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TOTAL COST OF SMALL ENTREPRENEURIAL CREDIT: AN ANALYSIS ON SELECTED PRIVATE COMMERCIAL BANKS IN BANGLADESH

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ABSTRACT

The small enterprises can act as a major force in furthering the process of economic development in Bangladesh through promoting employment, reducing poverty and ensuring sustainable growth. However, there are many problems in nourishing small scale industries in Bangladesh where as financing emerges as a significant one. Generally, working capital is sought from banks. However, the interest rate is high. Furthermore, other non-price financial cost of credit significantly enhances the total cost. This paper has revealed the cost of different activities at different phases of loan undertaking process such as cost regarding security, insurance, bank formalities, pleasing bank officers and so on. Further, this paper has pointed out that the cost of borrowing for the entrepreneurs is much higher than the declared interest rate. Therefore, this research can play a significant role to develop policy recommendations to trim down the total cost of credit so that the small enterprises can thrive.

KEYWORDS

Continuous Loan, Cost, Collateral, Documentation, Mortgage etc.

INTRODUCTION

In Bangladesh, considering the country's level of economic growth, composition of resources, level of global integration, urbanization and so on, there is ample scope for development of diversified and non-traditional small and medium enterprises (SMEs) (Moazzem, 2006). Small businesses provide immense economic opportunities of employment and income generation activities to middle-income and poor people by tapping local resources. It also plays a complementary role to the large industries for their sustainable growth in this developing country. Therefore, considering the promising role of small and medium enterprises, this sector has been declared as a priority sector in the government's Industrial Policy 2005.

Though a number of steps have been undertaken by the different organizations and institutions for the promotion and development of small entrepreneurship, expected development in the small entrepreneurship did not take place. Various surveys and studies (Hossain, 1998; Daniels, 2003; Minto, 2004) have identified access to finance as the main problems facing the SMEs whereas credit is an important development tool for the development of small industries and bank and other structured financial institutions can play the role to gear up the task of extending credit facilities to the small business entrepreneurs. Moreover, it has been revealed that commercial banks are reluctant to extend loans to this sector because SMEs are regarded as high-risk borrowers (Sia, 2003). It is already well recognized that in this country the interest rate of the small enterprise credit of private banks (generally 15%) is high ("Interest Burden," 2007) which needs to be reduced. Moreover, total cost of credit comprises not only interest but also the cost involved in the process of getting loan from banks. With the above background, the main aim of the study was to analyze total cost of credit of small entrepreneurs delivered by the private banks and suggest some policy recommendations so that this cost can be reduced for ensuring the sustainable growth of the sector.

RESEARCH OBJECTIVES

The mission of the study is to analyze total cost of credit of small entrepreneurs delivered by the private banks and suggest some policy recommendations so that this cost can be reduced for ensuring the sustainable growth of the sector. To achieve this mission the following specific objectives are outlined. These are:

- To identify and explore the elements of cost of small loan undertaking to withdrawal
- To determine total cost of credit on the utilized amount of loan for a year
- To determine total cost of credit on net loan (utilized amount excluding the non-price cost) utilized for a year
- To synthesize the findings and draw recommendations

RESEARCH METHODOLOGY

Considering the geographical and demographical profile, the study area selected for this study was Mymensingh Pourashabha of Bangladesh. For the purpose of this research, branch officers of all the private banks located in this Pourashabha are interviewed to know the process of undertaking small entrepreneurial loan. These banks are Pubali Bank Ltd., Uttara Bank Ltd., United Commercial Bank Ltd., National Bank Ltd., City Bank Ltd., Arab Bangladesh Bank Ltd. However, some banks (National Bank Ltd., City Bank Ltd., Arab Bangladesh Bank Ltd.) have just started providing loan in this segment. Therefore, considering the small enterprise lending experience and the number of loanee (loan undertaker), three private commercial banks - Uttara Bank Ltd., United Commercial Bank Ltd., Pubali Bank Ltd., have been taken into consideration. As the cost is calculated for one year, to select the loanees, this research has considered only those entrepreneurs who had more than one year experiences of taking loan from the selected banks. All these loanees have undertaken Continuous Loan (CC Loan), the widely undertaken loan, within the time frame of January, 2004 to June, 2006 as the research was conducted at the mid of 2007. The reason of selecting the time frame of two and half years is to maintain the consistency of cost of the loanees, who have taken loan in different periods. Considering all these criteria total 54 loanees are found in the area among whom 48 loanees were undertaken as sample through random selection.

Data were collected from both primary and secondary data. Through the face to face interview, primary data has been collected from the bank's Relationship Officers of Mymensingh. Besides, using a structured questionnaire, direct interview has also been conducted to collect data from the small entrepreneurs. Most of the questions were close-ended while only some were open-ended. As secondary sources bank documents regarding the information of the loanees have been used. Further, secondary data further have been collected from the Internet, different publications, newspapers, relevant journals etc. To make the study more broad-based and informative, materials of this paper have been presented systematically for analytical purposes and also to draw inference there from.

ANALYZING TOTAL COST OF CREDIT

UTILIZING AMOUNT OF LOAN: BASIS FOR DETERMINING COST OF CREDIT

For working capital, banks provide two types of loan – Term Loan and Continuous Loan (CC Loan). CC loan is widely used one and this study is only on the cost of this type of loan. First of all, CC loan is sanctioned for one year and it can be continued year after year with the provision of renewal in each year. The client not necessarily supposed to undertake entire amount of the loan sanctioned. Rather the loan can be held for any amount within the limit of sanctioned amount for any duration of period within one year. For example, a client may have the sanctioned amount of Tk. 15 lac for a year, out of which on the first month, he takes Tk. 10 lac and holds it for three months. Afterwards, he repays Tk. 5 lac to the bank and holds the rest Tk. 5 lac for next two months. Then he again takes loan of Tk. 7 lac from the bank and holds the total Tk. 12 lac for about three months. Therefore, the interest is charged not on the entire amount of loan sanctioned. It is

charged on the amount of the loan that is withdrawn from the account for a specific period by the loanee. This is why, it is not viable to determine the total cost of credit (in percentage) based on the sanctioned amount. Rather, it would be more justified to determine cost of credit on the basis of the average amount utilized (the average amount of loan that is held by the loanees in a year). Moreover, the total interest paid for the last year is considered to determine the average utilized amount of loan. Average amount utilized against average amount sanctioned within different ranges is presented in Annexure.

COST OF DIFFERENT ELEMENTS OF LOAN IN DIFFERENT PHASES

There are basically four phases for undertaking CC loan – Pre-Application Phase, Loan Sanctioning Phase, Loan Maintenance Phase and Loan Withdrawal Phase (Jaim and Arefin, 2007). It would be convenient and easily comprehensible to identify the cost elements of loan undertaking in different phases and then calculate the total cost.

COST OF DIFFERENT ELEMENTS OF PRE-APPLICATION PHASE

Cost of pre-application phase includes the cost for the activities in order to be prepared for undertaking loan before application to the bank. One major elements of cost of this phase is document preparation cost. To prepare documents, it requires collection of some new documents basically regarding collateral and also photocopy of some of the documents. Table-2 in Annexure reveals that this cost is, in general, higher for the borrowers applying for larger amount of loan.

Another important cost of this phase is the cost of entertaining or pleasing bank officers. The cost of entertaining the bank officer includes the cost of providing snacks or traveling cost when the officers have visited the business premise or have gone for assessing the security valuation. And the cost of pleasing indicates bribe in cash. It has been clearly demonstrated in Table-2 that in general, this type of cost is comparatively higher for the loanees having small amount of loan.

Pre-application phase also includes the cost of account opening, legal advisor fees, cost of traveling to legal advisor and bank and other pre-application cost. The table demonstrates that generally the total cost per loanee is high for the larger amount of loan. However, the cost in terms of percentage declined with the increase of the loan size which varied from 0.86 percent for the largest size of loan to 4.43 percent for smallest size of loan.

COST OF DIFFERENT ELEMENTS OF LOAN SANCTIONING PHASE

Cost of loan sanctioning phase comprises the cost of activities that will have to be incurred from applying for loan to obtaining the loan in the account. One major elements of cost of this phase is mortgage formalities cost that includes cost of photograph of loan applicant, legal advisor's fees, mortgage fees to government, stamp, transportation for this purpose and so on. Table-3 in Annexure reveals that for higher amount of loan this cost is increasing.

Cost of insurance of inventory is another important cost. To secure the loan amount the loanees will have to insure his or her inventory. The insured amount is 1.1% of the loan sanctioned. As this cost is directly related to the amount of loan sanctioned, with the increase of loan, this cost is also increased.

In this phase cost is also incurred for purchasing stamp for agreement with the bank, transportation and communication with bank. Cost of pleasing for loan sanctioning is another issue that can be considered for some clients. During this period, some loanees go to Dhaka Head Office to pursue officers there for sanctioning the amount of loan as desired by them within short period.

In general, most of the costs in this phase such as insurance cost are directly related with the amount of loan. This is why, with the increase of amount of loan, the total cost of the items included in this phase is also increased. But the percentage of total cost on utilized amount does not show such increasing trend. However, the highest percentage (3.75%) is found to be for the least sanctioned amount of Tk. 1,93,812 while the lowest percentage (2.67%) was found for the highest sanctioned amount of Tk. 16,00,000.

COST OF DIFFERENT ELEMENTS OF LOAN MAINTENANCE PHASE

In this phase, to receive and repay loan as well as to pay interest, the loanees have to go to bank many times. Therefore, here the cost of transportation and communication to bank for a year has been considered for calculating total cost. The loanees have to pay the interest during this period but as maintenance cost only other non-price financial costs are considered. Table-4 shows that the cost involved in this stage though it is a very scanty amount. The highest cost is only 0.23% for the sanctioned amount of Tk. 1,93,812.

COST OF DIFFERENT ELEMENTS OF LOAN WITHDRAWAL PHASE

In the phase of withdrawal, the loanees have to incur cost for taking away documents, for doing some formalities with bank and so on. According to banks this cost is negligible. But in this study, none of the loanees have withdrawn the loan. Therefore, this cost has been ignored in the analysis.

NON-PRICE FINANCIAL COST AND ILLEGAL BURDEN FOR A YEAR

In general, non-price financial cost for a year comprises the cost of pre-application phase, loan sanctioning phase, loan maintenance phase and also the withdrawal phase except the interest cost and cost of entertaining and pleasing the bank officers. On the other hand, the illegal burden includes the cost of entertaining and pleasing the bank officers. However, the withdrawal cost has been excluded here.

Non-price financial cost and illegal burden vary from Tk. 16,304 to Tk. 57,955 depending on the loan size. The highest percentage of the cost (8.41%) was for the sanctioned amount of Tk. 2,50,000 and the percentages decreased gradually. On the other hand, the lowest cost (3.62%) is for the highest sanctioned amount of Tk. 25,00,000.

Considering the types of cost regardless of phases, from the Table-5 it has been found that the cost regarding security is one of the major costs. For the small loanees this cost is almost half of the entire cost. Cost of insurance also incurs huge cost. Besides, although cost of entertaining or pleasing bank officers is a small amount of cost it is an illegal burden cost.

TOTAL COST OF CREDIT FOR A YEAR

Though the official interest rate is 15%, considering the entire process, the total cost of credit has been found much higher than the official rate. Total cost comprises interest as well as non-price financial cost and illegal burden. Table-6 demonstrates that with the increase of amount of loan total cost of credit has gradually increased. But as in percentage of total utilized amount, the highest cost of credit is 23.41% for the smallest amount of loan (Tk. 2,50,000) and the lowest is 18.62% for the largest amount of loan (Tk. 25,00,000). However, in a study (Chanda, 2006) on the SME loan lending by BRAC Bank Ltd. in Mymensingh district it has also been revealed that the average cost to obtain loan (including four components of loan cost - namely processing fee, VAT, insurance and stamps) is gradually higher for higher amount of loan.

Along with the percentage of total cost of credit on utilized amount, it is quite reasonable to look into the loan amount actually enjoyed by the sample loanees that is on the net loan utilized from the view point of loanee. After deducting non-price financial cost and illegal burden from the loan utilized, the net loan utilized is derived and the total cost of credit is calculated based on this net loan amount utilized. In such a context, it has been found from Table-6 that this cost of credit enjoyed varies from 19.32% (for loan of Tk. 25,00,000) to 25.56% (for loan of Tk. 2,50,000). This cost of credit shows the actual burden borne by the loanees. From the analysis it can be concluded that the total cost of credit on utilized amount or net loan is much higher than the official interest rate.

One important issue may be considered in this regard. The CC Loan or the Continuous Loan is operated year after year with the renewal of the loan. As because, some costs are incurred initially such as pre-application cost and loan sanctioning cost, these costs are spread out year after year as fixed cost. However, there are some variable costs which need to be incurred in each year. This is why, with the continuation of loan, there will be cost that comprises the interest and other variable cost (insurance cost and the maintenance cost). This cost can be considered as the least feasible cost because cost cannot be below that amount.

CONCLUSIONS

Development of small enterprises may contribute significantly to the overall economic development of the country. However, Acquisition of credit from the banks with easy terms and conditions is a pre-condition for the development of this sector. However, existing loan acquisition process is cumbersome, time consuming as well as costly. Considering all the formal and informal costs related to acquisition of loan the actual interest rate of loan was found to be considerably higher than what the bank charges. Therefore, to mitigate the problems related to loan acquisition for the small entrepreneurs from commercial banks, some recommendations for the policy makers have been made based on the findings from this study.

In the traditional banking system it is not possible to get loan facilities without collateral or guarantee. In order to minimize a major cost of managing collateral – cost of security and also cost of insurance, the collateral free loan should be offered. Finance Advisor ("Finance Advisor", 2007) urged the Bangladesh Bank and commercial banks to take initiative to provide collateral-free loans for the development of small and medium enterprises (SMEs) in the country. He also

requested to take initiative to provide loans considering the project viability and payback capacity of the entrepreneurs. Only through the collateral free loan the total cost can be reduced drastically by half. It would also reduce the harassment for preparing documents, visiting the legal advisor, mortgage formalities and so on.

Before thoroughly introducing the scheme, few steps can lend a hand to reduce cost of the existing process. Through eliminating some documents to prove the validity of the property which requires bribing in many steps, can reduce the cost to a great extend. Besides, undertaking responsibility of the bank to scrutinize documents by legal advisor and having the specific amount as the legal advisor fees can also trim down cost. In addition, the easiness of the process of collateral or to provide provision of collateral free loan will eventually reduce the cost of transportation.

This study has revealed that lack of easy access and adequate finance are the prevailing constraints for the growth and expansion of small enterprise sector. Therefore, the banking norms, procedure and attitude regarding investing in this promising sector should be changed. The policymakers of banks should take a positive action to provide credit with lower cost, more convenience and flexibility.

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ANNEXURE

TABLE - 1: AMOUNT OF LOAN SANCTIONED AND THE AMOUNT OF UTILIZATION

| Range of Sanctioned Amount (In Lac Tk.) | Average Amount Sanctioned (In Tk.) | Average Amount Utilized (In Tk.) | Sample Loanees | |
|--|---------------------------------------|-------------------------------------|----------------|------------|
| | | | Number | Percentage |
| Below 3.5 | 2,50,000 | 1,93,812 | 12 | 25.00 |
| 3.5-7 | 5,19,000 | 3,16,874 | 21 | 43.75 |
| 7-10.5 | 10,00,000 | 6,69,425 | 5 | 10.42 |
| 10.5-14* | - | - | - | - |
| 14-17.5 | 15,00,000 | 8,07,112 | 4 | 8.33 |
| 17.5-21 | 19,60,000 | 8,90,326 | 5 | 10.42 |
| 21-24.5* | - | - | - | - |
| 24.5-28 | 25,00,000 | 16,00,000 | 1 | 2.08 |
| Total | | | 48 | 100 |

Source: Data collected from Bank Documents and Field Survey; calculation is done by the author

*Note: No loanee is found in this range.

TABLE - 2: ELEMENTS OF PRE-APPLICATION COST OF CREDIT AND THE QUANTUM THEREOF

| Elements of Cost | 1,93,812 (2,50,000)* | 3,16,874 (5,19,000)* | 6,69,425 (10,00,000)* | 8,07,112 (15,00,000)* | 8,90,326 (19,60,000)* | 16,00,000 (25,00,000)* |
|--|-------------------------|-------------------------|--------------------------|--------------------------|--------------------------|---------------------------|
| Account Opening Cost | 35 | 35 | 35 | 35 | 35 | 35 |
| Document Preparation Cost | 5,596 | 7,420 | 11,080 | 8,375 | 12,680 | 12,000 |
| Legal Advisor's Fees | 1,250 | 1,319 | 2,900 | 3,325 | 1,600 | 1,600 |
| Cost of Traveling to Legal Advisor | 158 | 87 | 124 | 73 | 290 | 20 |
| Cost of Traveling to Bank | 90 | 83 | 28 | 38 | 60 | 100 |
| Cost of Entertaining and/or Pleasing Bank Officer | 630 | 265 | 130 | 25 | 20 | 0 |
| Other Pre-application Cost | 833 | 0 | 0 | 0 | 0 | 0 |
| Total Pre-application Cost | 8,592 | 9,209 | 14,297 | 11,871 | 14,685 | 13,755 |
| Percentage of Pre-application Cost on Utilized Amount | 4.43 | 2.91 | 2.13 | 1.47 | 1.65 | 0.86 |

Source: Field Survey

*Note: The figures in parenthesis show the average amount sanctioned

TABLE - 3: ELEMENTS OF LOAN SANCTIONING COST OF CREDIT AND THE QUANTUM THEREOF

| Elements of Cost | 1,93,812 (2,50,000)* | 3,16,874 (5,19,000)* | 6,69,425 (10,00,000)* | 8,07,112 (15,00,000)* | 8,90,326 (19,60,000)* | 16,00,000 (25,00,000)* |
|--|-------------------------|-------------------------|--------------------------|--------------------------|--------------------------|---------------------------|
| Stamp for Agreement | 150 | 150 | 150 | 150 | 150 | 150 |
| Mortgage Formalities Cost | 4,301 | 5,006 | 7,863 | 7,500 | 10,313 | 15,000 |
| Insurance of Inventory | 2,758 | 5,038 | 11,200 | 15,625 | 17,440 | 27,500 |
| Transportation and Communication of Bank | 53 | 50 | 14 | 20 | 37 | 50 |
| Pleasing for Loan Sanctioning | 0 | 95 | 0 | 0 | 200 | 0 |
| Cost of Loan Sanctioning | 7,262 | 10,339 | 19,227 | 23,295 | 28,140 | 42,700 |
| Percentage of Cost on Utilized Amount | 3.75 | 3.26 | 2.87 | 2.89 | 3.16 | 2.67 |

Source: Field Survey

*Note: The figures in parenthesis show the average amount sanctioned.

TABLE - 4: ELEMENTS OF LOAN MAINTAINING COST OF CREDIT FOR A YEAR AND THE QUANTUM THEREOF

| Elements of Cost | 1,93,812 (2,50,000)* | 3,16,874 (5,19,000)* | 6,69,425 (10,00,000)* | 8,07,112 (15,00,000)* | 8,90,326 (19,60,000)* | 16,00,000 (25,00,000)* |
|--|-------------------------|-------------------------|--------------------------|--------------------------|--------------------------|---------------------------|
| Transportation and Communication to Bank | 450 | 343 | 220 | 175 | 1,220 | 1,500 |
| Cost of Loan Maintenance | 450 | 343 | 220 | 175 | 1,220 | 1,500 |
| Percentage of Cost on Utilized Amount | 0.23 | 0.11 | 0.03 | 0.02 | 0.14 | 0.09 |

Source: Field Survey

*Note: The figures in parenthesis show the average amount sanctioned.

TABLE - 5: ELEMENTS OF OTHER NON-PRICE FINANCIAL COST AND ILLEGAL BURDEN OF CREDIT FOR A YEAR AND THE QUANTUM THEREOF

| Elements of Cost | 1,93,812 (2,50,000)* | 3,16,874 (5,19,000)* | 6,69,425 (10,00,000)* | 8,07,112 (15,00,000)* | 8,90,326 (19,60,000)* | 16,00,000 (25,00,000)* |
|---|-------------------------|-------------------------|--------------------------|--------------------------|--------------------------|---------------------------|
| Bank Formalities | 185 | 185 | 185 | 185 | 185 | 185 |
| Cost regarding Security | 11,305 | 13,832 | 21,967 | 19,273 | 24,883 | 28,620 |
| Cost of Insurance | 2,758 | 5,038 | 11,200 | 15,625 | 17,440 | 27,500 |
| Cost of Entertaining/ Pleasing Bank Officers | 630 | 360 | 130 | 25 | 220 | 0 |
| Other Cost | 1,426 | 476 | 262 | 233 | 1,317 | 1,650 |
| Total Non-Price Financial Cost and Illegal Burden | 16,304 | 19,891 | 33,744 | 35,341 | 44,045 | 57,955 |
| Percentage of Cost on Utilized Amount | 8.41 | 6.28 | 5.04 | 4.38 | 4.95 | 3.62 |

Source: Field Survey *Note: The figures in parenthesis show the average amount sanctioned.

**Note: Bank formalities includes cost of account opening, stamp for agreement etc., cost regarding security includes cost of documentation, mortgage and cost of legal advisor fees, other cost includes cost of transportation to bank and so on.

TABLE - 6: TOTAL COST OF CREDIT FOR A YEAR

| Average Loan Sanctioned | Average Amount Utilized | Interest @ 15% per annum | Non-Price Financial Cost and Illegal Burden * | Total Cost of Credit | Total Cost of Credit on Amount Utilized in % | Net Loan Utilized | Total Cost of Credit on Net Loan Utilized in % |
|-------------------------|-------------------------|--------------------------|---|----------------------|--|-------------------|--|
| 1 | 2 | 3 | 4 | 5(3+4) | 6(5/2) | 7(2-4) | 8(5/7) |
| 2,50,000 | 1,93,812 | 29,072 | 16,304 | 45,376 | 23.41 | 1,77,508 | 25.56 |
| 5,19,000 | 3,16,874 | 47,531 | 19,891 | 67,421 | 21.28 | 2,96,983 | 22.70 |
| 10,00,000 | 6,69,425 | 1,00,414 | 33,744 | 1,34,158 | 20.04 | 6,35,681 | 21.10 |
| 15,00,000 | 8,07,112 | 1,21,067 | 35,341 | 1,56,408 | 19.38 | 7,71,771 | 20.27 |
| 19,60,000 | 8,90,326 | 1,33,549 | 44,045 | 1,77,594 | 19.95 | 8,46,281 | 20.99 |
| 25,00,000 | 16,00,000 | 2,40,000 | 57,955 | 2,97,955 | 18.62 | 15,42,045 | 19.32 |

Source: Field Survey

*Note: Non-Price Financial Cost and Illegal Burden includes the total cost of pre-application phase, loan sanctioning phase and loan maintenance phase.

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