Lessons from Ugandan Moneylenders

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Moneylenders have been lending money since history began. Despite extremely costly services, they provide a product that people want and their numbers in Uganda are growing.

To better understand the money lending business, DFID's Financial Sector Deepening Project (FSDU) carried out a rapid study[1] of the money lending business in Uganda. The study sought to understand how money lending is organized; their financial and non financial costs; how lenders secure loans, and deal with repayment problems; and, how moneylenders compare with other financial service providers.

Legal context

Money lending is legal in Uganda, but theoretically constrained by the provisions of the Money Lending Act of 1952. This act requires moneylenders to obtain a certificate from the Magistrate who has jurisdiction over their area and a licence from their local authority annually. Interest is regulated by the Act and cannot exceed 24% annually. The act requires written contracts between the lender and the borrower, and obliges the money lender to keep proper records of accounts.[2]

It is noteworthy that the law is almost totally ignored: money lenders seldom apply for a licence, consistently exceed the interest rate ceiling, and rarely keep anything resembling proper records. Finally, most loans are guaranteed not through a contract but through a sales agreement for the goods offered in guarantee

In other countries, notably South Africa, moneylenders are considered a legitimate part of the financial system. In Uganda, their reputation is poor, and they are often skipped when one catalogues the various kinds of MFIs.

The Operations of Moneylenders

Moneylenders operate in diverse ways, as the following cases from the study's sample illustrate:

- In Kampala, a group of six moneylenders rent an office together. During our interview with them, there was a steady stream of walk-in customers. The six share the office but operate as independent businesses, and occasionally refer customers to one of their colleagues if they are unable to meet a customers' needs. They also share the services of a lawyer for collection of defaulting loans. Some of the six have business cards with "Money Lender" printed under their names.

[1] Field research was carried out by Ernest Kaffu, at times accompanied by Paul Rippey, from 10th to 21st October 2003. The study employed in-depth individual interviews with 14 moneylenders and five clients, and one focus group discussion with six participants, in Kampala and Masaka. In addition, the consultant carried out "mystery shopping" - posing as a potential borrower - and interviewed a number of customers of moneylenders.

[2] This section is based on information in *Possible Mechanisms to Regulate Tier 4 MFIs in Uganda*, Stefan Staschen with contributions from Michael Akampurira.

- Another moneylender in Kampala is also the manager of a SACCO, and operates his money lending business out of the SACCO office. During our interview, two women SACCO staff members, who also seemed to work for the money lending business, were present. No one seemed concerned about the apparent flagrant conflict of interest.
- A moneylender in Kikubo is also the accountant for a large enterprise dealing in real estate, transport, and wholesale trade, and operates his money lending business from his employer's office.
- Another moneylender is an employee of the Kampala City Council. He rents an office in town where he offers consultancy services and loans. He has a full time employee in charge of record keeping, loan disbursements and repayments, and loan recovery. This small money lending business uses computerised accounting software to track loans, compute portfolio at risk, and follow financial performance.

Position in the Market

Moneylenders see their principal competition being other moneylenders, MFIs and SACCOs. One particularly articulate and reflective moneylender said he thought that the money lending industry would not exist for long, as MFIs and other financial institutions became better able to offer more rapid and client-friendly loans.

Many small-scale moneylenders say they do not have enough good clients, so they end up lending to riskier clients. They complain of problems managing repayments. Moneylenders in this category typically have five to ten loans outstanding and loan sizes ranging from 50,000 to 200,000 Uganda shillings. Other moneylenders are substantially larger, more sophisticated, and better at debt management, often lending to salaried people with better guarantees (not only the pay check, but the fear of loss of status and embarrassment). These moneylenders typically have fifty or more clients, and loans from 250,000 to 500,000 shillings.

How Moneylenders Select Clients

Moneylenders select clients by first verifying that they have an unambiguous means of identifying the borrower, and second, by assessing the value of the security offered and the client's capacity to pay.

When selecting borrowers, moneylenders ask for valid identification documents like an identity card, a passport, and an introduction letter from the local council, an employer, and where possible a guarantor.

The candidate must demonstrate the capacity to pay. Salary earners are asked to present current pay-slips. The salary earner with a bank account usually provides a post-dated cheque for the total amount of principle and interest. In the absence of a pay-slip and cheque, the client is required to produce collateral. The non-salary earner's capacity to pay is determined by the market value of the collateral in relation to the loan requested; lenders request collateral equal to two to four times the value of the loan.

Loan Amount, Period, Interest and Collateral

Moneylenders make an intuitive calculation of three variables: the loan size, the period, and the interest.

Loan Amount

Most lenders said that their minimum loan size is 50,000 shillings, because administrative and collection costs would be too high for smaller loans. The maximum loan for moneylenders encountered in the survey was 10,000,000 shillings. The loan ceiling is due to the risk involved in entrusting large amounts to individuals who may have been dishonest in accessing their loans. For example one lender interviewed revealed that he had lost about five million shillings to a borrower who used a rented car and a forged logbook as collateral for a loan.

Period

With rare exceptions, the loan period is one month. This is because most loans are used for bridge financing or occasional urgent consumption needs. Moneylenders also say that they would have to negotiate lower rates on longer-term loans.

However, many salary-guaranteed loans are in fact paid back over longer periods. The borrowers reach an agreement with the lender to make partial payments, pay interest only, or simply roll the loan over into a new loan, thereby extending the repayment over several months.

Interest

The interest charged depends on the amount borrowed, the assessed risk, and the negotiating skills of the borrower. Interest rates encountered during the field research range from 8% to 30% per month, averaging around 20%. It should be noted that in almost all cases, the interest is the only charge levied, and, as discussed below, effective interest rates are apparently substantially lower than the nominal rates.

Collateral

Lenders ask for collateral registered in the borrower's name, typically land titles, houses, vehicles, chattel like furniture, and *Kibanja*[3]. The value is normally enough to cover the principal, interest and administrative costs (broker's fees, taxes, transport, insurance and other costs) in case a borrower defaults. Hence loans are usually no more than 25% to 50% of the value of the security.

Legal documents

Lenders are generally aware that the interest rates they charge are both illegal (that is, above the ceiling of the moneylenders act) and socially unpopular. Written loan agreements therefore often indicate the sale of the items pledged as collateral. Sometimes, loan contracts purport to be assistance agreements to friends in need. Other lenders ask for post-dated cheques. However, some registered money lenders do sign loan

[3] *Kibanja* title is an agreement issued by the registered landowner to the tenant as proof of purchase of the tenant's right to occupy a piece of land for which annual rent is paid to the owner.

agreements that more or less accurately reflect the actually terms of the transaction. These agreements are mostly made in vernacular.

Although the terms of the loan are verbally communicated transparently to the borrowers, who understand the amount they must pay, the period of the loan, and the guarantees, written loan contracts are deliberately obscure. Rather than stating the amount of the loan and the interest to be paid, contracts usually imply that the total amount of principal plus interest was lent and must be repaid, with no mention of interest. These contracts are considered more easily enforceable, not only because they obfuscate the illegality of the high interest rates, but because socially a magistrate is more likely to be sympathetic with the claims of someone who made a no-interest loan to a friend, than with a professional money lender charging 30% per month.

Repayments, Late Payments and Defaults

Repayments

It was extremely difficult to get accurate information on portfolio quality: the respondents in this study who were the most willing to share information had no reliable written records, while those who had records were very discrete about sharing information. The following data is therefore impressionistic.

Some lenders say that 80% of borrowers pay on time, motivated by a desire to keep a good relationship with the lender. Others lenders paint a different picture, saying that three out of four borrowers pose repayment problems. One moneylender cited a Luganda proverb, that when people ask for money, they are seated, but when it comes to repayment, people stand and shout. The one moneylender who was willing to share accurate records had a portfolio at risk of over 50%, but was unconcerned because of his practice of informally extending the period of one month loans, while collecting monthly interest on them.

Late payments

Like most lenders, Ugandan moneylenders do not like to seize borrowers' collateral, and are tolerant of a borrower who explains anticipated delays in good faith. In these cases, the lender may waive the interest for the period extended or request that the interest due be rolled forward into a new contract. Alternatively the lender may assist the borrower by purchasing the collateral at a more or less fair price to cover the debt; this is common among moneylenders who are also car dealers.

Defaulters

When a loan falls in arrears, the lender tries to collect through phone calls, messengers, or visits. Afterwards, the lender will turn to debt collectors or lawyers. If all this fails, the lender will sell the collateral. If the borrower has been cooperative and the lender is ethical, the lender sells the property, deducts the amounts owed, and gives any balance to the borrower. One notable exception among the moneylenders interviewed freely shared his profit-maximising strategies, including selling assets pledged as collateral, and then lying to the customer about the selling price, making a partial refund of the difference between the sale price and the amount due on the loan, and putting the rest in his pocket.

Money lending as a business

While lending at 30% a month would seem to be a highly profitable enterprise, in fact most moneylenders interviewed were running rather marginal businesses. This surprising result is due to two things:

Most moneylenders have very small portfolios, so that their fixed costs of office rent, telephone, printing, office furniture, publicity, and perhaps a means of transportation become a significant obstacle to profitability. Most moneylenders carry on other businesses to spread the overhead.

Profitability is also low because portfolio yield is apparently much lower than the high nominal rates of interest suggest. It appears that one-month loans are often paid back over a longer period that defaults are not unknown, and that customers manage to renegotiate interest rates as a condition for repayment.

How Moneylenders Compare with other Financial Service Providers

There is no reliable basis for estimating the part of the small loan market that belongs to moneylenders, compared to MFIs and banks, or whether it is increasing or decreasing. MFIs have some clear advantages over moneylenders, particularly lower interest rates and the possibility of making non-collateralised loans. Moneylenders also present clear advantages, discussed here in order of importance: rapidity; administrative simplicity; and total cost of borrowing including both direct financial costs and transaction costs.

Rapidity

People go to moneylenders because they need money urgently for a family emergency or for bridge financing. Clients of moneylenders said the time to receive a loan varies between 30 minutes and two days, much less time than it takes at an MFI or a bank.

Administrative Simplicity

Taking a loan from a moneylender requires only proper identification of the borrower, registration of the collateral to be pledged in the name of the borrower, and an agreement between the lender and the borrower, written in a language the borrower understands.

Total Cost of borrowing, both direct financial costs and transaction costs

Moneylenders, unlike MFIs, do not require application fees, processing fees, monitoring fees, insurance fees, or compulsory savings. (An exception is one high-end money lender in Kampala who has started charging a 5000 shilling processing fee on all loans). While MFI effective interest rates in Uganda often are over 100%, they do not attain the stratospheric rates of moneylenders.

The comparative advantage of moneylenders lies rather in their very low non-financial transaction costs. There are no meetings, groups, or training sessions, and loans can usually be applied for, approved and disbursed in one or two visits to the moneylender’s office. Because there are many moneylenders in Kampala, borrowers are likely to find one near their home or place of business.

Both moneylenders and MFIs expose their customers to considerable risk: moneylenders do so by taking collateral worth several times the value of the loan, and MFIs by requiring borrowers to co-sign the loans of other group members.

Conclusion

It would be useful for other providers of financial services to notice that many people continue to borrow from moneylenders, despite their extremely high rates and occasional poor business ethics.

Moneylenders do one thing well: they provide rapid short-term small loans with simple and clear access requirements. Other financial institutions should strive to do the same.