

Financing Small and Medium Enterprises in Bangladesh – Issues and Challenges

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Abstract. *Now-a-days, Small and Medium Enterprises (SMEs) have become an important sector that is supposed to play a pivotal role in boosting the economy of Bangladesh. But, SME financing is still facing some remarkable challenges that limit its potential success in contributing to the economy. Lots of thinking has contributed to the initiation and development of SMEs in Bangladesh. Now is the time to identify the challenges and making adjustments to the initial thinking. This paper is, therefore, an attempt to analyze various issues and challenges of financing this particular sector and find some worthy ways out to overcome these challenges. It will also survey various literatures and reports on the concerned field and recommend supporting actions to help this highly prospective industrial sector operate in a fully yielding manner.*

Keywords: *SME, Financing, Development, Bangladesh economy, Industrial sector*

1. Introduction

The SMEs (Small and Medium Enterprises) in Bangladesh are still a highly knotty industry. It is facing difficulty in access to finance yielding the lack of needed fund at the time they need it. The cost, terms and conditions of finance are also alleged to be unfavorable for the growth of the sector. The scarcity of incessant access to institutional credit is also an acute problem and appears to be one of the most serious constraints to SME growth in Bangladesh (Ahmed, 2001). SMEs are not supposed to possess enough assets to offer as acceptable

collateral to the lending agencies. In addition, for taking advantage industries have to develop critical sets of competitive tools. The large industries have research units capable to gather and analyze new technologies in commercial intelligence. But, SMEs, due to their small size and lack of proficiency in technology development are intrinsically in an inconvenient position to reach to this end. This is one of the most important reasons why financiers traditionally lose their interest in investing in multinational corporations (MNCs) (Ahmed, 2003).

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Thus an array of problems is in hand to solve before expecting a significant result from this budding sector. The problems and distinctiveness of many SMEs are akin to those of micro enterprises. These similarities may be identified as no access to formal finance; documentation is either not clear or non-existent, no clear separation of business and private spheres (LFS Financial Systems, an advisory and management firm based in Berlin, Germany). The main difference between micro and SME lending is that SME lending lays greater importance on risk costs while microfinance bothers mostly with administrative expenses (Marulanda *et al.*, 2010). But, these two has some other uniqueness that demands a little wider discussion.

Microfinance refers to financial services for lower income customers who do not have access to adequate formal financial services, and therefore rely heavily on informal financial service providers. It not only includes loans but also comprises deposit facilities, payment instruments and other services required by these customers. This study will identify the reasons for the growth and transformation of SMEs along with their impacts and prospects and other related issues of SMEs and the challenges the SMEs are currently facing in Bangladesh along with attempts at identifying the potential ways to overcome them. The various aspects of study will essentially aim at giving a lead to the up-gradation to the SME status for the enterprises, which exist currently in a status of inferior margin than SMEs in Bangladesh. This study will also focus on financial, technical and technological aspects as a tool of such up-gradation.

2. Literature Review

SMEs and their financing were studied by different scholars. However, institutional

effort is much more noteworthy in studying SMEs of Bangladesh compared to individual efforts. Several industrial policies (1999 and 2005) and Bangladesh Economic Review (2003 & 2004) have taken initiatives to define SMEs for Bangladesh and analyze potentials of the sector. Bangladesh Bureau of Statistics also defined SME from Bangladesh perspective. Cookson (1999) study SMEs' access to bank credit and identified a challenge for this industry clearly. Islam *et al.* (2005) and Siddiquee *et al.* (2006) also contributed to the same aspects of SME related study. Islam (2009) and Ahmed (2001) study the development trends of SMEs in Bangladesh. International Consultancy Group (ICG) & Micro Industries Development Assistance and Services (MIDAS) (2003) and The Swiss Agency for Development and Cooperation (SDC) & Bangladesh Unnyan Parishad (BUP) (1998) study the potentiality of SMEs in Bangladesh economy. In 2004, Government of Bangladesh formed National Task Force to formulate Report on SMEs of Bangladesh. Manu (1988) identified the hurdles in accessing institutional credit as one of the most important problems of SMEs long before deciding over the definition of the sector. However, Ahmed (2001) conclusively made a study to the same end. Ahmed (2003) cleared the need for sound and supportive technology management for SMEs that can faster SME growth and smoothen SME financing. A comprehensive study on the challenges of this sector and ways to overcome is yet to come out. Scholars need to focus on it now.

The main objective of this paper is to identify the problems of SME financing and put forward strategic recommendations for solutions to those problems in Bangladesh. Other relevant objectives of the study are –

1. To explore the emergence of SMEs in Bangladesh.

2. To highlight the prospects of SMEs and the potential contribution of SME financing to the growth of SMEs.

3. Methodology

This problem of the study was conceptualized upon consultation with the financiers and other stakeholders. The relevant national policy, Bangladesh Bank regulations and concerned reports and write ups were analyzed to find the views of the stakeholders. Published statistical data from reliable and recognized sources were also consulted in this regard. Necessary inferences were also drawn from the available qualitative and quantitative data.

Various types of other secondary materials were also analyzed. Several books, articles and some newspapers have been consulted to get a clear idea about the topic of the study with respect to objectives mentioned above. Besides, different other publications like National Task Force Report on SMEs, LFS Financial Systems Report, Bangladesh Bank Circular etc. were also consulted in order to make the paper informative, objective oriented and research-oriented.

This article is mainly based on secondary materials and, therefore, all the data were mainly collected through literature survey. The data used here duly acknowledged all the sources accessed for this study.

The Nature of SMEs

The government of Bangladesh characterizes the medium from large industry in terms of both capital and employment size. Thus, medium industry enterprises are defined as those employing between 50 and 99 workers and/or with a fixed capital investment between Taka 100-300 million (US \$2-6 million) (The Industrial Policy, 1999). But, significant changes were made to the policy in 2005 and a distinction has been made between

manufacturing and non-manufacturing enterprises. From then on, medium industry is defined as units with fixed capital of Tk. 15-100 million (US \$246 thousand - \$1.6 million) excluding the value of land and building while non-manufacturing medium enterprises are those with employment size between 25 and 100 workers. Manufacturing enterprises having fixed assets of less than Tk. 15 million excluding the value of land and non-manufacturing enterprises with fewer than 25 workers are now treated as small enterprise (The Industrial Policy, 2005). However, Bangladesh Bureau of Statistics (BBS) defines SMEs in a different way and they consider enterprises having 10-49 workers as “Medium” industries. The industrial enterprises including cottage industries having less than 10 workers are grouped under the “Small” category (BBS, 2004). The peculiarities that make SMEs different from other financial products are not limited to the fact that these operations are ‘small’ in volume. There are three more characteristic features (LFS Financial Systems) of such operations, which have important consequences for the lending technology:

- i. The clients' income generating activities, including small-scale business, cannot be clearly separated from their families and households.
- ii. The clients cannot provide reliable and sufficient information on their entrepreneurial activities.
- iii. Given the small size of each operation, microfinance can only be profitable if substantial economies of scale are reached.

This study will take these unique features of SMEs to analyze their performance, problems and prospects and place derived findings on it.

Sources of SME Financing

Access to bank credit is always limited for small and medium enterprises. Term loan is almost impossible for them while working capital is a somewhat better source of finance for them. An estimate was made in such a way that 20% - 25% small enterprises have working capital relationships and possibly 50% of medium size firms have working capital relationships. But, 3% - 7% of the small enterprises use term loans what is used by 20% of medium size enterprises (Cookson, 1999). This scenario suggests why small enterprises prefer moneylenders and other informal sources most often. In terms of source of finance, another estimate shows that bank is the most widely used (accessed by 54% of the SMEs) source while self-finance is the source for 46% of the SMEs and family and friends' sources are accessed by 21% of them (Islam *et al.*, 2005). Among the non-institutional sources, friends and families are the dominant contributors than local lenders. This is because it is easier for the borrowers to approach them to get loan on more flexible terms compared to that from other lenders (Siddiquee *et al.*, 2006).

Development Trends in SMEs

Sustainable development of SMEs in Bangladesh is considered a vehicle for accelerating economic growth including

reduction of unemployment and poverty alleviation. Most of the industrial enterprises in Bangladesh are characteristically SMEs by nature. By and large these are labor intensive concerns with relatively low capital intensity. They are also considered cost effective in nature. The SME sub-sector has shown remarkable dynamism, exhibiting reasonably high growth rates over the decades of 1980s and 1990s. Evidence (Ahmed, 1999) iterates that the SMEs were giving birth to 60 percent of the new industrial enterprises during 1980s. Growth in SME employment seems to have been even better during the same period. The annual compound rate of growth of value added by the SME sector not only shots up to 7.7 per cent per annum during 1989/90 and 1994/95, but also it exceeded that of the large-scale industries during most of the 1990s (Islam, 2009). This trend exhibits dynamism and vibrancy of the SME sector except in late 1990s when growth of the sector suffered slightly due to extensive damages caused to the sector by the 1998 floods, especially to its production and capital stock. The scenario got a slow and steady betterment in the last decade. The increasing contribution of SMEs out of total industrial contribution to the GDP can be calculated with the help of available data (Bangladesh Economic Review, 2003 & 2004) from governmental source.

Table 1. Increasing Ratio of SMEs/total industrial sector to the GDP (%)

	Contribution of SMEs/total industrial sector to the GDP (%)	Increasing Ratio of SMEs/total industrial sector to the GDP (%)
1999-2000	4.39/15.40	1:3.51
2000-2001	4.46/15.59	1:3.50
2001-2002	4.60/15.76	1:3.43
2002-2003	4.68/15.97	1:3.41
2003-2004	4.78/16.25	1:3.40

Another important indicator of SME dynamism is reflected through changes in product composition and structural

transformation occurred to the sector over the years. Broadly, four industry categories such as food and allied products, textiles

and apparels, and engineering and fabricated metal products are currently dominant in the SME sector (Ahmed, 2001).

Summarizing the above findings, it can be opined that SMEs have diversified their activities, entry and exit into the sector has become easier and small-scale entrepreneurship has grown significantly in agro-processing in general reflecting some crucial changes that are taking place in the situation of the SMEs in Bangladesh. It is also understood that the Ready Made Garment (RMG) industry has contributed significantly to SME development by providing them with orders for accessories and packaging materials through increased subcontracts to SMEs.

Prospects of SMEs

Numerous surveys have been conducted in Bangladesh on the impacts and prospects of SMEs. These surveys found that there were almost 6 million micro, small and medium enterprises (MSMEs), which included enterprises with “up to 100 workers” employing a total of 31 million people, equivalent to 40 per cent of the population of the country of age 15 years and above (ICG & MIDAS, 2003).

The survey also found that the industrial structure of SMEs consisted of primarily wholesale and retail trade and repairs (40 per cent), production and sale of agricultural goods (22 percent), services (15 percent), and manufacturing only (14 per cent). It reflects on the very fact that the large unused potential for expansion in manufacture and production could be exploited contributing significantly to the national economy. Another vital finding of the surveys under discussion was that SMEs contributed nearly to 25 per cent of the GDP in 2003 (ICG & MIDAS, 2003).

For LDCs like Bangladesh, SMEs may be a highly cost-effective source of employment

too. The current new job seekers together with millions of inactive people are still looking for employment. SMEs may surely be a very good solution to this problem. To compare what it might cost to provide employment with new jobs in the large industries in relation to SMEs, one needs only to look at some of Bangladeshi large fertilizer factories. Chittagong Urea Factory Limited (CUFL) costs BDT 14 billion (\$237 million) to build, and it employs 982 people. The Jumuna Fertilizer Factory (JFF) costs BDT 12.60 billion (\$213 million) and employs 1,082 people. Thus CUFL and JFF required BDT 14.26 and 11.63 million (\$241,000 and \$198,000) respectively for every person to be employed. But, in case of micro-enterprises, set or encouraged by the NGOs for self-employment of the very poor, the investment required per employment is BDT 5,000 (\$85) or less (SDC & BUP, 1998). The comparative scenario puts a very clear idea about the operation and potential contribution of SMEs in eradicating unemployment and reducing poverty together with yielding national economic development.

The study and other relevant observation identifies some concrete and unique features of SMEs that ensures us about its success in employment generation and the sector’s suitability to be focused for ensuring sustainable economic development in the backdrop of poor countries like Bangladesh with poor population. Being an over-populated nation Bangladesh needs to cash on labor-intensive organizations like SMEs. Besides, their need for qualified labor force is less than large enterprises. This is also suitable for countries like Bangladesh where skilled labors are not available at all. SMEs can also create more jobs than large enterprises at lower costs. They have a multiplier effect on development process as well. Apart from these points showing the said suitability, SMEs use little foreign sources as their products are mostly based

on domestic sources and create new markets and market shares. Their flexibility and adaptability to changing environment also help them to survive if they are financed adequately and perfectly. They usually become successful in meeting consumer demand too as they can establish close relations with each other. And, the most important character of SMEs in Bangladesh context is that they do not usually suffer from internal bureaucratic complicacies. Thus, SMEs, with their structure and core products, are set to offer something new and effective with a view to changing Bangladesh and the countries of its like nature very much positively.

Challenges for SME Financing

The main driving force in SME promotion in Bangladesh is in the growth of agro-based processing and essential consumer goods products. Many institutions at the national level are providing assistance to entrepreneurs through SMEs in the country. Industrial credit in Bangladesh is financed through government-sponsored industrial banks; commercial banks and specialized financial institutions (ESCAP, 2003).

The SMEs in Bangladesh face remarkable problems in access to finance for their businesses. These problems hinder the availability of needed amount of fund at the proper time at reasonable rates with suitable terms and conditions facing minimum bureaucratic hurdles. In this backdrop, lack of finance has been identified as the main obstacle of the advancement of SMEs in Bangladesh (National Task Force Report on SMEs, 2004).

The problem in managing institutional finance remains the biggest hurdle facing the SMEs in initiating as well as running and expanding a business. The paucity of continuous access to institutional credit is a recurrent problem and constitutes the most

serious constraint to SME growth and expansion (Manu, 1988). It is well recognized that the problem of adequately financing SMEs is a problem related to lack of certainty. One of the features of SMEs is the uncertainty involved in their activities. However, that is surely not a feature of large businesses. Large businesses have developed from smaller businesses and thereby built a track record – especially in terms of a long term relationship with the bankers. Bankers find the businesses well-run over a period of time upon what the managers can manage its affairs and can therefore trust those businesses while offering bank loans in a proper way (McLaney, 2000).

New businesses, typically SMEs, obviously do not have this track record. Another problem is even worse. Large businesses conduct more of their activities in public, or are subject to external scrutiny SMEs do not go for. But, making information public essentially creates less uncertainty. Many SMEs do not have audits; do not publish their accounts to the press making bankers reluctant about them. Hence, the main problem of SMEs is as how they can get over this hurdle of expressing that they can make good businesses, can make profits if they are provided with required finance.

The practice of collateral based lending followed by banks and other financial institutions also acts as a severe obstacle to SMEs who often does not possess assets what is generally considered to be acceptable as collateral by the institutional lending agencies. In general, SMEs are known for low capitalization, insufficient assets, and their incapacity to come up with collateral requirements. On the other hand, administrative costs for banks and financial institutions (FIs) are high because of close monitoring and supervision required for SME loans. The banks and FIs perceive SME financing as risky investments and

charge relatively higher interest rates to cover portfolio risks. Even the initiatives of central banks may fail in such cases. It is evident from the failure of Bangladesh Bank. Bangladesh Bank's decision to provide SMEs with easy access to loans failed to benefit this sector because of high interest charged by FIs. Banks and non-bank FIs charge as much as 20-24 percent interest rates for the loans provided under the central bank's SME refinance scheme. In line with the government's policy, the central bank introduced a SME refinance scheme (revolving) with Tk 100 crore to increase SMEs' access to bank finance at lower rate in 2004.

The fund was increased to Tk 300 crore in fiscal year (FY) 2007-08 and Tk 500 crore for FY 2008-09. Earlier, the Bangladesh Bank imposed 4 percent interest rates, which was raised to 6 percent. But no FI followed the rate. Later Bangladesh Bank was compelled to withdraw the directive on interest rate in May 2004 and allowed FIs to charge interest rates at their will (Rahman, 2008). As a result, the procedure to get finance from the banks and FIs appeared to be complex to most of the SMEs.

To attain competitiveness in financial market SMEs need to manipulate technological know-how and manage it successfully. Bangladeshi SMEs are yet to show any remarkable success to this end. But, SMEs must be creative and keep on improving technology and techniques. In fact, it is difficult for SMEs to directly invest in or invent any new technology due to their limited resources. But this can be done cheaply through technology transfer (Ahmed, 2003).

This study outlined lots of problems of SME financing by banks and FIs. In short, these challenges can be summarized as inadequate knowledge on ways of 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 etc. In addition to these ones, it is also observed that inadequate and ineffective coordination among concerned government agencies; lack of a functional definition of SMEs that can characterize their unique positions and absence of proper criteria for selecting potential SME entrepreneurs by the lending institutions worsened the financing scenario.

4. Conclusion and Strategy Recommendations

Now-a-days, SMEs are beginning to be adorned for their greater dependence and customized characteristics suitable for developing nations like Bangladesh specially for its labor-intensive production techniques, lessened dependence on imported raw materials and better utilization of production and market potentials. Interestingly, these are the factors which may tailor an industry or enterprise to the need of an over-populated nation like Bangladesh. In this context, researchers and practitioners started to show more and more interest to devise the mechanisms to ensure promotion and development of SMEs with a view to attaining sustainability of the sector. What is noteworthy here is that the first and foremost importance has always been laid upon providing adequate finance to start as well as to run small and medium enterprises.

In a situation where the SMEs are in general unwelcome to banks as well as to the FIs, financial support of any form required for setting up an enterprise, based on new technology or technologies acquired and upgraded, would be hard to come by. It is thus very important that the Government should come forward in a larger way to provide such financial facilities to promote

technopreneurs and develop modern technology-based and knowledge-intensive SMEs. SMEs are still facing an identity crisis too as many are in confusion regarding the criteria to consider an enterprise as an SME. However, in this context, Bangladesh Bank has framed guidelines to be used by the banks and financial institutions in defining SMEs (Bangladesh Bank, 2004). Different other institutions may have different other views that are nursing only confusion regarding this definition. A comprehensive effort of all concerned should remove it immediately.

Experiences of other successful countries with SMEs may also be a guideline for the countries like Bangladesh. In such countries, the support and finance to SMEs are provided both by the government and the private sector. Public-private partnership is also becoming popular in many countries. Some institutional approaches are also essential as alternatives for SME financing from traditional banking system of developing countries which is far from enough. This situation calls for the financial institutions that are especially designed for SME finance. Venture capital for SMEs through special department of banks may appear productive.

The best possible solution to financial problems of SMEs may be establishing specialized banks for it. Such a bank with perfect managerial and legal structure can solve the problems of SMEs effectively. A SME bank has a chance to have access to regional SME savings. SMEs may also mull over becoming shareholders of such a bank with a view to enlarge their capital structure. Having a certain market share and a stable position, such a SME Bank can also start to compete with commercial banks.

Identifying the technological needs of SMEs is essential when formulating an appropriate

technology management strategy. An enterprise technology strategy must be taken into consideration. The following issues or queries may offer a guideline for it:

- Considering how technology supports the business strategy of the SME;
- How technology can be utilized as a source of competitive advantage; and
- What actions in technology development and/or acquisition and/or transfer to be undertaken to achieve the organizational objectives.

Another approach may be the development of SME Division of Commercial and Development Banks. It is going to be very effective if commercial banks could establish divisions especially designed for SME financing. Commercial banks traditionally hesitate to accept long term financing as one of their normal activities. This characteristic of commercial banks should encourage them to go for establishing their SME divisions. But, such divisions can become efficient and effective only with the support of government funds. Central Bank should form a fund for SME financing of commercial banks. Another major problem of SMEs is in finding guarantees. The establishment of credit back-up funds by the government can eliminate this problem. Other than providing credits, different financing methodology can be designed for SMEs too.

The last approach, venture capital, is most probably the best possible long-term funding for SME's. Foreign funds originating from international development organizations can decrease the associated financial risk. Again, it can enable the exchange of shares where financial institutions may consider selling them

anytime. Developing regional financial markets will also create demand for SME shares.

Bangladesh is have proven capacity in overcoming many business challenges and winning the market if they are properly supported by the government and a conducive atmosphere required for it. Today's entrepreneurs are highly capable and have good exposure to the world. What they cannot do is solving problems that are beyond their capacity. The problem of arranging adequate finance and making it easily available to the entrepreneurs are the most important of those ones. Government should come forward to solve these problems with the highest priority. And, if the government can do so, the entrepreneurs will surely give their highest return for the nation.

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