Repayment Practices of the SME Borrowers

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Abstract: This study analyzes the repayment practices of SMEs operating in Sarawak, the largest state of Malaysia. Results showed that about 63% of the respondents did not pay their credit obligations on time. Furthermore, higher total liability per month was found to be significantly associated to higher loan delinquencies. Meanwhile, level of education attained by respondents also reported significant predictive power over their repayment practices. A higher level of education level attained implies better credit management. On the other hand, respondents’ financial capability which is represented by household income did not have any significant impact on their repayment performances.

Key-Words: - Repayment practices, SME, financing alternatives

1 Introduction
The Small and Medium Enterprise (SME) is the backbone of the economic growth of Malaysia. It represents 99.2 percent of the total business establishments in Malaysia. However, 80 percent of the SME in Malaysia are micro enterprises (defined as business concerns with less than five full-time employees, and an annual sales turnover of less than RM250,000 in the manufacturing sector and RM200,000 in the agricultural and services sectors).

In 2005, SME contributed 32 percent of GDP and 19 percent of the total exports of Malaysia. In terms of the contribution of SME towards the country’s employment opportunity, SME manage to create 5.6 million employment opportunities, which is equivalent to 56.4 percent of the workforce in Malaysia (Census of Establishments and Enterprises, 2005). Nevertheless, compare to more developed Asian countries like Japan and China where SME’s contribution is already above 55 percent of the country’s GDP, the contribution of Malaysian SME is still behind (SME Annual Report, 2007).

The National SME Development Blueprint has made improving the competitiveness, productivity and resilience of the SME sector of Malaysia its main agenda. Besides that, both the Ninth Malaysian Plan and The Third Industrial Masterplan also outline key strategies for SME development for the 2006-2010 and 2006-2015 periods respectively. Many agencies were setup to provide assistance to SME, nevertheless, the lack of coordination and transparency among these agencies has affected their efficiencies (APEC survey, 1994).

According to Ting (2005), among the challenges face by SME in Malaysia are: inability to adopt technology, lack of information on potential markets, difficulties in accessing loans and other forms of financial assistance, lack of skilled and talented workers as well as global competition. Inevitably, to capitalize on investment opportunities and adopt best business practice are the main ingredients for SME to compete successfully in the domestic and global market. However, all these can only be achieved with the availability of financing from either the government bodies or via the financial institutions. On the other hand, proper credit management on the financing received is equally essential to ensure the solvency and long-term survival of the SME.

2 Problem Formulation
Under the guidance of the Central Bank of Malaysia, banking and development financial institutions are targeted to approve RM70 billion in loans to 140,000 SME accounts in 2008. SME financing was accounting for 44.3 percent of total business financing in Malaysia as of the end of March 2008 (SME Annual Report, 2007).

While many SME had benefited from the various loan schemes obtained from the numerous avenues made available to them, some SME face difficulties in managing their debt. To assist this group of SME, The Central Bank of Malaysia has
setup Small Debt Resolution Scheme to facilitate the restructuring of non-performing loans (NPLs) of SME. As of the end of April 2008, 763 applications with total NPLs of RM527 million have been received by the authorized scheme. While intensifying the efforts to assist SME with financial difficulties, factors influencing repayment problems need to be identified.

2.1 Factors Affecting Repayment Problems
Martin (1997) analysed the determinants of the repayment performance of Grameen Bank borrowers and discovered that education level and the area of land possessed (proxy of wealth) by the borrowers have a positive impact on repayment performance. In a related study, Godquin (2004) contended that borrowers who have enough money to reimburse might also default strategically. He also reported that both age and size of loan have an inverse relationship to repayment performance. These results confirm the finding of an earlier study conducted by Freimer and Gordon (1965).

Pang (1991) proposed that collateral (assets to secure the debt), capacity (sufficient cash flow to service the obligations), character (integrity), condition of the economy as well as capital (net worth) need to be included in the credit scoring model. In a related study, Weinberg (2006)’s findings have provided support to that of Pang (1991)’s suggestion. He contended that two main determinants of household repayment obligations are the amount of debt and the interest charged.

On the contrary, Paul (1973) suggested the need for non-traditional measures of psychological attributes such as stability, sense of commitment and future orientation. This attributes might be reflected in religious body or club membership and newspaper readership. This was documented after the author failed to develop a scoring system with predictive power after studying 800 respondents in the Washington D. C. area.

A more recent study by Young, Glennon and Nigro (2008) documented that both ‘soft’ and ‘hard’ information have an impact on the repayment patterns of the borrowers. Hard information such as borrowers’ capacity, indebtedness and monthly instalments need to be taken into consideration. On the other hand, soft information like borrower-lender distance is important. A larger borrower-lender distance is associated with higher default risk because distance interferes with information collection.

Meanwhile, the condition of the economy is equally important; the recent U.S. economic slowdown has resulted in total delinquencies and monthly defaults climbing approximately 65 percent (Anonymous, 2009). Besides being affected by the economic crisis, Athmer and Vletter (2006) added that 70 percent of the defaulters in their samples are facing crisis related to health or experiencing death in the family. Finally, loans that are too big also lead to repayment problems, dissatisfaction and high drop outs (Hietalahti and Linden, 2006).

2.2 Methodology
This study used structured questionnaires to collect the data required for analysis. Apart from collecting data on the types of financing used by SME in Sarawak, data on repayment practices as well as factors influencing SME repayment capability were collected for further analysis.

After excluding incomplete questionnaires, a total of 114 samples collected using a combination of simple random sampling and snowballing techniques were used for further analysis. In order to capture the relationship of education attained, repayment capability as well as indebtedness and the dependent variable - loan repayment practices, the following model was used:

\[RP = \alpha - \beta_1 \text{EDU} - \beta_2 \text{CAP} + \beta_3 \text{TDPM} + \epsilon\] (1)

In this study, repayment practice (RP) is proxied using repayment pattern which refers to whether the borrowers pay on time, pay after 1, 2, 3, 4, 5 or 6 months of arrears or stopped paying. EDU refers to the level of education attained. A higher level of education attainment is foreseen to improve the ability of credit management among SME loan recipients. Therefore, the higher the level of education attained, the shorter the time would be required for the borrowers to settle their debt.

CAP refers to the capacity of the borrower which is calculated using total household income. A higher household income is expected to be associated with a shorter repayment period and hence, a better credit management performance. Finally, TDPM represents the indebtedness of the SME borrowers. Higher indebtedness leads to poorer repayment performance. Hence, a positive relationship between indebtedness and the length of time taken to settle monthly instalment is expected in this study.

3 Problem Solution
Descriptive statistics are presented in Section 3.1 while Section 3.2 discusses the multiple regression results.

### 3.1 Descriptive Statistics

From the analysis, SME owners use various means of financing to start their businesses. 57 percent of the SME respondents mentioned that they utilized their own savings, 15 percent used borrowings from friends and relatives while the remaining used a combination of the above instruments plus bank loan as their start-up funds. For those who managed to secure financing from banks either at the beginning or sometime after the setting up of their businesses, repayment patterns were examined.

The repayment period of the respondents can be broadly divided into pay on time, pay within one month, two months, three months and more than three months of arrears or do not pay at all. 37 percent of the respondents disclosed that they pay on time, 31 percent pay within one month of arrears, 20 percent pay within two months of arrears, 20 percent pay within three months of arrears while the remaining pay after three months of arrears or do not pay at all.

Mean household income for the respondents is reported at RM6056 with the minimum household income at RM2300 while the highest at RM18000.00 per month. On the other hand, the average total liability per month for the respondent is RM2132 with the highest at RM9300 and the lowest at RM200 per month. Last but not least, a majority of the respondents (43.9 percent) attained secondary education (‘O’ level’). 32.5 percent are diploma holders, 20.2 percent are university graduates while the remaining only attained primary education.

### 3.1 Multiple Regression Results

Overall, a majority of the respondents (63.0 percent) exhibited poor credit management. This group of respondents did not pay their loans on time; instead, they either pay after the due date or have stopped paying their loans.

Multiple regression analysis was employed to assess the predictive power of the level of education attained, repayment capacity and indebtedness on the repayment performance of the SME borrowers. The results from the analysis were exhibited in Table 1.

Referring to Table 1, the model employed in this study reported an F value of 10.004 and adjusted R-square of 0.193 which is significant at the 5% level.

### Table 1: Results of Cross-Sectional Regressions Analysis

<table>
<thead>
<tr>
<th>Independent variables</th>
<th>β</th>
<th>t-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education attained</td>
<td>-0.424</td>
<td>-3.420**</td>
</tr>
<tr>
<td>Household Income</td>
<td>4.664E-05</td>
<td>1.836</td>
</tr>
<tr>
<td>Total liability per month</td>
<td>0.001</td>
<td>3.367**</td>
</tr>
<tr>
<td>F value</td>
<td>10.004**</td>
<td></td>
</tr>
<tr>
<td>R²</td>
<td>0.214</td>
<td></td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.193</td>
<td></td>
</tr>
</tbody>
</table>

**Significant at 5% level.

Findings implied that the level of education attained and indebtedness of the SME borrowers have a significant predictive power over the repayment practices which is represented by borrowers’ repayment pattern. Respondents’ level of education attained was found to have a significant negative relationship with repayment practices. Higher education attainment leads to better repayment performance. However, findings also reported a positive significant relationship exist between monthly total liability (indebtedness) and repayment performance. Respondents with higher indebtedness are more likely not to fulfil their financial obligations on time.

Nonetheless, as shown in Table 1, respondents’ repayment capability which is represented by household income does not show any significant impact on respondents’ repayment performance. This could be attributed to the psychological attributes of the respondents. As documented by Gordon (1965), borrowers with the capacity to pay might opt to default their credit obligations strategically.

### 4 Conclusion

The limitation of this study was the difficulties faced in getting respondents to disclose about their repayment practices. From the secondary data collected, this study found that many types of financing have been set up by the government to assist SME to grow and to expand. Nonetheless, a majority of the SME disclosed that it is difficult for them to obtain financing due to the stringent measures taken especially by established financial institutions in assessing credit risk. Hence, 72
percent of the respondents indicated that they relied on their own savings and borrowings from friends and relatives for financing at the beginning stage.

Nonetheless, financial institutions should not be blamed for being careful in granting loans to the SME. From the result of this study, 63 percent of the respondents exhibit poor repayment performance. This is not a surprise finding as SME are riskier borrowers than large firms. Reason being SME are more vulnerable to market changes and often have inadequate management capacities due to their smaller size (Ganbold, 2008). Besides that, since most of the financing provided are micro in nature whereby collateral is not required hence, paying these financing become unimportant and this could be another possible explanation for the poor repayment performance.

Moreover, consistent with the credit scoring model suggested by Pang (1991) and Weinberg (2006), this study discovered that proxies of indebtedness have significant impacts on the repayment performance at the 95% level of confidence. On the other hand, proxy of wealth (repayment capability) - household income is not significantly related to the repayment performance. This could be due to attitude problems on the part of the borrowers. As argued by Godquin (2004), even though with enough money, some borrowers also opted to default their loan repayments intentionally.

In conclusion, the availability of credit is crucial as it allows the SME financial flexibility in meeting their business obligations and expansion needs. Nevertheless, “debt” is viewed as bad as it represents a lack of self discipline. Therefore, in order to survive in the long-run, SME needs wisdoms in managing this paradox.

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