

WHAT IS AN EFFECTIVE INTEREST RATE?



The Effective Interest Rate (EIR)- is a measure that consumers should understand and look at closely when they are negotiating a loan or deposit contract with a bank or micro-credit organization. It gives them the best measure of the real cost to them of a proposed loan or the real return they will get on a deposit.

It is also the best interest rate to use when they want to compare different types of loans or deposits or loans or deposits from different banks.

Uses of Effective Interest Rates: EIRs are important because they allow customers to quantify and easily compare the costs of a similar financial product among various banks or to compare the costs or returns among products that have different fees and other conditions. *They will then be able to make a better decision on which financial product to choose.*

The CBK has specified by Regulation the way in which

For example, they can compare the effective cost of a loan that has a 10% nominal interest rate and no fees against one that has a 8% nominal interest rate plus a set-up fee of Euro 100 and monthly service fee of Euro 10.

banks and micro-credit organizations should calculate EIRs on their loans and deposits. This is important as it means a consumer can compare the EIRs from different

What is an effective interest rate: the aim of an effective interest rate (EIR) is to measure the cost to a borrower or the return to a depositor after all fees and costs related to a loan or a deposit are included in the calculation of the interest rate

organizations knowing that they should have been calculated on the same basis.

What is included in an EIR calculation?

The following are the main items that are included in the calculation of an EIR:

- **The nominal interest rate.** This is the rate that is quoted by the bank as the interest rate on the contract. For example, the bank may say the interest payment on a loan is 10%. This is the rate that banks usually emphasise in their publicity and the one that customers have paid most attention to in the past. But once other costs related to a loan are also included, the 'effective' interest rate a customer would pay on the loan may be significantly different to the stated 'nominal interest rate' on a loan. *There are some examples later in the article;*
- **The time-schedule of interest payments:** for example, the EIR interest rate on a deposit that has a 'nominal interest rate' of 4% will differ between a deposit that pays interest annually at the end of the year and one that pays interest quarterly during the year. The frequency of payments also changes the EIR on a loan. The more frequently a borrower has to make interest payments, the higher the EIR will be;
- **Fees and charges that have to be paid to get the loan or make the deposit;**

All foreseeable and forecastable future fees, charges and price changes that will have to be paid during the life of the contract. These fees and charges can make a very big difference to the amount a consumer will have to pay on a loan or earn on a deposit. It is therefore important that customers find out what all the fees and charges related to a product are. The effective interest rate converts most of these fees to a common basis and includes them in a single number, the EIR, so that the consumer can make a more informed and effective comparison of the costs of different products. As well as allowing them to make a better-informed decision when choosing which loan or deposit to select, the EIR calculation should avoid the customer getting unanticipated and unpleasant shocks during the life of a

loan when a fee they had not noticed (or not been informed about) becomes payable.

DON'T FORGET TO ASK ABOUT THE EFFECTIVE INTEREST RATE (EIR)!

What is not included in an EIR calculation?

While EIR calculations try to be as comprehensive as possible, there are some costs that are not usually included. It is therefore also important for consumers to also know what costs are **NOT** included in most EIR calculations. The most important ones are:

- **Costs that are not linked to the credit or deposit:** costs that are not a direct consequence of the credit or deposit are usually not included in the calculation of an EIR. For example, the customer may have to pay a fee to register a property. This is a cost of the property transaction that the customer needs to be aware of as they need to ensure they have enough funds available to meet these other property-related costs. But this fee needs to be paid even if the property is purchased without taking out a loan. So it is not treated as a part of the EIR of the loan.
- **Costs and prices that are not foreseeable or forecastable at the time that the contract is being negotiated:** It is very important that a consumer understands that only foreseeable and forecastable future costs are included in an EIR at the time of negotiating a contract. This is so significant for products such as variable rate loans and foreign currency loans and deposits that we will explain it further:
 - a. **Variable rate loans:** *in* a variable rate loan, the nominal interest rate is not fixed for the whole term of the contract but will be able to be varied by the bank or micro-credit organization during the life of the loan based on financial market conditions or on the movement in some financial index. Variable rate loans are not widespread in Kosovo. At December, 2013 they represented 8.4% of total bank loans. But they do exist and they could become more common in the future so customers should understand *how they work*. If a customer is considering a choice between a fixed rate loan and a variable rate loan, they need to

be aware of a major difference in the way the EIR on the two types of loans are calculated. For a fixed rate loan, the rate of interest is set at the beginning of the contract and will not change during the life of the contract. So all interest payments over the whole life of the loan are 'foreseeable' from the beginning and will all be included in the EIR the customer gets before agreeing to take out the loan.

- For a variable rate loan, the EIR the customer will be given at the *beginning* will assume that the *opening* interest rate won't change during the life of the loan. But the interest rate on a variable rate loan can, and almost certainly will, change from time-to-time during the life of the loan. If the interest rate is raised by the bank, the EIR on the loan will rise. If the interest rate is lowered by the bank (and the interest rate on a variable rate loan can move in either direction), the EIR on the loan will fall. But the bank cannot include these future changes in the interest rate into the EIR calculation at the time the loan is being negotiated with the customer as the bank doesn't know the timing or the direction of future interest rate changes. So there is an added risk for a borrower in taking out a variable rate loan as the level of their future interest payments are uncertain.
- b. **Foreign currency loans:** foreign currency loan is one where the loan repayments have to be made in a foreign currency. As Kosovo uses the Euro as its domestic currency, *loans in Euros are not foreign currency loans in Kosovo*. But loans in other currencies such as the Swiss franc, British pound, or US dollar, are foreign currency loans in Kosovo. The value of the Euro against non-Euro currencies such as the ones mentioned CAN AND DOES CHANGE SIGNIFICANTLY. But the magnitude of these changes are not foreseeable or forecastable, so the EIR calculation a customer will receive from the bank during the negotiations for a foreign currency loan ASSUMES THE EXCHANGE RATE WON'T CHANGE DURING THE LIFE OF THE LOAN.



This is a much more risky and serious assumption for a borrower than in the case of a variable rate loan. The changes in some of these exchange rate changes are unpredictable and they **can be very substantial**.

The potential increases in the EIR on a foreign currency loan are therefore much larger and unpredictable than they are for variable rate loans .

Fortunately, foreign currency loans are currently very uncommon in the Kosovo banking system. As at December, 2013 they represented only 0.3% of total bank loans. Foreign currency loans have caused major problems for consumers in some countries in Eastern Europe, such as Hungary, Croatia and Bosnia and Herzegovina. Consumers in Kosovo need to be well aware of the risk involved should they consider this type of borrowing. For this product, the EIR calculation does not include the main potential risk, a change in the exchange rate, and so it is no help to the consumer in assessing the risk or in comparing the cost of a loan in Euros against the cost of a loan in another currency.

COMPARE THE EFFECTIVE INTEREST RATES (EIR)!

Examples of differences in EIRs:

Different fee structures: the following example calculates the different EIRs for three loans that have the same nominal interest rate, maturity and payment schedule BUT have different fee structures:

- a. A credit agreement for a total amount of credit of Euro 6000 repayable in 24 equal monthly installments of Euro 274-11 that has no fees or other payments. The EIR on this credit is 9.4%;
- b) A credit for the same amount and with the same 24 monthly payments but with an administrative charge of Euro 60 payable when the contract is signed. With this administrative charge added, the EIR on the credit increases to 10.5% (ie, the fee increases the EIR by 1.1%);

c. The same conditions as in b) with the addition of insurance costs of 5% of the credit limit spread over the 24 monthly repayments. This insurance payment increases **the EIR on this credit to 15.5%**. This insurance payment is high but it is used to illustrate how significantly EIRs can be increased by fees and charges. In this example, the EIR is over 60% higher than the EIR on the first loan that has no fees.

Regulation :

The CBK Regulation on the Effective Interest Rate and bank disclosure requirements (https://bqk-kos.org/repository/docs/korniza_ligjore/english/Effective%20Interest%20Rate%20and%20Bank%20Disclosure%20Requirements.pdf), requires all banks and micro-credit organizations in Kosovo to calculate the EIR on their loans and on their deposits. They are also required to disclose these EIRs to their clients **BEFORE THEY SIGN A CONTRACT**. Banks and micro-credit organizations are also required to visibly display the EIR on their loans and deposits in their branches and in their advertising.

These disclosure requirements are good and should be very helpful for consumers by allowing them to more easily and realistically compare financial products offered by different institutions. The requirement for institutions to calculate and disclose EIRs entered into force only in June, 2013. The CBK's Bank Examiners are currently following up on its implementation during their regular examination of banks in order to ensure it is being implemented in a consistent manner by all bank.

Customers can also play a part in this. When talking to a bank officer, they should make sure you are given a detailed calculation of the EIR on the loan or deposit they are considering before they sign a contract. The EIR is important information for the consumer and all banks and micro-credit organizations have a legal obligation to provide the information to their customers and to display it in their branches. If a bank or micro-credit organization can't or won't do so, the consumer can and should make a formal complaint to the CBK. This will help the CBK ensure that all banks and micro-credit organizations in Kosovo are meeting their obligations to provide this important interest rate information to their customers.