

Urban-Biased SME Finance in Bangladesh: Way to Solve the Puzzle

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Abstract

Small and Medium Enterprises (SMEs) play a vital role in the economic progress of developing countries such as Bangladesh. SMEs have earned special significance for their role in poverty reduction programs and potential contribution to general economic and industrial growth. SMEs are considered one of the motivating forces of Inclusive Growth, which has become the national policy of Bangladesh Bank in the past few years. Nevertheless, it can be questioned whether SMEs in Bangladesh are making any contribution to the inclusive growth. There is evidence which indicates that SME credits are concentrated in the urban regions than in rural areas by a notable margin, although Bangladesh Bank has achieved its targeted SME credit disbursement in recent years. Therefore the study aims to discover the reason for this urban concentration of financial institutions in Bangladesh. We have collected data from Bangladesh Bank's own data bank. In addition, the study looks at the potential role of Bangladesh Bank, as well as examining what policy measures can be undertaken to improve access to SME credit by rural entrepreneurs, in order to achieve inclusive growth in Bangladesh.

Keywords: SME, Inclusive Growth, Bangladesh, Credit, Bangladesh bank.

1. Introduction

Accelerating growth and reducing poverty, income inequality and regional disparity are the overarching goals of the current development paradigm in Bangladesh. The main strategy for achieving these goals include creation of productive employment in the manufacturing and organized service sector and withdrawal of labor force out of the low skilled and low return agricultural sector and informal activities. Small and medium enterprises (SMEs) are treated as the engines of growth and drivers of innovation worldwide. They play a significant role in driving economic growth and generating jobs. In Bangladesh, the sector is actually changing the face of the economy. SMEs are playing a vital role for the country's accelerated industrialization and economic growth, employment generation and reducing poverty. For achieving double digit growth in manufacturing, matching development of SMEs is considered critical. Enhanced micro, small and medium enterprise activities in the rural and backward regions constitute a key component of the strategy for rural development and reduction of poverty and regional disparity (GOB 2011). SME sector has played a vital role in economic development of some prosperous countries of Asia. Our neighboring countries have also given due importance on SME. Terming SME as 'employment generating machine' they stressed on SME development for higher economic growth, narrowing the gap of income inequality and poverty alleviation. The present government has also put much emphasis on the development of SME sector considering it as 'the driving force for industrialization'. The target of achieving double-digit growth hinges largely on the performance of the small and medium enterprises. In a labor surplus country like Bangladesh, SMEs can play a substantial role in providing the impetus to the development of the modern manufacturing sector and the job creation outside the agriculture and informal sectors. In Bangladesh, people exhibit lesser ability in processing capital and machinery. The country's SME sector has created 15 lakh jobs between 2009 and June 2014. Now, private and foreign banks disburse half of all farm loans and a third of these are going to SMEs. Potential of SMEs Every year about 2 million young people join the country's workforce. Half of them find jobs at home or abroad. So, it has become a challenge to create more jobs so that the rest can be employed. SMEs can be an answer to the problem. According to the Asian Development Bank (ADB), income inequality has risen more than 20% in Asia over the last two decades Park & Mercado (2015). The 2015 International Labor Organization (ILO) report, World Employment and Social Outlook, warns of the risk of continuing, growing inequalities in an Asia where unemployment levels are on the rise, especially among the young, and where falling wage shares may threaten future growth and stability in the region. These trends may be symptoms of a slowdown in economic mobility in many Asian countries, where education may not be enough to ensure a better income than one's parents, where quality jobs are scarce, and where entrepreneurs face a myriad of barriers that prevent them from seizing their share of the growth. The debate on reducing inequality and boosting economic mobility often focuses on key factors such as ensuring equal access to education, health, basic utilities, and public services; enhancing food security; expanding fiscal redistribution; increasing government expenditures on social security and welfare; and reducing gender inequality. All are important and necessary measures. However, creating open and transparent business environments that support entrepreneurship and small and medium-sized enterprises (SMEs), so they can grow and create jobs and wealth, may be just as important in the fight for more inclusive growth. According to the ADB, SMEs comprised 98 percent of all enterprises in the Asia-Pacific, employed 66 percent of the national labor force, contributed 38 percent of GDP, and accounted for 30 percent of total export value from 2007 to 2012.

Women-led enterprises have a critical role to play among SMEs, with a UN report finding that limiting the inclusion of women in the economy costs the region \$89 billion a year. Post-Independence, the main concern for Bangladesh has been its economic growth. We have achieved satisfactory growth over the last one decade. However one challenge is growth needs to be inclusive that is equally distributed among all sections of the society. The target of achieving double-digit growth hinges largely on the performance of the small and medium enterprises. In a labor surplus country like Bangladesh, SMEs can play a substantial role in providing the impetus to the development of the modern manufacturing sector and the job creation outside the agriculture and informal sectors. Bangladesh's inclusive growth strategy views SMEs as crucially important drivers of sustained broad based output, employment and income generation. According to the Bangladesh Bank Governor, SMEs account for 40% of overall employment and 80% of industrial jobs in Bangladesh. 90% of total industrial units are SMEs, contributing nearly 25% of the country's GDP. SME can reduce the urban migration in the capital and other major cities, increase cash flow in rural areas, and thereby enhance the standard of living of the rural people. SMEs are widely distributed all over the country which means developing SMEs will play a major role in bridging the urban-rural income gap and contribute towards inclusive growth. In a way, inclusive growth can only be achieved through a vibrant SME sector in a country like Bangladesh. The study therefore attempts to analyze and identify whether SMEs in Bangladesh are contributing to the inclusive growth in Bangladesh or not.

2. Problem Statement

In Bangladesh the term "Inclusive Growth" has become the national policy and Bangladesh Bank has taken many initiatives to achieve that. For Bangladesh to reach the middle income threshold by 2021, industrial expansion must move hand-in-hand with highly productive farm and non-farm agriculture. There is no alternative to creating an environment conducive to development of small and medium enterprises for attaining that goal and the National Industrial Policy-2010 has considered the SMEs as the thrust sector, given the planned and balanced development of these labor-intensive industries as the engine of growth. However SME financing in Bangladesh has been centralized to urban areas since Bangladesh bank has developed SME policy in 2010. Therefore question arises regarding the inclusiveness of SME financing.

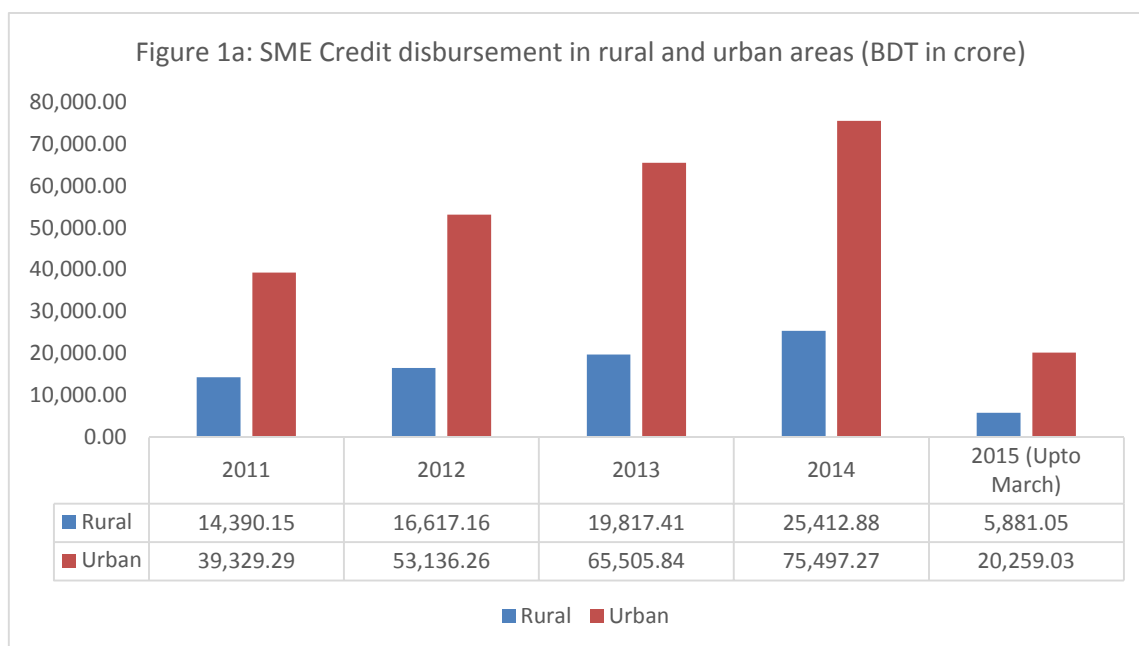
3. Methodology

The study is based on exploratory research along with secondary data analysis. In addition to this we have employed our job experience as banking professional to analyze the findings. Moreover we have interviewed several financial sector specialists e.g. deputy general manager, SME and special program department of Bangladesh Bank, Head of SME of different private commercial bank to generate further ideas over our proposed study. Finally we have compiled our findings to generate policy suggestion to overcome this problem.

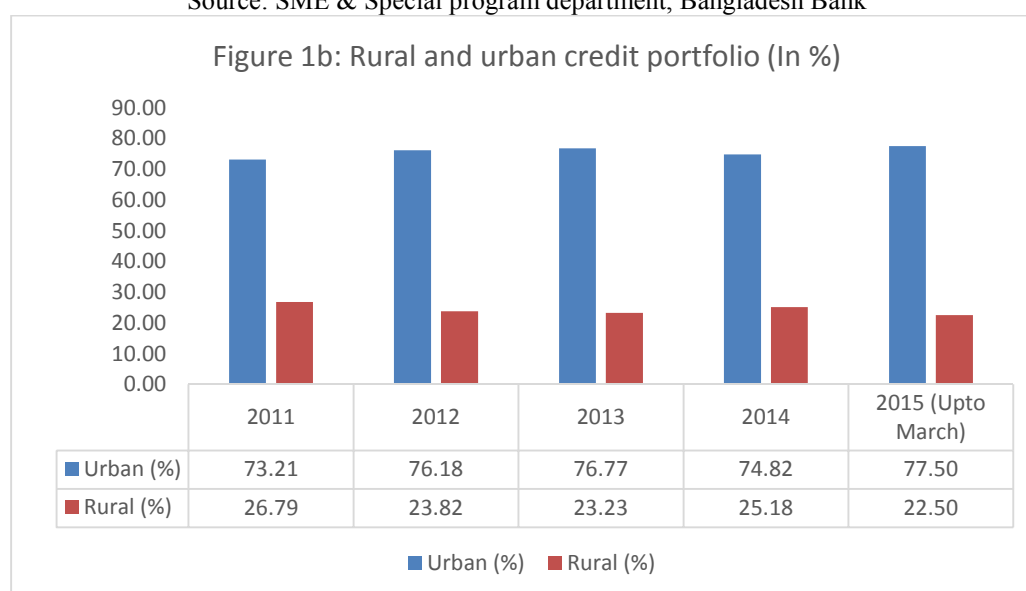
4. Present Status of SMEs in Bangladesh

SMEs now occupy an important position in the national economy. They account for about 45 percent of manufacturing value addition, about 80 percent of industrial employment, about 90 percent of total industrial units and about 25 percent of the labor force. Their total contribution to export earnings varies from 75 percent to 80 percent. The industrial sector makes up 31 percent of the country's gross domestic product (GDP), most of which is coming from SMEs. The total number of SMEs in Bangladesh is estimated to be 79,754 establishments. Of them, 93.6 percent are small and 6.4 percent are medium. The 2003 Private Sector Survey estimated that there are about 6 million micro, small and medium enterprises, with fewer than 100 employees. About 60 to 65 percent of all SMEs are located outside the metropolitan areas of Dhaka and Chittagong. The country's SME sector has created 15 lakh jobs between 2009 and June 2014. Now, private and foreign banks disburse half of all farm loans and a third of these are going to SMEs. The central bank has launched target-based credit activities for banks. Between 2010 and 2013, about 18.35 lakh SMEs got loans to the tune of BDT 262,340 crore. Loans of nearly BDT 100,000 crore are going to SMEs every year. BB has launched a number of refinancing schemes involving BDT 2,100 crore from its own fund as well as funds from development partners.

Figure 1a shows SME credit disbursement in urban and rural areas. We can see that banks and other financial institutions are concentrating in the urban areas rather than rural areas. The percentage in figure 1b shows the difference which is huge. Statistics shows that in the total credit only 20%-25% credits are being disbursed among rural SME entrepreneurs.

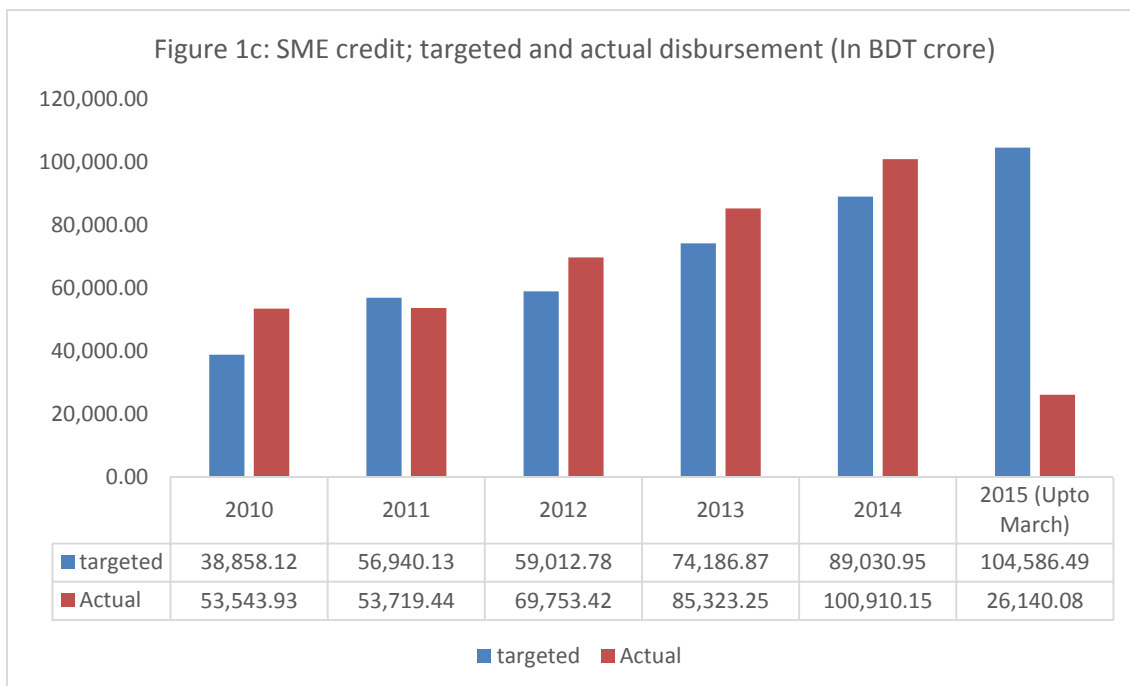


Source: SME & Special program department, Bangladesh Bank



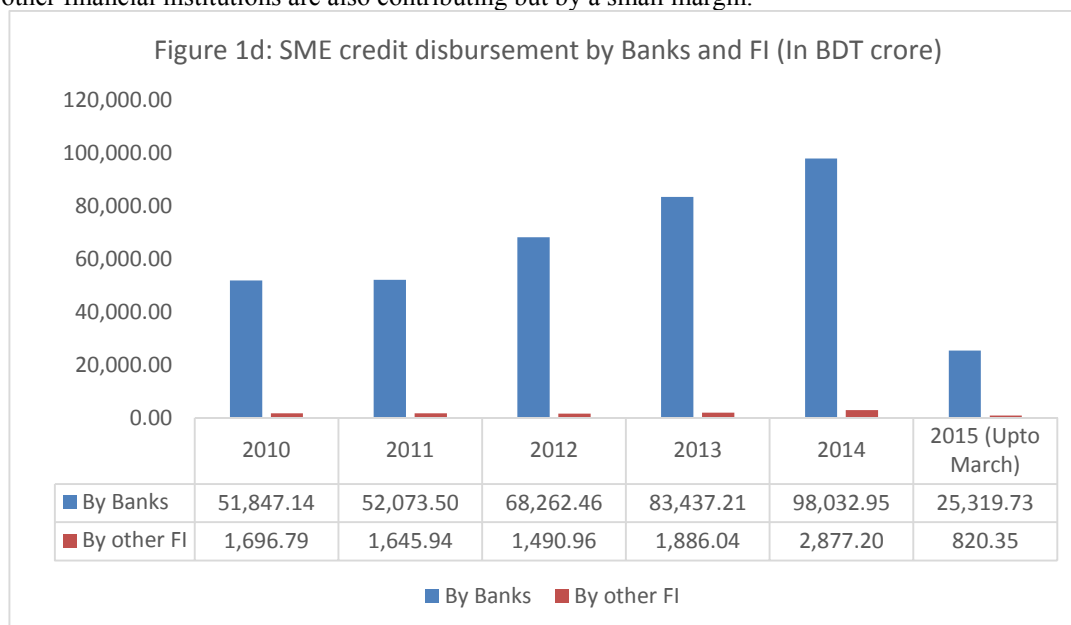
Source: SME & Special program department, Bangladesh Bank

On the other hand figure 1c shows that in most cases Bangladesh Bank achieves it targeted credit disbursement in every year by significant margin which is a good sign. Up to March 2015 nearly 25% of the targeted credit disbursement has been achieved.



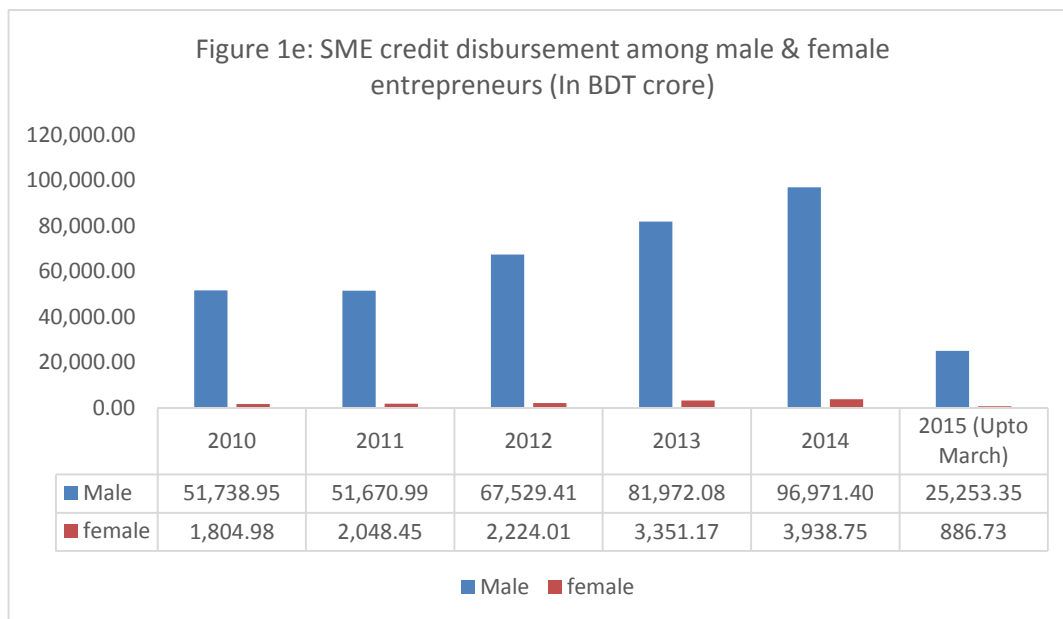
Source: SME & Special program department, Bangladesh Bank

Figure 1d shows that banks are contributing greatly in the SME sector development by providing credit facilities. The figure shows an upward trend of commercial bank's financing in the SME sectors in Bangladesh. On the other hand other financial institutions are also contributing but by a small margin.



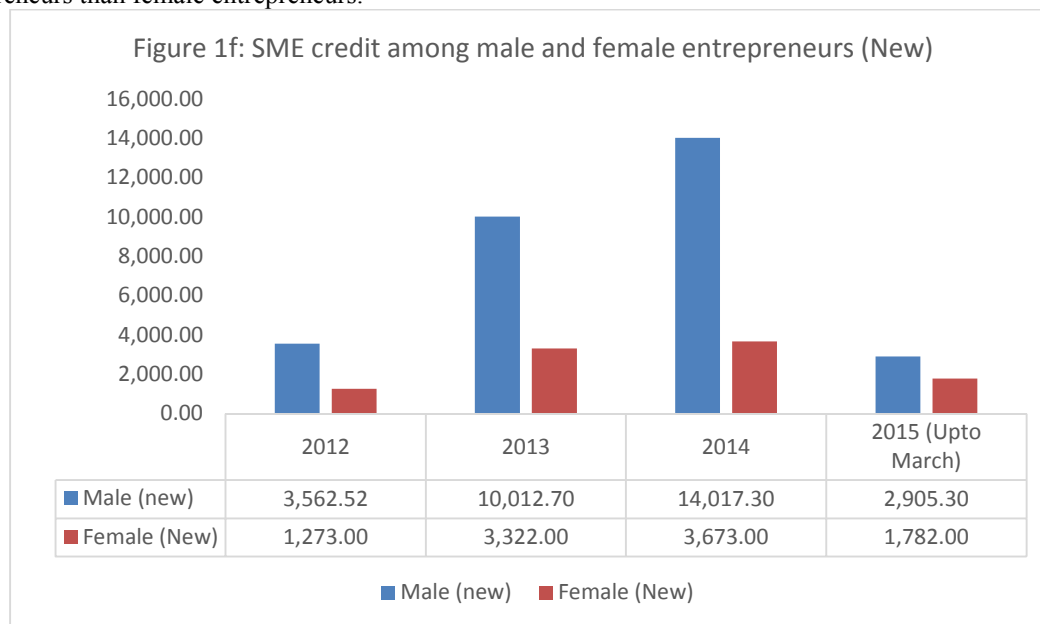
Source: SME & Special program department, Bangladesh Bank

Figure 1e shows that male entrepreneurs are getting more credit facilities than female members. Evidence shows that the difference is huge although Bangladesh Bank has made special arrangement for women entrepreneurs.



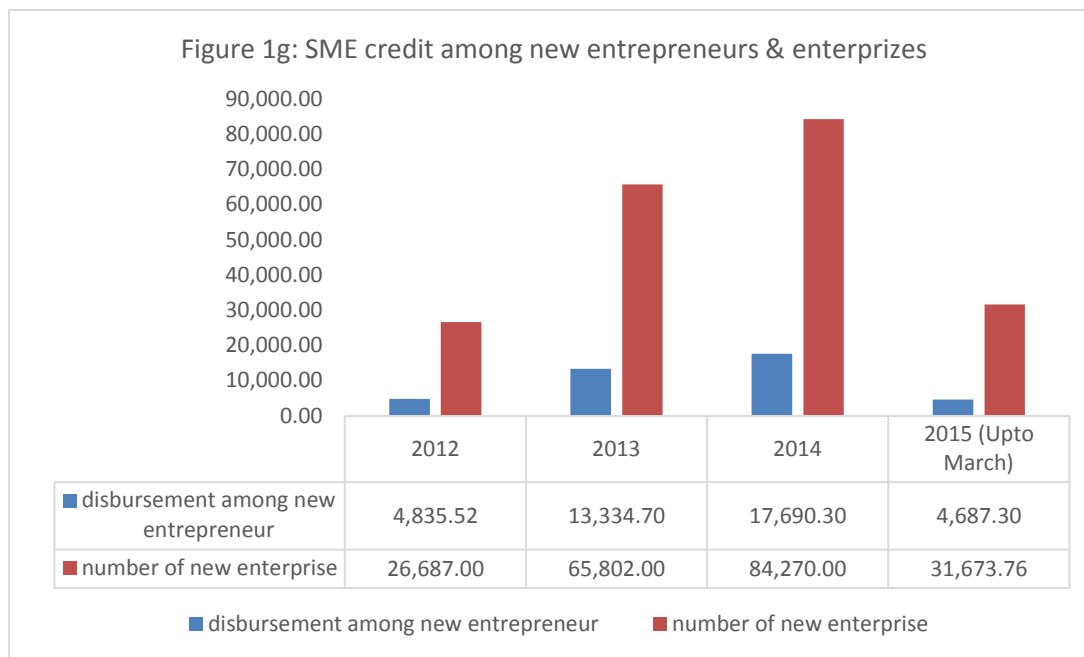
Source: SME & Special program department, Bangladesh Bank

Figure 1f shows SME credit disbursement among new male and female entrepreneurs. It is evident that male entrepreneurs are getting priority than female entrepreneurs. The increasing rate is also high in case of male entrepreneurs than female entrepreneurs.



Source: SME & Special program department, Bangladesh Bank

Figure 1g portrays that number of new SME entrepreneurs as well as SME enterprises are growing with the passage of time. The rate is also high.



Source: SME & Special program department, Bangladesh Bank

5. Urban-Biased SME Financing:

Scheduled banks and non-bank financial institutions are found to ignore rural entrepreneurs in disbursing small and medium enterprise loans as they distributed to them (rural entrepreneurs) only 25.17% of the total SME loans they sanctioned in the last year. According to Bangladesh bank a number of banks and NBFIs are reluctant to disburse loans to the SMEs located in the rural areas as they are not bound by laws to give certain amount of such loans in the rural areas.

- **Rural Areas are Not Covered by Banks:** In Bangladesh, rural areas are not covered by full-fledged banking services. Very few branches of commercial banks operate in those regions. The reason is the operating cost is very high in rural areas. It becomes very difficult for the commercial banks to go in rural areas for business. In case of private commercial banks, they are often centered within large corporate loans in urban areas.
- **Hard for Urban Branches to Disburse Credits:** It is very difficult for an urban branch of a commercial bank to monitor its disbursed credit in the villages. It is also difficult for them to manage the collateral. In Bangladesh most of the commercial banks are located urban areas and it becomes very difficult for them to provide credit facilities to the rural SMEs. Moreover in terms of assessing the risk banks also face problems.
- **Information Asymmetries:** Banks face a number of issues in lending to SMEs, the most pronounced being information asymmetry and granularity, the level of detail available on which to base business decisions. Banks do not have the requisite information and systems in place to quantify risk and differentiate between SMEs. This has resulted in tightened credit terms and in the inefficient allocation of resources. The rural consumers are mostly unaware of the SME banking products. Most of them have no idea about the existence of SME loan products in the market. On the other hand, bankers don't have adequate data to make investment decision as they don't have enough data to assess the consumer. For markets to allocate resources efficiently, all market participants must have the same relevant information. This is seldom the case, however, in developing countries, and the resulting market failures can create biases against small firms. Under these circumstances, for banks to obtain information on the creditworthiness of potential rural SME clients is difficult or costly. If, as a result, lenders perceive the risks of lending to rural SME to be greater than they actually are, they will charge higher interest rates or refrain from lending to them altogether.
- **Lack of Collateral:** Banks are also known to demand large amounts of collateral from SMEs because lending systems are based more on borrowing backed by assets than project earnings and cash flow. Many banks have revealed that they insist on large collateral as a safeguard to losses from risk exposure. The rural SME business owners, most of the time, don't possess sufficient collateral to avail the credit. In fact this is a common problem in financing urban SME as well. In case of rural SME owners the problem is in most cases their collateral values remain lower in comparison with urban SMEs.

- **Bureaucracy:** Borrowers face difficulties in comprehending documentation processes stipulated by lenders, many of which have been found to be exhaustive and too complex. A startup business owner sometimes finds the whole loan disbursement process too bureaucratic. They need to submit a lot of documents e.g. trade license, TIN certificate, other legal documents etc. to obtain SME credit. It is easy for a regular businessman to provide those papers quickly. But owners of newly established businesses' find it difficult to collect papers. This problem is even bigger for an entrepreneur residing in a rural area since they are going to start their new venture for the first time. Adding with a lengthy process often makes rural entrepreneurs demotivated for a startup.
- **Credit Information Gap:** The absence or limited track record of Credit Rating Agency (CRA), with regard to SME ratings, low analyst coverage of SMEs, and lack of access to information are some of the key barriers to credit appraisals of SMEs. The ability of banks to develop exhaustive credit models for the SME segment is impaired by lack of data. Greater availability, centralization and documentation of such data would not only promote better access to finance, but also aid in developing a more thorough understanding of the risk profile of the sector.
- **Negligence from the State Owned Commercial Banks:** The state owned commercial banks have presence in the rural areas in Bangladesh among state owned commercial banks Sonali Bank, Janata Bank, Agrani Bank and Rupali bank have their branches in rural areas. But they are already suffering from a lot of problems bigger than SME credit disbursement. Moreover their way of disbursing a loan is not transparent. They suffer from shortage of skilled Human capital as well. Besides existing bankers don't want to be accountable for the disbursed credits. They feel SME credit is just an additional responsibility. It is very common that in case of rural entrepreneurs, the collateral value will be lower. Therefore it is very necessary to formulate a strong "Risk Management Committee" who will assess the risk of those collaterals. This is also absent in case of state owned commercial banks.
- **Smaller Amounts with Bigger Risks:** One of the biggest reasons is that the loans are smaller in amount but the paperwork and other added formalities are not. The risk involved with these loans is also high. Normally SME credits are considered as risky investment. Therefore banks are not resultant to move in the rural areas for SME credit disbursement.
- **High Transaction Cost:** Transaction cost per SME loan is comparatively higher. The cost of processing a large loan is very much similar to a SME loan. Banks are not interested to bear high transaction cost by moving into rural areas for SME financing. This factor discourages the borrower as well as the lenders.
- **Quality of SME projects:** Most of the time the quality of an SME project is very low and don't promise significant return. It involves poor skills of the rural SME entrepreneurs along with unfeasible SME proposals. Therefore banks do not want to take risk with those unfeasible projects in rural areas.
- **Quality and Experience of Business Managers:** Most of the entrepreneurs and managers in rural areas are not qualified enough to manage a business. The ability to run a business is vital to success. Besides they don't have adequate accounting and marketing knowledge. These shortcomings hamper their business model. These shortcomings can't persuade commercial banks to provide SME credit in rural areas.
- **Innovation:** Bankers complain that SME entrepreneurs always present the common ideas. Lack of innovation ward off bankers from giving loans. This is a common problem in overall SME sector in Bangladesh. In case of rural areas this problems is very severe.

6. Way to Overcome; Policy Suggestions

The access to SME finance in general, and to rural SME in particular is not strictly a problem of supply of finance. Often the root of problem lies on the demand side. This can be tackled, in part, by improving linkages between the suppliers of rural finance and those that need it, including better flows of information, training of rural SME managers, self-assessment tools, creation of various forums where potential financiers, investors and rural enterprises can interact, use of award schemes and tools to improve the quality of demand. Based on our observations we have recommended the following policy suggestions.

- The first thing we have to change is the "Fit for all" SME policy. Policy makers have to identify different types of SME's, analyze their needs and formulate policy for them accordingly. Policy should vary depending on the types of business or region.
- Banks can offer tailor made products for different rural areas. They have to identify the right cluster and finance the businesses under it. It will not only develop the enterprises but also will help banks diversify their business.
- Besides government and other policy makers, commercial banks can come forward with effective plans. To strengthen the enterprises of a specific region or for a specific type of business, banks can actually finance the whole supply chain of that particular business or that particular area.
- To help make the total process better, mandatory credit rating for SMEs can be introduced. It will

certainly reduce the risks of banks and help solve the information asymmetry problem.

7. Recent Important Initiatives By Bangladesh Bank

Considering the fact that rural SME entrepreneurs are being ignored, Bangladesh Bank has taken some initiatives recently. Inadequate financing has been considered as a critical bottleneck in the development of SMEs of all types. The SMEs face financing difficulties mainly because of the problems of asymmetric information, inadequate assets and absence of markets. In several instances, it was proven that SME clusters were useful in handling the asymmetric information and other related problems effectively and made differences in ensuring efficiency in SME financing. There are evidences that in several instances, clustering were beneficial to SMEs, especially smaller manufacturers, because it facilitated connections with the external economy including suppliers, workers, trade parties and financial institutions. Considering the benefits of SME clusters, banks have followed cluster approach in several instances both in developed and developing countries. Cluster based approach in lending is intended to provide a full-service approach to cater to the diverse needs of the SME sector which may be achieved through extending banking services to recognized SME clusters. Most of SME clusters are located in rural areas, and due to the lower SME loan disbursement in the rural areas, the geographically concentrated SME manufacturing units are getting lower proportion of loans from banks and NBFIs. Available data indicates that a considerably low proportion of banks' SME credit goes to the clusters. Of the broad bank groups, performance of private commercial banks is relatively better. Of the total outstanding credit to the SME clusters, private commercial banks' exposure was three-fourth of the total. Industrial cluster helps solve the difficulty of bank financing of SMEs in several ways: cluster increases the symmetry of information i.e., a bank is familiar with the situation of local enterprises, as a result it facilitates the opportunity of getting loan; cluster helps reduce the cost of banks i.e., banks may benefit a lot from economics of scale through lending many enterprises within one industrial cluster; cluster helps reduce credit risk of banks. Moreover, credit risk within an industrial cluster is mostly reflected on the risk of the industry which can be anticipated to some degree by the direction of industry and the overall growth situation. It is believed that a single SME in non-clusters is unable to reduce information asymmetry. Financial institutions may be unwilling to finance small borrowers on an individual basis due to the high cost of frequent small credit provision, but they may be willing to provide loans for a cluster that assembles small borrowers at a reduced cost.

8. Conclusion

Bangladesh has managed to accelerate overall GDP growth by one percentage point on average every decade from 3% in the 1970s to 6% in the last 10 years. Acceleration of growth also helped 15 million people leave absolute poverty behind in the past three decades. Building on its social-economic progress so far, Bangladesh now aims to become a middle-income country (MIC) by 2021 to mark its 50th year of independence. However one challenge is growth needs to be inclusive that is equally distributed among all sections of the society. The distribution of economic opportunities across all population groups, and particularly those at the bottom, needs to improve in order to make middle-income country status meaningful. SMEs are considered one of the driving forces towards incisive growth. SME sector help alleviate poverty, increase income level of rural people and promote agro-industrial linkage in Bangladesh. Today, SME remains the engine of economic growth and considering the population of Bangladesh, SME offers large-scale employment and income earning opportunities at relatively low costs, especially in the rural areas. It strengthens efforts to achieve high and sustainable growth, which is a prerequisite for an exit from widespread poverty and socio-economic deficit. However inadequate financing has been considered as a critical bottleneck in the development of SMEs of all types. The SMEs face financing difficulties mainly because of the problems of asymmetric information, inadequate assets and absence of markets. Rural SMEs are being ignored continuously over the last five and six years. Our study has identified several reasons of ignoring rural SMEs. We have also suggested some policy measures and believe our policy suggestions can help to overcome this problem and achieve inclusive growth of our country.

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