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SME Loan Defaults in Bangladesh

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Summary

- SMEs are vital for growth and jobs in Bangladesh, accounting for 40 per cent of all employment.
- In comparison with large enterprises and microenterprises, SMEs have traditionally been underserved in terms of access to credit. However, more recently collateral-free loans through bank lending have become available to SMEs with the central bank's growing focus on SME financing.
- Although official statistics suggest that the SME loan default rate is about two per cent, it is acknowledged that overall SME loan default figures in Bangladesh may have reached five or six per cent.
- This study uses survey data gathered from 96 SME loan recipients, now in default, to explore the factors contributing to high SME default rates.
- Major factors contributing to the high default rate on SME loans in Bangladesh include general strikes and blockades, high competition, lack of business capital, slow seasonal sales, and issues such as fund diversion.
- Bank officials having high credit-disbursement targets as well as a lack of awareness of loan processing fees and charges amongst borrowers are also contributing factors. Many defaulters also had secondary loans from other sources.
- Better information sharing amongst lenders could prevent multiple loans being taken by SMEs thereby lowering default risks.

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1. Introduction

Small and medium enterprise (SME) financing in Bangladesh is receiving increased attention given the importance of SMEs in the economy, especially in employment generation. The majority of studies on SMEs in Bangladesh have thus far been limited to considering access to finance; problems associated with the implementation of SME projects in cases where financing is available have not attracted sufficient attention, despite a high incidence of SME loan defaults in certain areas. This research looks into the causes of SME loan defaults in Bangladesh through primary research. Assistance was obtained from the only Bangladeshi bank with an SME-focus (more than 50 per cent of its loans are dedicated to SMEs) among the 56 scheduled banks operational in Bangladesh and from the bank with the second largest SME loan portfolio of all private banks in the country.

Key national institutions in Bangladesh relating to SMEs include: the SME & Special Programmes Department, established in 2010, of Bangladesh Bank (the central bank); the SME Foundation (established in 2007); and the SME Cell of the Ministry of Industries (formed in 2003). According to the Bangladesh Bank Governor, SMEs account for 40 per cent of overall employment and 80 per cent of industrial jobs in Bangladesh. 90 per cent of total industrial units are SMEs, contributing nearly 25 per cent of the country's GDP.

Prior to 2009, collateral-free loans were only available through microfinance covering the micro-enterprise segment; with bank lending focusing on medium and large enterprises, the small enterprise segment was the "missing middle" in terms of access to loans. With the central bank's growing focus on SME financing since then, SMEs can now access collateral free loans of up to Bangladesh Taka (BDT) 2.5 million (about US$32,250)While microfinance has about 95 per cent of its credit disbursed to women, about 95 per cent of SME credit disbursed here thus far has been to men, although Bangladesh Bank has initiated special schemes to provide single-digit interest rate SME loans to women (typical SME loan interest rates for collateral-free loans to men are usually 18 per cent or above).

While there is some literature on access to finance for SMEs in Bangladesh, there is no economic literature on the performance of SME loans, including their default rates. While microfinance is known for low levels of loan default, official statistics suggest that official SME loan default figures are similar to that of microfinance (about two per cent), although informally, stakeholders acknowledge that overall SME loan default figures in the banking sector of Bangladesh are between five and six per cent.

The findings of this research indicate that general strikes and blockades, sales on credit, high competition, lack of business capital, slow seasonal sales, issues such as fund diversion and willful default were cited as major factors in the high rate of SME loan default. Providing bank officials high credit disbursement targets, especially in rural areas, also contributed to default, as higher loan sanctions than small entrepreneurs could subsequently handle often resulted in misuse and/or diversion of funds and ultimately in loan default. Lack of awareness regarding various fees and charges for loan processing purposes deducted at the outset was also found to be a problem: this made it more difficult for SMEs with monthly repayment schemes to meet payments beginning in the first month after the loan was sanctioned during a period of frequent political shut-downs. A lack of awareness regarding the high levels of interest charged was also observed. SMEs simultaneously taking out high-interest NGO loans while also being an SME loan recipient also contributed to the high incidence of loan default.

2. Coverage of the Loan Default Research

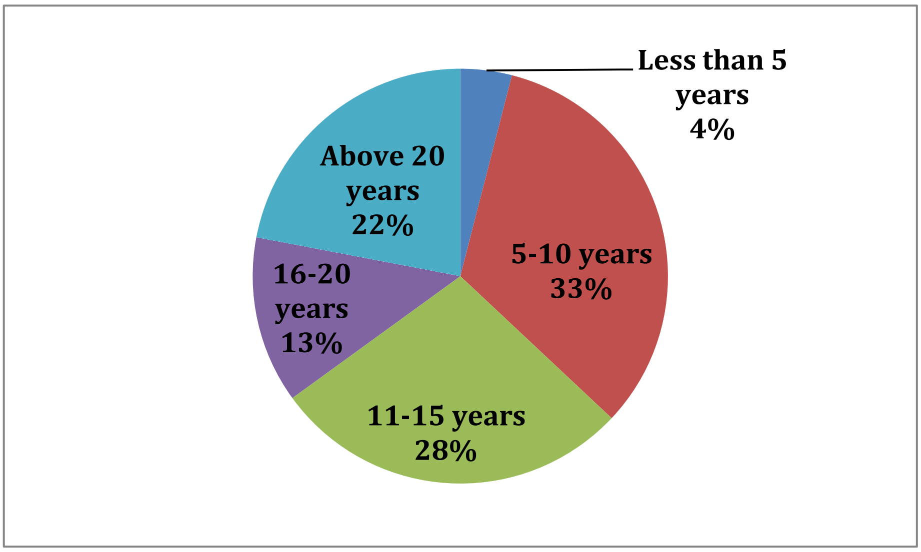
For the purpose of the research, the loan default guidelines of Bangladesh Bank were followed; thus, the classification of defaulters was that their SME loan installments are at least 60 days past due (DPD). The research covered SME loan defaults which ranged between 60 DPD to over 540 DPD; this list included a few cases of write-offs and a handful of instances where legal action had been initiated to recover the overdue loan amount from the entrepreneur. Interviews were carried out between June and September, 2013, at the urban and rural levels of at least one district of the northeast, northwest, southeast and southwest regions of Bangladesh (namely Sylhet, Rangpur, Chittagong and Khulna divisions). Twelve SME loan defaulter interviews were carried out at the business premises of the small entrepreneurs in each rural and urban site, with no more than two districts being chosen from an administrative division for this purpose, providing insight into various problems faced in conducting SME activities.

Only SME loan defaulters were chosen for this investigation, and areas which witness higher default rates on SME loan repayments were targeted; thus neither the SME loan recipients nor the site selections were random. While a list of loan defaulters was compiled by the SME Division of the head office of the private bank, in each and every site, some SME loan defaulters had to be chosen from outside the original list due to a variety of reasons, including the defaulter no longer being available in the area, the defaulter staying away from the business fearing the Collection Department, or the defaulter being out of business. While the investigation offers insights into the causes of SME loan defaults, it is more likely than not that to a varying extent, other (including non-defaulting) SME loan recipients are also affected by similar factors.

3. Findings

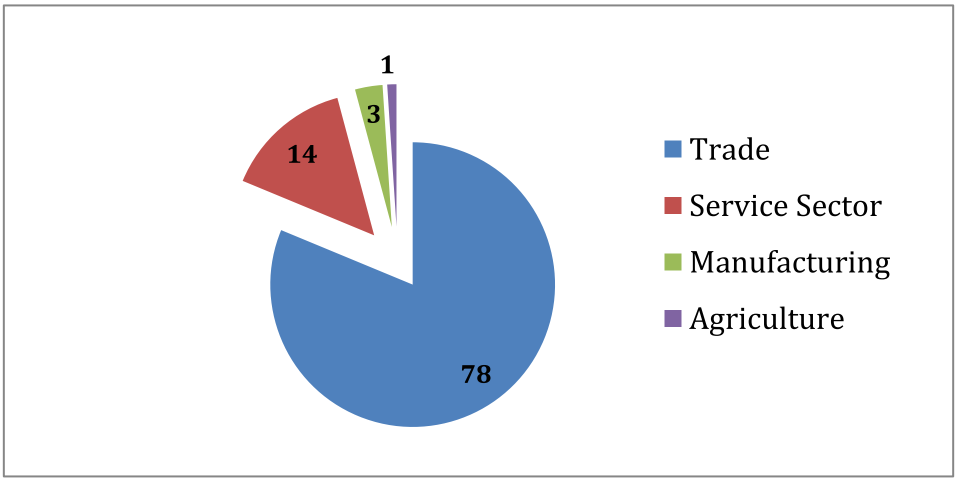
All defaulters interviewed were from the small entrepreneur segment, and had taken SME loan amounts between BDT 200,000 (USD 2,500 at the erstwhile exchange rate of BDT 80/USD) to BDT 1,000,000 (USD 12,500). All defaulters had collateral-free SME loans with monthly repayment schemes. Of the eight sites from the high default areas, only the urban site from Chittagong division had female SME loan defaulters; of the 12 defaulters interviewed there, 4 were female SME loan defaulters. All the remaining sites had only male SME loan defaulters. Thus, of the 96 SME loan defaulters in the 8 sites, only 4 were women and the remaining 92 were men.

Figure 1: Years of entrepreneurial experience of SME loan defaulters interviewed



Only four entrepreneurs interviewed were illiterate, and there were no entrepreneurs under the age of 20 in the sample; the majority of entrepreneurs had either completed Grade 10 (secondary school) or Grade 12 (high school), with 10 of them having graduate degrees or above, two of whom had post-graduate degrees. While 92 of the 96 entrepreneurs had at least five years or more of entrepreneurial experience, 60 had more than 10 years of such experience. While banks in Bangladesh are advised to discourage SME loans to entrepreneurs above the age of 50, 13 entrepreneurs were found above that age, with the senior most entrepreneur of the age of 68.

Figure 2: Type of business run by SME loan defaulters interviewed



While most of the retail and wholesale businesses were either small convenience or small department stores,[1] there were also a few clothing stores, book stores, sweetmeat shops and restaurants covered; only in Cox's Bazar were there a few gift shops and two beauty parlors. Of the 96 entrepreneurs interviewed, 22 had an existing other business. Although all 96 entrepreneurs claimed to own their own business, the SMEs were family-owned in six cases. The start-up capital for the entrepreneurs varied between zero and BDT2 million, with almost half (45) of the entrepreneurs claiming to have a start-up capital of BDT 0.1 million or less, while 22 entrepreneurs had a start-up capital of between BDT 0.5 million and BDT 2.0 million.

[1] In Bangladesh, a department store usually carries daily consumption items, some bakery products, soft drinks and some other items, and is thus often not comparable with the western concept of a department store.

On the source of their start-up capital, 79 of the 96 entrepreneurs interviewed mentioned having used their own money, money from their immediate family (father, mother, brother) or a combination thereof to start their business. Only one entrepreneur interviewed mentioned a bank loan as the sole source of start-up capital, while the others mentioned a combination of loans from non-government organization (NGO), friends and other relatives as the source of start-up capital.

Only four of the 96 entrepreneurs interviewed mentioned having suffered any business losses due to natural calamities; only one of them mentioned his business being affected by a cyclone, while the other three mentioned damage to their business due to severe rain and flooding. Of the 96 entrepreneurs interviewed, 95 had no insurance other than the fire and life insurance that are provided along with the SME loan; only one entrepreneur interviewed had insurance from before taking any SME loan from the bank. It is noteworthy that SME loan recipients from the bank in question have mandatory fire insurance and life insurance for at least the first year of their loan.

Almost two-thirds (62 of 96) of the entrepreneurs interviewed mentioned having taken SME loans two or more times from the same private sector bank (only after repaying one SME loan is another SME loan possible), while 34 were first-time SME loan recipients. Of the 62 entrepreneurs who had taken multiple SME loans, 29 had taken SME loans twice, 16 had taken it three times, 14 had taken it four times, two had taken it five times and one entrepreneur had taken an SME loan six times from the same bank. While the SME loans were provided through the branch of the same bank in urban areas, in all rural sites, there were corresponding banks that would provide the loans upon receiving instructions from the SME Unit Offices of the bank; loan repayments had to be made to the corresponding bank in such cases.

On the usage of the SME loan funds, 72 of the 96 respondents mentioned having utilized the funds only for the original purpose of the loan, while the remaining 24 mentioned using part or all of the funds for purposes outside of the sanctioned loan, without informing the bank. Of these 24 respondents, five mentioned using the funds for their business and for lending part of the money to others and another five respondents mentioned using the funds for their business and for using part of the money to fund or start a transport business, while four respondents had diverted part or the full amount of the loan money to the stock market (and suffered severe losses in the 2010 stock market crash), three respondents had used it to buy land, three respondents mentioned using the funds for medical treatment, while of the remaining three, one respondent used the money to cover his daughter's wedding expenses, one had given the whole amount to others, while the remaining respondent used the loan money to pay off other debts. It is noteworthy that although 25 per cent of defaulters admitted to diverting funds from the original purpose of the SME loan, it is highly likely that an even greater percentage had done so, albeit without making such an admission. Given the scope of the research and funding, it was not possible to investigate what percentage of recipients had actually diverted their SME loans to other uses and defaulted as a consequence.

Table 1: Major obstacles to SME businesses

Type of obstacle	Those who consider this an obstacle
Hartals (General strikes)	71
Slow seasonal sales	29
Lack of business capital	28
Competition	27

On the issue of whether there are any obstacles to their business, the majority of the interviewed entrepreneurs (87 of 96) mentioned that there were major obstacles to their conducting business; only nine entrepreneurs mentioned that there were none. Of the entrepreneurs who mentioned the existence of major obstacles, an overwhelming majority (71 of the 87 respondents) cited *hartals* (general strikes) as the main obstacle to their business, while an almost equal number cited lack of business capital (28), slow seasonal sales (29) and competition (27) as major hindrances to business. Another major problem cited was sale on credit – a large number of customers did not pay off later despite purchasing items on credit. Frequent electricity outages, business being shut down for extended periods (sometimes several months) for personal problems, robberies/thefts from business, dishonest salespersons and losses due to fund diversion to the stock market were also mentioned, while one or two also mentioned lower remittances and lack of tourists as major business challenges they were facing. It may be mentioned that one respondent was allowed to mention more than one obstacle to business.

Of the 96 SME loan defaulters interviewed, 27 had stopped paying any loan installments, 42 were paying whatever amount they could, often irregularly and generally much lower than the installment amount, and 25 mentioned having their loan installments rescheduled, while of the two loan write-off cases, one (more than 540 DPD) of the two defaulting entrepreneurs was in the process of paying off the loan amount by selling off a piece of land in order to avoid legal proceedings. Many (37) of the SME loan defaulters also had taken loans (of less than BDT 0.1 million maximum) from various NGOs while also taking loans from the bank. Of the 96 SME loan defaulters interviewed, only one had taken an SME loan from a different bank prior to taking the existing SME loan from the concerned bank.

On the overall assessment of the SME loan program of the concerned bank, an equal number of entrepreneurs (43) mentioned that the interest rate charged on the SME loans is very high and that SME loans offer easy access to finance, while 25 entrepreneurs highlighted the collateral-free aspect of the loans as a positive and 15 praised the quick (less than one month) time taken for sanctioning the SME loans from the time of application. Several entrepreneurs (13) mentioned that they were not aware of the high processing and other fees charged; an entrepreneur mentioned he had applied for a BDT 0.6 million loan but ended up receiving only BDT 0.561 million due to various fee deductions and charges, yet he had to start paying off installments within a month of receiving the loan. Three entrepreneurs complained about the rough behavior of the bank staff, and mentioned this was a reason why they had defaulted on loan repayment. In several sites, based on the business performance and admission of the loan defaulters in the absence of officials of the concerned bank, up to one-third of loan defaulters mentioned that they could pay off the installments, but were defaulting for a variety of reasons, the most often cited one being their being turned down for a significantly larger non-SME loan sanction. This is being referred to as “willful default” for the purpose of this research.

4. Conclusion and Recommendations

The findings indicate that while political turbulence in the form of general strikes and blockades, lack of business capital, stiff competition and slow seasonal business were the main factors contributing to a high rate of SME loan default, issues such as fund diversion and willful default due to being turned down for a larger non-SME loan sanction and rough behavior by credit relations officers were also significant factors. Thus, more adequate supervision is required in observing fund utilization, as loan recovery becomes all the more difficult when funds are diverted away from the business. Providing SME bank officials high loan targets, especially in rural areas, was also apparently partially responsible for the high incidence of default, as previous SME loan recipients who had not defaulted on several SME loans of smaller amounts were often given a higher loan sanction than they could subsequently handle, resulting in misuse of funds and ultimately in loan default.

Lack of awareness by borrowers regarding various fees and charges for loan processing purposes at the very onset, sometimes ranging as high as six and a half per cent of the total loan sanctioned, and lack of awareness regarding the high level of interest and various other fees charged and the monthly repayment scheme during a period of frequent political shut-downs had a negative impact on a large number of businesses.

Political instability, frequent electricity outages and a sluggish investment trends caused private sector credit growth to slow down in 2013, according to Bangladesh Bank data. Thus it would seem appropriate for SME lending to be more conservative during the cycle of pre-election violence and agitation in Bangladesh. This may explain why there was excess liquidity worth approximately BDT 900 billion (almost USD 12 billion) in the banking system of Bangladesh at the end of 2013. It is noteworthy that despite such a large amount of excess liquidity, interest rates charged on loans had not fallen in the country at that time.

Another major factor appears to be the issue of NGO loans accessed while also being an SME loan recipient. A more efficient information system needs to be created so that in the process of borrowing from multiple sources, one loan at a high rate of interest is not taken without the knowledge of the lender, in order to avoid borrowing from multiple sources and the ensuing debt traps similar to those witnessed in the case of microfinance (Faruqee and Khalily, 2011).

Despite all these issues, given the importance of the SME sector in the economy and in employment generation, it is imperative to create a supporting environment for SMEs to thrive and for banks to cater to the credit needs of SMEs. Many of the businesses interviewed would definitely have qualified for secured loans, even though the processing time would have taken longer than for that of a collateral-free SME loan.

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