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Institutional Lending and Financing Policy for SMEs in Bangladesh

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Abstract

Over the last few years, the government has taken a number of initiatives in terms of financial, fiscal, and related policies; adopted strategies; and implemented actions for promoting SME-led economic growth in Bangladesh. This policy note reviews the effectiveness of these initiatives in terms of flow of finance to the SME sector, compares the availability of financing facilities in Bangladesh with several other countries, and draws some policy conclusions.

¹ Assistant Director, Policy Analysis Unit (PAU), Bangladesh Bank. Views expressed in this note are author's own and in no way represent those of the Bangladesh Bank. The author is indebted to Dr. Mustafa. K. Mujeri, Chief Economist, Bangladesh Bank for his valuable suggestions and comments.

I. Introduction

The growth of small and medium enterprises (SMEs) in terms of size and number has a multiplier effect on the national economy, specifically on employment, GDP growth, and poverty reduction in Bangladesh. In the past, the government attempted to provide SMEs with access to finance by targeted lending; such as through directives that a certain share (e.g. 5 percent) of a bank's loan portfolio was to be set aside for small and cottage industry financing (Hossain 1998). The Bank of Small and Cottage Industries (BASIC) was set up in 1988 with the objective of financing small and cottage industries. Afterwards, several commercial banks have come forward with special packages for SME development. One such initiative is the 'gharaoa' project of the Janata Bank Limited. The Bangladesh Bank is also providing refinance facilities by using its own fund as well as channelling funds from IDA and ADB.

The SMEs provide a highly cost-effective and socially desirable route to industrialization in Bangladesh. Investment costs per person employed in large industrial units work out to be 78 to 100 times of those for SMEs.² The Small Enterprises Development Fund (SEDF) reports a higher growth rate (12 percent) for micro and small enterprises in 2003 compared with 5 percent for the medium enterprises. The return on capital investment is also higher for micro and small enterprises (above 30 percent) compared with 13 percent for the medium enterprises. In Bangladesh SMEs are characterized by higher profitability; operating margin for SMEs is 12 percent³ which is higher than in some industrial countries⁴.

II. Major Constraints in Access to Finance by SMEs

The SMEs in Bangladesh face significant problems in access to finance for their business activities. This relates to getting the right amount of fund at the right time at reasonable rates with suitable repayment schedule and facing minimum bureaucratic hurdles. In this context, lack of capital has been identified as the number one constraint to the development of SMEs in Bangladesh.⁵

In general, SMEs are characterized by low capitalization, insufficient assets, and their inability to fully comply with collateral requirements. On the supply side, administrative costs for banks and financial institutions (FIs) are high because of close monitoring and supervision required for SME loans. The banks and FIs consider SME financing as risky investments and charge relatively high interest rates to cover portfolio risks. The procedure to get finance from the banks and FIs is considered complex by most of the SMEs. A survey of SMEs reported that the business owners had to visit, on average, 15 times for one loan from the bank, whereas the frequency

² See, *The Financial Express*, 11 September, 2006.

³ As reported by SEDF (2006)

⁴ For example, operating margin for SMEs is 7 percent in Greece, 5.1 percent in France, 9.2 percent in Canada

⁵ See, *The National Task Force Report on SMEs*, September 2004.

of visit for getting loan from informal money lender was 3, from association 2.5, and from relatives and friends 2.25 (Choudhury and Raihan, 2000). The major constraints of SME financing by banks and FIs can be summarized as:

- Inadequate knowledge and ability to formulate proper project proposals for seeking institutional finance;
- Collateral based lending procedures of banks and FIs that are not suitable for SMEs;
- Complex bureaucratic procedures and corruption;
- Limited availability of information on technical and marketing aspects of SMEs;
- Inadequate and ineffective coordination among concerned government agencies;
- Lack of a functional definition of SMEs that can characterize their unique positions;
- Absence of proper criteria for selecting potential SME entrepreneurs by the promotional institutions.

III. Current Efforts in Streamlining SME Financing

In most countries where SME development has taken place, the support and finance to SMEs are provided both by the government and the private sector. Specific types of support include direct investment by the government including investment in venture capital, credit guarantee schemes, commercial bank credit, credit database, exit mechanisms for companies and stocks, credit scoring mechanisms, financing through specialized financing institutions, and similar other mechanisms. Public-private partnership is also becoming popular in many countries including Japan, USA, UK, and Malaysia.⁶ In the past, the government attempted to provide SMEs with access to finance through targeted lending.

In this context, Bangladesh Bank (BB) has formulated and issued prudential guidelines to be used by the banks and FIs in defining SMEs.⁷ As a part of its current initiatives to overcome the financial constraints facing the SME sector and encourage the banks and other FIs to provide credit facilities to this sector, BB introduced the refinance scheme for SMEs in May 2004 using three sources of funds: Tk. 100 million from BB's own resources, USD 20 million from IDA under the Enterprise Growth and Bank Modernization Project (EGBMP), and Taka 30 million from ADB. All scheduled banks and FIs are eligible to avail this facility at Bank Rate subject to fulfilling the stipulated conditions against their financing of SMEs. Under the BB's refinance scheme for the small enterprise sector, any industry/business entity having a maximum total fixed investment up to Tk. 10 million has been considered as a small enterprise.⁸ Table 1 shows the amount of refinance provided to banks and FIs up to August 2007 since the beginning of the refinance scheme.

⁶ For availability of some of these and other mechanisms in different countries, see Table A1 in the Appendix.

⁷ See Appendix for details.

⁸ See ACSPD circular no.1, 2 May 2004, Bangladesh Bank.

It shows that nearly Tk. 5,341 million were refinanced to 13 banks and 19 FIs by BB till August 2007 of which Tk 2,742 million (51 percent) were disbursed to the banks and Tk 2,599 million (49 percent) to the FIs. Among the banks, three banks (BRAC,

Table 1: SME Refinance by Bangladesh Bank

Name of bank/FI	Amount refinanced (million Tk)*				No. of beneficiary enterprises	Amount refinanced per enterprise (million Tk)
	Working capital	Mid term	Long term	Total		
Banks						
NCC Bank Ltd.	21.64	155.05	52.00	228.69	548	0.42
Jamuna Bank Ltd.	136.40	24.90	7.66	168.96	121	1.40
National Bank Ltd.	10.00	0.00	0.00	10.00	2	5.00
ONE Bank Ltd.	150.55	127.63	10.40	288.58	382	0.76
The Premier Bank Ltd.	208.29	24.54	9.35	242.18	205	1.18
BRAC Bank Ltd.	48.65	637.80	0.00	686.45	1,736	0.40
Southeast Bank Ltd.	81.20	3.20	3.50	87.90	86	1.02
Dutch Bangla Bank Ltd.	95.99	1.33	0.00	97.32	52	1.87
Mercantile Bank Ltd.	0.00	34.25	0.00	34.25	127	0.27
Eastern Bank Ltd.	112.61	190.56	0.00	303.17	392	0.77
Dhaka Bank Ltd.	268.61	123.35	0.00	391.96	476	0.82
Trust Bank Ltd.	5.00	0.00	0.00	5.00	2	2.50
Prime Bank Ltd.	179.72	10.72	6.90	197.34	211	0.94
Sub Total	1,318.66	1,333.33	89.81	2,741.80	4,340	0.63
Financial Institutions						
Uttara Finance & Investment Ltd.	8.76	95.75	332.41	436.92	234	1.87
Prime Finance & Investment Ltd.	22.50	19.00	12.84	54.34	30	1.81
MIDAS Financing Ltd.	0.05	283.00	154.82	437.87	684	0.64
IDLC of Bangladesh	7.75	215.03	70.05	292.83	211	1.39
Phoenix Leasing Co. Ltd.	10.10	39.08	138.65	187.83	101	1.86
United Leasing Co. Ltd.	47.03	115.75	136.03	298.81	191	1.56
Vanik Bangladesh Ltd.	0.03	0.05	0.00	0.08	2	0.04
Bay Leasing	2.50	5.15	4.70	12.35	8	1.54
Fidelity Assets & Securities Co. Ltd.	0.00	7.17	196.57	203.74	132	1.54
Islamic Finance and Investment Ltd.	6.10	104.31	23.25	133.66	107	1.25
Peoples Leasing and Financial Services Ltd.	0.00	116.41	181.83	298.24	110	2.71
Bangladesh Finance and Investment Ltd.	0.00	1.68	40.90	42.58	18	2.37
IIDFC	2.00	23.20	35.10	60.30	29	2.08
GSP Financing	5.00	0.00	20.80	25.80	6	4.30
National Housing Ltd.	4.00	7.60	9.14	20.74	12	1.73
Oman Bangladesh	0.00	0.00	40.84	40.84	19	2.15
International Leasing	1.00	17.80	19.72	38.52	16	2.41
Fareast Finance and Investment Ltd.	0.00	1.33	0.00	1.33	2	0.67
Premier Leasing	0.00	9.40	2.96	12.36	7	1.77
Sub Total	116.82	1,061.71	1,420.61	2,599.14	1,919	1.35
Grand Total	1,435.48	2,395.04	1,510.42	5,340.94	6,259	0.85

* Up to August 2007

Source: Agricultural Credit and Special Programs Department, Bangladesh Bank

Eastern, and Dhaka) together availed more than half of the refinance facility. Among the FIs, MIDAS, Uttara Finance, and United Leasing were in the leading position, together accounting for 45 percent of the total.

The BB has also introduced factoring to ease the working capital problem that guarantees the SMEs to enjoy consistent cash flow, lower administration costs, and reduced credit risks. BB has identified the following actions for SME development:

- Further extend refinancing facilities for SME finance;
- Introduce training for officials dealing with SME finance;
- Finding ways and means to minimize costs for managing SME finance;
- Establish risk fund or guarantee fund to cover risks;
- Develop SME data bank.

In Bangladesh, an entrepreneurs' equity fund has been established in 2000, which provides equity to SMEs in agro-based industry and ICT sector through the commercial banks.

As the prime public sector institution for the promotion and development of small and cottage industries in the country, the Bangladesh Small and Cottage Industries Corporation (BSCIC) is involved in lending programs from own resources; in association with the Bangladesh Shilpa Bank (BSB); and in association with consortium of commercial banks. Most of its policies are based on government experience in this sector.

The Bangladesh Small Industries and Commerce (BASIC) Bank Limited was set up in 1988 with the objective of financing small and cottage industries and it is envisaged that at least 50 percent of its loanable fund should be invested in small scale industries. The bank offers lower lending rates on SMEs compared with other banks.

At present, the development of the SME sector is increasingly promoted through the involvement of private agencies, such as MIDAS. This organisation has a successful record in facilitating the development of small scale industries by way of building up innovative models of small scale and micro enterprises, which are subsequently replicated by other entrepreneurs or institutions. MIDAS has recently increased its lending limit for SMIs from Tk. 30 million to Tk. 100 million to match with the government's new industrial policy.

IV. Role of Banks and FIs

A recent study by SEDF (2006) shows that SMEs have limited access to bank financing. It shows that about two-thirds of the SMEs did not approach banks for working capital loans. It takes about two months on average to have a loan sanctioned. For improving the situation, several commercial banks have come up with special packages for SME development. One such initiative is the '*gharoa*' project of the Janata Bank Limited. Currently, two banks are leading in this area: the BASIC Bank in the public sector and the BRAC Bank Limited which is a private commercial bank. Besides these two, several other FIs have opened special units to expand SME credit portfolio recognizing the sector as a new area of potential business. Table 2 shows the disbursement of loans to small and medium enterprises by all the scheduled banks as in June 2006. It can be seen that the private commercial banks (PCBs) have disbursed the highest amount of loans to both small and medium enterprises. In both cases, the largest amount of funds has been channeled to the trading sector. There is

no participation of foreign commercial banks (FCBs) in small enterprise financing and very little involvement in medium enterprise financing.

Table 2: Scheduled Bank Advances to SMEs

(million Tk.)

Types of Banks	Small enterprises			Medium Enterprises		
	Services	Trading	Industry	Services	Trading	Industry
NCBs	2,589.5 (48.9)	19,525.2 (29.2)	6,737.6 (39.5)	1,120.6 (15.0)	6,471.4 (14.1)	18,948.9 (37.5)
PCBs	2,455.1 (46.4)	43,945.5 (65.8)	5,872.7 (34.4)	4,023.0 (53.8)	36,735.7 (80.2)	25,233.6 (50.0)
FCBs	39.8 (0.7)	217.0 (0.3)	64.5 (0.4)	1,790.0 (23.9)	475.2 (1.1)	816.5 (1.6)
SDBs	209.8 (4.0)	3,097.4 (4.7)	4,387.5 (25.7)	542.4 (7.3)	2,111.4 (4.6)	5,500.5 (10.9)
All Banks	5294.1 (100)	66,785.1 (100)	17,062.3 (100)	7,476.0 (100)	45,793.6 (100)	50,499.4 (100)

*As in June 2006. Figures in parentheses are percentage shares.

Source: Agricultural Credit and Special Programs Department, Bangladesh Bank

V. Share of SMEs in Institutional Lending

There exists a perception among the banks and FIs that SME finance in Bangladesh is not an attractive and profitable business (see, for example, ADB 2005). The formal financial institutions consider SME lending as not cost effective because the SMEs do not have sufficient and consistent financial records and adequate assets to meet the collateral requirements of the formal institutions. In this regard, the National Task Force on SMEs has given emphasis on allocation of bank finance for the development of this sector. The loan application forms for investment financing from banks are often long, tedious, and redundant.

During the period 2004-2006, 14 banks and 7 FIs have established SME cell or SME financing unit to channel funds to the SME sector extensively. Nevertheless, despite the existence of government directives, policies, strategies, and initiatives related to financing of SMEs by the formal sector, it is still insignificant and inadequate.

Table 3 shows the results of a special survey conducted by the Agricultural Credit and Special Programs Department of the Bangladesh Bank. The results indicate that in spite of allowing refinance facility by BB, the banks availing refinance facility provided only about 18 percent of their total loans and advances to the SME sector during FY06.

It is also observed that, among the participating banks, only BASIC Bank and BRAC Bank disbursed a lion's share of their total loans and advances to the SME sector. The table also shows that, while the banks get funds at the Bank Rate (5 percent), their lending rates to the SMEs are relatively high.

Table 3: Loans and Advances by Selected Banks to SME Sector

Name	Loans disbursed (crore Tk)*			Rate of interest of SME loan (%)
	Total loans and advances	Loans disbursed to SME sector	% of SME loans in total loans and advances	
BASIC Bank	816.54	662.81	81.17	14
BRAC Bank	1695.58	802.93	47.35	20-24
Eastern Bank Ltd.	1052.07	446.72	42.46	N/A
National Bank Ltd.	2807.87	1107.09	39.43	15
National Credit and Commerce Bank Ltd.	2610.97	925.78	35.46	N/A
Dhaka Bank Ltd.	1044.42	133.57	12.79	14
The City Bank Ltd.	2791.44	340.15	2.19	N/A
Prime Bank Ltd.	4716.07	88.15	1.87	16
Southeast Bank Ltd.	5400.21	57.87	0.96	14
The Trust Bank Ltd.	717.85	3.99	0.56	16.50
ONE Bank Ltd.	4213.65	19.93	0.47	16
Dutch-Bangla Bank Ltd	3503.27	14.99	0.43	14.50
The Premier Bank Ltd.	3472.36	13.65	0.39	14
Jamuna Bank Ltd.	473.55	1.03	0.22	N/A
Mercantile Bank Ltd	2193.24	0	0	N/A

* Data refer to July 2005- June 2006.

Source: Agricultural Credit and Special Programs Department, Bangladesh Bank

VI. Conclusions and Policy Implications

In Bangladesh, the limited access to finance is one of the major areas of concern for SME development. Institutions to serve this sector need to have the financial capacity to accept the lending risks along with access to appropriate funding which matches the clients' requirements. The financing approach of the commercial and development banks in the country is largely traditional that does not suit the special characteristics of SMEs. They mostly subscribe to the view that collateral and third party guarantee minimize risks for the lenders. To ensure the flow of an adequate share of institutional lending to the SME sector, the following measures deserve consideration.

- Like in many other countries, the government may consider using grants as a major instrument to provide financial support for a limited period to selected SMEs having good potential and wide linkages, especially in areas where private finance is not forthcoming in adequate quantity, and the whole or a part of the amount may be treated as subsidy.

- To strengthen SMEs' financing capability, the government may consider providing credit guarantees on SME loans. Such credit guarantee schemes, which are common in many countries, may specifically target prospective sectors especially having export potential.
- Special SME development fund may be created to subsidize projects to be carried out by potential entrepreneurs. The banks and FIs may provide institutional credit and credit facilities under special programs and the special funds may be earmarked for SMEs through targeted support schemes, like new entrepreneurs fund, women entrepreneur fund, and similar other innovative programs.
- The government may consider the creation of SME training fund and SME export marketing fund to subsidize training facilities and export promotion activities.
- The government may provide guarantee to loans up to a certain limit to SMEs to purchase land, buildings, or equipment. Loans may be made through banks or other financial institutions.
- By using analytical soft wares like credit scoring model based on available data from reliable sources, banks and financial institutions can provide loans to SMEs with growth potential and good track record.
- In case of providing refinance facility to banks and FIs, the government may issue appropriate directives related to collateral requirements and interest rate that are consistent with SME characteristics.
- In addition to financial assistance, the SME sponsors need a package of services throughout the life cycle of the project. The package of services should cover pre-investment counselling, technical information services, assistance in project identification, preparing feasibility studies, accounting services, project implementation at economic cost, and other related services.
- Along with financial and related services, there is a need to ensure the availability of appropriate information on technical and marketing aspects.
- Measures are needed to improve and enhance the coordination among SME related government agencies.
- The promotion of venture capital is needed for young and new entrepreneurs with drive and initiative and requiring support for innovative project ideas. In this context, it is equally important to spread the activity of leasing companies so that the SME entrepreneurs can take lease of necessary machineries, tools and equipment to start their business.
- A bank syndication scheme may be introduced under which micro credit agencies can transfer the credit history of micro credit-supported organizations to banks and non-bank financial institutions so that they can be graduated through getting access to commercial loans. Such a bank syndication scheme may be implemented by BSCIC.

- The traditional system of loan sanctioning does not favor the development of the SME sector. This calls for strengthening the specialized institutions for SME financing and development; creating separate departments to deal with SME financing; forming small and medium enterprise development committees to allocate fund for business start up, training, and export promotional activities for SMEs; promoting graduation mechanism to be adopted for the SMEs; and developing mechanisms to meet the long-term credit needs of SMEs.

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Appendix

The Bangladesh Bank has defined the small and medium enterprises (SMEs) in its prudential guidelines (only for small enterprises) and through the Statistics Department for collection of SME related data from banks on a regular basis. All banks and FIs follow the definition of SMEs provided by BB as follows:

Small enterprise:

Service concern: Total fixed asset Tk 50,000 to 3 million excluding land and building; number of employees less than 20 persons.

Trading concern: Total fixed asset Tk 50,000 to 5 million excluding land and building; number of employees less than 30 persons.

Manufacturing concern: Total fixed asset Tk.50,000 to 10 million excluding land and building; number of employees less than 60 persons.

Medium enterprise:

Service concern: Total fixed asset above Tk 3 million to 10 million excluding land and building; number of employees less than 50 persons.

Trading concern: Total fixed asset above Tk 5 million to 20 million excluding land and building; number of employees less than 50 persons.

Manufacturing concern: Total fixed asset above Tk 10 million to 50 million excluding land and building; number of employees less than 100 persons.

Table A1: Availability of SME Financing Programmes in Selected Countries

Programme	Japan	USA	UK	China and Hong Kong	India	Malaysia	Sri Lanka	Bangladesh
Direct investment by government	√	√	√	√	√	√	√	√
Government investment in venture capital or equity capital financing schemes	√	√	√	√	√			√
Credit guarantee scheme	√	√		√			√	
Leveraged investment with government participation	√	√	√					
Venture capital	√	√	√	√	√	√		
Loans/ guarantees to SMEs through institutional network and through public-private partnership	√	√	√	√		√		
Credit database	√	√	√			√		
Sub-contracting arrangements	√	√	√			√		
Exit mechanisms for companies and stocks	√	√	√		√			
Strong legal and regulatory framework for the capital market	√	√	√		√	√		
Credit scoring mechanism	√	√		√				
Bank syndication						√	√	√
Specialized financial institutions	√	√	√	√	√		√	√

Credit rating system		√					√	√
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Source: GKP-IKED Handbook, 2005