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Policy, regulatory reforms to facilitate SME financing

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The focus on the small and medium enterprise or SMEs, as they are called, is a departure from concentrating only on large businesses as the route to generate income and employment opportunities of a significant number of people in a country like Bangladesh. SMEs are typically labor intensive industries with relatively low capital intensity and as such for Bangladesh, which is a labor abundant and capital scarce country, SMEs have a natural competitive advantage.

In recognition of the importance of the development of SMEs in promoting growth, employment generation and poverty reduction, the SMEs have been declared as a priority sector in the governments' Poverty Reduction Strategy Papers (PRSPs), the Industrial Policy 2005, and the Draft Industrial policy 2009.

Despite its importance, availability of finance is thought to be a major constraint to formation and growth of SMEs in Bangladesh. Banks and financial institutions are somewhat reluctant to expand their SME credit portfolio because they do not consider SME lending an attractive and profitable undertaking.

In this article attempts have been made to bring out some major issues on SME financing and highlight the importance of some policy and regulatory reforms to operationalise a "holistic" approach to development of SMEs in Bangladesh.

The premise for SME financing: Finance, though is not the only factor for business, but it is the most vital and basic element for any business to start and continue to stay in business. More than a century ago, the outstanding economist Adam Smith said "Money says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little" (Adam Smith, 1937: "An Inquiry into the Nature and Causes of the Wealth of Nations", Edwin Cannan (Ed.), The Modern Library/ Random House Inc., New York). It is a well known fact that it is very difficult for the SMEs to get fund from the banks and financial institutions for various reasons. These are mainly as follows:

(a) Banks and financial institutions are reluctant to expand their SME credit portfolio, because they do not consider SME lending attractive and profitable undertaking.

(b) Banks and financial institutions consider SMEs as high risk borrowers.

(c) SMEs have low capital base, insufficient assets and they are unable to comply with collateral requirements of the banks.

(d) SME requires close monitoring and supervision by the financing institutions which consider such administrative cost high and extra burden on them.

(e) Interest rate charged by banks and financial institutions are considered to be quite high.

(f) Time taken by banks and financial institutions to appraise loan requests of SMEs is quite long.

(g) The disbursement process of fund to SMEs is also lengthy and complex.

To overcome, the above problems, the access of SMEs to the range of financial services need to be considered in terms of banking of the un-banked. Further to this, SME enterprises lack of awareness and procedures (which make the hesitant to approach banks and financial institutions) must be removed.

SME scenario in Bangladesh: Definition of what constitutes a small and medium enterprise varies considerably across the countries of the world. The OECD for example, defines SME as independent firms employing fewer than 250 employees. However, a typical SME is much smaller than that. Bangladesh Bank under its refinance scheme, divides SMEs into two broad categories: Small and Medium enterprises covering three types of businesses: Service concern, Trading concern, and Manufacturing concern. In the small enterprise category, depending on the business type, an enterprise should have total assets (at cost) excluding land and building within a range of Tk. 50000 to Tk. 15 million employing upto 50 persons. In the medium enterprise category on similar criteria, an enterprise shall have total assets (at cost) within a range of Tk. 5.0 million to Tk. 200 million employing upto 150 persons.

These categorisations provide scope for wide variations in investment and employment amongst SMEs which require calibrated procedures with flexibility and innovativeness on the part of the banks and financial institutions. This is quite a challenging job for all the stakeholders involved.

The Industrial Policy of Bangladesh 2005 recognised four categories of industries: "Large industries" employing 100 or more workers having a fixed asset (excluding land/building) of over TK.100 million, "Medium Industries" employing between 25-100 workers and having fixed asset ranging between TK.15-100 million, "Small Industries" employing less than 25 workers with investment of less than TK.15 million, and "Cottage Industries" which is mainly managed by family members.

What makes SMEs so vital to an economy, however, is the fact that, although each enterprise is relatively small, their contribution is quite high. SMEs contribute over 55% of GDP in the OECD countries and between 60 to 70% of GDP in middle-income and low-income countries. In Japan, China, South Korea the contribution to GDP are in the range of 47% to 70%. In India, SMEs contribute about 80% of their industrial sector output. The contribution of SMEs to Bangladesh GDP is in the range of 20% to 25% though SME contribution to total employment is about 40%.

It should be pointed out that SME is not a monolithic entity- there is an array of diverse nature of entities, which necessitates calibrated policies and programs, not blanket or omnibus types of policies and programs.

Improving the roles of banks and financial institutions: When we look at the issue of SME lending, two sets of problems from the demand side (the enterprise) and the supply side (the banks and financial institutions) interact and as such the solution of the problems has to address both the demand and supply sides.

The major problems from the demand side of SME are:

(a) High interest rate

(b) Tenure and structure of loan are not appropriate

(c) Lengthy and complex process to get loans.

(d) Lack of information on SME financing.

(e) Lack of business advisory services.

From the suppliers' point of view the problems are:

(a) SMEs are risky enterprise

(b) Profits from SME loans are not adequate

(c) Insufficient funds for SME

(d) Processing of loans is difficult and supervision cost is high.

These two sets of problems along with policy and regulatory implications, if not addressed in a "holistic" approach, may create what is known as "growth trap". The net effect of which yields a "missing middle" in the financial domain of a country. It must be remembered that the term "missing middle" should not be limited to financial connotation only, the non-financial aspects like marketing, management support, training, supervision and monitoring to expand and improve the efficiency of SMEs should also be considered. In this backdrop, we should attempt to

(a) Motivate the banks and financial institutions to give special emphasis on SMEs,

(b) Find ways and means to minimise costs for management of SME financing

(c) Expand refinancing facilities for SME sector

(d) Extend training of officials dealing with SME financing.

(e) Improve supervision, monitoring and customer relationship.

(f) Develop SME Data Bank

(g) Establish Risk Fund or Guarantee Fund to cover risks

(h) Expand innovative financial products like factoring, collateral free loan.

(i) Devise rating of banks by introducing SME financing performance into CAMELS rating of Bangladesh Bank.

(j) Improve information dissemination and business advisory services to the small and medium entrepreneurs.

(k) Expand banking networks through branches, SME Service Centres, Agent Banking in the areas of potential SMEs to increase income and employment opportunities.

(l) Adopt modern IT to introduce "e-banking" to reach the un-banked and poor people.

Policy and regulatory measures: SMEs were not seriously considered in the government industrial investment policies during the past three decades. The industrial policies in the early decades centered on public sector and private sector led development. In 1986 Industrial policy, SME was given some priority. The Industrial Policy of 2005 took a big step to formulate SME policy which identified 11 industries as "boosters". The Poverty Reduction Strategy Papers (PRSPs) of the past governments identified SMEs as vital activities of a greater part of poverty group. The Draft Industrial Policy 2009, recognises deeper role of SMEs and so considers SMEs for broad financial inclusion. However, it must be pointed out that heavy demand upon scarce development resources precludes providing big direct assistance to the majority of SMEs. Providing an improved policy environment and removing undue policy and regulatory constraints, is more pragmatic, efficient and implementable.

Over the past three decades, economic policy biases and poor implementation of SME promotion programmes have often put constraints on SMEs growth and might have diminished the positive effects of direct credit or technical support to them. The Harvard Institute for International Development (HIID) led study in 1986 found a complex set of policies affecting small scale enterprises (SSEs). Monetary, fiscal, labor, trade, price and regulatory policies had, in the past, favoured larger enterprises and hindered efficient growth of SMEs.

What then will be the policy and regulatory reform priorities in Bangladesh?

There is no straight answer to that because standardised policy - regulatory packages can not meet all needs of all diverse enterprises in the SME sector. But that does not mean we cannot follow some guidelines for reforms. The first criterion to pursue the reforms is to address the premise for SME financing discussed in section 2 of this article and to pave the way to implement the suggestions made in Section 4. The second criterion for reforms is to eliminate all policy bias against SMEs.

The third criterion for reforms is to have a mix of neutral and targeted policies. Among most important targeted policies may be direct participation in the financial market through state-owned enterprises and selective protection to some categories of SMEs. Such measures may include reducing lending rate for SMEs and devising SME friendly structure and tenure of loan. Since targeting by public intervention is not always inclusive and efficient, the fourth criterion of reforms should be to adopt a participatory and decentralised approach to involve local government entities, private sector, non-government organisations (NGOs), trade bodies, advocacy groups, and community based organisations (CBOs) for dialogue on policies and regulations, and their effective enforcement.

In many countries including Bangladesh SMEs grew without an integrated approach and sound backing from the formal sector. Finances of SMEs in Bangladesh have come either through equity or from informal sources like family and friends. Banks and financial institutions should be SME friendly, flexible and innovative. It is high time for making the policies and regulations pragmatic and SME biased, avoiding rhetoric. Policy makers should be totally dedicated to the task of eliminating bureaucratic red tape, simplifying tax regimes, increasing access to different types and forms of financing and markets and reducing regulatory burdens. There are already signs of positive stance from the government, Bangladesh Bank, SME Foundation, different trade bodies, NGOs and advocacy organisations. Policy makers and financial institutions should have a common aim, because SME is a vital part of the economy and SME is a good and prospective business. This will lead to speedy and sustainable growth of SMEs in Bangladesh. Borrowing a quotation from Giles et al. ("Economics of Development", New York: Norton, 1987) we can conclude that SMEs are expected to "generate more employment, permit greater decentralisation, promote income equalisation, and mobilise latent entrepreneurs" in Bangladesh.

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