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ABSTRACT

Interest rate is an important measuring tool in the organizations to establish effective profitability of investments. The purpose of all organization is to maximize its earnings and wealth of its investors an efficient interest rate is the solution. In Mombasa county cooperative organizations had been experiencing fluctuations of interest rate as a result of mainly demand and supply of the credit markets. The shortfall of these loanable funds had forced depositors to shift their demands to other financial institutions rather than cooperative organizations. Sometimes members of the cooperative withdrew from these cooperative and deposits their investment to other financial markets forcing the cooperative to borrow external in order to lend at high interest rate. This study aimed at analyzing the effect of interest rate on organizations performance in the cooperative sector. This was elaborated by investigating the three components which included an investigation on interest rate on deposits, short term and long term loans disbursed to borrowers. This further explored theoretical, empirical literature and conceptual framework of interest rate and the organization performance. It consequently reviewed analytical theories and empirical studies on the three variables to investigate the relationship between the interest rate on deposits, short term and long term loans. The study showed increase of interest rate on short term and long term loans had reduced performance on organizations in the cooperative sector. This in contrast to interest on deposits which had positive performance on the organizations. It further concluded that for short term and long term loan, increase in interest rate had a negative performance in the organizations. Therefore it recommended that high interest rate on loans had a negative performance in the organization performance.

Key Words *Profitability, Interest rate on deposit; interest on short term loans; interest on long term loans, cooperative sector, credit markets.*

INTRODUCTION

An interest rate is the rate at which interest is paid by borrowers (debtors) for the use of money that they borrow from lenders (creditors). Specifically, the interest rate is a percentage of principal paid a certain number of times per period for all periods during the total term of the loan or credit (Pandey, 2012). Interest rates are normally expressed as a percentage of the principal for a period of one year, sometimes they are expressed for different periods such as a month or a day. Real interest rate is an interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender. Real interest rates also play a prominent role in explanations of business cycles and particular business cycle episodes(Frederick, 2000).If saving responds negatively to the real return on saving, as some have claimed, then declines in the real interest rate can have an adverse effect on capital formation and hence on productivity, a serious concern of policymakers

Overview of Cooperative

The origin of cooperative forms of interaction among people goes back as far as the first efforts by human beings to organize themselves in order to reap mutual benefits. However, it was with the emergence of the industrial society that cooperative forms of enterprises became more structured and spread among several kinds of industries. The first successful cooperative enterprise was the Rochdale Society of Equitable Pioneers, founded in 1844 by a group of weavers and artisans who intended to sell food items. Less than ten years later, in Germany, the first cooperative bank was founded by Franz Hermann Schulze-Delitzsch in an urban area, and in 1864 Friedrich Wilhelm Raiffeisen started the first rural cooperative banks – a model which has been influential over time. The basic ideological argument for the establishment of a cooperative was the rejection of charity as a way of fighting poverty, together with a commitment to the principle of mutual aid and self-help (Chaves, 2006). Members could express their preference through their right to vote, in the so-called general assembly (Cooperative Act, 2005). Cooperatives brought into the growing market economy the idea that an enterprise or an association should be owned and controlled by the people it served and by its workers. The central mechanism incentivizing members' contribution to the cooperative was sharing of profits. Nowadays, cooperatives are legal entities characterized by both ownership and management by members. The cooperative model is not unique and varies according to the country in which the cooperative is located (Mudibo, 2006). In most countries, although not in all, membership is remunerated through a share of the earnings, dividends. Dividends, unlike the case of a joint stock company, are not given according to the value of the shares held, but according to the degree of participation in the enterprise.

In 2007 the International cooperative alliance ranked the cooperative sector in Kenya number seven in the world and one in Africa in terms of membership, capital, number of enterprises and contribution to national economy (Gweyi, 2014). During the 2014 international cooperative summit it was revealed that largest 300 cooperatives have grown by 11.6% to reach USD 2.2 trillion equivalent to the GDP of Brazil.

Today, Kenya has about 15,000 registered cooperatives which can broadly categorized as non – financial and financial cooperatives. Non – financial cooperatives include trading, produce and marketing cooperatives. Financial cooperative are saving and credit cooperatives (SACCO), housing, and union of Sacco and investment cooperatives. The department of cooperative in the ministry of trade and industrialization is responsible for the development of cooperative sector through policy and legal framework to facilitate attainment of socio – economic goals in Kenya (Ademba, 2012). Unlike other commercial establishment, cooperatives are guided by cooperative philosophy which is based on seven principles formulated by International Cooperatives Alliance (ICA). It was also concluded that good cooperatives reported much higher growth rates of interest income, capital employed, net working capital, long-term capital, and net worth (Agrawal, 2002). But, in the growth rates of gross fixed assets and total sales, there was little difference between good and bad cooperatives.

There are a total of 493 cooperatives in coast region with a membership of around 210,000 out of this 244 active cooperatives come from Mombasa county with a total membership of 65,000. In Mombasa county only 7 cooperatives operate Sacco (Department of trade and investment, 2015).

Statement of the problem

Cooperative organizations used interest rate as a tool to determine returns on loans disbursements and deposits of its members. It's a sector which has influence unbanked population to access financial market as envisaged in the Kenya Vision 2030 that Kenya will streamline informal finance through cooperative organizations (Sacco) as well as micro finance institutions. So that to decrease the share of population without access to finance from 85% to below 70% (Republic of Kenya, 2007).Since inception, this sector has shown a lot of improvements in savings and loans disbursement which is a reflection of the cooperative organizations performance. In Netherland , for example ,a cooperative banks saw 10 % growth in saving and 16% increase in business loans(United Nation General Assembly, 2009).While in Kenya , from annual report of umbrella body, Kenya Union of saving and Credit Organizations showed an increase of 13% of members savings(KUSCCO, 2013 & 2014).

In spite of these developments many cooperative organizations have failed to meet members' satisfaction in terms of loans disbursements and interest on member deposits. From the study conducted by FSD (2013) revealed that cooperative organizations are facing some several liquidity problems and majority are unable to meet the demands of their clients for loans. And if these clients are accessing loans but with a high interest rate which is against cooperative principle of socio- economic empowerment. This is also seen with a majority of cooperatives in Mombasa County where its members are going for commercial banks loans instead of cooperatives.

The objectives of the study

The purpose of this research paper was to investigate the effects of interest rate on organizations performance in the cooperative sector in Mombasa County. The specific objectives were:

- To analyze the effect of interest rate on deposits on organizations performance.
- To analyze the effect of interest rate to short term loans on organizations performance.
- To investigate the effect of interest rate to long term loans on organizations performance.

LITERATURE REVIEW

The review of this research paper was basically an analytical review of both theoretical review and empirical studies on interest rate and its effect on cooperative organizations performance. The analytical literature review focused on specific research questions by gathering and put them into summary all empirical facts that matched with specified threshold. The objective of this analytical review was to explore as much as possible the existing theoretical and empirical evidence on the specific measures of interest rate and the relationship with organizations performance. The significance characteristics of this, analytical review included the outcome of the empirical studies from previous researchers that focused on the magnitude and the quality of these studies.

INTEREST RATE AND ORGANIZATION PERFORMANCE

Theories of interest rate

Classical theory

This classical theory explains that savings schedule is an upward sloping and the investment schedule is a downward sloping. Therefore, equilibrium rate of interest is determined by the interaction of savings and investment schedules in the economy. For a greater savings/ deposits, higher interest rate need to be offered therefore greater saving could be induced by offering higher and higher interest rate. There would be no savings at zero rate of interest. The classical view that disbursement of debts/loans as the elements of demand and the supply the in form of savings /deposits from members and external borrowing determine the level of interest rate in an organization performance.

Ricardo (1900) also added to this classical theory that supply of savings and demand for investment determine the equilibrium rate of interest. He proponent that aggregate saving is the difference between the total national income and the total consumption expenditure. Given the current income there is natural or normal tendency of the part of economic units to spend that income to the present or future consumption. Then money now is not the same thing as money next year, therefore money now is valued more than money next year.

Keynesian theory

Keynes theory explains that interest rate is determine by the monetary factors therefore it depends on the action of the monetary authorities i.e. government bank. In other words it depends on interaction between the supply of the money and the demand for it in the economic system. Therefore interest rate is a reward offered to people to induce them to hold the securities instead of cash.

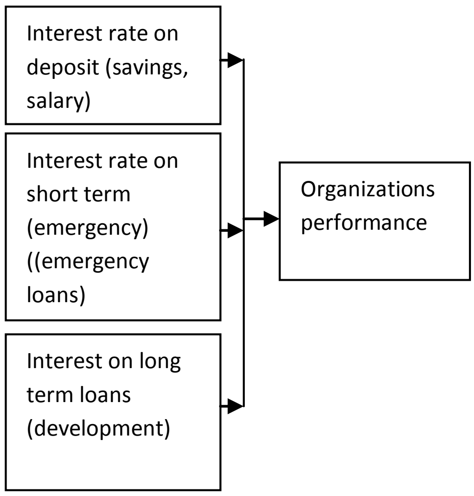
On the other hand Keynes affirmed that cash is perfectly liquid and safe in the sense that there is no danger of physical deterioration or capital. Then interest rate is the difference between the yield on the safe money and the yield on risk securities whereby it exists as a price or inducement for giving up liquidity of holding money in favor of holding securities.

Loanable funds theory

This theory suggests investment and savings in the economy determine the level of long term interest and Short term interest rates are determined by an economy's financial and monetary conditions. In an economy, there is a supply loanable fund in the capital market by households, business and government. The higher the level of interest rates the more such entities are willing to supply the loanable funds. .The lower is the level of interest rate, less depositors are will to supply. These households, business and government also demand loanable funds more with the level of interest is low and less when interest rates are higher.

Likewise the theory is supported by Wicksell (1900) who confirmed that level of interest rates is determined by the supply and demand of loanable funds available in the credit markets.

Conceptual framework



Independent variables Dependent variable

Figure 1: Conceptual framework

Interest rate is determine by the supply of money in the economy as explained by the Keynes theory that if central bank supply treasury bills and bonds at high interest rate ,households and organizations will be highly induced to invest and vice versa. Availability of funds that organizations can lend to the households and business also has impact on organization performance. In relation to term loans cooperative organizations will only lend at low interest rate if the availability of credits is adequate and vice versa. To the extent cooperative organizations is readily to offer short term loans at low interest rate than long term loans because of the risk exposure as a result maturity periods.

Interest on deposits

Interest on deposit is an item display as an expense in the income and expenditure statements of theorganizations in the cooperative sector accounting (KUSCCO, 2014). This account is a reward to savers in the organizations. It is the profitability to the depositors after their funds have been trading for one financial year. It is computed using the accounting principles of weighted average cost of capital(WACC) to arrive at the rate of interest on deposits.Investors will be induced to save more if the interest rate on deposits increases year after year and vice versa(CBK, 2006). Likewise progressive interest rate on depositors is a reflection of the organization performance in the co-operative sector.

Interest rate on short term loans

Interest rate on short term loans is a charge of interest on loans with maturity less than one financial year. It is shown in the financial statements as asset portfolio that is lending to the borrowers. The value of these interest rate varies from one to another short term loans depend on the period one possess this financial instrument (Jitegemee Sacco, 2013). These short term loans include salary advance, normal emergency and college loans. The demand of these loans is high because of low interest rate since there risk exposure is also very low. Therefore this interest rate on short term loans has a progressive trend to organizations performance.

Interest rate on long term loans

Interest rate on long term loans is a charge of interest on loans with maturity more than one financial year. It is shown in the financial statements as asset portfolio that is lend to borrowers who need to invest in capital markets. Because of these financial instruments being risky and longer maturity period, its interest rate is so high to compensate for the riskiness. Most risk averse investors shy away hence the interest rate on long term loans has retrogressive trend to organizations performance.

Empirical Literature Review

Several studies have been conducted on the relationship between interest rate and the performance of organizations with the aim of assisting organizations has effective interest rate. William and Mueller (2000) investigate the conflict of interest between the borrowers and lenders in credit co-operatives a case study of German co-operatives banks. They examine interest rate on lenders as supplier of deposits and borrower as the demand of the credits. The study reported that borrowers prefer a lower price for credit since a given decrease in the price translates into a relatively large increase in their consumer surplus and vice versa. In general, the investor prefers a higher price for credit, while the borrower prefers a lower price. In relation to lenders and borrowers, the study shows a mixture of relationship between interest rate and organization performance in the co-operative sector.

Makiyan (2006) examine the role of rate of return on loans in the Islamic bank system in Iran. Rate of return, total deposit and inflation rate were used as proxies to independent variables (Interest rate) and supply of loans was used as proxy to dependent variable (Organization performance).The findings were that supply of loans was largely influenced by the government intervention. The granting of loans has not been encouraged by their rates of return. Therefore the study conclude that supply of loans to the rates of return, total deposits and rate of inflation shows that the changes in the supply of loans are not related to the changes in the rates of return on loans. The study shows there is mixture of relationship between interest rate and organization performance.

CONCLUSIONS

- With regards to the relationship between interest rate and loans the empirical evidence reported that there was both negative and positive effect to the supply and demand of credits. Lenders preferred high priced loans and borrowers preferred low priced loans.
- There was positive relationship between inflation rate and organization performance, and negative relationship between rate of return and total deposits to organization performances.

RECOMMENDATIONS

In view of the conclusions, this paper recommended that organizations in the co-operative sector should strike a balance between borrowers and lenders in terms of determining the interest rate. Since these two stakeholders can significantly influence the organization performance in the co-operative sector.

It was also recommended segmentation of interest rate to fit the diverse of the stakeholders in the co-operative sectors. This is interest which is going to be inclusively for all the players in the co-operative sector.

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