraduates were few because they possessed professional skills related to financial and loan management. Hence, they are highly skilled, risk controllers and possess a high degree of accuracy when discharging their duties.

4.2. The Costs of Getting Business Loans by Borrowers in Financial Institutions

The researcher asked the respondents to give their views on the costs of getting business loans from borrowers in Pride Microfinance. Table 4 shows respondents′ views on the costs of getting business loans by borrowers in Pride Microfinance, Ishaka-Bushenyi municipality.

The indicators used for this research are: 4 represent Strongly Agree, 3 represent Agree, 2 represent Disagree, 1 represent Strongly Disagree.

Table 4. Respondents Views on The Costs of Getting Business Loans by Borrowers

SN	Variable Costs of Getting Business Loans	Response			
		4	3	2	1
1	PRIDE MICROFINANCE in Ishaka-Bushenyi municipality provide loans to business borrowers.	30	12	06	02
2	There are high costs of getting business loans by borrowers in PRIDE MICROFINANCE of Ishaka-Bushenyi municipality	25	14	07	04
3	Some business borrowers often run into problems shortly after beginning Business operations because of inadequate capital	22	18	03	07
4	High financial and operating leverage exposes the borrowers to substantial depreciation and maintenance expenses when sales of business products decline	18	21	06	05
5	Some business borrowers lack collateral security to enable them to obtain a loan from MFIs	29	14	01	06
6	Business borrowers are faced with the cost of strong competition while accessing products from financial institution	20	16	05	09
7	PRIDE MICROFINANCE insists on collateral to guarantee loans for group business borrowers	19	17	08	06
8	Borrowers experience a cost of high interest rates while obtaining credit from financial institutions	31	11	03	05
	Total (Average)	**24.3**	**15.3**	**4.9**	**5.5**

The findings from the field indicate that majority of the respondents 42 (84%) agreed that Pride Microfinance in Ishaka-Bushenyi municipality provide loans to business borrowers whereas the minority 08 (16%) disagreed. This means that obtaining loans leads to the formation of groups of relatively safe borrowers, hence limiting the transfer of risk from the group to the individual borrowers.

The findings also show that majority of the respondents 39(78%) also agreed that there are high costs of getting business loans by borrowers in Pride Microfinance of Ishaka-Bushenyi municipality whereas the least frequency of the respondents 11 (22%) disagreed. This indicates that if the loan term is too short, the business borrower fails to generate revenue to enable him/her to make repayments while a longer loan term may make the client extravagant and the client may in the end fail to pay back.

The findings continue to show that the majority of the respondents 40 (80%) accepted that some business borrowers often run into problems shortly after beginning business operations because of inadequate capital while the minority 10 (20%) disagreed. This means that owners underestimate the costs of opening the doors for business and overestimate the speed with which they can turn a profit.

The findings from the field also indicate that the majority of the respondents 43 (86%) agreed that some business borrowers lack collateral security to enable them to obtain a loan from Pride Microfinance whereas the minority of the respondents 07 (14%) were not in line with this. This highlights that for individual loans, security is a requirement and the Pride Microfinance takes security like land titles, and vehicle logbooks which are kept in custody.

Results from the field with the majority of the respondents 36(72%) also agreed that Pride Microfinance insists on collateral to guarantee loans for group business borrowers whereas 14(28%)

of the respondents disagreed. This implies that collateral is put in writing in the form of an agreement such that on default by a member, the group members would be liable to pay the loan.

Study findings from the majority of the respondents in the field 42(84%) agreed that borrowers experience a high cost of interest rate while obtaining loans from Pride Microfinance whereas 8(16%) of the respondents disagreed with the statement. This implies that the borrower has low-profit margins and a large amount of outstanding debt that makes it hard for the client to repay the loan considering the other costs of the business operations.

4.3. The Relationship between Interest Rate and Loan Default in Business Borrowers
Table 5 shows respondents views on the relationship between high interest rate and loan default in business borrowers in Ishaka-Bushenyi municipality.

Table 5. The Relationship between Interest Rate and Loan Default in Business Borrowers

SN	Variable	Response			
	Interest Rate and Loan Default	**4**	**3**	**2**	**1**
1	There is a close relationship between high interest rate and loan default in business borrowers	15	23	08	04
2	The level of interest rates has a direct effect on a consumer's ability to repay a loan by business borrowers	25	17	03	05
3	Some borrowers may even find it difficult to meet their existing loan repayments, especially if interest rates increase faster than the rise in a consumer's income	24	16	09	01
4	High interest rates make saving relatively more attractive and borrowing relatively more expensive which discourages business borrowers from obtaining a loan from financial institutions	33	15	01	01
5	An increase in interest rates results in deterioration of borrower's repayment capacity and hence, cause of increase in non-performing loans	18	16	10	06
6	Loan defaults are highly correlated with higher interest rates which increase the debt burden on borrowers and lead to defaults resulting in capital erosion of banks.	30	09	09	02
7	If interest rates rise sharply and stay high for a long period, some consumers will default on their loans	12	28	05	05
8	As interest rates fall, the default rate also falls as loans become increasingly easier to repay	15	28	04	03
	Total (Average)	24.3	15.3	4.9	5.5

The findings from the field indicate that the majority of the respondents 38 (76%) agreed that there is a close relationship between high interest rates and loan default in business borrowers whereas the minority of the respondents 12 (24%) disagreed. This implies that due to the high interest rate level on the clients, they will not be able to repay the required loan instalment on time because of the low-profit margins.

The findings also indicate that the majority of the respondents 48 (96%) agreed that high-interest rates make savings relatively more attractive and borrowing relatively more expensive which discourages business borrowers from obtaining a loan from Pride Microfinance while the minority 02 (04%) disagreed. This means that low interest rates will attract Business borrower and reduces loan default.

Further findings indicate that majority of the respondents 40(80%) agreed that if interest rates are high, some loan clients will default while the minority disagreed. This implies that some consumers may even find it difficult to meet their existing loan repayments, especially if interest rates are higher than the profit margin.

4.4. The Possible Solutions to reduce Loan Default in Financial Institution
Based on Table 6, the findings show that the majority of the respondents 37 (74%) also agreed that there are possible solutions to reduce loan default in Pride Microfinance with high interest rates on business borrowers whereas the least of the respondents 13 (26%) disagreed. This is an indicator that

lenders devise various institutional mechanisms aimed at reducing the risk of loan default. These include pledging of collateral, third-party credit guarantee and collection agencies.

Table 6. The Possible Solutions to Reduce Loan Default in Financial Institution

SN	Variable	Response			
	Possible Solutions to Reduce Loan Default	**4**	**3**	**2**	**1**
1	There are possible solutions to reduce loan default in financial institution with high interest rate on business borrowers.	11	26	09	04
2	Bad loans can be restricted by ensuring that loans are made to only business borrowers who are likely to be able to repay, and who are unlikely to become insolvent	28	18	01	03
3	Banks should avoid loans to risky customers, monitor loan repayments and renegotiate loans when customers get into difficulties	14	20	11	05
4	Proper and adequate appraisal by financial institutions.	25	17	05	03
5	Loan officer should visit the home or the work place of the business borrower	20	17	08	05
6	Lending to business borrowers should be based on capital, character and capability in order to reduce on default	28	15	04	03
7	MFIs should also carefully examine the monitoring and control stage in the lending process	19	18	08	05
8	The loans officers should first investigate on the customer's record, ability and experience	20	16	05	09
	Total (Average)	20.6	18.4	6.4	4.6

Findings indicate the majority of the respondents 36(72%) agreed that the loan officers should first investigate the customer's record, ability and experience while the minority 14(28%) disagreed. This implies that loans will be disbursed to clients that are capable of repaying on time and have good credit status.

4.5. Discussion
Based on the findings:

- **Costs of Getting Business Loans in Pride Microfinance**
From the findings, the majority of the respondents 39.6 (79.2%) agreed that there are costs of getting business loans by borrowers in Pride Microfinance while the minority 10.4(20.8%) disagreed. This is supported by [9], who points out that most business failures result from management expertise, inadequate planning and accounting systems, outright fraud and general incompetence.

In the related view, the researcher in [10], also argued that some business borrowers often run into problems shortly after beginning business operations because of inadequate capital. Owners underestimate the costs of opening the doors for business and overestimate the speed with which they can turn out a profit.

Also, the scholar in [11], contends that credit policies are a set of policy actions designed to minimize costs associated with credit while maximizing the benefits from it. The objective of these terms is to have optimal recovery from debtors as a firm may follow a lenient or stringent credit policy. It is in the terms of MFIs that in order for the surplus funds to be invested, credit-issuing procedure must be adhered to, to achieve efficiency in institution's management hence the need for credit terms.

The scholar in [12], also argued that sound credit lending policies in retail financial institutions involves identifying high-risk applicants, modifying loan conditions such as security requirements and monitoring repayments post-loan approval. The scholar asserted that for managers of credit unions, this procedure is complicated by the need to achieve a balance between the institutions social objectives of improving loan accessibility and so members can attain lifestyle goals and the possibility of reducing the institution's viability through loan default.

As argued by [12] common credit lending policies used by MFIs extending credit include; loan period, collateral, repayment schedule, loan size, interest rate and other charges. The scholar further

argued that based on these policies, MFIs can extend credit to the borrowers. In the related view, the researcher in [13], observed that if the loan term is too short, the business borrower fails to generate revenue to enable him/her to make repayments while a longer loan term may make the client extravagant and the client may in the end fail to pay back. For successful results, the loan terms should match the cash patterns to help the client budget cash flows.

In the same view, [14] noted that for individual loans, security is a requirement and the MFI takes security like land titles, and vehicle logbooks which are kept in custody. Microcredit is most often extended without traditional collateral. The author argued that if physical collateral were a requirement for borrowing, most MFIs clients would be unable to participate due to their extreme poverty levels. Since borrowers do not have physical collateral, MFIs focus on using social collateral via group lending. This shows that there are costs of getting business loans by borrowers in Pride Microfinance of Ishaka-bushenyi municipality.

- **The Relationship between Interest Rate and Loan Default in Business Borrowers**

From the findings, the majority of the respondents 40.5 (81.0%) agreed that interest rate is related to loan default in business borrowers while the minority 9.5 (19.0%) disagreed. This is in line with [15], asserted that when interest rates are low, people are willing to borrow because they find it relatively easy to repay their debt. When interest rates are high, people are reluctant to borrow because repayments on loans cost more. Some consumers may even find it difficult to meet their existing loan repayments, especially if interest rates increase faster than the rise in a consumer's income.

The scholar in [16] also observed that rising and falling interest rates will directly affect consumer and personal financial decisions. Rising interest rates make saving relatively more attractive and borrowing relatively more expensive. This means that low interest rates will attract Business borrower and reduces loan default.

A similar study was recently conducted by [17] [18] which investigated the macroeconomic determinants of loan defaults through panel regressions and panel vector autoregressive models. Author in this article suggested that hike in interest rates result in a deterioration of borrower's repayment capacity and hence, cause of increase in non-performing loans. Espinoza and Prasad (2010) contend that it's expected that as interest rates rise, the default rate also increase as loan becomes more difficult to repay.

Research conducted by [16] was also on the same lines and concluded that non-performing loans and interest rates have significant relationship. The study suggested that increase in the non-performing loans result in deterioration of bank assets and in subsequently time got bankrupt. Interest rates and their volatility are among the most critical and closely watched variables in the economy. This indicates that there is a relationship between high interest rate and loan default in business borrowers.

- **The Possible Solutions to reduce Loan Default in Financial Institution**

From the findings, majority of the respondents 39.0 (78.0%) agreed that there are possible solutions to reduce loan default in financial institution with high interest rate on business borrowers while the minority 11.0(22%) disagreed. This is credited by [19] who states that bad loans can be restricted by ensuring that loans are made to only borrowers who are likely to be able to repay, and who are unlikely to become insolvent. Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision.

In addition, [9], is of the view that proper and adequate appraisal is a key to controlling or minimizing default. This is the basic stage in the lending process. According to [20], the appraisal stage is the heart of a high-quality loan portfolio. The scholar in [5] opined that MFIs need a monitoring system that highlights repayment problems clearly and quickly, so that loan officers and their supervisors can focus on delinquency before it gets out of hand.

Also, the scholar in [21] observed that the loan default in Uganda has identified loan appraisal as the key factor. In a number of cases, the information received is not verified, in some cases, the information received is doctored or falsified. It must therefore, be emphasized that credit risk analysis is another important element in loan appraisal. When lending out money, the lender should consider the borrowing position and subsequent repayment in isolation from security. It should be noted that, the borrower should be screened based on the past credit history.

The author in [9] also noted that the loan officer will be able to predict the likely changes or effects on the business for which the money is being lent out. Another stage in the lending process which is

critical in minimizing default is the disbursement stage. In addition, the researcher in [22] [23] [24], lamented that many of the agonies and frustrations of slow and distressed credits can be avoided by good loan supervision which helps in keeping a good loan good.

5. Conclusions

In conclusion, the high costs of getting business loans by borrowers in financial institutions increase the rate of loan default. Furthermore, the high interest rate is related to loan default in business borrowers and there are possible solutions to reduce loan default in a financial institution. The proffered solutions include tightening and minimizing the high interest rates to favour business borrowers for greater productivity. Having critically examined this, it is so important that the financial Institution should lower their interest rate to enhance loan repayment by business borrowers and as well establishment micro insurance to protect customers and the institution in times of loan default.

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