

# The Supply Side Gaps and Opportunities of Small & Medium Enterprises (SMEs) in Bangladesh

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## Abstract

The growth and development of SME is largely dependent upon cheap and quick access to financial resources. More than ever before, nowadays SME contribute enormously to the economic development of a country; emerging economies top the list. In Bangladesh, 80% of the industrial employment comes through SME and hence much effort is being given toward flourishing it further. However, growth has been affected a lot with contracting funds in the hands of the owners making them vulnerable to slowing down. The major source of finance- the commercial banks face increasing risks from inexperience of the SME owners, lack of well prepared financial statements, in-depth knowledge about the actual need and government bureaucracies. This study attempts to light on the less pronounced challenges of SME development- those faced by the lenders or financiers in the process. It has been found that in Bangladesh the segment is underserved by the financial institutions (FI) with less focus on providing customer-tailored products, no specialized credit risk assessment system and huge time required for credit clearance information are some of the bigger challenges. With the knowledge we will be able to identify the risks inherent in lending by the prime commercial banks as well as find solutions to increase the credit flow in the sector.

**Keywords:** SME, Participating Financial Institutions (PFIs), supply side, commercial banks.

## 1. Introduction

Various countries have identified SME sectors as growing concerns seeing the impact they can create in economic development and hence have put up utmost importance in setting policies to govern these in the most efficient way. Bangladesh, being a developing country in terms of manpower and natural resources, posits ample opportunities for SME development. SMEs use locally available inputs and technologies, create large-scale employment opportunities, mobilize small private savings and develop entrepreneurial characteristics. However, this highly potential sector has not been able to reach the desired growth level. Several studies examined the reasons behind and came up with problems in financing, infrastructure facilities, government regulations, and inexperience. Access to financing continues to be one of the most significant challenges for the growth and survival of SMEs which stems mainly from the role played by the commercial banks. This paper focuses on the challenges faced by the financial institutions while lending SMEs in Bangladesh.

### 1.1 Objectives of the study

This study will help us to know the policy guidelines of banks in lending to SME sector. It will analyze the problems faced by commercial banks in financing SME sectors. Some understanding about the criteria followed by commercial banks in lending to SMEs has been provided through the discussions. Moreover this study has tried to identify the prospects for SME lending by commercial banks in Bangladesh.

### 1.2 Methodology

The study is based on information gathered through both primary and secondary sources. The primary source being personal interviews conducted by the authors with SME managers of different commercial banks in a project jointly Organized by Pohl Consulting & Associates, Germany, and Small & Medium Enterprise Sector Development Program (SMESDP), Ministry of Industries, Government of Bangladesh. The secondary data sources are various published articles, reports and the Participant's Manual published in SME Banking Training Program 2010, jointly Organized by Pohl Consulting & Associates, Germany, and Small & Medium Enterprise Sector Development Program (SMESDP), Ministry of Industries, Government of Bangladesh.

### *1.3 SME Definition*

Small and Medium Enterprises are businesses that are privately owned and operated, with a small number of employees and relatively low volume of sales. Small and Medium enterprises are normally privately owned corporations, partnerships, or sole proprietorships. The legal definition of 'small and medium' varies by country and by industry.

An SME generally has less than 50 employees. In addition to number of employees, there are some other factors to classify the Small and Medium Enterprises these are value of assets, net profit, legal positions, etc.

Small and Medium Enterprises are common in many countries, depending on the economic system in operation. Typical examples include: small shops (such as a bakery), hairdressers, tradesmen, lawyers, accountants, restaurants, guest houses, photographers, small-scale manufacturing, etc.

## **2. Literature review**

Small and Medium Enterprises (SMEs) contribute largely to any economy by creating abundant job opportunities, growing trade and investment sectors, increased output. SME sectors have huge prospects in contributing positively toward GDP growth of an economy and thus getting even increasing attentions now than ever before. Even the developed economies are quite ahead in positioning SME business in spite of slackening economic growth (The Economist, 2012). The survey included 530 senior managers from five economic giants and most views concluded that they are targeting growth in sales and earnings by incorporating newer technological developments. But most of the literature reviewed emphasizes on demand side problems and challenges. This is the specific arena where this study will be focusing on.

The OECD report of Promoting SMEs for Development (2004) states that economic growth potentials of the developing countries depend on how governments, development partners and the private sector address the supply-side problems in the trade and investment areas.

Ogbo (2012) studied the SME development in Nigeria by randomly selecting 100 SMEs around different states and interviewed SME operators through some standard questionnaire. The study aimed to identify greatest problems/challenges faced by SMEs and also to quantify relationship between form of business and source of its funding. The results clearly indicate that the poor performance of SMEs in Nigeria account to frequent policy changes in the part of Government and suggest that SMEs should strengthen themselves by incorporating efficient management as well as ample resources of their own.

A study on SMEs of Kenya (Bowen et al., 2009) showed that in spite of initial contribution in economic growth in 2005, the years followed brought up drastic failures of the enterprises. Interviewing with questionnaires to 198 business enterprises reveals that lack of access to credit, cheap imports, insecurity and debt collection seem to be the major challenges.

Singh and Belwal (2008) investigated problem areas and development issues concerning women entrepreneurs of SMEs in Ethiopia. Through surveying around 90 individuals, the study found that lack of financing source, lack of management exposures, limited institutional support, limited participation opportunities and absence of technological know-how were among the burning problems.

Naimy (2004) studied on 56 organizations in Lebanon to investigate financing problems faced by SMEs in Lebanese market. Results show that 100% of the SME depend on self-financing as bank loans are purely inaccessible since granting a credit requires, often, the satisfaction of almost impossible conditions to be fulfilled by these firms. High public debt in the country resulted in high interest rates unfavorable for any potential productive investment.

Muhammad et al. (2010) in their study on SME development of Malaysia found that economic downturns mostly affected small SMEs with few working capital, skilled workforce, etc., especially those involved with trading and supplying products or services to other businesses. The major challenges faced by the SMEs during the bearish period thus became lower cash flows and limited financing.

Nagaraju and Vani (2013) in their study on India showed that commercial banks being the largest source of financing for SMEs, more participation in lending can result in excellent opportunities by proving a wide market to serve and make SME lending a profitable banking operation.

### *2.1 Bangladesh perspective*

Chowdhury et al. (2013) attempted to identify problems of SMEs in Bangladesh and potential solutions to that. The study surveyed 100 SME consumers and the problems identified by them were long waiting period for

getting initial finance from banks because of tedious paper works, inability to provide collateral to get loans, inexperience in preparing sound financial systems for getting loans. As remedies the respondents advised financial incentives for sound business plan and public-private partnership in providing effective training. Another study (Khan et al., 2012) also reported similar problems faced by SMEs like lack of training for workers, harassment of government officials and poor supplementary utility facilities and sought integrated steps from government. Ahmed, Rahman & Haque (2011) attempted to identify the constraints of development of manufacture based SMEs in Bangladesh. According to their study, lack of infrastructural support, political unrest, shortage as well as price hike of raw materials, high financing cost and inadequate utility facility are some of the key factors for the slow development of manufacture based SMEs. Bangladesh faces some legal, regulatory and administrative constraints while working in the prevailing policy environment (Hossain 1998). The administration needs to be more transparent as well as accountable for the smooth functioning of SMEs and the government should increase policy and fiscal support.

Meagher (1998) identified expansion of capital as a critical success factor for SME development in Bangladesh. According to him financial institutions in Bangladesh are well below serving the capital needs of potential users because of complex legislative boundaries and hence hindering the potentiality of SMEs. Thus sufficient working capital along with technical assistance should be extended to existing SMEs. Not only the expansion of capital but also the designing of financial products is important for SME development (Akterujjaman, 2010). The major challenges emerge from the fact that businesses with SME follow quite an informal procedure compared to normal procedures of other banking activities, lack of proper financial statements by the SMEs and the relative inexperience of the banks judging the potential for growth of the SMEs.

Some researchers have specially pointed out the women entrepreneurs in SMEs. Minto (2006) mentioned that govt. had hardly provided effort to impart technical training to the 1.8 million women workers with little education, and resulting in deplorably low productivity. He further added that to boost up the most promising SME sector (RMG) authorities need to ensure introduction of suitable machinery to bring out high quality, enhancement of productivity and skills of workers through training, substantial improvement in finishing, packaging and transportation systems, and most importantly better use of e-commerce. The women entrepreneurs do also face continuous problems in getting sufficient credit facility in absence of specific policy recommendations as well as properly designed credit policy (Rahman 2009). None of the commercial banks design separate loan products for Women SME entrepreneurs. Very few of the banks have ladies branches and those branches focus on rather increasing savings than lending.

Riyadh, Bunker & Rabhi (2010) showed that e-finance system adoption for SME lending in Bangladesh is still far from optimal. Implementing e-finance across countrywide banks lacks satisfactory regulatory and infrastructural background. Bangladesh SME financing would be well-off with complete adoption of e-finance by reducing associated costs. The contribution of SMEs toward GDP can be enhanced by implementing effective use of ICT in SME centers (Uddin & Riyadh 2008). The sustainable development of SMEs in Bangladesh also depends largely upon the professional activities of SME Foundation (Abdin 2009). Apart from ICT, Khan (2010) recommended relationship-based lending than traditional lending for SMEs. The traditional lending rules & attitudes need to be redesigned for SME borrowers since they represent a different clientele with diversified needs from traditional borrowers.

If we just skim through the above literature reviews from various published sources then it becomes very clear that most of the articles have focused on the overall problems and prospects of SMEs in Bangladesh. And those have addressed several issues like:

- The ways SMEs can contribute in country economic growth
- Development of women entrepreneurs through SMEs
- Lack of proper paper works in SMEs
- Lack of infrastructural support for SMEs and training support for SME workers
- Lack of administrative transparency within the regulatory authority of SMEs
- Lack of proper financial statements which are required for SME financing
- Lack of capital problems faced by women entrepreneurs, etc.

Hence we see the studies which have focused on the supply side of SMEs are really meager. But the current article has mainly focused on the supply side problems and prospects of SMEs in Bangladesh. Besides very practical issues have been reflected in the article using very simple and straight forward words as it has been

emerged from the authors direct interviews with the SME Bankers in a project jointly Organized by Pohl Consulting & Associates, Germany, and Small & Medium Enterprise Sector Development Program (SMESDP), Ministry of Industries, Government of Bangladesh, where the authors worked as the field surveyors and organizers of several SME supply side surveys and SME Bankers training programs. This article will be very much helpful for the SME supply side policy makers in any developing country as many SME supply side problems which are faced by the SME bankers and SME entrepreneurs have been focused and some realistic recommendations have been made. Moreover it will also provide knowledge to those who are doing research in the field of SMEs particularly in SME supply side.

### 3. Definition of SME in Bangladesh

Generally SME can be defined from two perspectives. One is used capital and another is head count (number of employees). Ministry of Industry and Bangladesh Bank accepted the definition of small and medium enterprises recommended by Better Business Forum (BBF) as a uniform one. According to the definition, SME refers to the firm/business which is not a public limited company and complies with the following criteria:

Small Enterprise:

Name of the Enterprise (Small)	Fixed Assets other than Land & Building	Maximum Manpower Employed
Manufacturing	BDT 50,000 – BDT 15,000,000	50
Service	BDT 50,000 – BDT 5,000,000	25
Trading	BDT 50,000 – BDT 5,000,000	25

Medium Enterprise:

Name of the Enterprise (Medium)	Fixed Assets other than Land & Building	Maximum Manpower Employed
Manufacturing	BDT 15,000,000 – BDT 200,000,000	50
Service	BDT 5,000,000 – BDT 100,000,000	25
Trading	BDT 5,000,000 – BDT 100,000,000	25

#### 3.1 Overview of SME in Bangladesh

Before starting here we will provide a brief overview of SME sector in Bangladesh. It will help us to fathom the current development of SME in Bangladesh.

- The SME sector comprises about 476,442 establishments, of which 92.6% are small and 7.4% are medium
- The sector contributes 40% of gross manufacturing output, 80% of industrial employment and 25% of the total labor force
- Micro, small and medium enterprises provide more than 75% of the income of the households in Bangladesh
- SMEs contribute nearly 25% of the GDP of the country
- Average annual sales of SMEs grew by 6% from 2002 to 2005
- Exports by SMEs in FY 2005 increased by over 180% on average
- The average return on capital invested for SMEs is 15%
- The average working capital days for SMEs is 112 days
- The average receivable turnover days for SMEs is 49 days

Industrial Structure of SMEs:

- Wholesale, retail trade, and repairs 40%
- Production and sale of agricultural goods 22%
- Services 15%
- Manufacturing 14%

- Others 09%

Of the total SME contribution, approximately:

- 51% is contributed by those with 2-5 workers
- 26% is contributed by those with only 1 worker
- 10% is contributed by those with 6-10 workers

Sectoral Contribution of the SMEs:

- Manufacturing 38%
- Agriculture 24%
- Wholesale and Retail Trade 23%

Source: Nation-wide sample survey, 2008-2009; SME Foundation survey of six sectors, 2006-07; and NBR, First Schedule, 2008.

#### **4. Importance of SMEs in Bangladesh**

SMEs work as the vital success factor for any economy. The development of any country's economy largely depends upon the development of that country's SME. Japan, China, Malaysia, etc. have become developed nations as they have developed their SMEs. Now if we talk about a developing country like Bangladesh the role of SMEs is indispensable for its overall economic development. The following reasons can be identified as the importance of SMEs for the economic development of Bangladesh:

- Since SME sector is very much labor intensive with short gestation period, it is capable of increasing national income as well as rapid employment generation. Our neighboring countries have also given due importance on SME terming SME as 'employment generating machine'.
- The startup fund for SME is very low. So SME can accommodate our new, young and small entrepreneurs who have not enough funds to make their dream business true. In this way Bangladesh can nurture her entrepreneurs by SME.
- Again SME can act as the play ground for the new entrepreneurs. In our country there are so many new entrepreneurs who are intending to start a large industry but they have neither enough experience to start a large enterprise nor enough fund to operate it. So they can take SME as the play ground then after having enough experience and fund they can go for large scale enterprises.
- We should not remove our concentration from agriculture, because industrialization cannot be the substitute for agriculture in this country. But industrialization can complement our agriculture. If we think that industrialization can complement our agriculture then SME can do a lot to supplement our heavy industries.
- SME can ensure maximum social inclusion as it reduces the income inequality. Poor people who have not enough money they can start a small enterprise, they can earn their livelihood through this SME. So we see that SME supports pro-poor growth and it works for poverty alleviation.
- About half of the total population of Bangladesh is woman. If they remain underdeveloped then it is not possible to achieve development. Women can start small businesses to support their families. They can produce in which they are specialists like designer goods, handloom goods, handicrafts, etc. In this way they can also contribute to the country development and thus women empowerment can also be achieved.

#### **5. SME Lending in Bangladesh and our Observations & Findings**

PFIs (Participating Financial Institutions) face difficulty to target loans to SMEs because of the lack of a clarified definition of SME. Even there is a confusion that whether it will be SME or only SE. Because, 'S' is different from 'M' in many respects. 'M' for Medium Enterprise (lending) is very much adjacent to corporate lending. The loan amount, risk structure, borrower's profile, etc. of Medium Enterprises are quite similar to that of corporate lending. So when we are concentrating on the objectives of SME then we should have more focus on SE rather than SME. The policies and strategies for 'S' should be different from that of 'M'.

In general loan size for Small Enterprises is BDT 50,000 to BDT 5,000,000. By complying with other requirements within this range the loan given by the PFIs can be termed as small lending. Below this range the loan will be micro credit and above this range the loan will be medium.

### *5.1 Features and constraints of SME lending in Bangladesh*

In this country the requirement for SME lending has not been felt by the FIs (Financial Institutions) themselves rather it has been imposed by the Bangladesh Bank (the central bank of Bangladesh) for the betterment of the nation. In fact it is an underserved potential segment for the FIs which may bring huge profit for them by serving the nation as well. But as the FIs did not come here on their own accord they are serving here reluctantly only to get the benefits from Bangladesh Bank. Other observed features and constraints of SME lending in Bangladesh are discussed below:

- In most of the cases PFIs have opened an SME branch office without having any plan but just to abide by BB's (Bangladesh Bank) decision.
- The responsible persons in SME banking do not know about the SME banking strategy. Even they have not a clear concept about SME. In some cases they think that providing small loan to the small entrepreneurs is SME lending. They have not substantial training regarding the SME banking.
- PFIs generally provide SME loan with personal guarantee up to 5 lac taka without any collateral. Above this they require collateral (hypothecation) along with personal guarantee.
- In most of the cases SME branches do not offer any customer tailored products. They do not prepare any customer profiling. Even they do not focus on different business segments with different product schemes.
- Some PFIs are giving loan to the trading sectors rather than the manufacturing sectors, which contradicts with the objective of SME lending. Because the objective of SME lending is to generate employment opportunity through producing goods and services for the nation and to support the entrepreneurs who would start new venture for production.
- In order to assess the credit risk of the SME borrower there is no credit risk scoring model either developed by PFIs or Bangladesh Bank. CRG (Credit Risk Grading) scoring cannot be used here because it is used for corporate lending.
- Small entrepreneurs are not educated enough and they do not have sufficient banking knowledge. So they cannot follow the banking rules and regulations i.e. filling up an application form etc. for availing a credit.
- There is lack of borrowers' information. Because they are not habituated to maintain bank accounts. Even they do not trade through banks. So it is quite tough for the CRMs (Credit Risk Managers) to assess the risk for them.
- Again small entrepreneurs do not maintain financial statements. When it is manufacturing sector then the information can be collected to some extent but when it is trading sector then the SME bankers really fall in trouble to take the decision about the borrower.
- Sometimes borrowers take part in fraudulent activities. They apply for SME loan into several banks at a time. For this reason all the banks get that he has no debt at that time as the CIB (Credit Information Bureau) report shows the same thing. They also receive more than one trade licenses in different names. In this way they take loan from different banks simultaneously. Again in few cases it is found that borrowers tell that they are taking loan for SME but they use it in their personal expenditure or invest in stock market. Sometimes they do not repay the credit and change their abode as the shops and their houses are rental.
- On an average PFIs take about 30 days to process an SME loan (application to approval and approval to disbursement). This is a huge time. They complain that this delay is made because they require about 14-25 days to get the CIB (Credit Information Bureau) report. So they have no way to make it faster without getting the CIB report faster.
- Often SME bankers complain that they need to work under pressure because they are given a loan target to fulfill it within a specific time period. So after a course of time in order to fulfill the target they give loan randomly and in this way they make wrong selection of borrower.
- In order to encourage the woman entrepreneurs Bangladesh Bank has adopted the policy to give loan to the woman entrepreneurs with only personal guarantee and without any collateral up to 25 lac taka. Again 10% of total SME loan should be given to the woman entrepreneurs. After this announcement women come to the banks and claim 25 lac taka loans without fulfilling the requirements!

- Often SME bankers complain that the SME operations and transactions take place in different locations. SME related activities are performed in one place and disbursement and cash collection are performed in another place. So they fall in trouble to monitor their customers.

### 5.2 Suggestions, Recommendations and Opportunities

In order to develop the SME sector of this country and to get the maximum benefit from it, at first we need to define SME very much clearly and disseminate the concept toward all levels of its stakeholders. ‘S’ should be separated from ‘M’, and we should give special focus on small enterprises. Other suggestions, recommendations and opportunities are elucidated below:

- Both the PFIs and the SME entrepreneurs (borrowers) should be trained up properly so that they can understand the objectives of SME lending. They must know why this SME lending is required and how SME would help to foster our economic growth.
- Now the SME bankers are learning from their mistakes. But if they could plan properly then they might have been able to avoid the mistakes. So SME bankers should plan first before going to establish any SME center or branch.
- Bangladesh Bank must pursue the PFIs that SME sector is a profitable sector for their institutions. Here they can be able to make profit and also contribute to the country development.

Table 1: Percentage of equity in the sum of equity and debt at start-up year and study year across twelve SME industries

Sector	Startup year (%)	Study year (%)
Agro processing	80.78	83.30
Light engineering	91.61	94.48
Electrical	99.62	98.99
Furniture making	94.71	86.48
Knitwear	93.72	85.13
Leather	100	46.49
Non metallic minerals	92.43	90.40
Paper and paper based goods	91.51	98.09
Designer goods	89.69	97.92
Pharmaceuticals	99.95	100
Plastic	97.20	46.06
All others	100	100

Source: Nation-wide sample survey 2010, Participant’s Manual, SME Banking Training Program 2010, Jointly Organized by Pohl Consulting & Associates, Germany, and Small & Medium Enterprise Sector Development Programme, Ministry of Industries, Government of Bangladesh.

From the above table (table-1) it is also very clear that still now most of the SME sectors are underserved. The entrepreneurs are intending to take loan as we see that the equity portion is decreasing. So for the FIs, SME would be a potential profitable sector for lending.

- PFIs must go for cluster based lending. They must find out the potential SME segments and then design a product particularly for that segment. The guideline which will tell about the potential business segment for SME lending can also be prepared by Bangladesh Bank and should be disseminated to the SME centers so that they can make proper market segmentation. After that SME centers should evaluate the segments periodically to trace the changes and they should redesign their products accordingly.
- PFIs may give SME loan to the trading sector. But their main focus should be on the manufacturing sector. If they give more and more loan to the trading sector then it will not achieve the goal of SME lending.
- A specific credit scoring model has to be introduced for SME lending. It would assist the PFIs to assess their credit risk. Difference in the SME market segments should be reflected in this credit scoring model.

- The small entrepreneurs should be introduced with bank account. They must be agreed to use their accounts for transacting. This thing will not be possible within a short course of time rather the PFIs should create pressure on them in many ways to make them habituated with transaction through bank accounts.
- BDSs (Business Development Services- preparing the financial statements, preparing the business plan, filling up the loan application form, etc) should be provided by either PFI itself or third party. If PFI provides these then it can charge for these. Otherwise government approved third parties can also provide these services to the small entrepreneurs.
- CIB report should be made online and updated regularly so that all the PFIs can check the information whenever it is required. In this way if it is checked then the duplicity of loan can be avoided. Again the loan processing time will be reduced. Bangladesh Bank has already taken initiatives to make it online. To avoid forgery in CIB report unique code for each borrower should be introduced, past history of the borrower should be included, previous bank name (if became default before) and loan amount should be included.
- SME lending is relational rather than transactional. So here the RM (Relationship Manager) should be proactive that is to say he must acquire the borrower. He will prepare the customer profiles so that the wrong selection of borrower can be avoided.
- Loan target should be team based rather than giving it to an individual. And PFI should not consider the individual loan rather it should consider the loan in a portfolio. In SME lending recovery is a critical problem. Because of lack of collateral. But in amount an individual SME loan would be very much minimal comparing to that of a corporate loan. So PFI should think it as a portfolio context.
- PFIs can introduce some cross selling product like if you keep one lac taka deposit with the bank then you will get two lac taka SME loan.
- In order to support the PFIs for giving SME loan without collateral a Credit Guarantee Trust Fund can be established. This Credit Guarantee Trust can mitigate the inefficiencies deriving from imperfect information along with insufficient or no collateral.

## 6. Conclusion

From the above discussion it is quite apparent that SME is an important weapon for Bangladesh for fostering its growth and development. In this country SME is now in an infant stage. It is needed to be nurtured and brought to a long way to realize return from it. If the country takes much time to prepare policies for SMEs then its growth will be hampered and the implementation of the dream to be included in the mid-range developed nations will be delayed. So the country should take steps faster so that her SME sector can get enough time to grow and present her with a semi-developed nation. It is a matter of hope that the present government has also put much emphasis on the development of SME sector considering it as 'the driving force for industrialization'. All of the country participating authorities should make a united effort to make the SME a success.

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