Business Finance
for the Poor
in Bangladesh

POLICY BRIEF

Review the SME credit-related policies of Bangladesh Bank:

Identify areas of further improvement by focusing on MSE Finance.

July 2017

List of Abbreviations

ACSPD	Agriculture Credit and Special Programmes Department
ADB	Asian Development Bank
BB	Bangladesh Bank
BFP-B	Business Finance for the Poor in Bangladesh
BRPD	Banking Regulation and Policy Department
CGS	Credit Guarantee Scheme
CIB	Credit Information Bureau
CmSME	Cottage, Micro, Small, and Medium Enterprise
DFID	Department for International Development (UK)
EDP	External Development Partner
FI	Financial Institution
FID	Financial Inclusion Department
GOB	Government of Bangladesh
IGA	Income-generating activity
InM	Institute of Microfinance
IP	Industrial Policy
KYC	Know-Your-Customer
mE	Micro Enterprise
MFI	Microfinance Institution
MOF	Ministry of Finance
MOI	Ministry of Industries
MRA	Microcredit Regulatory Authority
mSE	Micro- and Small-sized Enterprise
mSME	Micro, Small-, and Medium-sized Enterprise
NBFI	Non-bank Financial Institution
NPL	Non-performing Loan
PAC	Policy Advisory Committee
SE	Small Enterprise
SME	Small- and Medium-sized Enterprise
SMEDS	Small and Medium Enterprise Development Strategy
SMEF	Small and Medium Enterprise Foundation

Issues discussed

Three broad areas discussed on which recommendations are made include:

a. a suitable and unified definition

b. developing two separate policies for financing different enterprise segments, and

c. for further improvements of Bangladesh Bank's current MSME (financing) policy.

On mSME definitions

Bangladesh Bank's SME financing policies currently follow the definitions provided in Industrial Policies. There is however a need to draw lessons from practices and assess the relevance of such definitions at operational level. Trading is no more an enterprise in IP 2016, but service includes few listed mSME.

Perspectives on mSMEs

Independent of facilitating the country's industrial development strategy and public policy of redistribution, two institutional dynamics originating from commercial banks/NBFIs and the MFIs may justify BB's role in promoting a product named 'mSME'. Banks would like to target potential clients on the fringe with small loan sizes, peculiarities in time-path of demand and repayment. At the other end, MFIs feel their clients have graduated out of IGAs and demand bigger loan size.

Journey from SME to CmSME Policy

Bangladesh embarked upon small and medium enterprise (SME) policy during 2003-04. The Bangladesh Bank (BB) had formulated guidelines for Small Enterprise (SE) financing by 2004, and the Ministry of Industries (MOI) had the Policy Strategies for development of SMEs in print by 2005. The modality of resource transfers under the SME Development Project (SMEDP) of the Asian Development Bank (ADB) had got entangled with the larger debate on relative merits of financing though banks as opposed to technology transfers through MOI or agencies affiliated with it. The urge to identify beneficiary enterprises led BB to define various segments of enterprises in 2007, which were subsequently notified via ACSPD Circular of 2008. With the Industrial Policy (IP) 2010 spelling out the definitions, BB chose to align its definitions accordingly to guide SME-targeted lending activities of participating banks and NBFIs. The IP 2016 adapted a new set of definitions for CmSMEs, which are summarised in Table 1.

Various Perspectives on SME

There are several perspectives on SMEs, differing across policymakers in industries and finance, and across regulators and technocrats. **First,** SMEs are a clientele group who could not be reached out with the financial products and the delivery mechanisms traditionally practiced by the commercial banks. Often, the latter associates the potential client on the fringe with small loan sizes, peculiarities in time-path of demand and repayment, and with those having legal entitlements perceived by lending community inadequate as securities to guard against risks. It is perceived that certain initial supports, on both demand and supply sides of the market, the banks may be able to break the inertia and engage in a sustained path of win-win exchange. **Second,** those in public policy domain justify assistance to the 'smaller' (and poorer) entities on grounds of redistributive justice. **Third** is a technocratic-economic perspective that takes cognisance of industry linkages and presumes that failure to perform among some of the weaker segments in the links may lead to greater loss in the economy. Thus, reaching out to those segments with special efforts is justified on ground of aggregate return to the economy. **Fourth** is an 'institutional' perspective rooted in the spectacular growth of MFIs in Bangladesh. The demand for increasing loan sizes continues to grow, and there has also been a gradual shift in portfolio from home-based income-generating activities (IGAs) to cottage and micro enterprises.[1]

[1] There is also the case of start-ups, or, the "Startupreneurs", a term recently coined for new entrepreneurs . In the absence of prior information to assess risks in lending to Startupreneurs, the banks as well as the non-bank financial institutions (NBFIs) have generally avoided them. It has largely been the venture capital firms who dominate such lending. Since functioning of venture capital firms are within the jurisdiction of SEC, the links between SMEs and 'start-ups' have hardly received any attention.

Table 1: Definition of CmSMEs in Industrial Policy 2016

Enterprise Type	Economic Sector	Value of Total Fixed Asset (Taka)	Employment # of workers
Cottage	All Cottage	Less than 10 lakh	Less than 15
Micro Enterprise	Industry	10 - 75 lakh	15 - 30
	Service	Less than 10 lakh	Less than or equal to 15
Small Enterprise	Manufacturing	75 lakh - 15 crore	31 - 120
	Service	10 lakh - 2 crore	16 - 50
Medium Enterprise	Manufacturing	15 - 50 crore	121 - 300
	Service 2	2 - 15 crore	51 - 120

Notes : 'Total Fixed Assets' excludes land and buildings. Under manufacturing in Small and Medium enterprises, the restriction on employment size does not apply to RMG or other labour-intensive production.

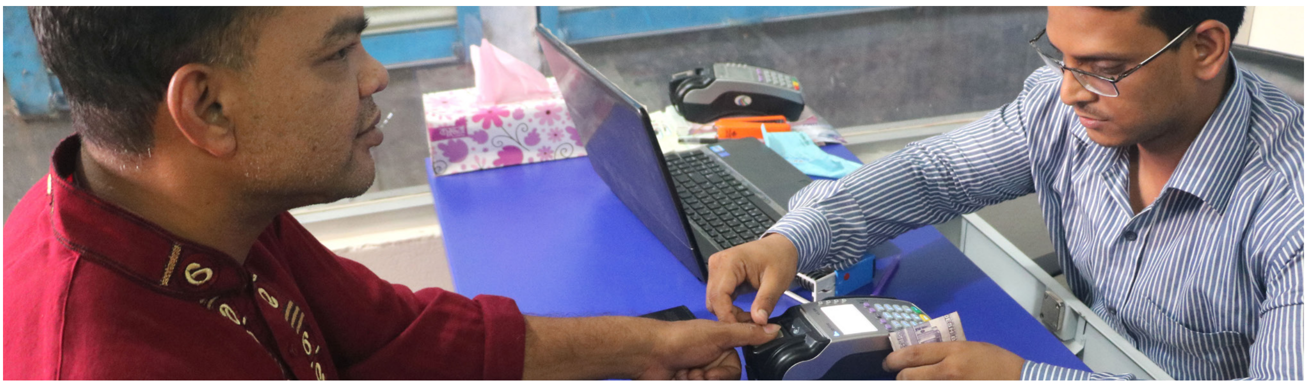
Source : National Industrial Policy (in Bangla), Ministry of Industries, 2016.

Refinancing and Loan Provisions

Banks lending to SMEs were refinanced by BB at low interests, and no obligation was imposed on banks to reduce lending rates. Major attraction had been 0.25% loan provisioning for unclassified SME loans. Policy on SME branches helped to bypass previous restriction.

BB's mSME Policy in a Multi–Actor Financial Market

While the target mSME beneficiaries are identified in the Industrial Policy and the SME development strategy, it is the Bangladesh Bank, along with the Ministry of Finance, who formulate the relevant financing 'policies' and oversees their implementation. Clearly, preferences of funding agencies, choice of target, and of financial and non-financial services/ benefits, along with delivery mechanisms, are all inter-linked. Figure 1 outlines the broader institutional canvass within which Bangladesh Bank's mSME credit policy, guidelines and regulations operate. BB clearly engages in multiple roles - beyond the traditional regulatory roles, it undertakes activities to promote government's development objectives, acts as service provider, and occasionally implements/facilitates projects involving financial institutions as partners. In its very last role, one finds significant BB presence in promoting mSME financing. Policy instruments for realising the latter, conveyed as BB's directives to the banks and NBFIs, include, refinancing, reduced loan provisioning, opening of SME centres/branches, etc. Few details on these are provided in Box 1.



Box 1: **Key Instruments to Incentivise Banks to engage in Lending to mSMEs**

Refinancing:

100% refinancing against disbursement of both working capital and term loans to SE sector (ACSPD Circular 01, 2/05/2004) and subsequently extended to MEs (in 2007). The facility has not been available for personal or consumer loans, and a bank is eligible to avail it only if the share of classified loan in its portfolio was less than 10%. Even though the policy meant to facilitate lending at lower interest rates, the circulars allowed lending banks or financial institutions to apply their own interest rates on loans made to ultimate borrowers. With declines in deposit rates and costs of fund, the facility is no more in demand among the better-performing banks.

Loan Provisions:

Under maintenance of provisions (BRPD Circular No. 14, 23/09/2012), banks are required to maintain General Provision @ 0.25% against all unclassified loans of SMEs, and @ 1% against all unclassified loans (other than loans to consumer financing, brokerage house, merchant banks, stock dealers, special mention account, as well as SME financing). At the cost of increased risk to financial health, reduced requirement of loan provisioning increases the volume of redistributable (post-tax) profit, thereby increasing the size of fund available for bonuses and dividends. A numerical illustration is provided below:

For every 100 taka disbursed, pre-tax profit is 5 taka and post-tax profit is 2.875 taka [5*(1-0.425)], when tax on profit is 42.5%. With 1% loan provisioning, redistributable profit is 2.875 – 1.0 = 1.875 taka.

Redistributable profit increases to 2.625 taka if loan provisioning is 0.25%. The additional (2.625 –1.875=) 0.75 taka can be expressed as 26.09% of pre-tax profit.

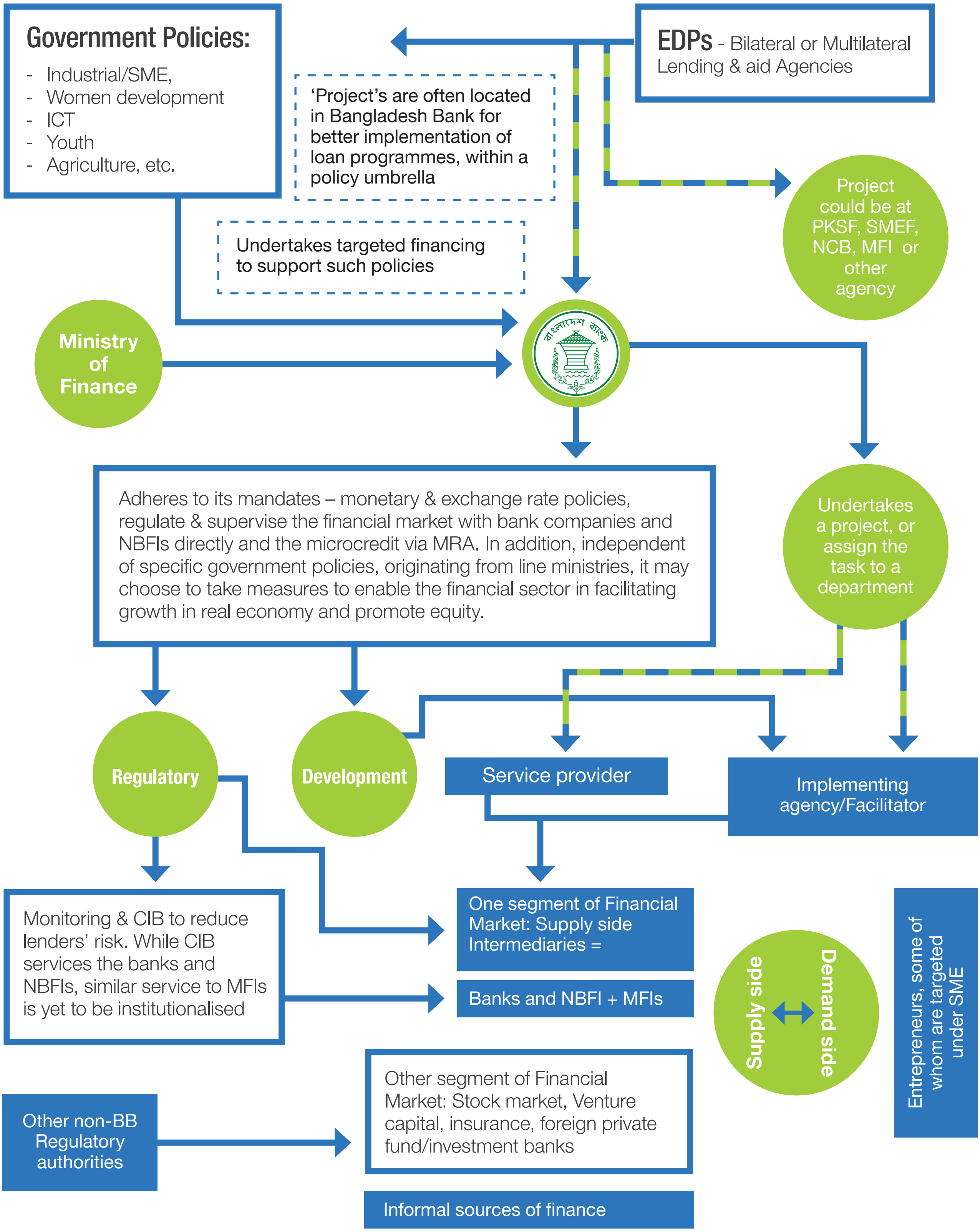
Tying in Credit Rating with share of loan disbursement to SMEs:

The weight of the share variable is reported to be hardly 1% in total rating, and is reported to have had very little influence.

SME centres or SME Branch:

BRPD Circular Letter No. 06 of 04/05/2008 accorded permission to open SME Service Centres **(i)** 'to render banking services only for receiving applications, disbursement, monitoring and recovery of loan' to SME sector; **(ii)** allowed to receive foreign remittances and deliver/ hand over the same in domestic currency; and **(iii)** allowed to open a separate desk in order to prioritise the women. The facility provided banks an opportunity to bypass restrictions on opening branches in urban areas, thereby, facilitating expansion of formal banking into pockets of intense commercial activities (such as, old Dhaka) which had significant presence of informal exchanges,

Figure 1: Contextualising BB's 'SME Credit Policy' within a larger Canvass



Note: In addition, there are three agencies which are to be accounted for: (i) NCBs under the supervision of Banking Division of M/O Finance, and administering separate microcredit and SME credit programmes; (ii) SMEF under the Ministry of Industry, focused on enterprises, often linking those with sources of fund, including commercial banks; and (iii) PKSF, a credit wholesaling agency, formally under the Ministry of Finance, and keen on tying their borrowers with technology and marketing agencies in order to reduce risk in their lending.

Issues and Policy Recommendations

1. On an umbrella Policy

Need for a Policy on DevFin

BB may benefit by formalising a development financing policy that distinguishes between ‘targeted’ financing from ‘all inclusive’ programmes, and has current mSME financing to implement MOI strategy under targeted financing.

BB’s current SME financing programmes primarily confine to promoting MOI’s industrial (and SME) development strategy. There are also other special financing programmes, such as that for women entrepreneurs, which overlap with mSME financing by BB. Policymakers recognise BB’s role in supporting development finance, which is perceived to cover issues beyond mSME. It is therefore recommended that a unified development financing policy framework be developed that addresses working through or with, **(i)** private (and foreign) commercial banks and non-bank financial institutions; **(ii)** nationalised commercial and development banks; **(iii)** with MFIs in partnership with MRA; **(iv)** other ministries and departments with the government who need support on the financial front; and **(v)** other development agencies, including external development partners, who may be keen on promoting a target sector and need collaboration with domestic financial organisations. It is further recommended that the policy framework distinguishes between ‘all inclusive’ (that is, non-discriminatory) and targeted financing, and within the latter, provisions be kept to facilitate financing for realising objectives of other line ministries and/or partnering with external lending/development agencies.

2. Importance of Definitions and steps to improve those

Operational definition through data analysis and exchange of experience

BB may benefit by formalising a development financing policy that distinguishes between ‘targeted’ financing from ‘all inclusive’ programmes, and has current mSME financing to implement MOI strategy under targeted financing.

Definitions are important for operational management of targeted programmes. In implementing mSME financing programmes, either designed by external development partners or by MOI and other line ministries, the banking practitioners claim to have made little use of the definitions in terms of value of fixed assets (excluding land and building) and employment on account of measurement difficulties. Clearly the excluded items come handy in defining collateral. Reportedly, the practice has been to assess (entrepreneur) clients based on business turnovers and using loan sizes as proxies while reporting on various entrepreneur categories. Since the IP2016 has been approved by the Cabinet and no change may be forthcoming in immediate future, BB may consider working towards fine-tuning its targeted financing policy and improve targeting strategy with meaningful definitions (of targets), taking cue from the experiences of mSME financing. Several actions, to be spearheaded primarily by BB’s research and policy wings, are proposed below towards realising such goals.

A target population needs to be defined in terms of observables which may be uniformly assessed by all implementing agencies, be it for BB’s own pursuits or to support government’s focus on

'access to finance' to some 'priority sectors'. Such observables may include territory (e.g. rural, or specific districts or upazilas), population segment like women or the 'urban poor' or narrowly defined economic activities (e.g. agro-based light engineering, backward linkage industries supplying to a firm in the formal sector), or even, a list of enterprises to choose from. Current definitions of mSMEs, based on value of fixed assets (minus land and building) and/or employment size, apply to economic sectors that are perceived too wide for effective use in targeting financial services. It is recommended that, where applicable, these be defined at disaggregated levels of more homogenous activities, or, by proxy observables (such as, turnovers and loan sizes) that financial institutions are accustomed with.

Extending the frontier

Beyond needs to complement MOI strategy, BB may find mSM product useful in reaching out to the ones outside the current net of formal banking and MFIs.

Independent of the concerns for enterprise/industrial development, banking operations have issues in dealing at the margins, and pro-active initiatives to deal with those, particularly in the conventional banking sector, got a boost under the package of SME financing. Inclusion of Micro (m) under the agenda is perceived to have similar bearings for the MFI sector, which is regulated by MRA. In the context of banking, efforts towards financial inclusion from two ends have often got mixed up with the agenda for industrial/enterprise development. It is important that BB sorts this out to avoid duplications that often hide failures in attaining the prime objective used to justify initial programme design. In case BB chooses to continue with mSM clients/ enterprises, it will have liberty to define micro, small and medium that are appropriate for capturing the clients at the 'extensive margin', and look for suitable proxies and thresholds.

Thus, a two-fold approach is recommended on definition; (i) continue with the status quo defined by line ministries or EDPs, but initiate pro-active engagement to translate those to proxies that are easily observable for better targeting, and (ii) undertake research and product development to reach out to entities in the immediate exterior of the current net of bankings from two ends — commercial banks and the MFIs.

There is an additional aspect to take note of with regards to definition. While financing to support MOI's strategy may not need to accommodate trading, BB may like to pursue the efforts to widen the net of the formal financial sector under the guise of micro and small 'enterprises'. If unattended, a drastic reduction in lending using the mSME window is expected.

3. On two separate policies and institutional arrangements

The two markets served by commercial banks and MFIs are segmented, and stakeholders as well as the products (and interest rates) are not comparable. Enterprise development may be better promoted by assigning the two segments to different groups of supply-side stakeholders, wherein the problems of expanding

Need for two separate policies for different segments

Commercial banks and MFIs serve two different markets, segmented by characteristics that sustain different interest rates and financial products. mEs and SEs are present in both segments, which may be better served separately by two different vehicles - banks/NBFIs and MFIs. Thus, two separate policies should be formulated.

the financial net at margin is dealt with separately. It is also recommended that two separate CmSME policy frameworks for lending programmes be developed: **(i)** to guide MFIs in reaching out to cottage and micro-enterprises, and subsequently to small-enterprises without succumbing to mission drift; and **(ii)** for formal banks and non-bank financial institutions, encouraging them to extending their lending to small and micro-enterprises. The former is within the domain of MRA's supervisory role, and BB may provide the general guideline in the proposed unified policy on development finance. The latter is clearly within the jurisdiction of traditional banking organisations, thus demanding direct attention of BB policy. Since major MFIs already have data on their lending to micro enterprises, having a CIB for MFIs and establishing real time exchanges via the two CIBs will facilitate collaboration between the two segments.

The ERG report also notes the presence of mSEs, particularly, "micro", in the two segments. Those however differ in characteristics across the two segments, not captured by the definition currently in place. It is therefore recommended that the two be considered separately and distinctions be made in terms of segment-specificity. There exists another segment consisting of those willing to borrow but not included in the financial/lending net due to either high transaction cost or high risk in lending to them. While the former issue is increasingly being resolved with the advancement of technology and engagement of Bangladesh Bank's Financial Inclusion Department, Bangladesh Bank can address the latter by including measures to reduce risks in its mSME financing policies. Introducing Credit Guarantee Scheme under appropriate authority, avoiding potential conflicts between roles of regulator and service provider, is recommended. In addition, Bangladesh Bank needs to develop strong in-house capacity for developing appropriate financial products.

4. On improving Bangladesh Bank's current lending policies

Lending policies pursued by commercial banks and NBFIs follow a strict regime of Bangladesh Bank prescribed guidelines comprised of strict due diligence, credit risk management, collateral requirement, property mortgage and loan documentation, loan classification, provisioning against non-performing loans and write–off policies. Very correctly, these principles have been introduced for prudent management and recovery of loans. These elaborate procedures however have not been found effective and workable in case of small loans. Drawing upon lessons from MFIs loan assessment criteria and collection methods, it is recommended that Bangladesh Bank permits liberal treatment for small loans, a threshold determined on the basis of borrowers' creditworthiness, track record and personal guarantee of family members. It is also recommended that the feasibility of introducing group guarantee be looked into, particularly, with a view to promote mSMEs through cluster financing. It is also recommended that separate statement be prepared for public knowledge on weighted average (lending) rates and performance statistics (NPL) so that the non-comparable price and performance indicators are not mixed up.

Incentives such as through refinancing or loan provision can only work if there is cost-effective monitoring and the monitor-cum-regulator remains immune from all allurements. This can be achieved through increased usage of IT, already underway. To this end, Bangladesh Bank will need to develop a unique (generic) software, which the participating banks will adopt allowing BB to effectively access and process information.

Refinancing at appropriate interest rates, with bars on eligibility for poorly performing banks and NBFIs, is found to have worked. However, it is recommended that the interest rates stipulated in any programme design be made flexible over a programme period, with benchmarks drawn from market data. In contrast, reduced loan provisioning may have contributed adversely to the health of the banking sector, and the ERG report recommends that the issue be critically examined, and appropriate decisions be made on the choice of such instrument.

Bangladesh Bank's mSME financing policy also needs to formally recognise the importance of product design and its relative merits in targeting segments of business enterprises. Several proposals raised in the SME development strategy of MOI on innovative financing (e.g. value chain financing, work-order financing, factoring etc.) should be actively pursued with a view to reach out to the marginal enterprise segments in each of the two markets. For transparency as well as to decrease the asymmetry in information, it is also advised that an open access e-platform be developed to enable loan applicants to know the status of their applications, eligibility criteria for accessing special programmes etc, including a dynamic B2B e-commerce platform to access market information and conduct buyer-seller interaction.

BFP-B Project

BFP-B is a programme funded by UKaid from the British Government. The Bangladesh Bank is the implementing agency, and the Bank and Financial Institutions Division (BFID) of the Ministry of Finance, Government of Bangladesh, the executing agency of this programme. Nathan Associates London Ltd. is the management agency. BFP-B is a multifaceted programme, aimed at bringing poor and marginalised people into the formal financial sector and promoting overall inclusive economic growth in Bangladesh. The programme targets 'access to finance' for Micro and Small Enterprises (MSEs) that are currently unserved / underserved by the formal financial sector.

BFP-B Partners

Bangladesh Bank

Bangladesh Bank, the central bank and apex regulatory body for the country's monetary and financial system. The key functions of Bangladesh Bank are formulation and implementation of monetary and credit policies, regulation and supervision of banks and non-bank financial institutions, promotion and development of domestic financial markets, management of the country's international reserves and issuance of currency notes.

www.bb.org.bd

UKaid

BFP-B Project is funded by UKaid from the UK government through the Department for International Development (DFID) which leads the UK's work to end extreme poverty that includes ending the need for aid by creating jobs, unlocking the potential of girls and women and helping to save lives when humanitarian emergencies hit. The UK government is currently among the largest bilateral donors to Bangladesh.

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This policy brief has been prepared by extracting the findings of the study on 'Review of SME Credit-related Policies of Bangladesh Bank: Areas of further improvement with a focus on Micro and Small Enterprise (mSE) Finance' conducted by Economic Research Group (ERG) for the Business Finance for the Poor in Bangladesh (BFP-B) Project funded by the UKaid/ DFID. The views expressed in this study report are entirely those of the authors, and do not necessarily reflect the views of BFP-B Project, DFID, ERG or any other affiliated organisations.

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Funded by — UKaid from the British people

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