

## Hire Purchase Financing: A Case Study of Finance Companies of Pokhara

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### ABSTRACT

*This study attempts to analyze the quantitative as well as qualitative information to identify and evaluate the performance and current state of affairs of finance companies in the field of hire purchase financing in Pokhara. The study reveals that the credit-deposit ratios are very satisfactory. The relationship between total deposit collection and total loan to hire purchase loan is highly significant. The businessperson and professional users are predominantly rushing in utilizing the hire purchase financing due to the easy payment terms. The IRR on hire purchase loan is normally higher than their explicit rate of interest and service charge. Except in few cases, there are loan defaulters in all finance companies. In general, the performance of finance companies in hire purchase financing is satisfactory*

THE COMMONEST METHOD OF selling property is the cash sale. The credit sale system is an alternative method of cash sale. The third system of selling property is the installment system. In installment system, property are delivered to the buyer immediately but payments is made in periodic installments such as weekly or monthly, quarterly or half-yearly or yearly so on. Hire purchase and installment purchase systems are the major parts of installment system. However, hire purchase installment system is the prime concern of this study.

With an increasing demand for better life, the consumption of property has been on the uprising scale. This has not been backed up by adequate purchasing power, transforming it into effectual demand (Mukharjee and Hanif 1998). This has created the market for hire purchase system. When a person is unable to acquire an asset against immediate cash payment, he may arrange with the vendor to stagger the payment. Financial institution plays role of facilitators between buyer and seller to enter into the hire purchase agreements. Hire purchase agreement makes it possible for businesspersons, professionals and others to take advantage of assets all of which enable them to organize and operate their activities effectively. After the liberalization policy introduced in 1990, the financial sector especially the finance companies have contributed significantly to increase the hire purchase business in Nepal. In this study, therefore, an attempt has been made to analyze the current performance of finance companies in Pokhara in the field of hire purchase financing.

### 1. Theoretical Framework

Hire purchase is a form of credit. It is a way to buy property when a buyer cannot afford to pay the full amount straight away. In this system, a customer agrees to buy property from a manufacturer or retailer and to pay price in a number of installments. Three parties—the manufacturer or retailer or vendor; the hiree and the hirer—involve in the hire purchase agreement. The hirer is a buyer or customer who buys property. The manufacturer sells property to the hiree who sells it to the hirer in exchange for the payment to be made over a specified period of time (Pandey 2004). In our study, finance company is the hiree.

A hire purchase installment system is an agreement drawn up, signed by the hirer, and lending institution. If a retailer is involved, it also signs the agreement and supplies the asset in question. It is an agreement whereby a buyer hires property for a period by paying installments and can own the property after the payment of all installments.

Manufacturers or retailers often have an agreement with a finance company to provide the hire purchase finance. In such a case, a hirer makes the payments to the finance company not to the manufacturer or retailer. The name of the finance company will be on the hire purchase agreement.

As soon as the contract is signed, the hirer acquires possession of the property and therewith the right to use the property over an agreed period. However, the ownership of the property remains with the finance company until the hirer pays all installments. Each installment paid by the hirer is treated as hire charges for using the property or assets. In case he fails to pay any of the installments, even the last one, the vendor or finance company takes back the hired property without compensating the hirer (Mukharjee and Hanif, 1998). Hirer, vendor, or finance company may terminate the hire purchase agreement at any time on the noncompliance of the terms and condition of the agreement by any parties. In the hire purchase agreement, the possession of the assets is transferred to the hirer with an understanding that the hirer will pay agreed installments over a specified period of time; the ownership of the asset is transferred to the hirer on the payment of all installments; and the agreement is terminated on the option of the hirer at any time before the transfer of ownership of the property (Pandey 2004). The hire purchase agreement normally specifies the property specified by the agreement, price of the property and installment. It should specify both cash price and hire purchase price. The installment should specify the amount of each installment, the due date of each installment, and the number of installments. In addition, agreement should state the names and addresses of all parties to the agreement, the right of the hirer to withdraw from the agreement within 10 days of receiving a copy of the agreement— "cooling off" period, fee and penalties and whereabouts of the hired property.

In hire purchase agreement, the hirer has an obligation to pay up to the last installment so that the ownership of property passes to him. If the hirer fails to pay any installments, the vendor has the right to take the asset back in its actual form without any compensation to the hirer. Then the hirer is called upon defaulter. The amounts received from the defaulter through down payment and installments are treated as the hire charges by the vendor. This act of recovery of possession of the asset is termed as "repossession" (Mukharjee and Hanif, 1998). The repossessed assets are ultimately sold to other customers after repairing or reconditioning, if necessary.

A hirer, on the other hand, also can terminate the agreement at any time by giving notice in writing to the vendor or finance company. It can also be done by returning the property either in accordance with a term in the agreement or with the finance company's consent. This is sometimes called a voluntary repossession. Hirers should be aware that breaking a hire purchase contract before its normal end date usually involves penalties. The hirer can terminate the hire purchase agreement if property hired under a hire purchase agreement is/ or become faulty and defective.

A guarantee under a hire purchase agreement applies in the same way as if property were bought outright. The manufacturer makes the guarantee. If there is a fault with the

property, the hirer can choose to have the property repaired under the guarantee or to seek a full refund or exchange from the owner. Under a hire purchase plan, the hirer has a duty to take reasonable care of the hired property. The vendor or finance company entitles to the cost of repairs if the property is damaged by the hirer and returned to the vendor or finance company.

In Nepal, a hirer wishing to buy a property requires to contact the retailer for the quotation of the property intended to hire. Then, hirer contacts the financial institution on his/her convenience for hire purchase financing. After receiving the quotation, finance company evaluates the property and fixes the certain percentage of the value of the property for hire purchase financing and signs the hire purchase agreement with hirer, and finance company instructs the retailer to sell the property especially vehicle to the hirer. The hirer needs to make a down payment. The ownership of vehicle is transferred to finance company after down payment and hirer acquires the ownership of the property only after payment of all installments.

## 2. The Methodology

**Sources of Information :** This study is based on both primary and secondary information. The primary information was collected by administering the structured questionnaire on the managerial level staff of finance companies being operated in Pokhara. Besides, some qualitative information was gathered by interviewing the credit managers of finance companies. The secondary information was downloaded from the official website and extracted from annual reports of concerned finance companies.

**Population and Sample:** There are altogether six finance companies in Pokhara. Of these, four finance companies—Annapurna Finance Company (AFC), Pokhara Finance Company (PFC), Om Finance Company (OFC) and Fewa Finance Company (FFC)—have their central office in Pokhara while rest two finance companies—Nepal SMFC (NSMFC), and Alpice Everest Finance Company (AEFC) have their central office in Kathmandu. This is census study. Therefore, this study has included all these finance companies.

**Statement of Hypothesis:** This study has tested the following null hypotheses:

- $H_{01}$ : There is no significant relationship between the total deposit collection and hire purchase loan.
- $H_{02}$ : There is no significant relationship between the total loan and hire purchase loan.
- $H_{03}$ : There is no significant difference in providing hire purchase loan among customers of different companies.
- $H_{04}$ : Views on interest rate of hire purchase loan is uniform in all finance companies.
- $H_{05}$ : The amount of installment is not based on the amount of down payment.
- $H_{06}$ : There is no difference in hire purchase loan provided to users by companies in different fiscal years.
- $H_{07}$ : Users of hire purchase loan repay their installments at stipulated time.
- $H_{08}$ : There is no difference in loan defaulters among finance companies.

**Statistical Tools:** Coefficient of Determination ( $r^2$ ) has been used to measure the relationship between total deposit collection and/or total loan disbursed and hire purchase loan and

significance of relationship has been tested by using Probable Error (P.E). Simple linear regression model has been used to measure the effect of deposit on hire purchase loan during the study period. In addition, compound growth rate model also has been used to work out the growth rate of hire purchase loan provided by finance companies in Pokhara. Chi-square test ( $\chi^2$ ) has been used to assess the difference in opinions of the financial executives or credit managers of finance companies on interest rates of hire purchase loan. It has also been used to test the goodness of fit of hire purchase loan defaulters. Moreover, chi-square test has been worked out in order to test independence in two attributes—hire purchase loan user types and different fiscal years. F-ratios have been computed to assess the differenced in (i) hire purchase loan defaulters with finance companies and different fiscal years and (ii) hire purchase loan users with finance companies and different fiscal years. For this purpose, analysis of variance on two ways classification has been adopted.

**Financial Tool:** Actual return to the hiree has been calculated using the following model:

$$A_0 = \sum_{t=0}^{mn-1} \frac{CF_t}{\left(1 + \frac{R}{m}\right)^t} + \frac{RV(1-T)}{\left(1 + \frac{R}{m}\right)^{mn}} \quad \dots \dots \dots (1)$$

Where,

- $A_0$  = initial cash outlay
- CF = cash flow (i.e. monthly installment)
- R = opportunity cost of capital
- RV = residual value
- T = corporate tax rate
- n = length of the loan agreement in years
- m = number of times in a year periodic installment payments are made.

It is assumed that there is no more residual value of assets and depreciation of assets has not been taken into consideration in this study. As such, the model (1) can be restated as follows:

$$A_0 = \sum_{t=0}^{mn-1} \frac{CF_t}{\left(1 + \frac{R}{m}\right)^{tm}} \quad \dots \dots \dots (2)$$

Model (2) is further restated as follows:

$$A_0 = \sum_{t=0}^{mn-1} \frac{CF_t}{\left(1 + \frac{R}{m}\right)^{tm}} \quad \dots \dots \dots (3)$$

In addition to the tools stated earlier, simple analytical tools like percentage, ranks as well as descriptive statistical tools have been used to analyze the qualitative information.

**3. The Results**

The first aspect of investigation deals with the study of secondary information available on online and published annual reports of finance companies. The deposit collection rate of finance companies being operated in Pokhara valley is satisfactory. However, its loan investment has not been increasing proportionately as expected. The average credit-

deposit ratio of the finance companies normally remains 97.45 percent. The loan disbursement focuses on the consumable sector. This fact indicates that finance companies are mobilizing the loan to the productive sector, which contributes to the economic development of the country.

The coefficient of determination ( $r^2$ ) between the amount of total deposit collection and hire purchase loan of all finance companies has been computed using the time series data of more than five fiscal years. The results are positive and almost near to one except AFC (0.591). However, in all cases  $r$  is greater than 6 times of its P.E. So, the  $H_{01}$  is rejected. This implies that there is significant relation between total deposit collection and hire purchase loan disbursement. In other words, the volume of hire purchase loan has been continuously increasing as the amount of deposit collection increases in finance companies. This implies that hire purchase financing is a significant component of investment and there is positive influence of hirers on the hire purchase loan provided by finance companies in Pokhara.

Regression model of  $r$  has tested the relationship between total loan disbursed and hire purchase loan of finance companies. The results are as similar as coefficient of determination between total deposit collection and hire purchase loan, as  $r$  of all finance companies is greater than 6 times of its P.E. The  $H_{02}$  also is rejected. Therefore, there is significant relation between total loan and hire purchase loan in finance companies. This indicates that the volume of hire purchase loan disbursement in relation to total loan is significant. This fact also implies that there is a satisfactory performance on hire purchase loan sector of finance companies.

With respect to the proportion of hire purchase loan to total loan provided by finance companies, it is 31.25 percent in AFC. Similarly, it is 9.62 percent in PFC, 14.44 percent in OFC, 21.45 percent in FFC and 27.78 percent in AEFC. These facts indicate that a significant amount of funds has been disbursed in hire purchase loan.

The slope of regression line of hire purchase loan on deposit is positive in all finance companies. The slope of regression line of AFC is 0.248. Similarly, it is 0.098 in PFC, 0.131 in OFC, 0.194 in FFC, 0.64 in NSMFC, and 0.071 in AEFC. The compound growth rate in the number of hire purchase loan user is 12.55 percent in AFC, 15.46 percent in PFC, 29.31 percent in OFC, 217.24 percent in FFC and 29.59 percent in AEFC. These evidences indicate that the hire purchase loan disbursement and its span of users have been increasing smoothly due to ease and efficient service.

The second aspect of investigation concerns with the study of the opinions of respondents with respect to the major aspects of hire purchase financing. The study is based on the opinion survey of executives and credit officers of six finance companies of Pokhara.

Regarding the overall ranks for various sources of income of finance companies like interest on housing loan, hire purchase loan, term loan, fixed deposit loan, share application collection commission, and remittance service charge, 83 percent of the respondents gave the third rank to the income from hire purchase loan and only 17 percent respondents gave it the first rank. This fact implies that the income on hire purchase loan is an important source of income of finance companies.

In their overall ranks to the user categories—businessmen, professionals and households—of hire purchase loan, 67 percent of the respondents gave the first rank to the busi-

nessmen and 33 percent of the respondents gave same rank to the professional users. Almost third rank has been assigned to the household user category. These evidences indicate that businesspersons and then professional users are more attracted to the hire purchase loan. The computed chi-square is 195.65 and the tabular values at 0.05 and 0.10 level of significance are 9.49 and 7.78 respectively. The  $H_{03}$  is rejected and alternative hypothesis is accepted. This indicates that there is significant difference in providing hire purchase loan among customers of different companies.

With respect to the factors to be considered while granting hire purchase loan, 50 percent of the respondents gave the first rank to earning capacity or income level of the customers. However, 33 percent of the respondents gave the first rank to nature of occupation of hirer and only 17 percent gave the same rank to the property of business. The credibility of customers has given second and third priority by all respondents. This fact implies that the income level and/or occupation of the hirer are the most important factor for granting hire purchase loan. It also indicates that there is no serious attention and system in assessing the creditworthiness of customers.

In their overall ranks for customer preference in the use of hire purchase loan, 50 percent respondents gave the first priority to no need of large amount of investment at a time. Sixty-seven percent of the respondents gave the second rank and only 17 percent gave the first rank to easy payment terms in hire purchase loan. These facts indicate that in hire purchase financing, there is no need of large amount at a time while acquiring assets and household appliances, and payment term is easier in installment basis as per the convenience of the hirer.

With respect to the ranks on different categories of hire purchase loan provided by finance companies, 50 percent of the respondents gave the first rank to light vehicles. Seventeen percent of the respondent gave the first rank to motorcycle. Seventeen percent gave the first rank to the long route bus and truck financing respectively. These evidences imply that finance companies have been granting their hire purchase loan especially in light vehicles and motorcycles, and financing in household appliances is negligible.

According to the various categories of hire purchase financing, the annual rate of interest is different in all finance companies except in OFC where the flat rate has been charged on various categories as per loan size. They opined that the reasons for discriminating annual rate of interest on hire purchase loan are model of the vehicle i.e., new vehicle-long life-low risk while old-vehicle-short life-high risk, low chances of reuse in case of home appliances, credibility and past performance of customers, private and/or commercial use of vehicle, additional collateral on loan and length of time.

With respect to views on interest rate on hire purchase loan, 67 percent of the respondents are with the view that the interest rate on hire purchase loan is moderate. In this connection, 17 percent of the respondents opined that the rate of interest is high while another 17 percent of the respondents feel that the interest rate is low in hire purchase loan. The computed chi-square value is 3.00 and the tabular value at 5 percent level of significance is 5.99. The  $H_{04}$  is accepted. Hence, there is uniformity on views of respondents in interest rates charged on hire purchase loan.

Every finance company charges service fee for its services provided to the customers. They all take the service charges from their customers on lump-sum basis at the begin-

ning of the loan agreement. The rate of service charge ranges from 1 to 3 percent on outstanding loan. Finance companies take 1 to 2 percent service charge on light vehicle, truck and long route bus and 2 to 3 percent on motorcycle. The rate of service charge on television is 2.75 percent. It is comparatively high in television, photocopy, refrigerator, furniture and generator financing by PFC. This indicates that there is no uniformity in service charges in hire purchase financing.

In respect of interest rate and service charge, these costs are explicit but the actual rate of return on hire purchase loan is higher in all the product categories. The computer IRR on hire purchase loan is more than 16.5 percent. The IRR on motorcycle is 16.77 percent per annum in PFC whereas it is 21.39 percent in SMFC. In light vehicles such as car, minibus, etc. the IRR falls between 18.08 percent and 22.51 percent. It is 18.08 percent, 22.51 percent, 21.10 percent, 21.52 percent, and 19.73 percent in PFC, FFC, SMFC, AEFC and AFC respectively. In case of truck financing, the behavior of IRR is somehow similar to the light vehicle. The IRR on bus financing is 21.10 percent in AFC. PFC earns 19.26 percent each in household appliances and other machinery items. These evidences indicate that the finance companies are making a higher return on hire purchase financing than the explicit interest rate charged annually and service charge taken at the beginning of loan agreement.

Regarding the number of installments on different product categories, the number of installments in motorcycle ranges from 12 to 24 months whereas in case of light vehicle it ranges between 12 to 60 months or 1 to 5 years. Overall, monthly installment payment system has been used by all finance companies in Pokhara. Moreover, the amount of installment differs in different product categories. Installments are determined in equal monthly installment. Some finance companies have used diminishing balance system. It implies that there is no similarity in number of installments and amount of installment in finance companies.

Regarding the rate of down payment on hire purchase financing, it differs from different product categories. The rate of down payment on motorcycle financing ranges from 40 to 50 percent of the total value of the asset except in FFC where it ranges from 15 to 16 percent. In case of car and truck, the rate of down payment ranges from 10 to 30 percent except in PFC where the rate of down payment ranges from 50 to 90 percent in all categories. AFC has no more financing on motorcycle and only twenty percent down payment is required in all categories of loan even in long route bus financing. These facts indicate that the certain rate of down payment is compulsory in hire purchase loan agreement to the retailer.

With respect of the amount of installment, 67 percent of the respondents opined that the amount of installment is based on the amount of down payment and only 33 percent of the respondents opined adversely. The computed chi-square value is 4.46 and the tabular value at 0.05 level of significance is 3.84. The  $H_{05}$  is rejected. Hence, the amount of installment on hire purchase loan is based on amount of down payment.

There is no gender discrimination in providing hire purchase loan by finance companies. Data on the total number of loan users are available for different fiscal years except loan users of NSMFC. The compound growth rates in the number of the hire purchase loan users, as mentioned earlier, are more than 12 percent in all finance companies during the

observed period. The computed values of F, by using ANOVA of two-way classification, are 64.12 and 9.94 while the tabular values at 5 percent level of significance are 7.01 and 8.65 respectively. The  $H_{06}$  is rejected. This implies that there is significant difference in hire purchase loan provided to users by finance companies during the study period.

With respect to the payment of installments, 33 percent of the respondents opined that the users of hire purchase loan pay their installment in time while 60 experienced that they do not pay in time. Sixty-seven percent respondents opined that the first reason for failure in payment of installment is due to the unfavorable business situation and the second one is lack of timely payment habit of the hirers. Negligence in paying installments and use of funds for other purposes are the other reasons of default of due installment. The computed value of chi-square is 4.46 and the tabular value at 0.05 level of significance is 3.84. So, the  $H_{07}$  is rejected. Hence, the users of hire purchase loan do not repay their installments in time. These evidences imply that the unfavorable political environment and the lack of professionalism in the users severely have affected the functioning of finance companies.

With respect to the penalty charge against non-payment of installments in time, 83 percent of the respondents opined that the defaulters of loan are penalized at a certain rate. In this respect, hirers are informed about the penalty charge at the time of loan agreement. When the hirers fail to pay their installment in time, a grace period has also granted to the hirers. The rate of penalty charges are different in different finance companies while no more such charges available in FFC due to the newly established venture.

There is the existence of loan defaulters in all finance companies except in FFC. The number of defaulters is increasing year by year. The computed value of chi-square is 16.423 and the tabular value at 5 percent level of significance is 7.81. The  $H_{08}$  is rejected. Therefore, there are differences in number of loan defaulters in finance companies.

Regarding the legal procedures against the loan defaulters, first, finance companies make a telephone call to the hirer. Second, they do personal visit with an official letter and request them to pay their outstanding installment. If still they fail to pay, companies take back the possession of the property and then publish a final notice in the newspaper. Finally, they publish a detail about hirer, his /her family background, and other collateral details provided by the hirer for the final settlement. In some cases, they take action against defaulters as per the provision of Bank and Financial Institution Ordinance, 2061 and Nepal Rastra Bank Directives.

## **5. Conclusions**

Hire purchase financing is one of the major and attractive investment schemes of finance companies in Pokhara in particular and country overall. Their emphasis has been more pronounced in consumable sector rather than productive sector. The deposit collection and their mobilization in hire purchase loan are significant. Businesspersons and professional users are the major segment, which enjoy the facility of hire purchase loan. This system is gaining popularity due to the low-income level and difficulties in paying cash immediately. The actual rate of return to the finance company on hire purchase loan is more than they have charged explicitly. In spite of easy payment term, loan defaulters are found almost in all the finance companies except in few cases. However, the performance of finance companies being operated in Pokhara is satisfactory.



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