

## **An Assessment of Hidden Charges on Bank Credit as Source of Short-Term Finance for Firm's Sustainability**

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### **Abstract**

*Bank credit has become an important source of short term funding for many organizations in recent time. The need to bridge the financing gap between sales and the actual receipt of payment as well as maintaining the desired level of production has made bank credit imperative for sustainability. This research is to assess the various methods often adopted by banks in the analysis and pricing of the facility in order to achieve optimum utilization of bank credit by organizations. The quantitative method of analysis will be adopted to determine the most effective pricing that minimizes cost of funds to the organization. Secondary sources of data such as text books, journals, magazine, and newspapers will suffice for the research. Conclusion and recommendation will be made based on our findings.*

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**Key words:** *Bank credit, Hidden charge, Impact and Sustainability*

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### **Introduction**

Bank credit is the total amount of funds a person or business can borrow from a financial institution. Credit approval is determined by a borrower's credit rating, income, collateral, assets, and pre-existing debt. There are two types of bank credit, secured and unsecured. Each one has its own fees, interest rates, terms, and conditions

Bank credit is an agreement between banks and borrowers where banks make a loan or overdraft to a borrower based on their assessment of the borrower's creditworthiness. The bank essentially trusts a borrower to repay funds plus interest for either a loan or overdraft at a later date. Bank credit also refers to money that banks lend or have already lent to customers.

Bank credit has grown considerably in Nigeria in the past one and half decade as a result of the introduction of microfinance bank regulatory and supervisory framework in 2005 as well as the effort of the central bank of Nigeria at attempting financial inclusion in Nigeria among other factors. They are basically two broad types of bank credit as follows:

1. Bank overdrafts, one of bank credits, are normally repayable on demand. They are never in practice, called in without reasonable notice. Except in credit squeeze conditions, businesses can easily borrow for up to a year with adequate provision for a rollover. When
2. The overdraft facility is turned over from year to year continuously, the overdraft in effect becomes medium term or even long term source of finance (although at

variable rate of interest and payable at short notice). In such a case, bank overdraft is not listed under current liability on the balance sheet, but long term debt capital.

Under an overdraft facility, a bank permits a client company to draw cheques in excess of the amount lying to its credit in its current account up to a pre-arranged.

Limit for usually up to one year. Interest of about 2.5% above the base rate is charged on the amount overdrawn, calculated perhaps on a daily basis.

Bank overdraft is free from transaction cost and the interest varies with the general Rate.

3. Advances and short term loans, which are forms of bank credit, unlike overdraft are taken in a single transaction and usually a fixed rate of interest is payable on them. Generally, the rate of interest charged by a bank is determined by the risk classification of the borrower and this varies from one borrower to another. There is however more to cost than the interest paid. The cost of a loan or overdraft includes also apart from interest, the cost of making the application which include professional fees paid to accountants and valuers who assist in preparing the application and the cost of conducting the negotiation. Even as far as interest is concerned, the effective rate paid will also depend on the other terms of the loan e.g. the method of calculating interest, the method of loan repayment allowed and any provisions relating to the loan. A lending bank may specify any of two ways of computing interest — it may use the regular (or simple interest) method or alternatively the discounted basis

### **Objectives of the study**

The broad objective of this study is examine how bank credit as a source of short term finance can bring about sustainability of an organization. The specific objective includes:

- i. To examine bank credit are priced to bring about sustainability.
- ii. To investigate if there is any hidden charges in the pricing of bank credit.
- iii. To determine the effective cost pricing of bank credit in the short term.

### **Statement of Hypothesis:**

For the purpose of this research, the following hypothesis becomes imperative.

**H01:** There are elements of hidden charges in the pricing of bank credit

**H02:** There are no elements of hidden charges in the pricing of bank credit

### **Literature review:**

Bank credit is as old as the business of banking itself, it is the fulcrum upon which the banking business revolves. Bank credit is alubricant that lubricates the wheel of economic growth and sustainable development. Banking business evolved as a result of the ancient goldsmith's discovery that those who deposited gold for safe keeping do not come to collect them all at the same time and that they could lend out a fraction of the gold deposited with them at a fee in the short time period. This discovery no doubt, brought about banking business as well as bank credit. Majekodunmi (2003) credit management lies at the heart of Banking. Although banks initially emerged as deposit takers, they soon matured into intermediators of funds, there by assuming credit risk

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The importance of credit to a lending banker would include, but not limited to the following:

- i. As earlier demonstrated, credit is the fulcrum upon which banking business revolves.
- ii. Credit no doubt remains the highest legitimate earning asset of the banking industry.
- iii. It is basis upon which banker-customer relationship revolves.

- iv. Credit is a major source of meeting stake holders expected returns on their investment by making profit
- v. Credit act as a balance of financial intermediation process as accumulated savings would be a waste if it cannot be channeled for productive purposes through financial intermediation.

The various types or combination of credits a bank customer may require will include the following:

- Overdraft
- Term loan
- leasing
- Hire purchase
- Trade finance
- import finance
- Project finance
- Mortgage loans
- Commercial papers
- Bankers acceptance

Irrespective of which ever form or shape the facility may take, the need for a written credit or lending policy cannot be overemphasized. Udendeh (2009) identified the importance of a written credit policy as follows:

- i. It provides a framework for reference and standard so that lending personnel can function with relative confidence when extending credit within delegated powers.
- ii. It facilitates the training of personnel who are new to the credit department.
- iii. It serves as a rule book for uniformity.
- iv. The performance of a credit is a statement of compliance with laid down rules.
- v. It makes delegation feasible at lower risk.
- vi. Written policies are a road map to culture entrenchment and once this is achieved, the cost of control becomes minimized

Capenter and Lange (2002) argued that for money demand function to measure the opportunity cost of holding non interest earning asset, interest rate or interest spread should be included in the specification.

The language of communicating the terms and conditions of the credit must be clear and concise enough for the understanding of the ordinary customer who are not bankers themselves. Onosode (2003). Those to whom bankers addressed more often than not are not bankers, but bankers are so used to technical terms that they frequently fail to reorganize that their customers are not experts in banking profession.

## **THEORITICAL FRAME WORK**

### **Different methods of Calculating interest charges on bank credit**

The sources of finance available to a business firm fall into two broad categories Short-term and Long-term. Each category is however composed of numerous individual sources. The finance manager frequently needs to choose between one source and another and in order to be able to do this, he must be aware of the particular features and cost of such source, the procedure for using it and its implications for the firm's overall financing strategy.

Short-term methods of finance are suitable for funding shortages in working capital. They should not, if it can be avoided, be used to finance long-term investments. The various credit types include:

### **i. BANK CREDIT**

Bank overdrafts, one of bank credits, are normally repayable on demand. They are never in practice, called in without reasonable notice. Except in credit squeeze conditions, businesses can easily borrow for up to a year with adequate provision for a rollover. When the overdraft facility is turn over from year to year continuously, the overdraft in effect becomes medium term or even long term source of finance (although at variable rate of interest and payable at short notice). In such a case, bank overdraft is not listed under current liability on the balance sheet, but long term debt capital.

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$$N100,000 \times 10\% = N10,000.$$

However under the discounted basis, interest is calculated at the beginning of the year and deducted from the capital sum before advancing the balance to the borrower. Using the same figures as in the foregoing, but assuming the interest is to be calculated on the discounted basis, the computed interest of N 10,000 is deducted from the capital sum of N 100,000, and the balance of N90, 000 would be advanced to the borrower. The borrower therefore has use of only part of the borrowed funds even though he pays interest on the full amount.

### **EFFECTIVE INTERST RATE**

The effective interest cost under this condition is therefore not 10% but 11.11% calculated thus:

$$\frac{10,000}{90,000} \times \frac{100}{1} = 11.11\%$$

Where borrower is obliged to maintain a specified minimum balance, the effect is the same as the discounted interest basis.

The method specified for repaying loan also has an effect on the interest cost of the loan financing. Where the loan is repayable in bulk at the end of the loan term, the effective interest cost is the same as the quoted rate. The same is the case where there is provision for installment payment but interest is calculated on the balance of the loan at all material times.

There are situations; however where the loan is to be repaid at installments but interest is

calculated on the full amount of the loan. In this arrangement the rate of interest is significantly higher than the quoted rate.

Suppose a firm borrows N10, 000 at 12% interest for one year. The amount is repayable in 12 installments while interest is calculated on the whole amount of the loan. The effective period during which the whole amount was used during the year was therefore only six months and not one year.

What is the effective rate of interest payable:

$$\begin{aligned} \text{Annual interest payment} &= \text{N}10,000 \times 12\% \\ &= \text{N}1,200 \end{aligned}$$

$$\begin{aligned} \therefore \text{Effective rate of interest} &= \frac{1,200}{10,000} \times \frac{12}{6} \\ &= 24\% \end{aligned}$$

ii.

### COMMERCIAL PAPER

A commercial paper or commercial note is an unsecured money instrument. In other words, a commercial paper is an unsecured debt certificate issued by company and sold directly to finance houses or through commercial paper dealer. Large companies with good credit rating can raise short-term funds by issuing commercial notes which are then purchased by investors in the money market, e.g. insurance companies and pension funds. Purchasers are attracted to this form of investment by the relatively high return (higher than bonds). The notes are usually issued on behalf of the company by an issuing house normally a merchant bank).

Commercial papers are usually issued for a stated period, say 90 days, 120 days or 180 days. Its maturity falls between days and 12 months. It attracts a specific rate of interest coupon rate). To large companies with sound credit rating, this is an important source of finance, more so when CBN credit guidelines restrict direct bank lending. The cost of a commercial note issue is made up of two components:

- (i) The interest rate (coupon rate) say 15% p.a.
- (ii) An issuing house commission (usually 1/8 % to 1/2%) flat on the amount raised. The interest is usually paid in advance (i.e. upfront) so that the issuer receives the net proceed of the issue. As a result the effective yield to the Investor (and hence the effective cost to the issuer) will be higher than the coupon rate.

Suppose a 90 day commercial paper for N1,000,000 at 15% coupon rate and 1/4 % issuing house commission. The cost to the company will be calculated thus:

$$\begin{aligned} &\text{N} \\ \text{Interest cost } &\text{N}1,000,000 \times 15\% \times \frac{90}{365} = 36,986.30 \\ \text{Issuing house commission } &\frac{1}{4}\% \times \text{N}1,000,000 \quad \underline{2,500.00} \\ &\quad \underline{39,486.30} \end{aligned}$$

The decision of the investor to invest on the commercial paper will involve a comparison of the returns from the commercial paper investment and returns from other short-term investments like bank deposit interest. As in the above, the effective yield to the investor may be calculated as follows:

$$\text{Actual amount invested} = \text{N}1,000,000 - \text{N}36,986.30$$

$$\begin{aligned}
 &= \text{N}963,013.70. \\
 \text{Interest income} &= \text{N}36,986.30 \\
 \text{Yield} = \frac{36,986.30}{963,013.70} \times 100 \times \frac{365}{90} \\
 &= 15.57\%
 \end{aligned}$$

Similarly, the decision to raise funds by way of commercial paper will involve a comparison of the cost with the cost of other similar sources of finance like bank overdraft. The effective cost of the commercial paper to the company will be:

	%
Interest cost	15.57
Issuing house commission (the annualised cost is $\frac{1}{4}\%$ x $\frac{365}{90}$ )	1.01
	<u>16.58%</u>

### iii. TRADE CREDIT

A trade credit is the facility which is given by the supplier in the normal course of business to a buyer to postpone payment for a specific period. Trade credit is one of the easiest means of borrowing because it is not negotiated separately but as part of the purchase transaction. The cost of taking cash discount or rejecting same may be computed using the following formula:

- a. The loss of supplier's goodwill.
- b. Loss of any available cash discounts, for the early payment of debts.

$$\frac{D}{100-D} \times \frac{365}{Tc-Td} \times \frac{100}{1}$$

Where:

P = Discount rate per cent

365 = Number of days in the year

Td Term of credit, i.e. the maximum number of days allowed for settlement of debt.

Td Term of discount, i.e. the maximum number of days allowed for settlement in order to be entitled to take discount.

The cost to the buyer of foregoing the cash discount offered under the terms 3/30, net 90 will be:

Use of N97 for 60 days cost N3

$$\begin{aligned}
 \text{Use of N100 for 60 days cost} &= \frac{3}{97} \times 100 \\
 &= \text{N}3.09
 \end{aligned}$$

That is 3.09% for 60 days. This cost has to be annualized for comparison purposes the effective annual cost =

$$\begin{aligned}
 &= (1+r)^{\frac{365}{T}} - 1 \times 100 \\
 &= (1+0.0309)^{\frac{365}{60}} - 1 \times 100 \\
 &= 20.03\%
 \end{aligned}$$

$$\begin{aligned}
 \text{Tb nominal annual cost} &= \frac{3.09}{60} \times \frac{365}{1} \\
 &= 18.8\%
 \end{aligned}$$

Tb effective annual cost is arrived at by compound interest method and is preferable to nominal annual interest which is computed using simple interest approach.

Effective interest may also differ from absolute interest when interest is compounded monthly, quarterly or by-annually or otherwise refer to as multi-period compounding.

### **MULTI-PERIOD COMPOUNDING**

We have assumed that cash flows occurred once a year in our previous calculation. However, in practice, cash flows could occur more than once a year. Banks may pay interest on savings account quarterly. On bonds or debentures and public deposits, companies may pay interest semi-annually. Similarly, financial institutions may require corporate borrowers to pay interest quarterly or half-yearly.

The interest rate is usually specified on an annual basis in a loan agreement or security (such as 'bonds), and is known as the nominal interest rate. If compounding is done more than once a year, the actual annualized rate of interest would be higher than the nominal interest rate and it is called the effective interest rate. Suppose you invest N100 now in a bank, interest rate being 10 per cent a year, and that the bank will compound interest semi-annually (i.e., twice a year). How much amount will you get after a year? The bank will calculate interest on your deposit of N100 for first six months at 10 per cent and add this interest to your principal. On this total amount accumulated 'at the end of first six months, you will again receive interest for next six months at 10 percent. Thus, the amount of interest for first six months will be thus:

$$\text{Interest} = \text{N}100 \times 10\% \times \frac{1}{2} = \text{N}5$$

While the outstanding amount at the beginning of the second six-month will be  $\text{N}100 + \text{N}5 = \text{N}105$  Now you will earn interest on N 105 for next six months which will be:

$$\text{Interest} = \text{N}105 \times 10\% \times \frac{1}{2} = \text{N}5.25$$

Consequently the effective interest rate will be:

$$(\text{EIR} = 5 + 5.25 = 10.25\% \text{ and } 10\% \text{ as negotiated from the on-set.})$$

### **NON-INTEREST CHARGES BY BANK:**

Banks in a bid to make huge profits, given the competition between bank and competition between bank branches more often levy non interest charges on their unsuspecting clients. Most times these levies are never explicitly discussed in the process of negotiating the terms of the loan contract itself. All these charges added up increase result in the relative cost of the becoming less than the effective cost of the loan or facility and limit the ability of the borrower to repay the loan and there-by lead to create toxic assets or bad debt in the bank books. Some of these charges usually go by the following names:

- i. Commitment fee
- ii. Administrative fee
- iii. Maintenance fee
- iv. Processing fee
- v. Legal fee
- vi. The research also observed that while the customers current account is in credit during the loan period it never attract interest. However if for any reason the current account goes into debit even if for one day interest is levied. The bank's information system is programmed to automatically charge the account, but not programmed to credit the account with interest when in credit.

### **CONCLUSION**

All these deviations ranging from relative interest to effective interest charges, non- interest charges as well as extra debit when the customer's account goes into debit without corresponding credit during the period that the customer's account is in credit obviously tend to make the customer believed that there is a foul play, refer to as hidden charges by banks.

### **RECOMMENDATIONS:**

- i.** There is urgent need for the regulators of the banking system to make policies to regulate these over ambitious charges by the banks.
- ii.** It is important that the regulators intensify their efforts in carrying out on-site examinations of these banks to check mate these excess charges by banks.
- iii.** The regulators should endeavor to sensitize the members of the public on banking and financial education, most especially the small and medium scale enterprises who most times lack the capacity to negotiate favourable loan conditions with the banks which could lead to unexpected closure of these small businesses.
- iv.** The regulators should make policies that make it mandatory for the external auditors of these banks to reverse all such excess charges back to the customer's account in the course of their yearly examination of these bank. To achieve this objective the central bank should make available the approved banker's tariff to the banks external auditors to ensure implementation.
- v.** For the big multinational companies there is need to employ qualify professionals to regularly examine their bank statement and ensure that banks play by the rule. It is no longer news that many organizations in recent past have had to engage experts to recover bank over charges to their corporate account running into millions of naira.

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