CONSUMERS' KNOWLEDGE ON INTEREST RATES AND REPAYMENT PERIOD ON CREDIT SOURCE

Patrick Chege Muchiri[1] and Walter Bichanga Okibo[2]

School of Human Resource Management,
Jomo Kenyatta University of Agriculture and Technology

ABSTRACT

Quantitative approach was adopted where descriptive research design was be applied. A sample of 100 potential and existing credit consumers was used to collect data using a questionnaire, by visiting lending institutions, market and business places, learning institutions and some respondents at their home places. Findings suggest that credit consumers were not fully aware of the credit lending conditions so as to make an informed decision on where to acquire the credit facility. The study also showed that Work place and financial institutions constituted 72 and 78 percent of the financial information respectively to the credit consumers despite some biasness expected from the financial lending institutions. According to these findings and previous research work, it is evident that lack of financial knowledge is more likely to affect specific groups and this should concern the policy makers, including less financially sophisticated and lower-income consumers.

Keywords - *Consumers' knowledge, Interest rates, Repayment period and Credit source*

1. Introduction

A Credit Reference Bureau (CRB) is a firm that collects information from various sources and provides consumer credit information on individual consumers for a variety of uses. The firms are known by various names: In the US the firms are called credit bureaus, in the United Kingdom, a credit reference agency, while in Kenya it is a credit reference bureau. A CRB provides information on individuals borrowing and bill paying habits. CRB gather and sell credit information. They collect information about your credit activities, store in giant databases, and charge a fee for supplying the information. The most common type of CRA is the credit bureau(Lee, 1999). Credit bureaus can provide information only to the following requestors: Creditors who are considering granting or have granted you credit, employers considering you for employment, promotion, and reassignment, or retention, insurers considering you for an insurance policy or reviewing an existing policy, government agencies reviewing your financial status or government benefits, anyone else with a legitimate business need for the information, such as potential landlord (Lee, 1999).

Credit bureaus also furnish reports if required by court orders. They will also issue your report to a third party if you request this in writing.There are three credit reporting agencies in the United States of America, Equifax, Experian and TransUnion, which use FICO software to generate FICO scores (Fair Isaacs Corporation 2003). In Kenya, the first credit bureau has just been authorized to generate credit reports.Kenya has over 42 banks, numerous MFIs (Microfinance Institutions) and Saccos (Savings and Credit Cooperative Organizations) and in 2009, lending of over 25 billion Kenya shillings was granted. The healthy state of the economy offers an untapped opportunity for the credit bureau business(Betsey, 2006). Lenders need to base their decisions on relevant information about consumers, so automated and sophisticated credit information retrieval systems are key to managing credit risk. The predictiveness of decision making solutions has been enhanced by the introduction of shared credit information via credit bureau, resulting in better risk management for lenders and improved profitability. Credit bureaus are key enablers for the growth of a nation's consumer economy and the quality of consumer credit portfolios, whilst protecting the privacy and credit exposure of individual consumers.The purpose of this study was to establish consumer's financial knowledge and its effects on credit source (Rosella B., 2010).

2. Statement of the Problem

Financial knowledge has become not just a convenience but an essential survival tool with the changing structure of our economy. A lack of financial knowledge can contribute to the making of poor financial choices that can be harmful to both individuals and communities. Those who study financial literacy generally agree that many, if not most, credit consumers lack the financial literacy necessary to make important financial decisions in their own best interests (Perry, 2008); (Braustein, 2008). Experts also generally agree that, financial appears to be directly correlated with self-beneficial financial behavior(Hilgert, 2003). Agencies transfer the premium risk - what banks charge for not knowing how a consumer repays a loan - that has traditionally been borne by consumers as a portion of the lending rate. Interest rates are not uniform for all consumers; they can be based on risk-based pricing, a form of price discrimination on different borrowers, as set out in their Credit score and history. This is why consumers with poor credit repayment histories or court adjudicated debt obligations like tax defaults, bankruptcies and other such bad history pay a higher interest rate than those who don't (Hilgert, 2003). Findings in the developed countries like USA suggests that, approximately 36% of consumers do not know about Credit source, approximately 32% has no enough financial knowledge about their Credit source while only 4% are conversant with their Credit source. Those with who overestimate their credit quality are less knowledgeable about financial matters in general and are more likely to have acquired their financial knowledge from difficult past experiences (Chang, 1992). Little if any is known and documented on the figures in developing countries like Kenya on financial knowledge awareness on Credit source information. The study therefore was to examine how consumer's rates on their knowledge on interest rates, repayment period, loan collateral and insurance charges of the lending institution and its effects.

3. Literature Review

Interest rate is the rate at which interest is paid by a borrower for the use of money that they borrow from a lender. Specifically, the interest rate is a percent of principal paid at some rate. For example, a small company borrows capital from a bank to buy new assets for their business, and in return the lender receives interest at a predetermined interest rate for deferring the use of funds and instead lending it to the borrower. Interest rates are normally expressed as a percentage of the principal for a period of one year (Courchane, 2008).Re-payment period is the time which a borrower is responsible for repaying his or her loan. However, when you go into repayment you will have the option to choose other terms. For example, you may extend the repayment period in order to make your monthly payments more affordable. Be aware that this means it will not only take you longer to be free of loan debt, but you will be paying more interest over the life of the loan. It is much better to limit your borrowing so that you can afford to pay your loan off within the specified period (Courchane, 2008). Finance companies (loan companies) offer consumer loans and financing for all purposes to the general public. Most finance companies tend to limit the amount loaned to any one customer and do not take deposits, offer credit cards or overdraft checking. Insurance companies commonly offer loans to holders of their policies. The loans are frequently limited to the cash value of the policy held by the borrower and must be applied for through the insurance agent or the company's home office. Rates are usually very low because you are, in essence, borrowing your own money (Courchane, 2008). Commercial banks generally offer a greater variety of credit than do other lenders. Banks can offer credit cards, lines of credit, term loans and installment loans, both on a secured or an unsecured basis. Most will make loans for cars, boats, home purchases, taking a vacation, paying off another loan, investing in a business, paying taxes, or a myriad of other reasons. As a general rule, they tend to be rather selective, choosing to make loans to individuals and businesses with established credit histories. At one time savings & loan associations were restricted to making residential real estate loans. Federal deregulation led to numerous speculative and risky lending practices, which precipitated the massive S&L failures of the late 1980s. The associations which survived gravitated back to a concentration on residential and commercial real estate lending. Most of the larger S&Ls operate in a manner which is identical to that of commercial banks (Ards S. H., 2006).

Financial literacy has grown in importance to researchers and policy makers in recent years. Much of the policy debate has centered on educating consumers and encouraging legislators to include financial literacy in public school curriculums (Perry, 2008). Research in this area has focused on measuring the extent to which consumers lack financial knowledge and the resulting consequences(Biais, 2005). For example in USA, in a nationwide survey of twelfth graders (Camerer, 1999)found an average score of 52.4% correct on a test of personal finance basics. In another example,(Hilgert, 2003) found that approximately 40% of mortgage borrowers did not understand the interest rates associated with their loans. This implies that significant number of borrowers make financial decisions without considering the implications those decisions have on their short-term and/or long-term financial status. Several studies have also linked consumer financial knowledge with responsible financial behavior. For example, (Chang, 1992)found that increased level of financial information resulted in more-efficient decisions. (Hogarth, 2002), (Hilgert, 2003)and (Betsey, 2006)found that consumers who are financially knowledgeable are more likely to behave in financially responsible ways. Similarly (Perry, 2008) found that consumers with higher levels of financial knowledge were more likely to budget, save, and plan for future. This study will examine the relationship between understanding of Credit source and financial decisions as well as relationship between education level, income level and gender to knowledge of Credit source.

Consumers are often confused about the true nature of their investment. In particular, investors, especially purchasers of pensions and structured products, are often uncertain whether or not they are exposed to the risks of stocks and shares. Nearly 40% of investors in stocks and shares (wrongly) believe their initial investment is protected. Although investments are usually triggered by a change of life circumstances and not marketing, information search is very limited. Only around 33% of investors compare investments from more than one provider or consider more than one product from a single provider. Just 27% of investors shop around to get the best deal. Advice is ubiquitous in the retail investment market. Nearly 80% of investments are made in a face-to-face setting, usually with an employee of the investment provider or a professional advisor. 58% of investors say their final choice of product was influenced by an advisor, while the advisor initiated the purchase on a quarter of occasions(Rosella B., 2010).Trust in advisors is high, but consumers are often unaware of potential conflicts of interest. The majority of investors mostly or completely trust the advice they receive, and do not perceive their advisor to be biased. Conflicts of interest are often only verbally disclosed, if at all, and most investors disregard the information or do not think about it (Rosella B., 2010).

4. Research Methodology

A descriptive research design was used involving a case study. The study targeted both existing and potential credit consumers with commercial lenders. The respondents included individuals cutting across all social status, both in formal and informal sector. A sample of about 100 respondents was used, randomly drawn to represent the entire population of credit consumers. It was estimated that there are about 5,000 existing and potential credit consumers in Ruiru and its environs, and therefore about 2% of this was used for the study. Distribution of questionnaire to the respondents/population was randomized so as to gather information from all potential social, gender and income categories necessary to provide the required information. Samples were collected from credit consumers visiting lending institutions, market and business places to capture business facility lenders, learning institutions and some respondents at their home places. The data was collected from two sources, namely primary and secondary data. The data was collected from the respondents and analyzed quantitatively using descriptive statistics to provide simple summaries about the population of interest and measures.

5. Findings

Table 1. Source of financial knowledge for the credit consumers

	Nothing	Little	Some	Fair Amount	A Lot
High school and College	7(8%)	20(21%)	20(21%)	35(38%)	11(12%)
Training, seminars outside school	6(7%)	6(6%)	20(21%)	42(45%)	19(21%)
Financial lending institutions	0(0%)	0(0%)	2(2%)	19(20%)	73**(78%)**
Difficult experiences “Hard knocks”	0(0%)	6(6%)	10(11%)	28(30%)	49(53%)
Parents, spouse/ domestic partner	0(0%)	6(7%)	20(22%)	33(35%)	34(36%)
Work place	0(0%)	0(0%)	9(10%)	17(18%)	67**(72%)**
TV or radio (media)	0(0%)	0(0%)	14(15%)	27(29%)	52(56%)
Friends and Peers	0(0%)	6(6%)	17(18%)	24(26%)	46(50%)

The study did establish that 78% of the total respondents reported to have acquired a lot financial knowledge from financial lending institutions especially where the credit consumer acquires the credit facility. The study also established that 72% learnt from their work place, 50% having learnt the same amount from Friends and peers, while 53% had learnt a similar amount from “hard knocks” and 56% from Media. Approximately 38% of the respondents reported having learnt a fair amount from High school and/or College, which is an indication of how insufficient our education systems are with regard to this vital and basic topic of financial knowledge. It implies that interaction from workmates, friends and peers seems to have the most significant impact on financial knowledge, while difficult financial experiences also significantly influences financial management.

Table 2. Consumer credit information knowledge on lending the institution

Consumer credit information knowledge on lending the institution	Yes	No
1. Before you acquire credit, did/do you find out, the interest charged on the loan and?	81(87%)	12(13%)
2. Do you find out, the re-payment period?	57(61%)	36(39%)
3. Do you find out, thecollateral required for the loan?	55(59%)	38(41%)
4. Do you find out, the amount charged for the insurance?	18(19%)	75(81%)
5. Do/did you find out change of interest rate from time to time based on the market rate will affect the loan given?	15(16%)	78(84%)
6. Do/did you do a comparison with other lending institutions on the above lending conditions before acquiring the loan?	7(8%)	86(92%)

European Journal of Business and Social Sciences, Vol. 3, No. 8 , **November 2014.** **P.P. 45 - 52**
URL: *http://www.ejbss.com/recent.aspx-/*
ISSN: 2235 -767X

From the findings 87% of the respondents were aware of interest charged on loan. Majority of those respondents got most of the information from the financial institutions and in a large extent from the actual lending institution where one acquired the credit facility.

Table 3. Correlation between Lending Interest rates and Credit source choice

		Lending Interest Rates	Credit Source
Pearson Correlation	1.000	.836**	
Lending Interest Rates	Sig (2 tailed)	0	.000
N	93	93	
Credit Source	Pearson Correlation	.836**	1.000
Sig (2 tailed)	.000		
N	93	93	

*****Correlation is significant at the 0.01 level (2-tailed)***

The table above shows there is a strong positive correlation between the Institution lending interest rates and the choice of the credit source that the credit consumer is likely to choose.

From the findings 61% of the respondents were aware of the re-payment period asked for a specific loan.Majority of those respondents got most of the information from the financial institutions and in a large extent from the actual lending institution where one acquired the credit facility.

Table 4 Correlation between re-payment period and Credit source choice

Loan re-payment period	Credit Source		
Pearson Correlation	1.000	.584**	
Loan re-payment period	Sig (2 tailed)	0	.000
	N	93	93
Credit Source	Pearson Correlation	.584**	1.000
	Sig (2 tailed)	.000	
	N	93	93

*****Correlation is significant at the 0.01 level (2-tailed)***

The table above shows there is a positive correlation between the loan repayment period and the choice of the credit source the credit consumer is likely to choose.

7. Conclusion and Recommendation

The loan lending interest rate charged by the lending institution remains one of the key determinants when one is acquiring credit facility. Majority of the credit consumers in the first instance seek to know how much interest rate that will be charged on the loan beforehand. Nevertheless, still a significant number of the credit consumers fail to compare the interest rates across the lending institutions to ease in a more informed decision. It is therefore importance to create more awareness both in the media and other plat forms that will enlighten the credit consumers to better their skills in making an informed decision. The loan repayment period also plays a key role in determining how much the credit consumer with qualifies as it determines the installment payments. Many of the credit consumers are informed on the same through many different plat forms and some remains biased especially the financial institutions as they displays their brighter side to the consumer as a winning strategy as number of the credit consumers fail to compare notes across the lending institutions to ease in a more informed decision. Financial knowledge and other crucial financial information need to be incorporated in school curricular at various levels of education to create awareness and therefore produce generations that embraces the general principles of making informed financial decisions.

According to these findings and previous research work, it is evident that lack of financial knowledge is more likely to affect specific groups and this should concern the policy makers, including less financially sophisticated and lower-income consumers. Given these findings, it is critical for policy makers and consumer advocates to encourage consumers take advantage of CBK requirements by obtaining a copy of their credit report and to keep abreast of changes in their credit requirements and also compare lending conditions of different lending institutions before acquiring credit. This will undoubtedly improve the accuracy of consumer’s decision makingon where to acquire credit. Several studies in the judgment and decision making literature have found that feedback tends to improve consumer’s sound decision making on credit acquisition(Rosella B., 2010);(Ards S. H., 2006). Policy makers and consumer organizations involved in financial literacy education could use public service campaign strategies and other social marketing approaches to promote this behavior.

References

1. Ards, S. a. (2001). The Colour of Money. (A. B. Scientist, Ed.) *Bad Credit, Wealth, and Race, 42*(2), 223 - 229.
2. Ards, S. H. (2006). The Effects of Bad Credit on Loans Denial Rates. *APPAM Fall Research Conference Proceedings.November 2*, pp. 45 - 58. WI: Madson.
3. Betsey, C. (2006). Believe Truth: How Perceptions may Hinder Equal Acess to Credit. *APPAM Fall Research Proceedings.November 2*, pp. 45 - 67. WI: Madison.
4. Biais, B. H. (2005). The Review of Economic Studies. *Judjmental Overconfidence, Self Monitoring, and Trading in Performance in an Experimental Financial Market., 72*(251), 287 - 312.
5. Braustein, S. W. (2008). Financial Literacy. *An Overview of Practise, Research, and Policy, 88*(11), 445 - 457.
6. Camerer, C. a. (1999). Overconfidence in Excess Entry. *An Experimental Approach, American Economic Review, 89*(1), 306 - 318.
7. Chang, R. R. (1992). Consumer Credit Search Behaviour. *Journal of Consumer Studies and Home Economics, 16*(1), 207 - 227.
8. Corporation, F. I. (2003, June 8). *Understanding Your Credit Score*. Retrieved from FICO Website: http:/www.myFICO.com
9. Courchane, M. G. (2008). Consumer Credit Literacy. *What Price Perception?, 60*(1 - 2), 125 - 138.
10. Griffin, D. a. (1992). Cognitive Psychology. *The Weighing of Evidence and Determinants of Confidence, 24*(3), 411 - 435.
11. Hilgert, M. H. (2003). Household Financial Management. *The Connection between Knowledge and Behaviour, 89*(July), 309 - 322.
12. Hogarth, J. a. (2002). Financial Knowlege, Experience and Learning Preference. *Preliminary Results from New Survey on Financial Literacy, 1*, 48.
13. Kahneman, D. a. (1996). Psychology Review. *On the Reality of Cognitive Illusions, 103*(3), 582 - 591.
14. Kinsey, J. a. (1998). Journal of Consumer Affairs. *Consumer Knowledge of the Costs of Open - End Credit., 15*(2), 249 - 270.
15. Lee, J. a. (1999). The Price of Money. *Consumer Understanding of APRs and Contract Rates, 18* (Spring), 66 - 76.
16. Perry, V. (2008). Is Ignorance Bliss? *Consumer Accuracy in Judgements about Credit Ratings.*(2), 42.
17. Rosella B., C. M. (2010). *Classification of Concepts in Consumer Education* (Vol. Monograph 137). MI 48197: South Western Publishing Company.