

SME Financing: A Case of Bangladesh

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Abstract: The objective of this study is to analyze the challenges faced by SMEs in need of financing in developing countries, with a focus on Bangladesh. In Bangladesh, the SME sector is a major economic player and therefore, reinforcing the responsibility of this sector in the national production is a major strategy of the country. The main source of financing for SMEs in Bangladesh are commercial banks, however the constant monitoring required with loans forward to SMEs, problems of recovering the loan amount and the high risk associated with low returns as compared to industrial loans, make SME financing appear far less attractive to the commercial banks. Despite the heavy presence of SMEs outside of metropolitan areas, SMEs with a closer proximity to big cities get more advantage of these loan schemes. The major portion of financing provided to SMEs goes to the SMEs in urban areas. The main challenges facing banks when offering loan facilities to SMEs is the lack of good quality collateral, lack of appropriate documentation and poorly defined business plans. The usually high interest rates charged for SME financing, quality collateral requirements and guarantee obligations combine to make access to financing difficult for SMEs all over the country.

Keywords: SME Financing; External Financing; Developing Countries.

1. INTRODUCTION

Bangladesh is a small country surrounded on three side by an economic giant, India with the Southern coast bordering the Bay of Bengal. Bangladesh is one of the world's fastest-growing economies and one of the fastest growing middle-income countries. However, an insufficient power supply is a significant obstacle to Bangladesh's economic development along with poor governance, corruption and weak public institutions.¹

In Bangladesh, the SME sector is a major economic player and therefore, reinforcing the responsibility of this sector in the national production is a major strategy of the country. SME presence in Bangladesh is vital to its economy as the private small and medium businesses are estimated to be around 90% of the total private entities. Of this huge share of private enterprises, about 60 to 65 percent of the SMEs are located outside of the metropolitan areas employing an estimated 80 percent of non-agricultural workforce, cementing their role as an important employer group in the country. Despite the heavy presence of SMEs outside of metropolitan areas, SMEs with a closer proximity to big cities get more advantage of these loan schemes. The major portion of financing provided to SMEs goes to the SMEs in urban areas.

1.1 SME OVERVIEW

The Government of Bangladesh categorized SMEs into two broad classes in the Sixth Industrial Policy in 2002 i.e. manufacturing enterprises and non-manufacturing enterprises. Manufacturing enterprises are divided into two categories: small enterprises and medium enterprises. The Seventh Industrial Policy made little to no changes in the definition of SMEs and left it as its predecessor. The most recent definition of SME is given by Government of Bangladesh in its Industrial Policy 2010, based on the size of capital owned and employment of labor by the SMEs.

A manufacturing enterprise is treated as small if, in current market prices, the replacement cost of plant, machinery and other parts/components, fixtures, support utility, and associated technical services by way of capitalized costs (of turn-key consultancy services, for example), etc. excluding land and building, are to up to BDT. 100 million and/or employ 25 to

¹ Economic Reforms Can Make Bangladesh Grow Faster, (October 2018), World Bank Report <https://www.worldbank.org/en/news/press-release/2018/10/02/economic-reforms-can-make-bangladesh-grow-faster>

99 workers. It defines the parameters of a medium manufacturing enterprise as an entity whose, in current market prices, the replacement cost of plant, machinery and other parts/components, fixtures, support utility, and associated technical services by way of capitalized costs (of turn-key consultancy services, for example) etc. excluding land and building, are to up to BDT 300 million or employ 100 to 250 workers.

Non-manufacturing activities (such as trading or other services) are similarly divided into two categories of small enterprises and medium enterprises. Small enterprises comprise an enterprise that has less than 50 workers in full-time equivalents and have assets worth BDT 0.5 million to BDT 10 million whereas an enterprise should be treated as medium if it has between 50 and 100 employees and have assets worth BDT 10 million (1.0 core) to BDT 150 million. The following table explains how different enterprises are defined according to BBS, in a comprehensive manner.

Table: 1

Enterprises	No of Employees (Manufacturing)	No of Employees (Service)
Small	25 – 99	10 - 49
Medium	100 – 250	50 - 100
Large	Over 250	

SME presence in Bangladesh is vital to its economy as the private small and medium businesses are estimated to be around 90% of the total private entities. This huge share of private enterprises makes these SMEs a veritable powerhouse for Bangladesh to focus on. Besides constituting the large chunk of private enterprises, about 60 to 65 percent of the SMEs are located outside of the metropolitan areas of Dhaka and Chittagong where approximately 80 percent of non-agricultural workforce is estimated to be employed by these private enterprises, thus making them an important employer in the country (Ahmed, 2009).

According to economic estimates, SMEs in Bangladesh add more than 25 to the total GDP of the country and are also estimated to contribute more than 40 percent to the Gross Manufacturing Output, besides the employment of around 25 percent of the total labor force (Mintoo, 2007). These statistics clearly indicate that prompt industrialization and national economic growth through reduced investment of capital and higher employment generation is heavily dependent on the success and successful management of the Bangladesh’s SME sector.

An estimated 6 million SMEs are actively contributing 25 percent to Bangladesh’s total GDP by employing around 31 million people and furnishing an approximate 75 percent of household income. Different categories of SMEs, when combined, contribute about 85 percent to the industrial employment and about 23 percent to the total employment of Bangladesh (Qamruzzaman, 2015). They account for about 80% of industrial employment, about 90% of total industrial units and about 25% of total labor force. Their total contribution to export earnings varies from 75- 80%. The total number of SMEs is estimated at 79754 establishments, of which 93.6% are small and 6.4% are medium which contributed around 20-25% of GDP².

2. SME FINANCING

SMEs have been actively involved in the promotion of economic development and fostering of industrial development all over the world, but more importantly in the emerging economies. In these emerging economies, SMEs hold a special place, as they are considered the driving force behind the enforcement of a sustainable economic development model. SMEs, particularly in developing economies, play a crucial part in employment generation, domestic technological development, diversification of output, fostering indigenous entrepreneurship and forward integration with large-scale industries. SMEs are ever increasingly the dominant form of business organization in all developing countries and SMEs are gradually being more recognized as engines of economic growth and employment generation for sustainable industrialization.

2.1 FINANCING CONSTRAINTS

The main source of financing for SMEs in Bangladesh are commercial banks as the many regional banks in the country very conveniently overlooked the needs of the SME sector. Constant monitoring required with loans forward to SMEs, problems of recovering the loan amount distributed to the SME sector and the high risk associated with low returns as compared to industrial loans, make SME financing appear far less attractive to the commercial banks. Therefore, the provision of loans to SMEs by commercial banks in Bangladesh in the face of all these issues highlights the crucial responsibility undertaken by the commercial banks in financing the SMEs for the development of Bangladesh’s economy.

² Source: Agricultural credit and special programs department, Bangladesh Bank

The SME loans issued in Bangladesh by non-banking financial institutions (NBFIs) has shown a considerable increase in the recent years with the financing forwarded to small firms being marginally more than that extended to medium enterprises. However there seems to be declining trend in the number of borrowers.

Despite the heavy presence of SMEs outside of metropolitan areas, SMEs with a closer proximity to big cities get more advantage of these loan schemes. The major portion of financing provided to SMEs goes to the SMEs in urban areas. The sector receiving the most financing remains the wholesale sector, followed by the manufacturing and service sectors.

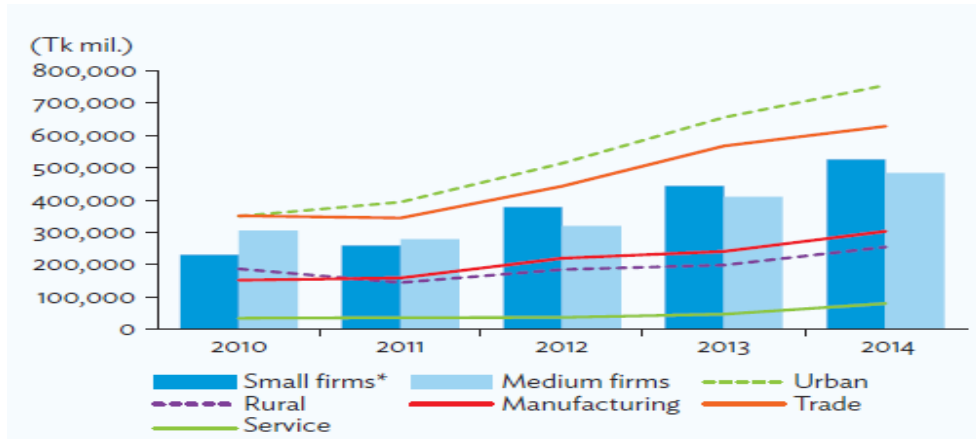


Figure bd.1: SME Loans by Size, Region and Sector

Since 2010, Bangladesh Bank has set specific targets for SME loans to be provided by the government and private banks operating in Bangladesh. Since the launch of the program, both, banks and NBFIs have exceeded the targeted SME lending as shown in the graph below.

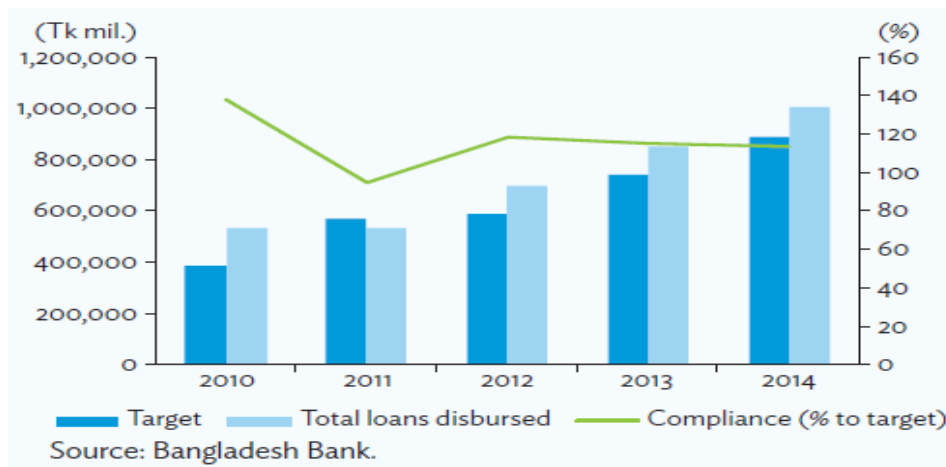


Figure bd.2: SME Loans by Banks and NBFIs against Lending Targets

Banks and NBFIs are being provided refinance facilities against their SME credit by Bangladesh Bank, from its own fund and with the help of its development partners Japan International Cooperation Agency (JICA) and three others that stopped in December 2014. The discrepancy arising from the recently closed schemes providing the refinance facility to banks and NBFIs is being addressed by the Bangladesh Bank's SME and Special Programs Department (SMESPD)'s two newly established schemes that include the new entrepreneur refinance fund for cottage, micro and small sector industry and the Islamic shariah based refinance scheme for Islamic banks that is targeted to increase the role of Islamic banks in SMEs, particularly women-led SMEs.

Although NBFIs have a limited outreach as compared to the commercial banking institutions, the growing presence in the SME financing market is being propelled by their edge with regard to unique offerings, including factoring and lending as compared to commercial banks. The largest NBFI in Bangladesh, the Industrial Development and Leasing Corporation (IDLC), is also the receiver of the SME NBFI of the Year 2013 award which highlights its contribution to the SME sector. SME loans constitute the largest portion of the total loan portfolio of IDLC, followed by consumer loans and corporate

loans. IDLC's total SME loans showed a 40.8% increase over the previous year's figure. The unique offering of IDLC that has made it a prime choice of financing for SMEs is the reverse factoring product in which IDLC makes payment to SMEs as soon as the product or service is delivered to the corresponding corporate client.

The biggest challenge facing the NBFIs in financing SMEs is the limitation with regard to geographical expansion in Bangladesh as most NBFIs are concentrated in urban centers with negligible rural presence. This leads to well served urban SMEs and starving SMEs in the rural areas.

Another important area, noted for its contribution to SME financing, especially in Bangladesh is microfinance. It continues to be a vital player in the provision of financing to micro and small enterprises. All the governmental and non-governmental microfinance institutions in Bangladesh are regulated by the Micro Credit Regulatory Authority (MRA) with the exception of Grameen Bank, which is under the supervision of Bangladesh Bank. The number of non-government microfinance institutions has shown an increasing trend in recent years which indicates the demand for their offering and the increasing access to finance by SMEs.

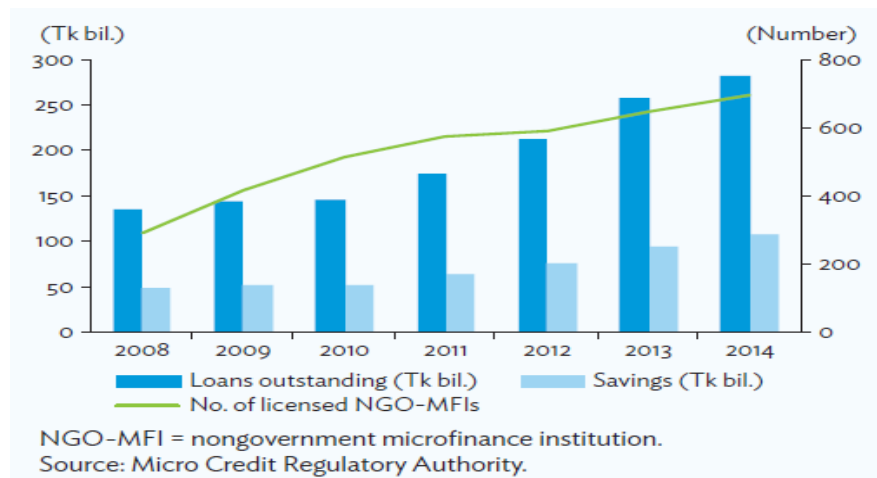


Figure bd.3: Savings and Loans—Nongovernment Microfinance Institutions

Bangladesh has a well-established microfinance structure. Loans issued by microfinance institutions are categorized as micro loans and micro enterprise loans. Micro loans comprise of financing issued to the limit of BDT. 50 thousand and micro enterprise loans are up to BDT. 1 million. Microfinance institutions in Bangladesh authorize financing for SMEs based on group guarantees rather than the traditional collateral taking process. For this reason, the receivers of these loans tend to be repeat borrowers with good credit history. The Microcredit regulatory Authority of Bangladesh has set an upper limit of 27 percent for all micro loans issued. The non-government microfinance institutions have also been steadily contributing to meet the demand of microcredit in last years.

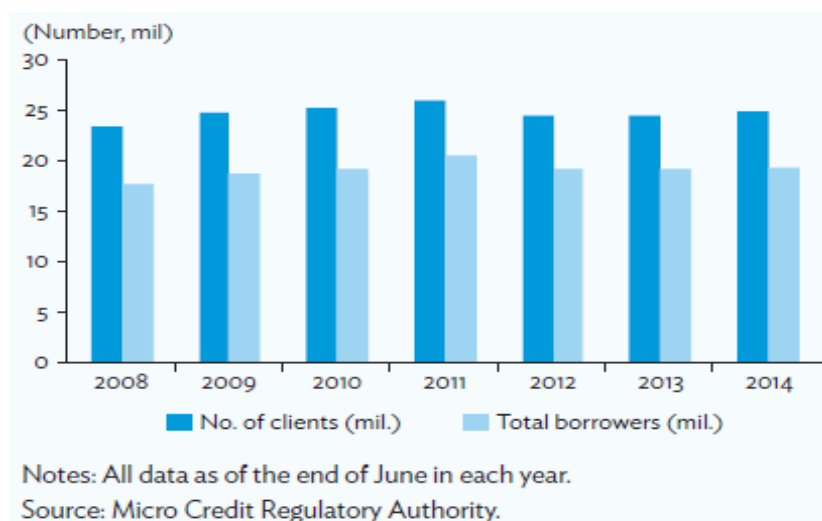


Figure bd.4: Clients-Nongovernment Microfinance Institutions

The Nobel Prize winning idea of Grameen Bank has a vital role in Bangladesh’s microfinance sector. With an ever-increasing trend of the number of borrowers and savings, Grameen bank has set an example for the merits of microfinance worldwide. The graph below shows recent statistics pertaining to the performance of Grameen Bank.

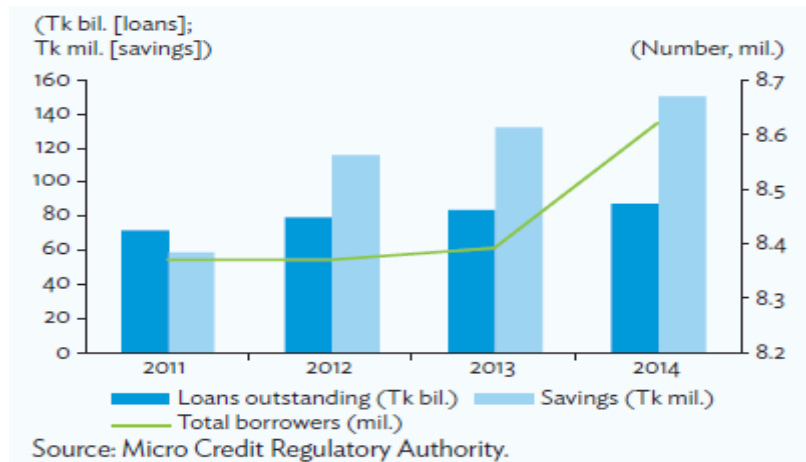


Figure bd.5: Savings and Loans—Grameen Bank

Another important player in the microfinance sector of Bangladesh is the Palli Karma Sahayak Foundation (PKSF) which was founded by the Bangladesh government in 1990 as non-profit organization for promoting a favorable environment for non-government microfinance institutions to flourish as it does not directly engage in loan provision but via non-government microfinance institutes.

2.1.1. BRAC Bank

A growing trend in the SME sector of a country, especially that of an emerging economy, is indeed a desirable objective as the contributions of this once overlooked sector in areas ranging from the decentralized job creation to the creation of output increasingly come to light. For a developing country like Bangladesh, SMEs are vital to the development of the economy as they play a vital role in generating employment opportunities and involving in the construction of useful machine substitutes and spare parts thus lowering imports and balancing of payment (Chowdhury et al., 2013).

In 2001, BRAC Bank was established to bring banking services closer to a large number of unbanked people which were not covered by traditional banks or banking methods. The main idea behind the establishment of the bank was to focus on the facilitation of Small and Medium Enterprises. BRAC Bank has proved to be country's fastest growing bank, since its inception. It currently boasts a network of 88 Branches, 21 SME Service Centers, 48 SME Branches, over 300 ATMs and 400 SME Unit offices all over Bangladesh. The Bank has successfully disbursed over BDT 220,139 million of SME loans to over 1.2 million individual customers with online banking facilities. The unique characteristic of BRAC bank that has made it a success in Bangladesh is that its services cut across all strata of clients, including corporate clients, retail clients and SMEs.

BRAC Bank is under the license of Bangladesh Bank and is regarded as the fourth largest specialized SME bank in the world. It is, therefore of no surprise that BRAC Bank is the largest SME credit provider among commercial banks in Bangladesh with a 6 percent share in the total SME lending in the country.

The unique success achieved by BRAC Bank in a relatively short time is credited to its endorsement of the ‘go-to-customer’ approach. This approach has been developed by setting up a network of about 570 access points for customers. It has also initiated a program of agent banking to reduce the hurdle of access to financing for SMEs in which the bank will appoint field agents all over the country to approach SMEs and meet their financing needs. The customers of BRAC Bank are categorized into secured and unsecured segments, based on the type of loan forwarded. The character assessment of the entrepreneur plays an important part in securing a loan from the bank as the entrepreneur’s credit worthiness is based on it.

For SME banking clients, BRAC Bank has two product lines consisting of deposit products and loan products. The Deposit Product line includes three options, including Prapti current account, Prachurjo fixed deposit and Shonchoy SME deposit. Prapti Current Account gives its customers the convenience to deposit and withdraw money through any branches, SME sales & service centers during banking hours and through ATM and CDM 24 hours, besides the additional

advantage of daily interest on balance. Prachurjo Fixed Deposit is a rewarding fixed deposit for SMEs with a minimum BDT 10,000 opening balance for and business enterprise having valid trade license for a minimum of 1 month. Shonchoy SME Deposit is a product targeted specifically toward SMEs that allows them to save on a monthly basis as per their organization's requirement and get a handsome return at maturity with the additional advantage of the business concern getting up to 95% secured over draft facility on the deposited amount.

The Loan product line of BRAC Bank offers six unique offerings, namely Anonno Rin, Apurbo Rin, Prothoma Rin, Shomriddhi Rin, Shompod Rin and Shokti Rin. ANONNO is an unsecured loan facility available to all entrepreneurs that are involved in small sized trading, manufacturing, service etc. for working capital, purchasing fixed asset or for any other business purposes. APURBO is another specialized product SMEs for general business needs, offering BDT 1 million to BDT 30 million financing against registered mortgages. Prothoma is a specialized term loan for SMEs owned and managed by female entrepreneurs which offers unsecured loan up to BDT 1 million at very low interest rate. SHOMRIDDHI loan is designed to meet all the import-export related needs of SMEs expenses including facility for letter of credit, overdraft, local bill discounting etc. and offers BDT 1 Lac to BDT 50 million. SHOMPOD offers financing up to BDT 35 million against home or business premise mortgage with monthly installment repayment facility for up to 10 years. SHOKTI is the basic loan product on offer that provides up to BDT 10 million against partial cash security to meet any business need of the entrepreneur.

3. BANGLADESH BANK INITIATIVES FOR SMES

In 2004, Bangladesh Bank issued the first edition of its prudential Regulations for Small Enterprise Financing that highlighted the guidelines and regulations for SME finance by banks and financial institutions.

The prudential regulations emphasized the role of regulators and policymakers in the success of SME sector. Bangladesh Bank delegated Ministry of Industries the responsibility of developing and outlining industrial policies, including those focusing on SME sector development. The National SME Task Force for established with the sole purpose of SME promotion policy and the Micro Credit Regulatory Authority was assigned the responsibility of regulating and supervising microfinance institutions. Bangladesh Bank took the role of regulation and supervision of commercial banks and nonbank financial institutions with regards to SME financing.

Observing the problem of credit worthiness associated strongly with SME loan financing, Bangladesh Bank recently recognized a specialized credit rating agency, specifically for SMEs. Bangladesh Rating Agency Limited (BDRAL) has to follow Bangladesh Bank's guidelines for the credit rating of SMEs, known as the Credit Rating Methodology for Small and Medium Enterprises.

The Government of Bangladesh, in collaboration with the European Union has funded the INSPIRED (Integrated Support to Poverty and Inequality Reduction through Enterprise Development) program with the objective to advance the SME sector of Bangladesh. According to a recent survey by INSPIRED, the major obstacles that are being face by SMEs in Bangladesh, particularly those involved in the manufacturing sector include lack of availability of utilities, particularly electricity, because of either load shedding or no electric lines near rural SMEs. The poor condition of country's infrastructure, insufficient access to finance, increasing competition from foreign imports and increasing labor costs combined with a lack of skilled labor in production have hindered the growth of SME sector in Bangladesh.

4. CONCLUSION

An estimated 6 million SMEs are actively contributing 25 percent to Bangladesh's total GDP by employing around 31 million people and furnishing an approximate 75 percent of household income. Different categories of SMEs, when combined, contribute about 85 percent to the industrial employment and about 23 percent to the total employment of Bangladesh.

The benefits of SMEs in Bangladesh are wide spread; most importantly including the provision of income earning opportunities though large-scale generation of employment at comparatively low costs. Another of its wide-reaching impacts is the ability to spur employment generation in usually ignored areas, particularly the rural regions in Bangladesh as about 60 to 65 percent of the SMEs are located outside of the metropolitan areas of Dhaka and Chittagong and SMEs are providing job opportunities to around 80 to 85 percent of the non-agricultural labor force. Therefore, we can surmise that the growth of SME sector as a whole, leads to strengthening of the overall economic effort to achieve increasing and sustainable economic growth, which is not only a prerequisite for an escape from widespread poverty and socio-economic backwardness but also the way forward for an emerging economy like Bangladesh.

The foremost challenge that banks have to face when offering loan facilities to SMEs is the lack of good quality collateral, lack of appropriate documentation and poorly defined business plans. The usually high interest rates charged for SME financing, quality collateral requirements and guarantee obligations combine to make access to financing difficult for SMEs all over the country. Besides these obvious hurdles, banks show reluctance for first-time borrowers because of their lack of credit history and usually prefer the SMEs to be at least two years in business to qualify for a bank loan.

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