# DEFINITION OF A STANDARD MEASURE FOR CONSUMER INTEREST RATES IN KENYA

A SCOPING STUDY

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FSD Kenya
Financial Sector Deepening

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FSD Kenya
Financial Sector Deepening

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty.Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), theWorld Bank, the Swedish International Development Agency (SIDA) and Agence Française de Développement (AFD).

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# Acronyms

| | |
|---|---|
| **AER** | Annual Equivalent Rate |
| **APR** | Annual Percentage Rate |
| **APY** | Annual Percentage Yield |
| **BAFIA** | Banking and Financial Institutions Act (BAFIA) 1989 |
| **BLR** | Base Lending Rate |
| **BOG** | Bank of Ghana |
| **CPA** | Consumer Protection Agency |
| **FCAC** | Financial Consumer Agency of Canada |
| **FIs** | Financial Institutions |
| **FPAC** | Financial Protection Agency of Canada |
| **FSA** | Financial Services Authority |
| **FTC** | Federal Trade Commission |
| **MFIs** | Microfinance Institutions |
| **NCA** | National Credit Act |
| **OFT** | Office of Fair Trading |
| **RETSAS** | Registry of Interest Rates, Fees and Other Costs |
| **TCEA** | Annual Effective Cost Rate |
| **TCC** | Total Cost of Credit |
| **TILA** | Truth in Lending Act |

# PREFACE

FSD's consumer information project seeks to improve competition and consumer choice in the financial sector. It does so by generating and disseminating clear information on financial services to end users. This information explains how to assess and select the best service offer. The first milestone was to introduce a Survey on Bank Charges and Lending rates. The second, which this report addresses, was the investigation of different lending rate disclosure regimes with the ultimate aim of introducing a standard disclosure regime in Kenya.

This report was presented at a workshop held on 19th March 2009 and opened by the Governor of the Central Bank, Professor Njuguna Ndung'u. Participants included a broad spectrum of lenders including banks, KUSCCO (Kenya Union of Savings and Credit Cooperative Organizations), as well as the Ministry of Cooperatives, Ministry of Trade, FSD Kenya and the Central Bank of Kenya.

There was a generally positive reception from the financial sector to the idea of the introduction of a standard disclosure regime. There was also the recognition that there will be implementation challenges. Therefore a phased approach will be followed starting with the total cost of credit (TCC) and/or repayment schedules (RS) and then moving onto an APR (annual percentage rate). A key concern is that consumers understand the information presented to them. The aim is to introduce the easier to understand TCC and/or RC within the next year and that APR would follow within two years. It is vital that a strong financial education initiative is part of the implementation plan, to teach consumers how to use the TCC/RS to make informed credit decisions.

FSD Kenya will continue to support the introduction of a standard measure for disclosing interest rates as a vital part of improving competition between lending institutions.

# EXECUTIVE SUMMARY

This scoping study was conducted to develop options for a standard measure for consumer interest rates in Kenya and to make recommendations on how to implement a disclosure regime. The study discusses all elements of a comprehensive disclosure regime including the identification of an appropriate interest rate measure, different calculation methodologies for a standard rate, required regulation for compliance and enforcement, disclosure requirements, dissemination channels and initiatives to support the process and create consumer awareness and understanding. The research was initiated by FSD Kenya and the Central Bank of Kenya. Our overall aim is to promote greater transparency and consumer protection within the Kenyan financial sector and to allow consumers to compare rates and shop around to their advantage.

Looking at practices across the world, the major interest rate measures encountered for credit include the Annual Percentage Rate (APR), the Total Cost of Credit (TCC), the Repayment Schedule (RS) and for savings accounts the Annual Percentage Yield (APY) and the Annual Equivalent Rate (AER). Common definitions of these are explored in the report. The survey looks at established regimes such as those in the US, UK, Canada, Ireland and the EU which all use the APR measure, newly established APR regimes in Peru and Ghana and then alternative disclosure regimes in Malaysia and South Africa. In some of these a significant reduction in interest rates has been linked to the introduction of disclosure. In Peru a 15% fall in interest rates has been attributed to Its new disclosure regime.

APR is the most widely adopted disclosure regime in the developed world, supported by extensive regulation that monitors the definition of the rate, its calculation, accuracy, scope and dissemination. The regime is backed by a central regulating authority which regulates and enforces compliance and disclosure. APR comparison largely depends on the standardisation of charges included in the calculation. The US and Canada have a more open ended approach, broadly defining included and excluded charges and leaving the actual calculation up to the financial institutions (FIs), while the EU adopts a more stringent approach with a clearly defined list of charges, resulting in a more comparable measure across loan sizes.

Another important difference is that the US and Canada regulate institutions, while the EU regulates by type of credit. The latter allows for more comprehensive regulation and reduces the task of enforcement. In both cases however, apart from providers of very small loans, disclosure requirements and regulation are applied to all types of institutions with no exemptions for micro-finance institutions (MFIs) and smaller credit providers.

For savings products only two countries were found to use standard interest rate measures, the APY in the US and the AER in the UK. Both measures are less well known and with less regulation than their credit counterparts suggesting that the savings measure is yet to be widely established as a useful tool for consumers.

Alternatives to the APR regime were also examined. These disclosure regimes, with South Africa as a prime example, emphasise the TCC and RS measures in which the consumer is able to see the total cost of credit as well as a monthly repayment amount. International evidence consistently suggests that consumers find the APR complex while the TCC and the RS are reported to be readily understood.

Extensive consumer research conducted by the Financial Services Agency in the UK shows that consumers calculate in terms of simple heuristics and approximations. The most relevant measure here is the monthly repayment amount. There is also evidence that a standard measure does not in fact lead to increased shopping around by the consumer.

These views were consistent with the results from focus groups conducted in Kenya during the study. Consumers, especially in rural areas, were not comfortable with interest rate measures and did not initially comprehend them. When the rates and their purpose was explained to them, the RS and TCC were found to be more helpful and easier to relate to their monthly budgets. However, the usefulness of the APR was also appreciated and the general conclusion was that all three interest rate measures would be useful for the consumer and should be reported together with explanations.

On the savings side, a standard interest rate measure was not felt to be very useful, especially since the returns on savings from the ubiquitous savings and credit co-operatives (SACCOs) are generally in the form of a dividend which cannot be expressed in advance as an interest rate. Television, radio and advertisements were mentioned as the most effective dissemination channels, followed by a helpline, road shows, seminars and the availability of brochures and sales staff to explain the rates at credit provider locations.

The Kenyan financial market is made up of 45 commercial banks, 3,600 SACCOs and up to 100 MFIs. Bank regulation at present does not require stringent disclosure and from the focus groups it was apparent that consumers were given little information about interest rates when opening a savings account or taking out a loan. There was some reluctance found on the part of credit providers to participate in the research study and comment on the usefulness of a standard rate measure or regulatory reforms. This is likely to reflect concerns around the cost and regulatory implications for the sector.

Out of the total Kenyan population only 3.2 million people or 18.9% of the population is formally banked, although this is growing, and with 5.5 million or 32% having some form of credit. Data shows that a significant percentage of the population seeks credit in the informal, largely unregulated sector. Feedback from focus groups and discussions with some credit providers indicates that the smaller credit providers such as SACCOs have simple, easy to understand reporting measures in their credit agreements. This seems to suggest that a disclosure regime based on standardising current practices could be implemented relatively easily, enabling greater comparison. Savings products are more widely used with approximately 52% of the population holding a savings account, 56.5% with a ROSCA, 29% with formal banks, 11% with Postbank, 24.7% at a SACCO and just 3% with micro-finance institutions.

Financial education needs among the population are centred on the recurring theme of making the right choice in deciding where to place money and choosing the right credit product and provider. The growth in the banked versus the unbanked population in Kenya, self-expressed financial education needs and the large consumer market for credit all point towards a need to support consumers in making better and more informed choices.

Current financial regulation in Kenya does not cover consumer protection and there is no standardisation of interest rates as yet. A Consumer Protection Bill (2007) has been introduced in Parliament, but is still pending and upon examination, does not provide much detail in terms of disclosure requirements for financial institutions. The conclusion of this study is that there is strong case for a standard interest rate measure be adopted in the Kenyan market, supported by regulation and with a focus on sustained dissemination.

The disclosure regime needs to be comprehensive in terms of scope, encompassing all institutions in the financial sector without exception and in terms of regulation, enforcement and compliance. Regulation around the regime should follow the EU model with tightly defined standards and requirements. Enforcement, accurate

dissemination and compliance will require regulatory oversight. Supportive measures such as help-lines, workshops and a media campaign must be put into place to educate consumers and build awareness.

The disclosure measures that were felt to be most useful were the TCC and the RS which are recommended as a first step towards an eventually more comprehensive disclosure regime. The APR measure could be implemented as the next step following determination of actual capacity and assuming support from the financial sector. On the saving's side, a standard measure is not recommended initially. As awareness and acceptance increases over time for similar credit measures, consideration may be given to adopting the APY or AER measures.

Chapter 1

# INTRODUCTION

## 1.1 BACKGROUND

The overall cost of credit or savings products can be difficult for the average consumer to understand. This is due not only to the different ways that the interest rate may be represented (which, for instance, may be simple or compounded at regular time intervals, variable or fixed), but also the associated charges and fees that are often hidden. With a credit agreement, for instance, the overall cost varies not only with the loan amount, the term of the loan and the interest rate but also a range of other charges and fees. In addition the interest rate charged is influenced by the risk profile of the applicant and the presence of risk mitigants such as collateral (e.g. property, land). Applicants with regular income and steady employment are generally considered to have less risk than those who earn irregular income. The complexity of calculation and the non-standard way that interest and charges are applied and disclosed makes it difficult for customers to compare products in advertising or quotes.

Much work has been done internationally on the need to develop the financial literacy and capability of low-income consumers who are at a disadvantage and are disempowered by a lack of knowledge in the financial market. In South Africa, for example, over-indebtedness in the low-income population is a major problem with 40% of the population having an impaired credit record (Credit Bureau Monitor, 2008). Finscope data analysis across age groups indicated interest rates as one of the areas that consumers wanted more advice and knowledge on (Finscope, 2007). This situation can be improved by giving consumers access to more useful information about the cost of credit. Empowered consumers, able to compare and shop around for better rates, will also increase competition among providers and can lead to more competitive rates in the market.

In Kenya, the Central Bank of Kenya (CBK) and the Financial Sector Deepening Trust (FSDT) have taken the lead in trying to improve the value for money for customers of the financial sector by providing better information to consumers to improve cost competition. As a first step, the CBK published bank charges and lending rates in 2003, but this did not result in any significant movement in charges or rates, mainly because of the complexity in these publications coupled with low awareness among consumers, leading to low usage of the published figures.

The FSDT has recognised the need to produce a standardised framework for comparing published, advertised total costs of credit and to a lesser extent on savings and deposits, appropriate for the Kenyan financial market. This report looks at the design and delivery of an appropriate, accessible and easy-to-understand measure based on an understanding of consumers and consumer usage of financial products and customised for Kenya.

## 1.2 OBJECTIVES

The objectives of this study were to explain and develop options for establishing a standard measure for determining consumer interest rates in Kenya, to recommend how that measure can be implemented most effectively, based on a review of approaches used internationally, and to identify the specific demands for effective communication in the Kenyan context.

## 1.3 SCOPE AND APPROACH

The project was a scoping study to explore various options for the definition of a standard measure for consumer interest rates in Kenya. This report provides an overview of interest rate measures followed by an in-depth review of international disclosure regimes. The next section details the Kenyan context with reference to the financial characteristics of the market. Insights from all the sections are then discussed in a key learnings section which is followed by a summary and recommendations specific to the Kenyan market.
The approach for the study has been to draw out international experience via a review of central bank and regulatory authority websites, qualified by research and journal articles and consultations with experts from central banks, academic institutions and practitioners. Persons interviewed included Professor Elaine Kempson from the University of Bristol, Mr. Raymond Amanfu and Mr. Amoa-Awuah from Bank of Ghana, Mr. Omondi from KUSCCO, Astrid Ludin, a consultant for Finmark Trust and Katherine McKee from CGAP.

The insights on the Kenyan credit market were driven by visits to branches of credit providers, and supplemented by previous research and publications. Although the intention was to have detailed discussions with credit providers and key stakeholders this was not possible due to a reluctance to talk or comment on a standard interest rate measure and the increase in regulatory requirements that it would entail. However, credit providers were open to the idea of participating in a workshop driven by the CBK and FSD to comment on the results of the scoping study. In line with the TOR, the report focused more on credit than on savings. This in part was due to limited data on a standard savings interest rate internationally.

Consumer financial characteristics were derived from the results of detailed financial surveys conducted primarily by FSDT and FinScope. An overview of market perceptions was obtained by conducting 8 focus groups segmented along geographical, income and financial usage patterns. These focus groups were held in Nairobi, Eldoret, Kisumu and Mombasa and were used to test various disclosure options with the respondents. Details on the sampling methodology and composition of the groups is given in the Appendix.

## 1.4 OVERVIEW OF BASIC CREDIT TERMS

This section of the report provides an overview of the main terms used in credit agreements. These are the principal amount, term and interest rate. The first two terms are generally clearer in close end credit agreements i.e. credit agreements whereby there is a specific principal amount lent for a specified time period and an amount determined for each periodic payment e.g. personal loans. An open end credit agreement, also known as a revolving line of credit may be defined as 'a pre-approved loan between a financial institution and borrower that may be used repeatedly up to a certain limit and can subsequently be paid back prior to payments coming due (Investopedia, 2008) e.g. credit cards.

### 1.4.1 The principal amount

The principal amount refers to the initial amount that is lent/ disbursed to the borrower, at the start of the credit contract. It is also referred to as the capital amount and usually acts as the basis for calculation of interest payable. Closely related to the principal amount is the principal balance outstanding. This is the unpaid portion of the principal amount. At the start of the credit agreement the principal amount is equal to the principal balance outstanding.

As the borrower makes repayments to the credit provider, the principal balance outstanding decreases by the portion of the repayment that is allocated to the principal amount (Repayments usually comprise two portions – one is allocated to payment of the principal, and the remainder is allocated to the payment of the interest due. More detail is provided in later sections).

For example:
*Mr. A applies for a loan of Ksh. 10,000 from Bank Z. Bank Z approves the loan and disburses Ksh 10,000 to Mr A. In this case, the principal amount is Ksh 10,000. After 1 month, Mr.*

*A makes a repayment of Ksh 1,000 of which Ksh 900 is allocated to the repayment of the capital amount. The principal outstanding balance after the repayment is Ksh 9,100 (Ksh 10,000 less Ksh 900).*

### 1.4.2 The loan term

The term refers to the period of time within which the principal amount has to be repaid, or the time period for which the credit is granted. The term is usually measured in days, months or years largely determined by the size of the loan. Smaller loans tend to have shorter terms and are more likely to be expressed in days or months while larger loans usually have longer terms and these are generally expressed in months or years. Short term products are usually held for less than a year, while long term products are held for longer than a year.

### 1.4.3 The interest rate

Interest is the fee that the borrower pays the lender to compensate the lender for the opportunity cost of the funds borrowed. By lending the funds to the borrower, the lender foregoes other productive uses that the funds could have been invested in. The interest charged therefore usually, at a minimum, matches the rewards the borrower would have received from the next best alternate use of the funds.

The interest rate refers to how much interest is charged over a specified time period and is usually expressed as a percentage e.g. 10% per month, 10% per annum. The interest payable for each time period is calculated based on the borrowed amount to which the interest rate is applied and the time period for which the amount borrowed is considered held. There are a number of variations which may lead to different interest charges payable even where the quoted interest rate, principal amount and term are identical. The most common variations are briefly introduced below:

### 1.4.4 Simple and compound interest

Simple interest is interest that is only applied to the principal or the principal balance outstanding. The formula for calculating simple interest is as follows:

$$I_{simple} = (r.\,Pb)\,.\,m\,,$$

where, r is the period interest rate (= I/n, where I is the stated interest rate and n is the number of periods), Pb is the balance on which interest is charged (usually the initial balance), and m is the number of time periods that have passed.

For example:
*Take a personal loan that has an outstanding balance of Ksh 10,000, where the simple interest rate is 20% per annum. The interest added at the end of 6 months would be,*

$$I_{simple} = \left(\frac{0.2}{12}\ Ksh\ 10{,}000\right) 6 = Ksh\ 1{,}000$$

Compound interest is similar to simple interest except that unpaid interest is added to the principal balance outstanding i.e. interest is also charged on the unpaid interest. The formula for calculating compound interest is as follows:

$$I_{compound} = Pb\,[(1+r)^{m} - 1]\,,$$

where, Pb is the balance on which interest is charged (usually the initial balance), r is the period interest rate, and m is the number of time periods that have passed.

For example:
Take a personal loan that has an outstanding balance of Ksh 10,000, where the compound interest rate is 20% per annum. The interest added at the end of 6 months would be,

$$I_{compound} = Ksh\ 10{,}000\ \left[\left(1+\frac{0.2}{12}\right)^{6} - 1\right] = Ksh\ 1{,}043$$

As is evident from the above examples, compound interest generally results in higher interest payable. The difference in interest amounts charged between simple and compound interest is proportional to the frequency of compounding and the time period for which interest remains unpaid.

### 1.4.5 Fixed and floating interest rates

Fixed rates are interest rates that remain the same for the term of the loan. Floating interest rates are interest rates that may change over the term of the loan. These are usually linked to a reference rate e.g. the prime rate. Many loans have a combination of fixed and floating rates. For instance, loans may have an initial introductory period during which the interest rate is lower – the interest rate increases once the introductory period ends.

### 1.4.6 Nominal and effective interest rates

The nominal interest rate is the periodic interest rate unadjusted for compounding[1] i.e. the periodic interest rate times the number of periods per year. For example, a nominal annual interest rate of 12% based on monthly compounding translates to 1% interest rate per month. Nominal interest rates are usually indicated with the frequency of compounding. Nominal interest rates are not directly comparable unless the compounding periods are similar.

The Effective interest rate (also called the effective annual rate, annual equivalent rate) converts the nominal rate into an annual compound interest rate based on the frequency of compounding. The formula for calculation is as follows:

$$r_{effective} = \left(1+\frac{r_{nominal}}{n}\right)^{n} - 1\,]$$

For example:
*The effective rate for a loan with a nominal interest rate of 20% compounded monthly is,*

$$r_{effective} = \left(1+\frac{0.2}{12}\right)^{12} - 1\,] = 21.94\%\ per\ annum$$

*The effective rate for a loan with a nominal interest rate of 20% compounded daily is,*

$$r_{effective} = \left(1+\frac{0.2}{365}\right)^{365} - 1\,] = 22.13\%\ per\ annum$$

Converting the nominal rate to the effective rate enables comparison between loans that may have similar nominal rates but different compounding periods. As with the compound interest rate, the effective interest rate increases with the frequency of compounding. In the example above the daily effective rate is higher than the monthly effective rate. It is worth noting that loans quoted in nominal terms (as is often practiced by FIs) can be misleading, as they understate the 'true' interest rate that is paid ( in the example above the quoted nominal rate is 20% compounded monthly, while the effective rate is close to 22%).

1. The nominal rate may also be defined as the interest rate unadjusted for inflation.

### 1.4.7 Flat rate interest vs reducing balance interest

A flat interest rate calculates the interest payable based on the initial principal amount borrowed. The interest charged remains constant throughout the term of the loan.

For example:
*Mr. A is granted a loan of Ksh. 10,000 by Bank Z for a term of one year at a flat rate of 20%. This equates to total interest charge of 20% of Ksh 10,000 which is Ksh 2,000. This translates to monthly interest payment of Ksh 167 for 12 months (in addition to a monthly capital repayment of Ksh 833). The reducing principal balance outstanding each month has no effect on the interest charged.*

A reducing balance interest rate calculates the interest payable based on the principal balance outstanding at each time interval. As the capital amount owing is repaid and decreases, so does the interest charge.

For example:
*Mr. A is granted a loan of Ksh.10, 000 by Bank Z for a term of one year at a reducing balance rate of 20%. Assuming that he makes no payments during the first month, the interest charged for the first month will be the same as the flat rate interest as the principal outstanding is the same i.e. Ksh 167 (with a capital repayment of Ksh 833). However, the interest charged for the second month will be based on the lower capital amount of Ksh 9,167 leading to a lower interest amount of Ksh 153, and this pattern proceeds for the term of the loan. The table below illustrates the differences in interest charges.*

In the example above, the flat rate results in total interest payments of almost double the amount due under the reducing balance method. To get broadly equal total interest payments for the year, the flat rate would need to be approximately 11% with the reducing balance rate at 20%, or alternatively the reducing balance rate would need to be approximately 37% with the flat rate at 20%. This emphasises the analogy that flat rates are the most expensive rates offered by FIs and that consumers may be misled by quoted low flat rates.

**Table 1: Comparison of flat rates and reducing balance rates**

Source: Genesis Analytics, 2008

| Month | Principal balance outstanding (Ksh) | Flat rate interest charge (Ksh) | Reducing balance interest charge (Ksh) |
|---|---|---|---|
| 1 | 10,000 | 167 | 167 |
| 2 | 9,167 | 167 | 153 |
| 3 | 8,333 | 167 | 139 |
| 4 | 7,500 | 167 | 125 |
| 5 | 6,667 | 167 | 111 |
| 6 | 5,833 | 167 | 97 |
| 7 | 5,000 | 167 | 83 |
| 8 | 4,167 | 167 | 69 |
| 9 | 3,333 | 167 | 56 |
| 10 | 2,500 | 167 | 42 |
| 11 | 1,667 | 167 | 28 |
| 12 | 833 | 167 | 14 |
| | **Total interest paid** | **2,000** | **1,083** |

### 1.4.8 Differences in terms used for interest calculation

This subsection looks at differences in how the time period or number of days for which interest is due may be calculated. The four most common are:

- Actual/ actual – the actual number of days are counted (including the effect of leap years)
- 30/360 method – all months are assumed to have 30 days and all years have 360 days
- Actual/365 – counts the actual number of days but assumes a 365 day year i.e. excludes leap year effect
- Actual/ 360 – counts the actual number of days but assumes a 360-day year

Depending on which method is used, differences may occur in the number of weeks in a year and the relative weight of months in a year.

### 1.4.9 Fees and charges

Many credit agreements also have various fees and charges that the applicant needs to pay to access the credit facility. These fees are generally categorised based on their timing (for example upfront costs, such as application fees, and ongoing costs, such as insurance premiums) and whether they are directly related to the credit or incidental (for example, notary fees). The fees and their allocations are discussed in greater detail in the International Review below.

Chapter 2

# INTEREST RATE AND COST MEASURES

This section reviews the main approaches in the application of interest rate measures for credit and savings products. The focus on the credit side is on the application of a standard interest rate measure to structured loans made to the retail and small business market segments. The measures differ with respect to the information disclosed and the methods of calculation.

## 2.1 STATED INTEREST RATES

In many instances credit providers simply state the interest rate at which the credit is to be provided. There is no detail offered with respect to other charges that are levied on the consumer. The consumer usually only becomes aware of these once the credit agreement has been signed and is underway, in many cases only realizing the charges after a number of payment cycles have elapsed.

The flat rate is commonly stated as it appears to be lower than other interest rates. However, as detailed in the discussion above, the flat rate is actually the most expensive rate that a credit product can be quoted on as the interest payments during the term of the product remain constant and do not take cognizance of the reduction in the balance owed. The reducing interest rate is usually quoted as an alternative to the flat rate by more formal financial institutions. In some cases no indication is given of the type of interest rate that is quoted.

The main drawback of the generally stated interest rate measures is that they do not contain enough information for the consumer to easily compare credit products across financial institutions or to accurately judge if they can afford the product. They also fail to disclose the various charges linked to the credit offered and thus understate the cost of obtaining the credit, once again to the consumers' disadvantage. However, they are simple to compute and disclose, and are thus favoured by credit providers, despite their weaknesses.

## 2.2 REPAYMENT/PAYOUT SCHEDULE

The repayment schedule maps out the payments that are required to be made by the consumer at each time interval; starting from when the loan amount is disbursed to when the principal, interest and any other charges have been paid off. There are also various arrangements with respect to the timing of the payment of the principal and interest amount and other charges, for example some credit agreements require that all associated costs are paid up front, in which case these will not be included in the repayment schedule; while in some cases credit costs are amortized and payment spread across the term of the product. Repayment schedules vary in terms of the information disclosed. The examples below set out illustrative scenarios with respect to repayment schedules.

### Example 1: Decreasing instalments and upfront costs

*Assume a loan of 1,000 to be paid in four monthly instalments, with the principal to be repaid equally spread across the four months. A monthly interest rate of 1% is charged on the reducing balance. Loan application costs of 100 are paid upfront and thus do not form part of the repayment schedule.*

| Month | Total Instalment | Principal | Interest | Outstanding Balance |
|---|---|---|---|---|
| 0 | | | | 1,000 |
| 1 | 260 | 250 | 10 | 750 |
| 2 | 257.50 | 250 | 7.50 | 500 |
| 3 | 255 | 250 | 5 | 250 |
| 4 | 252.50 | 250 | 2.50 | 0 |

The instalments decrease monthly in line with the reducing balance (Tucker, 2000).

### Example 2: Decreasing instalments and amortised costs

*Assume a loan of 1,000 to be paid in four monthly instalments, with the principal to be repaid equally spread across the four months. A monthly interest rate of 1% is charged on the reducing balance. Loan application costs of 100 are not paid up front, but are amortised into the term of the loan. Thus they form part of the repayment schedule as they are added to the principal balance.*

| Month | Total Instalment | Principal | Interest | Outstanding Balance (principal plus costs) |
|---|---|---|---|---|
| 0 | | | | 1,100 |
| 1 | 286 | 275 | 11 | 825 |
| 2 | 283.25 | 275 | 8.25 | 550 |
| 3 | 280.5 | 275 | 5.50 | 275 |
| 4 | 277.75 | 275 | 2.75 | 0 |

Amortising the costs leads to a greater amount having been repaid by the end of the loan term, as interest is charged to a higher outstanding balance in each time period. Consumers who cannot afford to pay the upfront costs at the time of the loan application usually prefer the costs to be amortised but are often not aware of what the effect will be in terms of the additional interest to be paid. In other instances, the upfront costs are deducted from the principal amount disbursed. In the above example, the loan given to the consumer would now be 900 i.e. 1,000 less 100. While this 'relieves' the consumer of the burden of paying additional interest, it also leads to the consumer having to pursue other sources of borrowing the balance of the loan that has been used to settle the upfront costs. Consumers may also resort to applying for a larger amount than they actually need to make up for the upfront costs to be deducted.

### Example 3: Equal instalments and upfront costs

*Assume a loan of 1,000 to be paid in four monthly instalments, with the principal to be repaid equally spread across the four months. A monthly interest rate of 1% is charged on the reducing balance. Loan application costs of 100 are paid upfront and thus do not form part of the repayment schedule. The formula to calculate the amount of each equal monthly instalment is as follows[2]:*

$$\text{Loan Amount} \times \frac{i(1+i)^n}{(1+i)^n - 1} = \text{Size of each installment}$$

*Where i is the periodic interest rate and n is the number of instalments in the loan. In the above example the loan amount is 1,000, i is 1% and n is 4, leading to the repayment schedule below.*

| Month | Total Instalment | Principal | Interest | Outstanding Balance |
|---|---|---|---|---|
| 0 | | | | 1,000 |
| 1 | 256.28 | 246.28 | 10 | 753.72 |
| 2 | 256.28 | 246.28 | 7.54 | 504.98 |
| 3 | 256.28 | 246.28 | 5.05 | 253.75 |
| 4 | 256.28 | 246.28 | 2.53 | 0 |

2. Periodic Interest rate, William Tucker, Bankakademie Micro Banking Competence Centre

The monthly instalment amount remains constant during the term of the loan. This type of repayment schedule is used by many MFIs. The consumer has the advantage of being able to budget accordingly and judge affordability as the monthly amount to be repaid does not change.

**Example 4: Flat rate interest**

Assume a loan of 1,000 to be paid in four monthly instalments, with the principal to be repaid equally spread across the four months. A monthly interest rate of 1% is charged on a flat rate basis. Loan application costs of 100 are paid upfront and thus do not form part of the repayment schedule. In this case the total interest to be paid is calculated upfront. Hence, 1% flat per month for 4 months works out to 4% of the principal i.e. total interest to be paid is 40.

| Month | Total Instalment | Principal | Interest | Outstanding Balance |
|---|---|---|---|---|
| 0 | | | | 1,000 |
| 1 | 260 | 250 | 10 | 750 |
| 2 | 260 | 250 | 10 | 500 |
| 3 | 260 | 250 | 10 | 250 |
| 4 | 260 | 250 | 10 | 0 |

As discussed earlier, flat rate interest leads to the higher interest payments than the reducing balance methods.

Repayment schedules are simple to understand as most potential borrowers are primarily concerned with the amount that has to be repaid back at each time interval. However, it is possible to 'hide' higher interest charges within a repayment schedule, as in example 4 above. Many consumers are unlikely or unwilling to work out that the interest rate and interest payments illustrated in example 4 would be higher than in the other examples. Thus repayment schedules are a simple, if misleading, reference point as many borrowers have the tendency to judge affordability by simply referring to the periodic repayment amount and not the cost of the credit facility as a whole.

## 2.3 TOTAL COST OF CREDIT (TCC)

The total cost of credit is the sum of all interest payments, fees and charges on the loan contract. It is generally the difference between the amount that is given as the principal amount and the total amount that is paid back by the borrower. It is useful in terms of making the consumer aware of exactly how much more he will ultimately pay as a result of taking the credit facility.

For Example:

*Assume a loan of 1,000 to be paid in four monthly instalments, with the principal to be repaid equally spread across the four months. A monthly interest rate of 1% is charged on the reducing balance. Loan application costs of 100 are paid upfront and thus do not form part of the repayment schedule.*

| Month | Total Instalment | Principal | Interest | Outstanding Balance |
|---|---|---|---|---|
| 0 | | | | 1,000 |
| 1 | 260 | 250 | 10 | 750 |
| 2 | 257.50 | 250 | 7.50 | 500 |
| 3 | 255 | 250 | 5 | 250 |
| 4 | 252.50 | 250 | 2.50 | 0 |
| Total | 1,025 | 1,000 | 25 | |

In the above example the TCC would be the summation of the loan application costs and the total interest charges i.e.

$TCC = interest\ charges + other\ charges = 100 + 25 = 125$

In jurisdictions where there is no standardized disclosure regime, the TCCs of different credit providers are not easily comparable as there is no defined list or criteria for inclusion of costs in the TCC calculation. In these cases, the TCC is primarily useful for disclosing to the consumer how much the credit facility will actually cost him.

Where there is a standardized disclosure regime, TCCs across credit providers are more readily comparable as they broadly follow similar criteria for calculation. In many cases the TCC is linked to the calculation of the APR. For example, in the UK there is a direct link between the TCC calculation and the APR calculation. The finance charges to be included in the TCC form the basis for the calculation of the APR. These include security charges, credit brokerage charges and payment protection insurance (more detail on finance charges is provided in the international review).

Thus the TCC and is simply a summation of the total costs related to the credit facility and varies by the way the credit agreement is structured. As the TCC is reflected in absolute terms it may be easier for consumers to relate to. Furthermore, it usually prompts reconsideration by the applicant on whether the credit facility us actually necessary, as in many cases the difference between the loan amount and the total amount to be repaid is significant.

## 2.4 ANNUAL PERCENTAGE RATE

The APR is a 'standardized' rate which takes into account all compulsory fees associated with a loan, thus expressing the 'real' cost of borrowing. Thus, both interest charges and finance charges are included in the calculation of the APR.

Interest charges in the APR are based on the reducing balance method and not the flat rate i.e. the principal used in calculating the APR is equal to the amount of the loan the borrower has to use at any time (Gelinas, 2006). However, there remain differences in the calculation and disclosure of interest rates across different jurisdictions and these are touched on further below.

Finance charges 'include any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident or condition of the extension of the loan' e.g. loan application fees (Truth in Lending Act). Once again, there are differences with respect to the fees that are defined as finance charges for the purposes of the APR calculation.

The APR measure is aimed at disclosing the 'actual' interest rate to a borrower by including bank charges and 'hidden' costs into the calculation. APR disclosure assists borrowers by letting them know the actual cost of a loan/credit, allowing them to compare rates between banks and shop around for a better rate. While there are other ways of reporting bank interest rates and charges (e.g. initiation fees), the APR measure is the most widely used and due to its single measure reporting, is also the simplest to compare and understand.

Various formulae exist for calculating the APR. The most accurate and widely used is the Actuarial method (Truth in Lending Act), which 'relates the amount and timing of value received by the consumer to the amount and timing of payments made' and involves calculating the interest rate at which the current value of the loan is equal to the net present value of instalments (including repayments under the credit agreement, and

other costs deemed to be included e.g. application and processing costs).

The method reflects 'interest computed on unpaid balances of principal at a fixed rate, with each payment applied first to interest and the remainder to principal. The formula used in the UK and EU (see figure below) is an example of the actuarial method.

**Figure 1: Calculation of the Annual Percentage Rate**
*Source: Office of Fair Trading, 2007*

$$\sum_{K=1}^{K=m} \frac{A\,K}{(1+i)^{t}} = \sum_{K'=1}^{K'=m'} \frac{A'K'}{(1+i)^{t_{K'}}}$$

MEANING OF LETTERS AND SYMBOLS

| | |
|---|---|
| $K$ | is the number identifying a particular advance of credit; |
| $K'$ | is the number identifying a particular instalment; |
| $Ak$ | is the amount of advance K; |
| $A'k'$ | is the amount of instalment K'; |
| $\Sigma$ | represents the sum of all terms indicated; |
| $m$ | is the number of advances of credit; |
| $m'$ | is the total number of instalments; |
| $t_k$ | is the interval, expressed in years, between the relevant date and the date of advance K; |
| $t_{K'}$ | is the interval, expressed in years, between the relevant date and the date of instalment K'; |
| $t$ | is the APR, expressed as a decimal. |

For any credit agreement, the standard interest rate measure is the correct value of i in the mathematical equation given above, expressed as a percentage. Calculating i requires an iterative process and is thus done using various computer packages and software.

The constant- ratio method is an approximation of the APR and uses a simpler method, but leads to an overestimation of the APR rate.

$$APR = \frac{2MC}{P(N+1)}$$

where M is the number of payment periods in a year, N is the number of scheduled payments, C is the finance charges and P is the original proceeds of the loan.

The direct-ratio method, also an approximation, however leads to an underestimation of the APR.

$$APR = \frac{6MC}{[3P(N+1)+C(N+1)]}$$

The N-ratio method provides an approximation of the APR that is closest to the actuarial method.

$$APR = \frac{M(95N+9)C}{[12N(N+1)(4P+C)]}$$

The example[3] below illustrates the four methods:
A loan of Ksh. 1,000 taken over a year is to be repaid in 12 monthly instalments. The total finance charges including interest add up to Ksh. 116.

Thus, M (the number of payment periods in a year) is 12, N (the number of scheduled payments is also 12), C (the finance charges) is Ksh 116 and P (the original proceeds of the loan) is Ksh 1,000.

3. Schaum's quick guide to business formulas, J. Siegel, J Shim et al

Actuarial method: APR = 20.76%

Constant-ratio method:

$$APR = \frac{2MC}{P(N+1)} = \frac{2\,x\,12\,x\,116}{1000\,(12+1)} = 21.42\%$$

Direct-ratio method:

$$APR = \frac{6MC}{[3P(N+1)+C(N+1)]} = \frac{6\,x\,12\,x\,116}{3\,x\,1000\,(12+1)} = 20.62\%$$

N-ratio method:

$$APR = \frac{M(95N+9)C}{[12N(N+1)(4P+C)]} = \frac{12(95\,x\,12)+9)\,x\,116}{12\,x\,12\,x\,13\,x\,[(4\,x\,1000)+116)]} = 20.76\%$$

The last 3 formulae are approximation formulae and are less useful where there are variations in the amounts paid or in the time periods between payments. All three formulae can be easily conducted on a calculator without need for computers or software. The N ratio is the most useful in this case as it provides the best closest approximation of the true APR.

### 2.4.1 Differences in APR calculations

These are broadly categorised under differences relating to: a) interest charges, b) finance charges and c) other assumptions.

Many of the variations in APR calculation with respect to interest charges are related to the differences in the assumptions on the methodology of applying interest rates, and the time period over which interest is charged. In some cases (e.g. credit cards in the US), the APR is be quoted as a nominal APR compounded monthly rather than as the effective 'annual' APR rate. As seen in the discussion on nominal and effective rates, the nominal rate compounded monthly understates the true annual rate. In the US the APR'shall be the nominal annual %age rate determined by multiplying the unit-period rate by the number of unit periods in a year[4]. Thus the periodic nominal monthly rate is multiplied by 12 to get the'annual' APR leading to lower results than would be achieved if the calculation had been one of the effective annual rate (as in the UK).

There are also differences with respect to the treatment of unpaid interest in APR calculations. In the US, the two main variations in interest treatment are the US Rule and the Actuarial method. Lenders have the option of disclosing the APR using the US rule or the Actuarial method (most States require the use of the US rule). The US rule prohibits the charging of interest on interest (usually arises when payments are skipped or the first loan period is longer than one month) i.e. interest that is unpaid is not added as outstanding debt to the principal outstanding balance, it is instead held aside in an escrow account. This is similar to the simple interest method discussed above. As seen earlier, the Actuarial method permits the charging of compound interest .Thus unpaid interest is added to the principal balance outstanding and interest is charged on the total amount.

Variations in interest charges may also relate to the time period selected, and over which interest is charged. Regulation Z of the Truth in Lending Act (TILA) in the US leaves the definition of the unit period up to the lender[5]. The unit period 'shall be that common period. . .that occurs most frequently in the transaction[6]. This may lead to significant differences in APRs based on the frequency of compounding.

4. Regulation Z, appendix J (b)(1)), TILA
5. 'Computing the APR', Walter Witthoff & Jamie Wolfe
6. Regulation Z, appendix J (b)(4)), TILA

The actuarial method as defined in Regulation Z generally requires an equal month computation based on the federal calendar while under the US rule, the 360-day (1/12th of a year) or a 365-day (actual day) method may be used at the lender's discretion[7].

Despite these differences in calculations, there is usually a clearly defined tolerance level within countries with respect to how much the stated APR can diverge from the 'true' APR. For example, in the US the divergence limit is 1/8th of a percent i.e. the stated APR must be not be greater than or less than the 'true' APR by more than 1/8th of a percent (TILA).

### 2.4.2 Finance charges

There is variation in terms of the fees that are deemed necessary for inclusion in the APR calculation (the international review details this later). Generally, there is no definitive list that clearly allocates all costs between those that are to be included and those that are to be excluded. This leaves the financial institutions with some leeway for manipulation and reduces the comparability of APRs across institutions. Some fees are only included if certain conditions are met e.g. attorney fees may be included if the client has little or no choice in selecting an attorney while they may be excluded where the choice of attorney is entirely up to the consumer.

One time fees are generally not included e.g. valuation fees, even though these are costs that the consumer may have to face in receiving the loan. The absence of such costs from the APR calculation limits the presumption that it reflects the total cost of lending, and may make the APR appear lower than it really is.

A number of fees and charges are conditional upon certain client behaviour and are usually not included in finance charges. These include default charges, missed or late payment fees, collection fees and early repayment charges. These have the effect of increasing the stated APR if they become applicable, but are not considered for the initial APR calculation as they are based on assumptions about the behaviour of the consumer.

### 2.4.3 Other assumptions

The APR is calculated on the assumption that the loan is held for its full term. However, many longer term loans such as mortgages may be repaid early or refinanced before their initial term is through. This has the effect of increasing the APR as the initial upfront costs of the loan are allocated over a shorter term. Furthermore, there may be early repayment penalties that would also lead to a different APR if the loan is repaid early.

In addition to this, some credit products may not have a constant interest rate for the length of their term e.g. a 5 year loan may be charged an interest rate of 15% for the first year and 20% thereafter. The APR calculated based on the total interest to be paid over the term of the loans also results in a mis-estimation of the APR that the client faces if the loan is not held to term. There is also the risk that the APR may only be calculated based on the introductory rate and not account for changes in the rate going forward.

## 2.5 SAVINGS PRODUCTS

### 2.5.1 Annual Equivalent Rate

The Annual Equivalent Rate (AER) is a notional rate quoted for interest-bearing accounts which illustrates the gross interest rate, excluding any bonus interest payable, that would be paid and compounded on an annual basis.

If the account pays interest once a year the AER is equal to the contractual interest rate and if the account pays interest more than once a year the AER is calculated by compounding all the interest payments.

The following guidelines[8] for deriving the AER are to ensure consistency of calculation and fair comparison of products.

- The only changes to the amount deposited to be taken into account are those that required by the terms of the account. On an account from which withdrawals may be made, the AER is based on an initial deposit with no subsequent moments, while for a monthly savings account each monthly deposit is taken into account.
- The only changes to the rates that are taken into account are those that are stated at the outset. No allowance is made for changes that may occur as a result of the fluctuation of rates in the market.
- The AER calculation is to be made for the term of the account. If period is fixed or minimum term then this is the period for consideration, if the term is indefinite then the calculation is done for the first year or until the first payment is made if this occurs after one year.
- If there is an unconditional charge that is payable whenever a withdrawal is made the AER must take this into account. If the account has a fixed or minimum term then the calculation must be made for this period, if the term is indefinite then the calculation is based on the first year.
- All interest paid is treated as if it is invested and earns an interest rate equal to that being earned on the deposit. All interest is compounded.
- AER is rounded and displayed to the second decimal place.

The general formula involves calculating the interest which, if applied each year to the deposits made, will equal the value of the contractual interest rates and interest bonuses (if applicable). The formula assumes a depositor makes a series of payments (some of which may be zero) into the account at annual intervals and the interest (which can vary year-to-year) is paid annually. Deposits are assumed to occur at the beginning of the year while interest is paid at the end of the year. The formula treats all interest as compounded and interest paid is compounded at the contract rate.

This formula can be represented as follows[9]:

$$\sum_{n=1}^{m} D_n \left(1+\frac{\partial}{100}\right)^{1+m-n} = \sum_{n=1}^{m} D_n \left(\prod_{j=n}^{m} \left(1+\frac{i_j}{100}\right)\right) \quad (=T)$$

Where:

| | |
|---|---|
| $\partial$ | is the Annual Equivalent Rate; |
| $D_n$ | is the deposit to be made in the year $n$; |
| $i_j$ | is the interest rate (including bonuses, if any) payable at the end of the year $j$; |
| $m$ | is the number of years for which the product has to be held; |
| $\Sigma$ | represents the sum of all terms indicated; |
| $m$ | is the number of years for which the product has to be held; |
| $T$ | is the amount the depositor will receive at the end of year $m$. |

**Calculation of the Annual Equivalent Rate**
*Source: British Bankers' Association*

The general form of the equation can only be solved by iterative computation. The following general equation can be used to solve for specific cases:

1. AER if only one deposit is made at the start of period:

$$\partial = \left(\left(\sqrt[m]{\prod_{n=1}^{m}\left(1+\frac{i_n}{100}\right)}\right) - 1\right) \times 100$$

7. 'Computing the APR', Walter Witthoff & Jamie Wolfe
8. British Bankers' Association
9. British Bankers' Association

2. AER if the interest rate is quoted as the total payable on the initial deposit over a period of longer than one year:

$$t = \left( \left( \sqrt[m]{1 + \frac{r}{100}} \right) - 1 \right) \times 100$$

Where r is the total interest payable over *m* years.

3. AER if interest if payable more frequently than on an annual basis

$$\partial = \left( \left( 1 + \frac{i}{n \times 100} \right)^{n} - 1 \right) \times 100$$

Where *n* is the number of times per year that the annual interest rate i is paid.

For example:
*A deposit of KES 13,283 is made at the beginning of year 1 and KES 6,641.50 is added to this at the start of year 2. Interest is 10% for year 1 and 11% for year 2.*

Solution
*The first step is to work out the return at the end of year 2 (T) using the right hand side of the general formula*

$$T = \sum_{n=1}^{2} D_n \left( \prod_{j=n}^{2} \left( 1 + \frac{i_j}{100} \right) \right)$$

$$= \text{KES } 13{,}283 \, (= D_1) \left( \left( 1 + \frac{10 \, (= i_1)}{100} \right) \left( 1 + \frac{11 \, (= i_2)}{100} \right) \right)$$

$$+ \text{KES } 6{,}641.50 \, (= D_2) \left( 1 + \frac{11 \, (= i_2)}{100} \right)$$

$$= \text{KES } 23{,}590.61$$

*Then using this result, a needs to be solved for the left hand side of the general equation*

$$T = \text{KES } 23{,}590.61 \; = \sum_{n=1}^{m} D_n \left( 1 + \frac{\partial}{100} \right)^{1+m-n}$$

$$= \text{KES } 13{,}283 \, (= D_1) \left( 1 + \frac{\partial}{100} \right)^{2} + \text{KES } 6{,}641.50 \, (= D_2) \left( 1 + \frac{\partial}{100} \right)$$

*Trying a = 10.5 gives KES 23,557.80; 10.6 gives KES 23,593.80; 10.59 gives 23590.08.*

This process of iterative computation yields the AER of 10.59% to two decimal places.

### 2.5.2 Annual Percentage Yield[10]

APY is the yield that is earned on the principal amount in the savings/ deposit account over a year (or the interest rate that is paid to the depositor).

APY takes compounding into account and generally increases with the frequency of compounding periods as well as the period over which the compounding is applied. It is expressed as an annualized rate based on a 365-day year.

The following general rules outline the basis for calculating APY:
- Institutions must calculate APY based on the actual number of days in the term of the account.
- If the account has no stated maturity date, the APY calculation is based on an assumed term of 365 days

The general formula for APY is as follows:

$$APY = \left(1 + \frac{i_{nom}}{N}\right)^{N} - 1$$

*Where $i_{nom}$ is the nominal interest rate and N is the number of compounding periods per year.*

For example:
*An institution pays a nominal interest rate of 5.4% compounded semi annually; the APY can be calculated using the general formula above.*

$$APY = \left(1 + \frac{0.054}{2}\right)^{2} - 1$$

$$= 5.5\%$$

The primary advantage of using APY is that it can be used to standardize varying interest rate agreements into an annualized percentage number. This helps to illustrate the effects of compounding for depositors choosing between different interest rate terms.

APY is the interest rate standard quoted in the advertising of savings accounts in the United States in place of the AER standard quoted in the United Kingdom. The two standards are analogous as they both taken into account the effect of compound interest[11].

### 2.5.3 AER & APY: Practical application and challenges

The research conducted into the methodologies for the calculation of a standard interest rate charged on deposit accounts revealed two major methodologies used: i) the AER methodology used in the United Kingdom, and ii) the APY methodology used in the United States. The regulation of these two methodologies focuses on the method of calculation, exception handling and the regulations related to the advertising of the interest rate which are further discussed in the International Review section.

There is no regulation around charges for AER/APY based deposit accounts. Any amount charged is done so at the bank's discretion, and is driven by competitiveness concerns and the importance of attracting depositors by offering attractive rates. Charges that can be incurred include charges for withdrawals from a deposit account, which may vary depending on whether these withdrawals are made at an ATM or over the counter. Any such unconditional charge must be taken into account by the AER/APY.

Other charges can be applied to withdrawals made before a required notice period has elapsed or penalties for withdrawals made during a period when a certain minimum balance needs to be maintained. Charges can be in the form of flat rate fees or percentages

10. Federal Deposit Insurance Corporation

11. The Guardian Newspaper Money Section

of deposit value. Other requirements at the discretion of the bank for an AER/APY based savings account include minimum balances required in order to earn interest, a minimum or maximum withdrawal or transfer allowance and terms over which certain deposit levels need to be maintained.

Challenges related to calculating a standard interest rate are primarily associated with variations in deposit levels, deposit payments or the terms of deposit accounts. These include calculating the interest for fixed term accounts versus accounts with indefinite terms, the timing of the initial deposit for an account and the timing of the interest payments.

Chapter 3

# INTERNATIONAL REVIEW

This section provides an overview of the standard interest rate measure reporting practice in a selection of developed and developing countries. Developed countries include the United States, the United Kingdom, Canada, the European Union and Ireland. The regimes of all these countries have been detailed in the section below, except for Ireland, which was reviewed but found to be exactly following EU dictates and was therefore repetitive.

Peru and Ghana offer examples of recently introduced disclosure regimes in the developing world. South Africa and Malaysia are also included as examples of alternative disclosure regimes. The lessons learned from the international review inform are included in Section 5, and applied towards the development of a standard interest rate measure in Kenya.

The information in this section is compiled primarily through a desktop review of existing literature. In addition, consultations with experts in disclosure regimes and Central Bank representatives provided additional insight on international practices.

## 3.1 DEVELOPED COUNTRIES

### 3.1.1 Regulation and enforcement

The Annual Percentage Rate (APR) is the standard comparison measure for the US, Canada and across the EU countries, as well as the UK and Ireland. The US and Canada have country-specific APR calculations and regulation standards. For instance, the US regulates credit and service providers, whereas Canada and the EU regulate credit agreements. In Europe, an EU Directive issued on June 2008 mandated full harmonisation of APR calculation, reporting and regulation across all member countries.

The Act in the US is enforced by the Federal Trade Commission (FTC) which regulates all credit providers and can take legal and punitive action against defaulters including financial penalties. In the UK, the Act is enforced by the Office of Fair Trading (OFT), the Financial Services Authority (FSA) and by a voluntary Banking Code.

Enforcement takes place through close monitoring by these organisations and non-compliant organisations have to face a public campaign of 'naming and shaming' as well as have financial penalties imposed on them.

### 3.1.2 Disclosure requirements

On the classification of charges, the US APR calculation categorises charges as either 'finance' or 'interest'. The finance charge for a consumer credit transaction is determined as *"the sum of all charges payable by the person to whom credit is extended as an incident to the extension of credit"* (Truth in Lending Act). Both charges are included in the APR calculation, but the categorisation of charges is left to the discretion of individual credit providers.

The EU, on the other hand, specifies exactly what charges are to be included or excluded with no scope for institutions or individual countries to divert from the approved standard. However, in both regimes it is important that the calculation applied is uniform across the different institutions. Accuracy in the US for example, needs to be within one-eighth of a percentage point .

There are also variations in the reporting of the APR. In the UK, the APR can be represented as either 'typical', referring to the rate that will be applied to 66% of consumers applying for that particular credit or 'variable', which refers to a variable interest rate and which would therefore affect the APR quoted going forward.

### 3.1.3 Scope of products

In the US and Canada, mortgage agreements are regulated, while the EU (and therefore the UK and Ireland) does not regulate mortgages. Mortgage agreements in the US must include the APR rate and state any assumptions made in the calculations. While the APR on mortgages can be calculated relatively easily, it is rare for a mortgage to be carried for the entire term of the agreement. In this case, the APR mortgage measure does not accurately reflect the cost to the consumer and can be misleading.

Another difference in regimes is that credit agreements in the EU that are less than €200 and above €75,000 carry a specific exemption and are not regulated. Additionally, EU consumers have a right of withdrawal under which they have fourteen calendar days to withdraw from a credit agreement without giving any reason. The EU directive which enforces this 'cooling off' period is based on pre-existing norms in the UK which had a 5 day cooling off period, Germany which had a 14 day period and Ireland which had a ten day period (Schwartz, 2007).

### 3.1.4 Consumer education

The UK, US and Canada have extensive and wide-reaching supportive measures in the form of consumer awareness and financial literacy programs and campaigns that focus on educating consumers about interest rates and how to understand and use them. This information is also available through regulating bodies and their affiliated agencies and there are dedicated consumer protection agencies such as the Financial Protection Agency of Canada (FPAC), the FTC Bureau of Consumer Protection in the US and the UK's Consumer Protection Agency. These disseminate information, print booklets and provide advice through consumer helplines.

In addition, consumers have access to non-profit organisations such as The UK's Citizens Advice Bureaus, National Debtline and Building Financial Capability, a national programme that provides financial education, advice and counselling. The US website My Money.Gov offers toolkits and informational material through its website as well as a free advice hotline.

A wide range of media is used to disseminate information. These include workshops, financial education initiatives, consumer helplines, interactive websites, physical advice centres and consumer protection agencies.

| Disclosure regimes in developed Countries | | | | |
|---|---|---|---|---|
| **Country/ Region** | **UK** | **USA** | **Canada** | **EU** |
| **Name for standard measure** | Annual Percentage Rate (APR) | Annual Percentage Rate (APR) | Annual Percentage Rate (APR) | Annual Percentage Rate of Charge (APR) |
| **Definition** | The APR is based on the total charge for credit (TCC) which includes interest and other charges that affect the cost of borrowing - even if they are not payable under the credit agreement itself. The APR is an annualised rate reflecting the timing of such charges, as well as the rates and amounts. | The annual percentage rate (APR) is an interest rate that is different from the note rate. It is commonly used to compare loan programs from different lenders. | The APR for a credit agreement is the annual interest rate if there is no cost of borrowing other than interest. | Annual percentage rate of charge' means the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit, where applicable including the costs referred to in Article 19(2) |
| **Act** | Consumer Credit Act 1974 | The Federal Truth in Lending Act (TILA) 1968 | Bank Act 1991 | Directive 2008/48/EC of the European Parliament and of the Council on credit agreements for consumers. Directive 2005/29/EC 'Unfair Commercial Practices Directive' |
| **Regulator** | Office of Fair Trading Financial Services Authority (FSA) | Federal Trade Commission (FTC) | Financial Consumer Agency of Canada (FCAC) | European commission |
| **Scope of institutions and products** | All credit and loan providers | Banks, Insurance companies, mortgage lenders, credit providers | Banks, insurance companies, mortgage lenders, credit providers | All credit and loan providers |
| **Mandatory/voluntary** | Mandatory | Mandatory | Mandatory | Full harmonisation among Member States by 2010 |
| **Products to which measure is applied** | Credit - loans, credit cards, mortgages | Loans, mortgages, credit cards | Loans, Credit, Mortgages | Applies to all credit agreements except: mortgages, amount less than EUR 200 and above EUR 75,000, hiring or leasing agreements where an obligation to purchase the object is not laid down, overdrafts, interest free agreements, private offerings by employers to employees, agreements with investments firms, deferred payment, secured loans |
| **Charges included** | Charges payable under the credit agreement (documentation or administration fees or an option to purchase fee under a hire-purchase agreement), charges payable under a linked transaction, charges payable under other mandatory contracts, security charges, credit brokerage charges, charges for Payment protection insurance, repayment of credit | Prepaid interest, loan processing fee, underwriting fee, document preparation fee, private mortgage, insurance, discount points | (a) Administrative charges, including charges for services, transactions or any other activity in relation to the loan; (b) charges for the services, or disbursements, of a lawyer or notary that a bank required the borrower to retain; (c) insurance charges other than those excluded; (d) charges for a broker, if the broker's fees are included in the amount borrowed and are paid directly by the bank to the broker; and (e) charges for appraisal, inspection or surveying services, related to property that is security for a loan, if required by the bank. | All costs including interest, commissions, taxes and any other kind of fees that the consumer is required to pay in connection with the credit agreement and which are known to the creditor, costs in respect of ancillary services relating to the credit agreement, in particular insurance premiums, are also included if, in addition, the conclusion of a service contract is compulsory in order to obtain the credit |

| Disclosure regimes in developed Countries | | | | |
|---|---|---|---|---|
| **Country/ Region** | **UK** | **USA** | **Canada** | **EU** |
| **Charges Excluded** | Default charges, charges paid by cash and credit customers, incidental charges, care, maintenance and protection charges, bank charges (atm charge etc), guarantee charges, charges for the transfer of funds, insurance premiums | Title or abstract fee, escrow fee, attorney fee, notary fee, document preparation fee, home-inspection fee, recording fee, transfer taxes, credit report and appraisal fee. | Charges for optional insurance, charges for an overdraft; fees paid to register documents; penalty charges for loan prepayment; services of a lawyer or notary; charges for appraisal of secured property; insurance against default on a high-ratio mortgage; fees to maintain a mortgage tax account ;fee to discharge a security interest; or default charges. | Notarial costs, default charges, transactional charges including accounts and transfers (except where the consumer does not have a reasonable choice or such charges are abnormally high), membership subscriptions. |
| **Disclosure** | The APR must be included in credit agreements and pre-contract information. A typical APR must be included in most credit advertisements | Banks are required to provide complete information about the cost of credit, monthly payments and interest rates and to provide a complete list of costs upon request. | Full disclosure of credit terms. Anyone providing goods or services on credit must give the consumer a written statement showing all financing charges and the annual percentage rate of the credit transaction. It must also explain how any extra charges would be calculated if you failed to make the payments. | Pre-contractual information should include type and amount of credit, duration, and borrowing rate, APR illustrated by means of representative examples mentioning all assumptions used to calculate the rate, conditions and procedure for terminating the agreement, applicable charges. |
| **Advertising** | Most credit advertisements must include a typical APR. The typical APR must be more prominent than any trigger information, and any other financial information. In the case of advertisements in printed or electronic form, it must be at least 1.5 times the size of financial information including the price of goods offered in the advertisement. Financial information must be presented together as a whole in the advertisement, and with equal prominence. Some advertisements for mortgages or other secured loans may be subject to dual regulation under the Consumer Credit (Advertisements) Regulations and the Financial Services and Markets Act. | All credit advertisements must display the APR at font size 18 and ensure that it is prominently placed. Additional information to be provided in the advertisement is scheduled payments, total size of loan and finance charges. | Advertisements for loans and credit cards must disclose the APR, the term of the loan and any non-interest charges. The APR and information on the charges must be provided at least as prominently as the representation and in the same manner, whether visually or aurally, or both. If the APR or the term of the loan is not the same for all loans to which the advertisement relates, the disclosure must be based on an example of a loan that fairly depicts all those loans and is identified as a representative example of them. | Standard information to be included in credit advertising: the borrowing rate, particulars of any charges included in the total cost of the credit to the consumer, annual percentage rate of charge, if applicable the duration of the agreement and the total amount payable and the amount of the instalments. |

## 3.2 DEVELOPING COUNTRIES

### 3.2.1 Peru

#### Regulation

In Peru, consumer credit protection has been consolidated under the *Regulation for Information Transparency and Applicable Rules for Contracting with Users in the Financial System*, which falls under Consumer Protection Law. The enforcing agency is the Superintendency of Banks, Insurance and Private Pension funds (SBS), which enforces the disclosure of quantitative and qualitative information on the products and services of financial institutions including interest rates and bank charges. Enforcement is ensured through regular monitoring, yearly compliance evaluation and unannounced branch visits. Financial institutions are obligated to provide complete information regarding interest rates, commissions and other fees to their clients communicated through leaflets, posters inside the bank, staff and on the banks website.

The standard measure used is the APR, which in Peru is called the Annual Effective Cost Rate (TCEA).

#### Disclosure

Disclosure is mandatory and under an initiative called the Transparency of Information. The SBS publishes on its website and in newspapers the maximum and minimum interest rates charged by banks and other financial providers. Originally, the SBS periodically published the rates, fees and costs associated with credit. In 2005, the SBS created a computer application called Registry of Interest Rates, Fees and Other Costs (RETSAS) which enables supervised banks to enter data regarding all costs linked to their asset and liabilities transactions and allowing clients to see up to date interest rates, costs and fees in a comparable form. In addition,as stated above, disclosure to the consumer takes the form of direct disclosure in financial instituitions and the prominent display of information at all client interfaces.

#### Scope of institutions and products

The institutions that have their product related information disclosed include banks and financial institutions, municipal savings banks, farm loan banks and Edpymes[12]. Interest rates and APR rates are posted on the SBS website and in major national newspapers for different categories of credit such as personal loans, credit cards, loans for micro-enterprises and loans to low-income persons.

In each category of credit, the minimum and maximum TCEA is listed for loans of different sizes and terms. The TCEA for credit cards is reported separately. In addition, the SBS also publishes monthly payments, fees, insurance and account maintenance costs associated with specific credit products such as mortgages, consumer and small business loans.

To enable the customer to understand the rates and fees better, the SBS ran a national awareness campaign through newspaper ads, explaining the TCEA measure and its significance. Extensive financial literacy awareness campaigns are in the pipeline for 2009 along with planned partnerships with mass media to get the message out. The SBS states that before this detailed publication the interest rates had shown resistance to fall even in an environment of high liquidity and low international interest rates. After publication the average credit card interest rate fell 1500 basis points in six months (Arrunategui, 2008).

12. Microfinance institutions

### 3.2.2 Ghana

#### Regulation

Ghana recently embarked on borrowing cost disclosure reforms with a view to 'making it easier for consumers to compare the cost of credit from different sources of credit' (Bank of Ghana, 2008). The reforms initially focused on setting minimum disclosure requirements for financial institutions by requiring them to publish their audited financial statements in newspapers on an annual basis.

#### Disclosure

The Bank of Ghana recognised challenges in the disclosure and pricing of loans and deposit products and established a new disclosure regime in March 2008, which incorporates the requirement that each bank and non-bank financial institution excluding rural banks,calculate and disclose to the central bank an APR measure for structured small loans to the retail and small business segments. Financial institutions, including Non-bank financial institutions are required to submit these APRs to the central bank, which then reviews and publishes these results quarterly in newspapers. All institutions that provide credit to lower market segments are obliged to submit the APR but rural banks are exempt because of their small size and the fact that their credit products and fee structure are relatively simple.

#### Scope of institutions and products

The Bank of Ghana has clearly stipulated which fees are to be included and excluded. Fees such as the processing fees and insurance premiums are not included as the Bank expects that the consumers can easily ascertain these personally. The Bank has not stipulated the exact term and principal amount that should form the basis for the calculation of the APR, but the general perception among the banks is that the APR is calculated for a typical short term loan to the retail or small business segment. The loan size and terms are not mandated because of the wide variation in loan size, terms and client bases among the different types of FIs, but generally comparison is straightforward between similar institution types, e.g. MFIs generally offer smaller loans and shorter term loans to low income consumers and enterprises, while smaller banks offer slightly larger loans for longer terms to mid income consumers. This has led to complaints from the MFIs because the APR on their loans is relatively high when the short term interest rates are annualised. The Bank of Ghana's APR measure focuses on smaller structured personal and business loans as the corporate sector is in a position to negotiate favourable terms on its borrowing.

The Bank of Ghana does not see the possible differences in the loan amount and term on which the calculation of the APR is based between banks as a major hindrance in the market due to the general understanding of the type of loan that the APR refers to. The list of charges in the APR calculation is included as a note to the charges published in the national newspaper, but the repayment schedules and other aids are not published.

The Bank of Ghana reviews the APR submission by financial institutions to ensure that the required format is adhered to. In addition it checks the figures submitted against financial statement data that is also submitted to the central bank. Rather than having the individual institutions publish these rates, the APR measure and the charges are published by the central bank in a national newspaper to ensure accuracy and increased credibility. The initial reception and impact of the new disclosure regime has been mixed. While consumers have generally appreciated the increased pricing transparency and competition in the financial sector, the financial institutions have raised reservations about the formula

used and the differences in loan sizes and terms between the different institutions. Most of the non-banks have commented that they have lost clients as a result of their APRs being perceived as too high due to the nature of their products.

However, compliance has been good, mainly as a result of the severe financial penalties and reputational risk associated with non-compliance. The Bank of Ghana has also provided ongoing training and on site visits to ensure that the measure is widely and uniformly adopted.

**Table 2: Disclosure regimes in Peru and Ghana**

*Source: Desktop research, stakeholder consultations*

| | Peru | Ghana |
|---|---|---|
| **Name for standard comparison measure** | Annual Effective Cost Rate (TCEA) | Annual Percentage Rate |
| **Act** | Consumer Protection Law in Financial Services Issues. Regulation of Transparency | Banking Act for banks Non-banking Law for NBFIs |
| **Regulator** | La Superintendencia de Banca, Seguros y AFP (SBS) | Bank of Ghana (BOG) |
| **Disclosure requirements** | Full disclosure of interest rates, commissions and costs of credit to consumers. | Full disclosure of all related charges to consumers and to the BOG. APR rate on loans to be provided to the BOG. Finance charges include service charge, finder's fee, credit report fee & insurance premiums. |
| **Advertising** | Market interest rates published daily in major newspapers and on the SBS website. Comparative interest rate, costs and fees published periodically by SBS and updated on the website. | BOG publishes APR rates for all credit institutions in newspapers on a quarterly basis. |
| **Which institutions/products services it applies to** | Banks, MFIs | Banks, Non-Banks, Rural banks |

### 3.2.3 South Africa

#### Regulation

South Africa does not have a standard prescribed interest measure such as the APR, that enables the uniform comparison across different financial and non-financial institutions. However, it does have its own regulations and policies that standardize disclosure and credit practices and that address some of the same concerns around greater transparency within the financial sector and when entering into a credit agreement.

This regulatory framework emerged to protect low-income consumers who had limited financial knowledge, limited access to formal credit and were at high risk of exploitation when entering into credit agreements. To rectify this and to provide uniform guidelines in lending practices across the different segments, the National Credit Act (NCA) was signed and put into practice in 2007.

The Act seeks to 'promote the development of an accessible credit market, particularly to address the needs of historically disadvantaged persons, low income persons, and remote, isolated or low density communities' (National Credit Regulator, 2006)). It is enforced by the National Credit Regulator while the National Credit Tribunal has been set up to hear cases of non-compliance under the NCA. The NCA sets out quite extensive disclosure requirements for FIs. A consumer must be provided with a pre-agreement contract detailing the principal debt, the proposed distribution of the amount, the interest rate, credit costs and the total cost of credit including any additional costs incurred as part of the credit agreement. Depending on the type of credit agreement, the Act also has clear and detailed guidelines on what charges may be added to the credit agreement (e.g. initiation, collection fees) and also outlines what percentage range this cost can fall into relative to the principal amount. In addition there are caps on the interest and fees that can be charged on a particular product. Credit life insurance in particular, has stringent rules and regulations surrounding it. The onus is also on the credit provider to assess the consumer's debt level and assess whether the consumer can take on more debt. The purpose of these regulations are broadly to 'promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers' (National Credit Regulator, 2006). These measures ensure comprehensive disclosure across the board and consistent treatment of different credit products and providers, aiding the consumer in making informed choices.

#### Disclosure

Apart from the prescribed disclosure requirements, the regulation also addresses unfair disclosure to consumers, for example quoting misleading information in advertisements and brochures and also requires financial institutions to present information in plain language to the consumer. This is further clarified in section 64 of the NCA which states that "a document is in plain language if it is reasonable to conclude that an ordinary consumer of the class of persons for whom the document is intended, with average literacy skills and minimal credit experience, could be expected to understand the content, significance and import of the document without undue effort".

A standardised credit agreement format clearly laying out price information and tested for simplicity and consumer understanding is utilised by all financial institutions. At the level of formal financial institutions, most of the bigger banks voluntarily, make available their base lending rates (ABSA, Standard Chartered). However, the charges and fees associated with the products are not as easily available unless a consumer asks for a quote or a pre-agreement document.

Deliberations leading up to the promulgation of the Act put the protection and interests of vulnerable, low-income consumers at the centre of the debate. A review of disclosure regimes was conducted and the findings from the review and international research were contextualised in the South African context. Broad conclusions were that firstly, consumers would benefit most from simple standardisation that they could understand and secondly, that disclosure alone was not enough and needed to be balanced by additional regulation. There was also a consideration that micro-lenders and smaller credit providers would be adversely affected by an APR disclosure regime since their APRs would necessarily be higher, and since these smaller credit providers were seen as providing critical access to credit to the low-income population, it was felt that this would not be appropriate for them. The NCA therefore moved away from an APR disclosure model towards a more generalized disclosure policy and increased the regulation on interest rates and charges and fees.

#### Consumer education

Over a year was given to FIs before the regulations came into full force. During this time the NCR launched several awareness campaigns and conducted in-depth workshops with credit providers. The most widespread campaign was run by the Credit Bureau regarding the new regulations, reaching out through mass media advertising in print and on television. Credit providers were also required to advise their clients of the new

regulations. Currently organizations like You & Your Money, Money Sense and Summit Finance offer credit advice, debt counselling and financial education to credit consumers and also offer information about the NCA regulations.

### Implementation

During the implementation phase several issues were encountered especially regarding the restriction on fees. While micro-lenders and smaller credit providers were less affected by the tightening of the fee structure since they had fewer fees to start with, the formal banks had to consolidate their varied fees into the required categories which required extensive re-working of contracts, wording and software.

Interest rate caps were a greater problem for the micro-lenders, given that their loans were generally charged higher rates given the nature of the loan, the risk and its short term period. Other implementation issues emerged around low consumer awareness and understanding and the misrepresentation of pre-contractual agreements to be as binding as actual contracts.

Enforcement for the Act has also been less effective than expected. The Act empowered consumers by giving the option of self-enforcement. Consumers could have provisions and contracts overturned if the credit-provider was non-compliant with the new regulations. The tribunal was given extensive powers, equivalent to a court order and could impose financial penalties of up to 10%.However there have been low instances of consumer complaints and tribunal orders.

The impact of the NCA is anecdotal and points towards reduced over-indebtedness. General feedback in terms of disclosure is that consumers care about monthly premiums above and beyond any other type of information including the interest rate. The monthly payments rate is of key concern to the consumers, who have less regard for loan size and term.

## 3.2.3 Malaysia

### Regulation

Consumer protection in Malaysia is regulated by the Consumer Protection Act (CPA), which came into force on November 15, 1999. The CPA applies to areas of consumer protection that are not already covered by other statutes. In terms of general consumer credit protection, the Act offers broad guidelines to support greater disclosure and transparency and ensure that consumers have access to relevant, comparable and timely information on products and services. A significant focus has been on the insurance sector, given that a significant segment of the Malaysian consumers do not have good understanding of insurance products. In particular, guidelines on medical and health insurance and the requirements for marketing of life insurance policies, have been strengthened while rules for independent financial advisers have been introduced.

### Disclosure

Currently, Malaysia does not have a standardised interest rate measure or a well-defined disclosure regime although there is an active interest in introducing such measures. Regulation for consumer credit falls under various pieces of legislation and is enforced by different government authorities.

Among these are the Hire-Purchase Act of 1967, the Moneylenders Act of 1951, the Islamic Banking Act of 1983 and the most recent, the Banking and Financial Institutions Act (BAFIA) 1989. BAFIA is under the jurisdiction of the Ministry of Finance and is administered by the Central Bank of Malaysia (Bank Negara Malaysia).

### Scope of products and providers

Credit offerings in Malaysian banks include personal loans, home loans, hire-purchase financing and credit cards. While the BAFIA regulates both banks and finance companies, it provides protection primarily to depositors and not to the creditors of these institutions. Interest rate on loans is regulated through guidelines issued by the Central Bank and is pegged at Base Lending Rate (BLR) plus a spread of 2.5%, while interest rate for credit card loans are not regulated at all and vary from 1.75% to 2% per month.

For credit card loans, the Central Bank guidelines only stipulate that the minimum monthly repayment is to be at 5% of total credit usage. All other terms and conditions are stipulated and imposed by the banks and finance companies via the loan agreement signed. Regulation for hire-purchase only provides a maximum cap of 10% per annum on a fixed term basis.

These rates are posted on two Central Bank-supported informational websites for consumers called BankingInfo and InsuranceInfo. BankingInfo provides comparative tables and rates are provided on Base lending rates, fixed deposit rates, Hire purchase, Credit Card and Housing loans for all banks and credit providers. The consumer can thus pull up interest rates and compare them without having to go to the provider to access information or get quotes. Insurance companies have similar rates on the InsuranceInfo site.

### Consumer education

Malaysia has a strong focus on consumer education and awareness and especially in raising financial literacy levels. BankingInfo and InsuranceInfo also provide consumer education through booklets in various local languages, detailed information on credit products and services and simple examples to illustrate what consumers should do in different scenarios and how to go about making credit decisions. In 2006 the Credit Counselling and Debt Management agency was created to offer financial advice to consumers about credit and over-indebtedness.

Chapter 4

# INTRODUCING A STANDARD RATE IN KENYA

This section outlines the Kenyan context in terms of financial providers and the consumers of those financial services and products. It broadly describes i) the types of formal financial institutions present in Kenya, ii) access to finance, iii) financial education needs of consumers, especially low-income, iv) and the usage of financial services and products both in terms of savings and credit. It then proceeds to describe market perceptions and attitudes as gleaned from in-depth focus groups conducted in four regions and split along gender and age. These focus groups are used to understand consumers' decision making processes and are used to test the concept of a standard interest rate measure as well as other forms of disclosure.

## 4.1 KENYAN FINANCIAL LANDSCAPE

The Kenyan financial landscape is shaped by the following formal and informal institutions:

- 45 commercial banks (including 1 non-bank financial institution and 2 mortgage finance companies);
- 3,600 SACCOs;
- 50-100 formal and informal MFIs.

Banks publish pricing information on interest rates, transaction charges, processing fees and insurance costs, usually expressed as a percentage. This information is also published in local newspapers and on the CBK's website. Apart from these initiatives, at present there is no stringent regulation around financial reporting in Kenya and no financial consumer protection law in place. Within these initiatives as well, little or no information is provided to explain how these rates are calculated and individuals may not understand how these may affect their loan or account balances. MFIs and SACCOs generally provide pricing information in the form of repayment schedules, detailing the total amount to be repaid every month. The interest rate is often a composite of all the costs associated with the financial product, including all fees and the cost of insurance.

This section discusses the needs and perceptions of the target market, regarding a disclosure regime that is simple yet comprehensive.

**Table 3: Bank pricing information disclosure**

*Source: Daily Nation, September 2008*

| Bank | Rates % | Period Max | Max Loan | Fee % | Insurance Cover |
|---|---|---|---|---|---|
| KCB | 16.0 | 36 months | 1.5m | 2.0 | 0.54% |
| Equity | 15.0 | 60 | | 3.0 | n/a |
| StanChart | 19.0 | 48 | 1.3m | Nil | n/a |
| NIC | 19.0 | 48 | 1.0m | Nil | 0.25% |
| CFC Bank | 19.5 | 36 | 1.0m | 1.5 | |

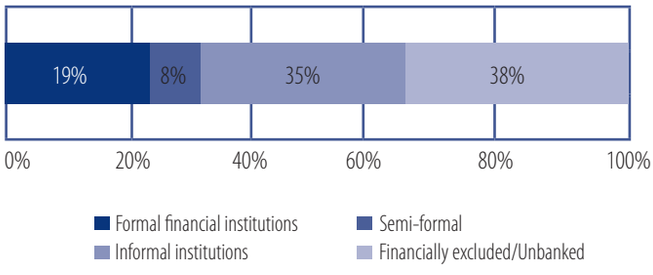
## 4.2 ACCESS TO FINANCE[13]

The adult population, comprising individuals above the age of 18 was an estimated 17.4 million in 2006. This is a population that is young – approximately 50 % between the age of 18 and 34, literate – 73 % of adults are literate (HDR, 2007) and technologically-savvy – 55 % own or have access to a cell phone. The population is evenly split between men and women, and also between urban and rural dwellers.

The Access Strand in Figure 2 shows the proportion of banked and unbanked in Kenya. Only 3.2 million people or 18.9 % of the population are formally banked. However, the availability of m-payments services, the rapid expansion of bank branch networks and the introduction of innovative new products targeted at reaching the unbanked and the poor is likely to increase the number of financially included individuals significantly (CBK, 2007). This is a population that is aggressively being courted by formal and semi-formal financial providers and is in dire need of impartial information, skills and tools to differentiate between products and providers, to negotiate the terms of contracts and to seek recourse when needed.

**Figure 2: The Financial Access Strand**

*Source: FinAccess (2007)*




## 4.3 FINANCIAL SERVICES USAGE

### 4.3.1 Credit

32 % of the population or about 5.5 million people had a credit product, service or facility, the bulk of which constituted goods purchased on credit from local shops or suppliers. Personal loans from a bank and credit card facilities were being used by only 6 % and 2 % of the population respectively, while 13 % obtained a credit facility from a SACCO. Surprisingly, only 3 % obtained a loan from a microfinance institution. 10 million people or 62 % of the population had never had a credit service, product or facility.

Credit is seen as a grudge purchase. Most people do not like owing money but find that it is necessary to do so, especially when running a small business. When it comes to the servicing of debt, 46 % of the formally served, and 38 % of the informally served admitted that they were often surprised by the final repayment amount. In addition, a quarter of the total population agreed that they never seemed to be able to repay their debt. Instead, the amounts owed kept escalating. This demonstrates a need for education on the need to determine how much credit one can afford and how to calculate the amount to be repaid regularly.

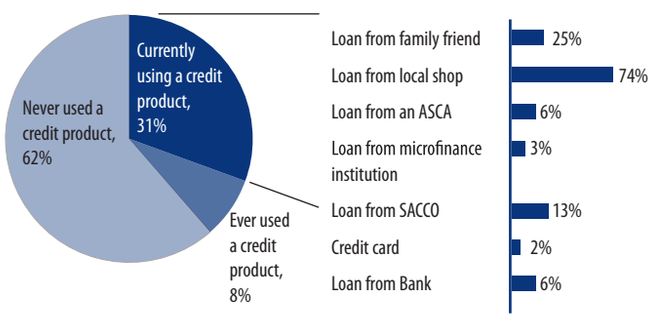



**Figure 3: Credit products usage**

*Source: FinAccess (2007)*

13. This section mainly covers data obtained from the FinAccess survey results (2007)

### 4.3.2 Savings

Savings products are more widely used. Approximately 52 % had a formal or informal savings product. The majority of these were savings accounts with a ROSCA (56.5 %), although there are quite a substantial number of individuals with savings accounts at a bank (29 %), at Postbank (11 %) or in a SACCO (24.7 %). Very few people bank or save with microfinance institutions (3 %), which is to be expected as very few of these institutions are deposit-taking institutions.

Under the Banking Act section 16A, Kenyan banks are not allowed to impose any form of charges on a savings account and are required to pay interest accruing to that account as long as a minimum balance is maintained. The minimum balance limit is set by banks themselves, and interest rates vary according to the amount of balance maintained in an account. The interest rates also vary with respect to the number of transactions per account, and most banks specify a minimum balance and a maximum number of withdrawals per month. The rates that are published by the CBK in a national newspaper report monthly fees, cost of an interim statement and withdrawal fees both over the counter and through ATMs for savings accounts per month. Interest rates are listed for fixed deposits, but not for savings accounts.

SACCOs and deposit taking MFIs in Kenya generally do not report an interest rate. This is largely due to the fact that most of these organisations operate on a profit-sharing basis. Profit earned is distributed out amongst members at the end of the year and the interest rate earned is dependent on the profit which is an unknown at the beginning of the year and cannot be quantified.

Perceptions of savings products and providers provide an illustration of consumer education needs. Of those who had used a savings product in the past but had stopped using them, high charges, erroneous charges or low interest on savings were cited as the most common reasons for discontinuing use of the product. Understanding how interest rates are calculated and the potential growth value of accumulated savings can prove very beneficial for individuals as there is high demand for savings products. This represents a population of only about 1.3 million people but we can extend this hypothesis to individuals who have never used a savings product, about 7 million people.

Also, the fear of losing money was prevalent, ranging from 10 % for SACCOs to 27 % for MFIs, indicating the need to understand the risks associated with different savings vehicles and the need for guidance on safe places to store accumulated savings.

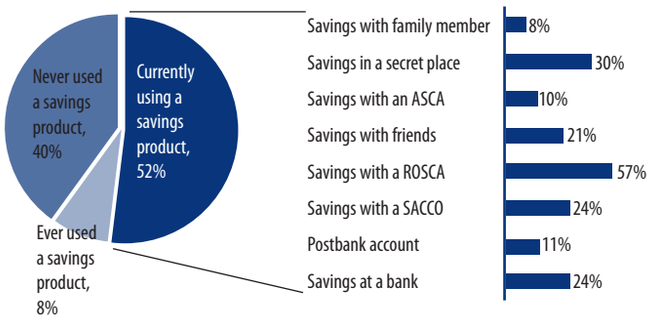



**Figure 4: Savings products usage**
*Source: FinAccess (2007)*

## 4.4 FINANCIAL EDUCATION NEEDS

The results of a scoping study on the provision of financial education in Kenya identified fourteen high-level initiatives by formal, semi-formal and informal financial services providers (FSD Kenya, 2008). The majority are programs on how to run a small business and basic education on the benefits of saving. In addition, banks also promote their products through this medium, thereby introducing some bias into the process. Some skills such as calculating interest rates, comparing between lenders and determining repayment amounts are not widely taught.
Financial education themes identified in the report are listed in the table below. A recurring theme is that of making the right choices, that is, deciding where to place one's money or choosing the best credit product or provider. Given the current context of aggressive formal banking expansion into new markets, it is imperative that individuals are empowered to compare between products and providers.

**Table 4: Financial education themes**
*Source: FSD Kenya. (2008). Financial education in Kenya*

| Product type | Financial education needs |
|---|---|
| Savings | Value of savings<br>How to save<br>Where to save<br>Understand savings products |
| Debt management | Why borrow<br>When to borrow<br>How much to borrow<br>Avoid over-indebtedness<br>Where to borrow (choosing between lenders)<br>Loan products and terms |
| Bank services | Why and how to use money transfer services<br>E-banking and M-banking<br>The difference between non-regulated and regulated financial institutions<br>Bank instruments |
| Investments | Investment opportunities<br>How to choose investments<br>How to recognise fraudulent schemes<br>Recognise false lure of 'get rich quick' schemes<br>Recourse when financial institutions fail |

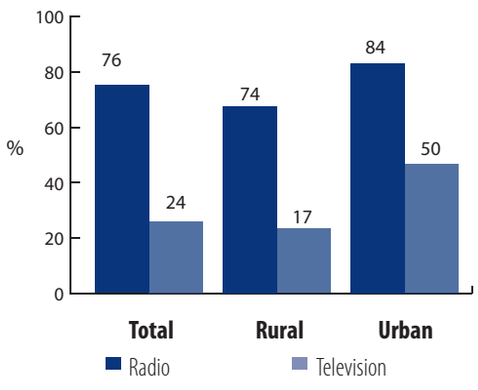
Integrating more specific information and skills building into the proposed national financial education programme such as how to compare between products and what goes into the costing of a loan can be done effectively by leveraging existing programs and initiatives. However, the use of mass media to educate individuals on how to apply the new APR measure can be even more effective, reaching more people in a standardised format that will ensure that the proper information reaches the population that needs it most. For instance, three-quarters of the total population owns a radio, while 25 % own a television. The incidence of ownership is higher in urban areas than rural areas, especially for television ownership.

Newspapers are another important medium. These are widely disseminated and often contain numerous bank advertisements for a variety of financial products, facilitating the immediate application of newly-acquired skills. For example, an individual can read about the new APR measure, what it constitutes and how it can be applied to compare between financial products and immediately apply this knowledge towards comparing between

two bank advert for a personal loan product. However, newspapers can be restricted in the format and language of communication. On the other hand, radio programs can be broadcast in a variety of formats and languages, and are free.

**Figure 5: Ownership of mass media channels**

*Source: FinAccess, 2007*




## 4.5 MARKET PERCEPTIONS AND ATTITUDES

The section which follows reports on the main outcomes of the focus groups which were conducted within the Kenyan market in October 2008, the principle objectives of which were to understand the financial products and services decision-making process and explore perceptions towards different interest rate measure reporting mechanisms. Details of the focus group composition, sampling methodology and approach are given in the Appendix of this report.

### 4.5.1 Interest rate measures

Although most respondents were aware of the interest rate applicable to their respective loan products, there was no understanding of how these are calculated or the impact of these rates on the loan value. Users of loan products did not know whether the interest was calculated as a flat rate or on a reducing balance or what the terms meant. However, not all wanted to know or understand these rates.

Some respondents expressed a preference for a simple summary of how much needed to be repaid, including costs and charges, while others wanted to understand how these charges were calculated so that they could conduct their own calculations and compare between products.

> *"I was not told this is a flat rate I was just told you will be paying the loan at 15% interest rate. I think banks take advantage of first timers."* (Male, Older Loan, MFI & Bank, Nairobi Urban)

Most respondents did not understand the fees and extra charges on loan products. The banks were identified as being particularly defective in the dissemination of information on fees and other costs.

> *"There is another thing which is common that is 16% which is included but you are never told what it is for. In fact I was going through the bank statement the other day and I realized that there was 16%."* (Male, Older Loan, MFI & Bank, Nairobi Urban)

### 4.5.2 Standard cost measures

An exercise applying the TCC and APR measures and the repayment schedule was conducted in all groups to determine preferences in the disclosure of pricing information and also to determine the best way of disseminating this information.
The TCC was considered helpful for the following reasons:

- It psychologically reassures and gives confidence that indeed one is making the right decision as there is transparency.
- The TCC concept is easy to understand as it does not require high literacy level.
- The total amount being paid for the credit facility can be calculated.
- How much the bank is gaining from the transaction process can be understood.
- Comparison of offers by different financial institutions is made possible.
- It will aid in decision making as far as understanding calculations on flat interest rates in an interesting and interactive manner.

The APR measure was considered helpful for the following reasons:

- It gives consumers the ability to know how much is being paid when it comes to loan products.
- It equips consumers with information to help decide which payment period is best and will result in some savings.
- It will help the borrower understand how bank charges on loan/credit products are calculated.
- It will bring about healthy competition between banks because of transparency, with the customer benefiting ultimately.

The repayment schedule, already in use by local banks and MFIs was considered useful for the following reasons:

- The repayment/payout schedule has a better layout as one is able to know how much they should pay back, while at the same time keeping track of payments made so far.
- Most respondents were of the opinion that it is more transparent and better to understand as compared to the APR.

Overall, there was a greater preference for the TCC and repayment schedule measures, the former because disclosure is comprehensive and the latter because the layout is very easy to understand. Many respondents felt that they did not have the skills to calculate the APR or did not know how to translate this into accessible numbers. In addition, they felt that the APR measure does not take into account other costs such as processing fees which are currently a source of confusion and which customers factor into their calculations of how much needs to be repaid.

### 4.5.3 Scope of institutions and products

Respondents were very familiar with a range of formal products including different types of current accounts, savings products and loan products such as housing development loans, car loans, asset financing. The awareness and usage of informal financial products and services such as "Shylocks" and "merry-go-rounds" was also very high with a great deal of cross-usage between different types of formal and informal products among respondents. In spite of this awareness, many rarely compared products and providers according to available pricing information. The main drivers of decision-making in the choice of one credit product or credit provider over another were as follows:

- Account ownership/Group membership: This was especially the case for short-term and emergency loans. Individuals usually borrow from institutions or groups where they already hold accounts or have savings. Longer-term loans may require more scrutiny of the pricing structure and other terms and conditions.
- Direct Marketing by Banks/MFIs: Individuals were guided in their decisions by

advertisements seen on television and radio or through direct interaction with a sales representative from a bank or MFI. Forums, employer recommendations and the advice of friends who use or have experience with the product or provider is also highly influential.

- Pricing Structure: The pricing structure was also considered, but respondents mainly related this to minimum balance requirements and the flexibility of terms and conditions for current accounts. The smaller the minimum requirement balance, the more attractive the product or provider to the individual, especially if these are low-income individuals. [this para seems to refer to deposits rather than loans?]

Product take-up, especially for loans appears to be driven primarily by emergencies. In their haste to obtain credit, individuals may not take the time to consider the product offerings of different types of providers. This is especially true of the previously unbanked consumers, who are vulnerable to exploitation. This places the onus of responsibility on government and financial institutions to provide this information prior to a crisis or emergency, so that the individual is already well-equipped when an emergency strikes.

On the savings side, the focus groups showed that respondents found bank procedures to be both complex and cumbersome involving a multitude of forms, signatories, with requirements for an affidavit and often a guarantor. Most reported that they had no idea how much interest their money was earning, or was supposed to earn, and the consensus was that banks did not disclose this information clearly. Most respondents felt that it was not worthwhile to have a savings account with a bank and that banks were more suited to people with money. They preferred opening an account with a SACCO that had fewer opening requirements, would also enable them to get a loan easily and gave dividends at the end of the year. No real interest was displayed by respondents at the prospect of having a standardised interest rate for savings accounts.

### 4.5.4 Disclosure and dissemination requirements

The process of obtaining a loan from a bank is characterized by complexity and a lack of transparency. Banks were described as having too many documentation requirements, and did not provide enough time or explanation to enable customers understand the terms and conditions and pricing of the loan. In addition, there is a perception that there are hidden charges which are not disclosed at the outset and are only evident in bank statements. While respondents admitted that the insurance costs, processing fees and repayment schedule are provided by some banks and most MFIs, respondents also felt that they also needed to know how much they would have to repay in total, including other transaction costs and interest payments. The general feedback was that smaller credit providers had more transparency in their credit processes and their credit agreements were easier to understand in terms of interest and repayment amounts. In terms of savings, focus group respondents felt that banks did not disclose the interest rate clearly and most respondents were confused about how much interest their money earned.

> *"I took a loan in March in one of the banks around I was surprised to find that I was taking Ksh.50000 and they deducted Ksh.10000 I asked them why they were taking this and they told me it was for insurance and what have you and they did not explain that to me in the first place. I tend to think that SACCOs do not have any hidden charges"*. (Males, Younger, Savings, MFI & SACCO, Eldoret Rural).

> *"Yes like now that one of double paying they cannot tell you that exactly. Therefore, when you realize or when you have a problem that is when they show you those terms and conditions. Sometimes you do not understand as they are normally written in very small letters. And sometimes they use the banking language that jargon and sometimes you do* not understand." (Female, Older, MFI & Banks, Nairobi Urban)

Many respondents did not feel that banks would readily adopt the TCC measure as it will expose all hidden charges and would introduce greater competition.

> *"They (banks) will not do that because they will lose customers. If they show those details you will not take the loans as you will have seen the high charges."* (Male, Older, Savings, MFI & Bank Mombasa Urban)

In terms of the communication channels to be used in educating consumers on any or all of these measures, respondents mentioned the following:

- Advertisements on media/posters/billboards
- Road shows
- Sales team
- Brochures
- Customer care offices/call centres
- Seminars at banks or MFIs
- In booklets during the loan application process

### 4.5.5 Supportive mechanisms

Many respondents felt that they did not have the skills to calculate the APR or did not know how to translate this into accessible numbers. This was especially the case for rural respondents. They explained that they were not particularly interested in how the rates and fees were calculated as they just want to get a loan, although they would not mind getting more information on them. For this group, a simple method such as the repayment schedule was considered more suitable.

> *"The problem is most of us are very poor in maths. In addition, we are usually taken for granted. So that is the problem with this, they give you figures, figures, figures. I would prefer to be given the final figure for the whole year."* (Male, younger, Savings, MFI & SACCO, Eldoret Rural)

On the other hand, urban respondents were comfortable with the TCC and APR measures due to their higher levels of numeracy. However, as these are self-reports, actual understanding of these measures may be much more limited. Some education on how to calculate interest rates can be useful for urban dwellers, while a verbal description of a repayment schedule (by radio) may be more useful for rural clients. To address different needs and to ensure comprehension, some respondents proposed that all three measures should be adopted and communicated by the government or by the financial institution.

> *"I tend to think that all three of them should be made available to the customer/ customer at the time of taking a loan. With The repayment schedule, Total cost of credit and the annual percentage rate… it is very easy for anybody to manipulate the repayment schedule and insert figures that do not even correspond with the total cost of credit and the annual percentage rate."* (Male, Older Loan, MFI & Bank, Nairobi Urban).

Chapter 5

# APPLICATION TO THE KENYAN MARKET

This section relates the findings from the international review and the analysis of the Kenyan market to the standard interest rate measures.

## 5.1 SUITABLE MEASURES FOR KENYA

The interest rate measures most widely used are the APR, the TCC and the repayment schedule. The APR provides a way for consumers to compare interest rates across different products and institutions. However, comparison of APRs across loans that do not have similar sizes and terms may produce misleading results. The TCC represents all the costs associated with the credit agreement. It is shown as a lump sum and includes all interest payable and all charges (both finance and non-finance). The TCC can also be used as a comparison measure across loans with similar sizes and terms. However the component charges of the TCC are less regulated and standardised than the APR.

The international review shows that the APR method is generally used in developed countries, while developing countries have less standardised interest rate measures. The US, UK and the EU report the APR measure for the majority of credit agreements. However there are differences in the APR calculation in these countries based on the method of interest calculation and the types of charges that are either included or excluded. Of the developing countries reviewed, only Peru and Ghana have adopted the APR methodology, while the rest use a variety of regulatory tools to enforce and monitor disclosure requirements.

A key outcome of a comprehensive disclosure regime is to empower consumers by enabling them to compare interest rates and to shop around for a suitable product. It is very important therefore, to keep the consumer in mind when deciding and designing a disclosure model and to understand what type of disclosure would most benefit the target market. The Financial Services Authority in the UK has conducted several in-depth studies on consumer credit decision making and behaviour. One such study shows that consumers get confused by a plethora of information and do not know how to access comparative information (Financial Services Authority, 2000). Another report on consumer rationality and choices shows that consumers use simple heuristics to arrive at their decisions, and that while the APR measure is important for decisions about the source of credit, the Total Cost (TC) is more important in repayment schedules (Rob Ranyard, Lisa Hinkley, Janis Williamson, Sandie McHugh, 2006). Research from the US shows that consumers are bad at making choices when confronted with choices and are bad with numbers, leading to the conclusion that there needs to be a simple, unified message for consumers to truly understand and engage with the concept (Rusconi, 2008).

Most countries that have implemented the APR disclosure regime also require the TCC to be disclosed in credit agreements and advertising. In these cases, the TCC only includes the charges included in the APR. Of the developing countries reviewed, South Africa requires TCC disclosure in credit agreements. The repayment schedule illustrates the amount and timing of the payments that the consumer is required to make to the credit provider. These payments include repayment of the principal, interest charges and other associated charges. The RS is useful as it allows the consumer to easily compute the affordability of credit. However, it gives little insight into charges and the overall cost of the credit to the consumer. The countries that have adopted the APR generally require credit providers to also state the repayment amount per time period. In developing countries, the repayment schedule is generally reported to the consumer and as stated above, does not offer any insight into charges.

In terms of calculation, the APR measure is the most standardised of the three, and can be regulated by means of a single standard equation and a stringent list of included and excluded charges. While all the developed countries specify which APR equation to use, the US and Canada are more open-ended in terms of the charges to be included in the APR, leaving it up to the credit providers to include all finance charges into the calculation. The EU, on the other hand has specific list of charges that all institutions and all countries must adhere to. This does not allow credit providers to devise creative ways of labelling charges and therefore leads to greater standardization and therefore a measure that is truly comparable.

While all three measures are useful for consumers, the APR measure generally allows for the most standardised form of comparison across institutions. However, there is a strong body of research, driven largely by findings from the FSA in the UK, which indicates that even when provided with comparison measures and information, consumers tend to focus on the simplest measure and make their decisions accordingly. This measure is usually the monthly repayment amount (Kempson, 2008), which is the easiest for consumers to relate to their monthly budget and offers them a simple measure of affordability. The South African disclosure regime is a case in point which has a comprehensive disclosure policy in place, but relies mostly on TCC and repayment amounts and the listing of charges rather than on an APR measure.

The perception within the Kenyan market, derived from focus groups, is that consumers would have greater comfort with the use of repayment schedules and TCCs. This is similar to findings from international research. Many of the informal and smaller credit providers that provide the bulk of facilities to the Kenyan market already have some degree of disclosure relating to these measures. However, these are not standardized across institutions. Standardisation of these measures would increase the comparability of these measures between institutions and products, while maintaining the simplicity that is likely to encourage active consumer use of the measures.

## 5.2 SCOPE OF INSTITUTIONS AND PRODUCTS

Usage of formal financial services in Kenya is low. The financial access strand from the FinAccess database shows that only 19% of the Kenyan adult population makes use of formal financial institutions.

The scope of the disclosure regime may cover institutions and/or types of credit and is primarily determined by the answers to the following questions:

*What is the degree of competition and disclosure in the financial industry?* The levels and uniformity of disclosure in the Kenyan financial industry is generally low. Interest rates are not calculated or disclosed similarly across the institutions. The primary rates indicated are the flat interest rate and the reducing balance interest rate, which are not comparable at face value. Furthermore, there is a plethora of finance charges that are not clearly defined and categorized, increasing the degree of variation across financial institution.

Competition for unsecured loans to the salaried market has increased in the last five years, as market saturation in the higher end of the market and falling interest rates have contributed to banks' willingness to extend lending to previously ignored sections of the market. However, for consumers that do not fit the criteria required i.e. employed, regular salary, getting a loan from a bank remains a difficult process with stringent requirements.

This has resulted in a large section of the market approaching non-bank credit providers. These range from the more formalized (such as MFIs and SACCOs) to the unregulated lenders (such as 'shylocks').

Many of the focus groups respondents shied away from approaching banks for loans

because the process of acquiring loans from banks was perceived to be too cumbersome; with lengthy turnaround times, low levels of transparency and too many requirements to be fulfilled prior to accessing the credit or opening a savings account.

*Who does the institution lend to?* Disclosure methods are likely to be influenced by the financial sophistication and bargaining power of the end user. Clients who have higher bargaining power and are better informed are more likely to demand greater transparency and are in a position to negotiate better rates. This is the case in the corporate lending market, where bigger corporates can negotiate pricing and access information on competing offers due to the large volume of business they command. The individual consumers in the lower market segments have neither the resources nor the bargaining power to successfully access and understand information on the competitive space, and make relevant comparisons.

*What is the capacity of the financial institution to institute a standard interest rate measure?* Formal institutions may find it easier to comply with the requirements of a standard interest rate measure, taking into account the associated costs and resource requirements. Smaller, less formalised institutions may experience difficulties due to limitations in capacity and lower skill levels. These capacity issues must be addressed when designing the APR calculation. However, it must also be noted that generally these organizations have simpler products and fees. In Peru for example, capacity constraints are taken care of by centralisation of the calculation through a computer application managed by the Superintendency of Banking, while in Ghana all the APR figures are re-checked by the Central Bank. The choice of APR calculation can be used to overcome capacity constraint issues, e.g. the N-ratio APR can be calculated using a calculator. Another option can be to provide a simple computer tool that allows for APR calculations or to manage APR calculations centrally through data submitted by financial institutions.

The measure may also lead to a comparison of different types of FIs. For example, in Ghana MFIs had higher APRs due to the short term nature of their lending i.e. the short term interest rates were relatively higher when annualised. However, the APR comparison requires a comparison of similar loan sizes and terms and it would prove useful in comparing the offerings of different MFIs.

The international review shows that the scope can be approached from an institutional or product point of view. The US has adopted an institutional view whereby the institutions providing credit are regulated and monitored to ensure compliance. In the EU countries (including UK & Ireland), the approach has been to regulate the type of credit agreement rather than the providers of such agreements. Both approaches have merit – the first enables a clear segmentation of institutions to be regulated and tailored regulations; the second allows for more inclusion within the regulatory ambit, with little distinction between the different sized credit providers.

The Kenyan market could be receptive to either method. The current financial landscape is already segmented between different types of financial providers, with various institution-specific regulations in place. Thus the disclosure regulations could also be institution-specific.

While all credit providers would now be subject to some form of disclosure regime, the requirements would differ by perceived capacity. For example, the informal and smaller credit providers (with less capacity) could be required to disclose the less stringent repayment schedule and total cost of credit, while more formal and larger credit providers would in addition be required to calculate and disclose the APR. However, it could be argued that all institutions have the capacity to calculate and disclose the APR. As mentioned earlier, the N-ratio APR is a close approximation of the actuarial method APR and can be easily worked out on a calculator. Furthermore, training programs by the CBK would increase skill levels where this is seen to be lacking. The calculations in terms of savings rates are more complex given the open ended nature of most savings accounts and in the case of SACCOs that give dividends rather than interest, can be less relevant.
Disclosure of regulation by credit product could also be feasible in the Kenyan market. The inclusion of credit agreements would be determined by various characteristics such as the type of product, the size and the term. The EU approach applies the disclosure regime to products based on their size – only credit agreements between €300 and €75,000 are subject to the APR disclosure regime. This could be introduced to Kenya and the restrictions on size of the credit agreement be used to include or exclude the targeted institutions and products.

The market perception was that all institutions be subjected to more rigorous disclosure requirements, without any exception. However, the Kenyan financial market, especially informal credit providers, has not been subject to disclosure regimes and requirements in the past. It is expected that the credit providers would possibly be resistant to the introduction of further regulation around disclosure of interest rate measures. This would be driven mainly by cost and capacity concerns.

## 5.3 DISCLOSURE REQUIREMENTS

As mentioned earlier, international research indicates that consumers tend to get overwhelmed and confused by too much information, therefore it is also important to give consumers the most relevant information, without 'overloading' them. This is especially true where there is less awareness about interest rates and credit calculations, and where consumers, particularly low-income consumers, have low levels of financial literacy. This is especially relevant for Kenya where most of the credit applicants approach the less formalized credit providers for credit.

Currently, there is no standard disclosure regime in Kenya. However, the CBK has introduced regular surveys that give an indication of the bank interest rates and charges. Notwithstanding the methods of interest calculation remain varied (most indicate either flat rates or reducing balance rates) and there is no defined list of charges (or disclosure requirements) that are to be included in credit agreements.

A Consumer Protection Bill (2007) that consolidates all consumer laws in Kenya was introduced to Parliament in was introduced to Parliament on the 24/8/07 and went through one of 3 readings on 30/8/07. It is still pending and has a long process to go through before it is adopted. The bill addresses consumer credit protection, requiring financial institutions to deliver an initial disclosure statement to the borrower before or at the time of entering into an agreement. However, there is no specific information prescribed for disclosure, nor are there any compliance guidelines.

For effective disclosure, the bill would need to be re-visited and more comprehensive guidelines established around disclosure, its scope and enforecement.The market perception derived from the focus groups is that the more financially astute preferred disclosure of the calculations leading to the standard interest rate, while the less financially astute were only interested in the final results of such calculations. However, the interest rate concept needed to be explained in detail to both groups before they could engage with it.

It is important to mention here that for the standard interest rate to be truly comparable, consumers must compare similar loans of similar size and term. Dissemination can take place through direct or indirect disclosure channels. Direct disclosure involves the FIs being responsible for the active dissemination of the information to the consumer. In the UK, all banks are required to have the APR figure prominently displayed wherever

advertising for credit products exists, including in bank branches. The US, UK, Canada and Ireland all require the APR to be displayed in all credit advertisements and credit/pre-credit agreements. Credit agreements between the parties generally also include the details of the APR, charges included and total cost of credit. Further protection is offered to consumers in the EU whereby consumers are offered a 'cooling off' period after the signing of the loan agreement during which the consumer may cancel the credit agreement without penalty.

Direct disclosure is important in reaching down to the low-income consumers who may have limited or no access to websites and may not purchase newspapers. These consumers will largely obtain their information directly from the service provider or from leaflets and brochures provided by the FIs. To reach down to this mass market it is imperative that direct disclosure be required.

Indirect disclosure occurs when FIs submit their calculated measure to the central bank or other authority for verification and dissemination. In Ghana, the central bank receives this information from the FIs, verifies the method of calculation and relates it to other information on the FIs (e.g. financial statements) and publishes the consolidated figures quarterly in newspapers. The Superintendency of Banking in Peru also consolidates information and then publishes it on a daily basis on its website.

Indirect disclosure is often viewed as being more objective and therefore more reliable than the information provided by credit providers themselves. This can take the form of publishing rates and measures in reports, on websites, in newspapers and/or advertisements. The FSA in the UK, the OFT in the US and the Financial Consumer Agency in Canada all play dual roles of regulator as well as information disseminator. In the US and the UK, where the APR is commonly used extensive information is available on websites and through consumer advice and protection centres. Peru ran a series of prominent newspaper advertisements explaining the rate and what it meant for the consumer at the time of the APR launch. However, dissemination is costly and will require buy-in from larger financial institutions, while smaller organisations may not be able to bear the cost themselves. The Central Bank of Ghana, by taking on the cost of publishing the APR has been able to address this issue.

There is a general preference expressed in the focus groups for a combination of direct and indirect disclosure. However, increasing the variety of dissemination channels to be more inclusive should not lead to an overload of information to the consumer. In the Kenyan context, the TCC and repayment schedule are both relevant and easily understood by low-income consumers, while the APR measure can be useful for more financially knowledgeable consumers.

In Kenya the focus group results showed that the preferred channels were widely circulated local newspapers and the radio to specifically reach the lower income market, while the higher income market can be targeted via more sophisticated channels such as websites and online advertising. Disseminating at the local points of presence of the credit providers would also aid in consumer awareness.

## 5.4 SUPPORTIVE MECHANISMS

International experience shows that consumers need to better understand interest rates and financial terminology in order to engage with the credit market in an informed manner. Towards this end, the disclosure regime needs to be backed by a range of supportive measures that aim to educate and inform consumers, especially the low-income market, about the standard measures, their usefulness and about how to utilise the measures to make informed credit decisions.

There are two broad levels of support mechanisms used in parallel with a disclosure regime. A disclosure regime launch is generally accompanied by a marketing and awareness campaign to make the consumer aware of their right to information, to explain what a standard measure is and how it is used for comparative purposes, and to explain other disclosure methods if any. Peru for example had an extensive campaign that backed up the launch of the disclosure policy.

The results from the focus groups indicate that consumers would require extensive ongoing training and information drives to ensure that the standardized measures are understood and used. Respondents initially found the new concepts difficult to understand and interpret but this was reduced by further explanations and clarification of queries. The market response and use of any new measure will be enhanced by increasing consumer knowledge and comfort with respect to interest rate measures. International research in the space of consumer outreach shows that successful outreach programs by governments have an extraordinary focus supported by broad outreach and a big budget and simple message that is repeated as many times, in as many ways as possible (Rusconi, 2008).

## 5.5 REGULATION AND COMPLIANCE

Regulation and compliance is crucial to ensure that a uniform measure is adhered to by credit providers. If this is not adequately addressed the whole purpose of introducing standard interest rate measures is made redundant. Most regulatory authorities have adequate experience in introducing and monitoring regulatory changes to the financial industry. The introduction of a standardized disclosure regime must be viewed in the same light as other existing regulation i.e. it must be promulgated in a clear, concise and unambiguous manner, and the penalties for non-compliance must be severe enough to incentivize compliance.

The international review shows that in the countries where APR disclosure has been implemented, it has been made mandatory for the relevant financial providers. In the countries reviewed, there has been no instance of voluntary compliance, which is largely driven by the additional cost and regulatory implication of the disclosure regime. The regulation around disclosure needs careful design and wording to ensure correct implementation. The APR calculation needs careful definition in terms of charges included and excluded with little scope for creativity around exclusion. Only if all relevant charges are reflected in the measure, is it possible for it to be useful and comparable. The regulation must also specify how the APR is to be disseminated and displayed, whether on a weekly, monthly or quarterly basis and through which channels, e.g. websites, brochures, advertisements and how prominently.

In the US and Ghana, in addition to financial penalties levied by the regulator, consumers can take legal action against the credit providers that make misleading or dishonest disclosures. In the UK, the OFT has established a call line for complaints mechanism in support of financial penalties and 'name and shame' campaigns.

Standard disclosure regimes have been regulated and enforced by a central body where they have been introduced. Voluntary compliance is unlikely to be successful as such regimes usually lead to additional regulatory and implementation costs to the credit provider. The Kenyan situation demands even more enforcement mechanisms as there is no disclosure regime currently in place and credit providers are unlikely to openly embrace the initiative.

The Kenyan financial industry is currently regulated by institution type. Each type of institution is governed by specific legislation. For example, while Banks are governed by the Banking Act, MFIs and SACCOs will fall under the MFI and SACCO Acts once these are

finalized. Consumer protection as relating to the provision of credit is not well entrenched. It is likely to be more efficient to include disclosure regimes within existing institutional regulations with oversight by the various bodies e.g. CBK, Ministry of Co-operative Development and Marketing. These efforts could be co-ordinated by an independent third party to ensure that the disclosure regime is uniformly applied across the various institutions. This third party can be an existing body mandated to oversee the regulation, or can be created for this sole purpose. For example South Africa introduced a tribunal that has the power to penalize non-compliant credit providers on a wide range of regulatory infractions.

Enforcement and compliance are important elements of an effective disclosure regime (Office of Fair Trading, 2008). Patchy compliance can lead to distortion in the market, with compliant credit givers posting higher interest rates in the form of APRs being viewed as more expensive relative to non-compliant credit givers. However, lack of adequate compliance needs to be met with functional penalties, such as is the case in South Africa where non-compliance could lead to a penalty of up to 10% of turnover.

## 5.6 IMPLEMENTATION CHALLENGES

The introduction of additional regulation to any industry faces implementation challenges. These can be reduced by conducting consultations with the main stakeholders within the industry prior to the introduction of the regulation. The main challenges internationally have revolved around resistance from credit providers in general, capacity constraints relating to smaller credit providers, a non-standard application of finance charges, difficulty in calculation of the standard interest rate measure and lack of consumer awareness and use of the measures.

Kenya is likely to face the challenges listed above, especially those relating to low financial literacy levels and possible resistance to greater regulation by credit providers. There would also be challenges with respect to co-ordinating the various regulations that govern the different types of credit providers. The fact that the majority of credit extension is provided by less formalized credit providers with limited regulatory oversight also poses a challenge.

Chapter 6

# CONCLUSIONS AND RECOMMENDATIONS

International research shows that consumers generally do not make substantive use of detailed information when shopping around for loans and can get confused by excessive information. It is important to identify the most relevant information for the target market. Thus the focus groups generally found the repayment schedule and total cost of credit to be the most relevant to their needs. There was also feedback that suggests that the credit agreements of smaller credit providers were simple and easy to understand and that these can be reviewed and standardised for wider application as an initial step. More interest was also expressed in absolute numbers than a percentage measure. However, the credit providers should be required to submit adequate information to the regulator to enable it to monitor and check the basis of the calculation and disclosure.

Disclosure requirements should be comprehensively and clearly set out. At the minimum, the disclosure requirements should ensure that consumers understand the contracts, terms and conditions of the credit agreements that they are entering into. Financial institutions should also be obligated to provide information about the fees, costs and charges built into the credit facility. An informed consumer will then have the capacity to move to the next level of understanding a standardised interest rate and using it for comparison purposes. Comprehensive disclosure requirements will lay the foundation for the introduction of a standardised interest rate. In addition, it is imperative that it should be made clear to consumers that the measure is comparable across loans of a similar size and term.

It is critical that regulation which is introduced be mandatory and apply to all institutions without exception including MFIs and SACCOs. This is because there is an increasing overlap in terms of market segmentation and market presence. For example, banks in Kenya are increasingly pursuing opportunities for extending credit to the lower end of the market, while smaller players are looking to expand lending to segments that were previously the reserve of banks. This also enables greater standardization of disclosure across the board and enables meaningful comparisons across similar loan sizes and terms. Exceptions related to the application of the disclosure regime to specific products should be tightly defined and related to specific products e.g. products below a clearly defined size, products with clearly defined features. As with other regulation, penalties for non-compliance will ensure that the new regulation is introduced by most institutions These penalties could include financial fines related to the company's turnover, and /or reputational penalties e.g. public naming of the transgressors.

In terms of a savings interest rate, the calculations involved are more complex due to the open ended nature of most savings accounts. In addition, the rate varies according to minimum balance requirements, number of withdrawals and term of deposit, and these components must also be compared across products to get a true comparison. A standard rate is also not relevant in the case of dividend paying SACCOs which do not have an upfront rate to quote. It is therefore more practical to focus on the credit side and expand the regime and regulation at a later stage to encompass savings products.

It is also important that the regulatory body be actively engaged in applying and monitoring the content and methods of disclosure by the credit providers. Given the general perceived lack of transparency in the financial industry in Kenya, the CBK's involvement would add to the authenticity and reception of the measures by the consumers. Dissemination by the credit providers needs to be supported by dissemination by the CBK to ensure the streamlining and uniformity of the disclosure regime. In addition, the CBK can also ensure that the standard interest rate measure is applied to different categories of credit i.e. loans of a similar size and term for comparison purposes. The CBK would also need to be the primary provider of support to institutions seeking to apply the new regime and to consumers seeking assistance in understanding the new measure. This could be achieved by creating a disclosure regime department that oversees the implementation of the new regime.

To ensure the success of the supporting information campaign, it is vital to choose a method that is in-line with the information dissemination channels and methodology in a particular country. In a country with low literacy levels and low newspaper circulation, using print media will be a less effective channel, as compared to radios for example. Internet access and connectivity will be important if disclosure is mandated through websites. Therefore it is important to evaluate available channels and use a combination of methods to allow for widespread dissemination, which will lead to the greatest awareness and ultimately to the most impact. The most effective channels indicated in the focus groups were television and radio advertisements, followed by a helpline and then seminars and workshops and brochures and the sales staff at credit provider outlets.

Finally, it is essential to run both short and long term support programs for consumers to launch and sustain awareness about interest rate measures and disclosure policies. The key is to have a central coordinating body to integrate and give high level direction to the support measures put in place, but to supplement central directives with a range of on the ground measures. This central body could be an existing organisation, or could be put in place to coordinate these measures. At the government level in Kenya, depending on the range of resources available it would be useful to establish advice centres and helplines to allow consumers to better understand and engage with a disclosure regime. In addition, partnerships must be established with existing organizations and not-for-profit agencies on the ground to disseminate a unified simple message.

## 6.1. RECOMMENDATIONS

*What standard interest measure and what method of calculation?*

- The report recommends that the disclosure regime in Kenya start with a simple standardized measure that can be easily implemented as well as understood by the average consumer. The TCC and RS measures meet both criteria.
- An APR measure can be introduced as a next step, once consumers and credit providers become more familiar with the concept of standardized disclosure.
- The APR measure calculation should follow the EU norms in terms of the equation and adopt the standardized and comprehensive EU list of charges to be included or excluded from the calculation.

*Scope*

The disclosure regime should be applied to all institutions and/or to clearly specified credit agreements. Exceptions could be introduced, based on the product characteristics, but the majority of the credit agreements especially relating to the lower end market segments should still be covered e.g. there could be a cut-off loan amount below which the loans are not regulated.

*Disclosure*

- As a first step, comprehensive disclosure requirements should be clearly set out and defined, requiring all financial institutions to disclose all the terms and conditions of the credit to the consumer prior to entering into a contract. A standardised format for credit agreements that is easy to understand and sets out price information clearly needs to be developed that can be applied to all institutions.
- The standard measure must be disclosed to the Central Bank for publication and further dissemination. The measure must also be advertised on location by credit providers and disseminated through available brochures and booklets. The measure must be standardised in terms of loan size and term to ensure comparability across institutions.
- All contractual agreements and pre-agreements must include the standard measure, as well as details of all charges related to the cost of credit in plain, easy to understand language.

- The standard measure should be clearly displayed on all promotional material and/or products and service advertising by a credit provider. The standard measure should be prominently displayed, in a large font size, be able to be clearly seen, and should be stated in clear, easy to understand terms.
- All additional branchless banking outlets and channels must also display this information and have details on hand for the consumer.
- The CBK must publish the standard interest rate measure of all credit providers on a quarterly basis. Banks must send in their rates to the CBK on a monthly basis and this information should be regularly updated on the CBK and service provider websites and in credit provider branches.
- The launch of the standard rate measure and the disclosure regime should be accompanied by media campaign with advertisements on the radio, in newspapers and on television. This campaign should be further supported by the publishing of brochures and leaflets and by workshops.

*Supportive measures*

- There should be a parallel effort to work with financial education programs to incorporate information about the disclosure regime and to build consumer financial literacy to enable them to benefit from the new regime.
- From the focus groups it seems that the most effective and wide-reaching form of dissemination is through a sustained media and advertisement campaign on television, radio and in national newspapers.
- A money advice helpline that can assist consumers in understanding the standard interest rate measure and how to use it is also recommended.

*Regulation, compliance and enforcement*

- The disclosure regime must be made mandatory, with supporting regulation to enforce and monitor the regulations. This can be addressed through revisiting the pending Consumer Protection Bill (2007), or by drafting supporting legislature.
- A disclosure regime regulating department must be established with the jurisdiction to enforce the measure through monitoring, liaising with a dedicated agent at the credit providers' organization and with the power to impose financial penalties in the case of non-compliance.
- There should be a mechanism in place to enable the hearing and judgement of consumer cases. This role can be played by existing financial ombudsman and courts, or this power can be mandated to the regulating department.
- Financial and reputational penalties should be introduced and applied.
- Furthermore credit providers should provide monthly reports and feedback to the CBK.

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# APPENDIX

### Focus Group: Sampling and Methodology

Qualitative methodology was used to collect data on consumer perceptions. This was through 2-hour focus groups comprising of 8-10 participants held in a central location. The focus groups were conducted by The Steadman Group. The methodology made it possible for the moderator to explore and interact freely with respondents, while getting incisive insights. The output of the discussions was transcribed, analysed and correlated by geographical and usage profile. Transcripts and the learnings have been sent to the client. The reporting format focuses on (majority) aggregate output, while highlighting insights from the minority.

### Sampling and composition

A screening questionnaire was used to select the respondents. The selection criteria were as follows:

- All the urban respondents had a loan product and microfinance membership (MFI)
- All rural respondents had a saving product, in addition to either microfinance (MFI) or SACCO membership
- Rural respondents were mostly low-income while the urban respondents had a more varied profile and included some relatively higher income responsdents.

The urban rural sample split was as follows:

- Urban sample: Nairobi and Mombasa, males and females target, aged 23-49
- Rural sample: Kisumu and Eldoret, males and females aged 23-49 years

Overall, the gender split was at 50:50 ratio.

**Table 5: Sampling Methodology and Focus Group Composition**
*Source: Genesis Analytics, 2008*

| Group | Participation Criteria | Age | Town |
|---|---|---|---|
| Group 1 | ■ Must have a loan product<br>■ Urban dwellers<br>■ Males/MFI & Bank membership | 23- 35 years | Nairobi |
| Group 2 | ■ Must have a loan product<br>■ Urban dwellers<br>■ Females/ MFI & Bank membership | 36- 49 years | Nairobi |
| Group 3 | ■ Must have a savings product<br>■ Urban dwellers<br>■ Males/ MFI & Bank membership | 36- 49 years | Mombasa |
| Group 4 | ■ Must have a loan product<br>■ Urban dwellers<br>■ Females/ MFI & Bank membership | 23- 35 years | Mombasa |
| Group 5 | ■ Must have a Loan product<br>■ Rural dwellers<br>■ Males/ MFI & SACCO membership | 36- 49 years | Kisumu |
| Group 6 | ■ Must have a savings product<br>■ Rural dwellers<br>■ Females/ MFI & SACCO membership | 23- 35 years | Kisumu |
| Group 7 | ■ Must have a loan product<br>■ Rural dwellers<br>■ Males/ MFI & SACCO membership | 25- 35 years | Eldoret |
| Group 8 | ■ Must have a loan product<br>■ Rural dwellers<br>■ Females/ MFI & SACCO membership | 36- 49 years | Eldoret |

# Notes

# Notes

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