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FINANCE, COMPETITIVENESS & INNOVATION INSIGHT | FINANCIAL INCLUSION, INFRASTRUCTURE & ACCESS

Financing Solutions For Micro, Small And Medium Enterprises In Bangladesh

WORLD BANK GROUP

pri Policy Research Institute

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
ADR	Alternative Dispute Resolution
BACH	Bangladesh Automated Clearing House
BASIC	Bank for Small Industries and Commerce
BBS	Bangladesh Bureau of Statistics
BFID	Bank and Financial Institutions Division (Ministry of Finance)
BIAC	Bangladesh International Arbitration Center
BPC	Business Promotion Council
BSCIC	Bangladesh Small and Cottage Industries Corporation
IB	Credit Information Bureau
CGS	Credit Guarantee Scheme
CIB	Credit Information Bureau
CIC	Credit Information Companies
CRS	Credit Reporting System
DFS	Digital Financial Services
ECGS	Export Credit Guarantee Scheme
EFT	Electronic Funds Transfer
EGBMP	Enterprise Growth and Bank Modernization Project
FCI	Finance, Competitiveness, and Innovation
FIRST	Financial Sector Reform and Strengthening Initiative (World Bank)
FSPDSME	Financial Sector Project for the Development of Small and Medium-Sized Enterprises
FY	Fiscal Year
GDP	Gross Domestic Product
ICT	Information and Communication Technologies
IDLC	Industrial Development Leasing Company
IFC	International Finance Corporation
IFI	International Financial Institution
InM	Institute for Inclusive Finance and Development
JCAP	Joint Capital Markets Initiative
JICA	Japan International Cooperation Agency

JPY	Japanese Yen
LFS	Labor Force Survey
MFIs	Microfinance Institutions
MFS	Mobile Financial Services
MOI	Ministry of Industry
MRA	Micro-Credit Regulatory Authority
MSME	Micro, Small and Medium Enterprises
NBFI	Non-bank Financial Institution
NGO	Non-governmental Organization
NPL	Non-Peforming Loan
NSDC	National SME Development Council
OECD	Organisation for Economic Co-operation and Development
PFI	Partner Financial Institutions
PRI	Policy Research Institute
R&D	Research and Development
RMG	Ready-made Garment
RSF	Risk-Sharing Facility
SBA	Small Business Administration
SBIC	Small Business Investment Company
SCI	Small and cottage industry
SEF	Small Enterprise Fund
SMEs	Small and Medium Enterprises
SMEDP	The Small and Medium-Sized Enterprise Development Project
SMEF	SME Foundation
SMESDP	Small and Medium Enterprise Sector Development Project
SOB	State-owned banks
SOFI	State-owned financial institution
STR	Secured Transaction Law
Tk	Bangladeshi taka
TSL	Two-Step Loan
UK	United Kingdom
USAID	United States Agency for International Development
US$	United States Dollar
VC	Venture Capital
WBG	World Bank Group

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EXECUTIVE SUMMARY

Improving access to finance for micro, small and medium enterprises (MSMEs) is a fundamental challenge at the heart of a country's financial and economic development; debates continue over the design and effectiveness of MSME policy. This report presents a desk review of the financing gap, constraints and policies related to the MSME financing in Bangladesh. It aims to provide relevant policy recommendations at a critical time when past policies can be objectively evaluated, and as innovative and alternative instruments emerge, thereby presenting as a unique opportunity to address these financing challenges.

Despite significant knowledge gaps, MSMEs are undoubtedly the backbone of non-farm job creation in Bangladesh. The country lacked a uniform MSME definition until the 2016 Industrial Policy. It now needs to promote this as a unified definition at the policy level, while also improving relevant data collection and analysis. Nevertheless, the 2013 Economic Census and Enterprise Survey of the same year provide important insights. Some 99 percent of all non-farm enterprises fall into the micro and small enterprises categories, providing employment to 20.3 million Bangladeshis workers in 2013. Most of these enterprises are informal and focus primarily on trading activities. As such, they face a substantial productivity challenge. Women's economic participation lags expectations given the country's current development stage.

Access to formal finance by MSMEs is limited compared to the average for the South Asia region, with an estimated financing gap of Bangladeshi Taka (TK) 237 billion (US$2.8 billion). Small and medium firms perceive access to finance as the third most important obstacle. In line with its Vision 2021, the government has sought to improve MSMEs' access to finance through multiple channels. Bangladesh is famous for pioneering the global micro-credit revolution based on group guarantees and the total banking sector lending to MSMEs almost tripled from 2010 to 2016. Nevertheless, there still appears to be a sizable financing gap for MSMEs, estimated at TK 237 billion (US$2.8 billion) (building on International Finance Corporation [IFC] calculations).

While recognizing the multi-sectoral challenge of MSME policy making, improvements in strategic vision and coordination can yield significant results to MSME development and finance. MSME policy invariably involves several agencies. However, there is currently little institutional coordination and no strategic vision or overarching policy framework. Among a multitude of agencies, the Ministry of Industry has taken an active role in MSME development, and the Bangladesh Bank has led MSME finance policy, including direct interventions such as refinancing windows. Based on international experience, Bangladesh would benefit from establishing a central coordinating, multi-party body to promote MSME development and finance.

The Bangladesh Bank's efforts appear to have increased MSME financing overall from a low base; however, its impact and effectiveness could be enhanced by reviewing past and present financing schemes and institutions. Most of the success has been with medium enterprises that do not necessarily face the strongest financing constraints — and most of the financing is short-term in nature. The Bangladesh Bank should refocus its attention on the most constrained among the MSMEs. In addition, the Bangladesh Bank's policy emphasis on banks does not appear to be fully internalized. Indeed, the banks' response can best be characterized as one of passive compliance. The reasons appear to be based on persistent underlying financial infrastructure weaknesses and banks' risk perceptions. Nevertheless, success cases such as Brac Bank, the Industrial Development Leasing Company (IDLC), and Prime Bank deserve some credit. The Bangladesh Bank would benefit from undertaking an evaluation of past schemes, guidelines and success stories to inform future MSME finance policies. Lastly, state-owned financial institutions, which would traditionally support MSME development, are faced with significant challenges – notably with regard to their mandate and governance, profitability, capital adequacy, and non-performing loans. It is important that the government clarifies the long-term goals, mandates and objectives of the state-owned financial institutions, and undertakes the necessary reforms to enhance their role.

There are significant financial infrastructure weaknesses that need to be addressed to encourage market-driven MSME financial inclusion. The 2018 World Bank Group's Doing Business survey ranks Bangladesh at 159 (of 190 countries) for the 'Getting Credit' indicator, a measure of credit information sharing and legal rights of borrowers and lenders. In future, the credit bureau coverage should include all commercial loans, regardless of value. It should also mine all available data to strengthen MSME credit information. Furthermore, loans are primarily secured through property-based collateral (that face a challenge regarding property rights), whereas movable collateral is not yet accepted for secured lending. Therefore, MSME financing would benefit from the expansion of the registry's mandate to include movable collateral, the enactment of the Secured Transactions Law and the creation of a register. Notwithstanding several legal avenues in place, insolvency and debt resolution are, in practice, very difficult and costly. A Small Claims Court could lead to faster adjudication with lower costs for cases relating to MSMEs. In this regard, it is important to codify and operationalize mediation within the Money Loan Courts and the general courts. To settle disputes involving small claims or recovering loans to small enterprises, the Small Cause Courts Act will require amendments. Institutionalizing Alternative Dispute Resolution (ADR) mechanisms for commercial dispute settlement could also help address contract enforcement processes.

Payment systems, in particular, hold promise in expanding MSME financial access through Digital Financial Services (DFS). Technology is transforming the global economy and MSME financing. Several enabling factors are critical to successfully galvanizing this technology, and the regulatory environment is particularly important. The Bangladesh Bank has made significant advances toward the adoption of a digitized payment system, and has encouraged mobile financial services. The rapid growth of information and communication technologies (ICT) services has led to the increasing use of technology for the delivery of financial services, but penetration is limited. Among the key challenges, the legal and regulatory structure of the mobile-payments system is restrictive by only allowing for a bank-led model. The goal should be to transform this into a mobile-financial system with a broader range of financial services. Therefore, the Bangladesh Bank needs to review its strategy and policy relating to DFS, including making the eco-system more supportive for the growth of Fintech.

Several innovative and alternative financing options can be further explored, including risk-sharing facilities (RSFs), factoring, warehouse receipt finance, and/or start-up capital policies. RSFs can partially cover the risks of MSME lending and help de-risk lending decisions by commercial banks. Bangladesh can launch a MSME-focused scheme that learns from its past experiences, specifically by addressing governance concerns. In addition, a range of pre-bank financing options has emerged to support young and dynamic firms. However, the requisite enabling environment is still under development. As financial infrastructure improves and digital technology develops, asset-based solutions — such as factoring and warehouse receipt financing — are likely to become more attractive. Finally, start-up capital is much needed, but still missing. In this regard, public policy can help to reduce the risks associated with this segment.

Table 1 provides a summary of key recommendations found in this report.

Table 1: Financial Inclusion Indicators, by Country, South Asia

	Short-term	Medium-term
Institutions		
Promote the use of a unified definition at the policy level and improve data collection and analysis.	•	
Establish a multi-party, central coordinating body to promote MSME development and financing.	•	
Undertake an evaluation of past schemes and Bangladesh Bank guidelines to inform future MSME finance policies.[H]		•
Refocus attention on the most constrained among the MSMEs – the 'missing middle'.[a]		•
Clarify the long-term goals of the government and the mandates and objectives of state-owned financial institutions and undertake the requisite reforms.[H]		•
Infrastructure		
Improve the credit information infrastructure, expanding the reach of the credit information bureau.[H]	•	
Enact the Secured Transaction Law and create a register.		•
Establish a Small Claims Court and institutionalize ADR mechanisms.		•
Innovation		
Promote an effective payment system and financial infrastructure to support the rollout of DFS and the evolution of Fintech.[H]	•	
Pursue the necessary legal and infrastructure needs for the introduction or expansion of alternative finance.[H]		•
Introduce a Risk-Sharing Facility for SMEs.		•

Note: ADR=Alternative Dispute Resolution; DFS= Digital Financial Services; MSME= micro-, small and medium enterprises; SME= small and medium enterprises.
[H] = High priority reform. Short-term is within 9 months, and medium-term is within 18-24 months.
[a] The 'missing middle' refers to small firms and firms at the low-end of the medium-sized enterprise segment that have the most difficulty in accessing bank finance.

I. MSMES: IMPORTANCE AND FINANCING CONSTRAINTS

Introduction

Despite limited data, micro, small and medium enterprises (MSMEs) are undoubtedly the backbone of non-farm job creation in Bangladesh. Some 99 percent of all non-farm enterprises fall within the micro and small enterprise categories, providing employment to 20.3 million Bangladeshi workers in 2013. Yet, the use of formal finance by small firms is limited compared to the South Asia average, with an estimated MSME financing gap of Bangladeshi Taka Tk 237 billion (US$2.8 billion).[1]

Improving MSME access to finance is a fundamental challenge at the heart of a country's financial and economic development. Development theory emphasizes the role of finance in achieving growth and income equality. However, one of the most important issues facing MSMEs is their difficulty in accessing finance. Given market imperfections, the role of state policy is critical — from promoting an enabling environment to more active market interventions.

This report presents a desk review of the financing gap, constraints and policies related to the MSME financing in Bangladesh.[2] In doing so, it aims to provide relevant policy recommendations at a critical time when past policies can be objectively evaluated, and as innovative and alternative instruments are emerging, thereby presenting a unique opportunity to address these financing challenges.

Section A outlines the structure and role of MSMEs in the economy of Bangladesh, as well as their financing constraints. Section B.1 turns to the regulatory and financing policies pursued by the authorities, examining coordination challenges and the effectiveness of efforts toward formulating key recommendations. Section B.2 focuses on the challenges and recommendations in the realm of financial infrastructure, specifically credit reporting, secured transactions and collateral registries, insolvency and debt resolution, and payment systems. Section B.3 outlines innovative and alternative financing options for MSMEs, including risk-sharing facilities, asset-based solutions, and Fintech (financial technology). Finally, Section C concludes with an overview of key findings from the report.

MSMEs in Bangladesh

Classification

Bangladesh has lacked a uniform MSME definition, which has resulted in fundamental knowledge gaps,[3] as well as an inability to quantify the impact of government and donor financial assistance. There have been multiple definitions deployed since 2003 (see annex 1), including by the Economic Censuses conducted by the Bangladesh Bureau of Statistics (BBS), the Bangladesh Industrial Policy, and surveys by international organizations, such as the World Bank Group's (WBG) Enterprise Surveys. Some special-purpose sample surveys have also been used occasionally to diagnose constraints, albeit in a limited manner.

The MSME definition set by the 2016 Industrial Policy is now broadly accepted as a unified definition at the policy level. It is based on the value of fixed assets (excluding land and buildings) and/or the number of employees (see table 2). This unified national definition should be followed by all government entities. Notably, the Bangladesh Bank has updated its definition accordingly (see annex 1).

Table 2: Unified MSME Definition Adopted under the 2016 Industrial Policy

Type of Industry		Amount of Investment in Tk (Replacement Cost and Value of Fixed Assets, excluding Land and Factory Buildings)	Number of Employed Workers
Cottage Industry		Below 1 million	Maximum 15
Micro Industry		1 to 7.5 million	16-30
Small Industry	Manufacturing	7.5 to 150 million	31-120
	Service	1 to 20 million	16-50
Medium Industry	Manufacturing	150 to 500 million	121-300
	Service	20 to 300 million	51-120

Source: National Industrial Policy, Government of Bangladesh, 2016.

Structure and Role

Despite the absence of consistent data over time, there are still some useful conclusions that can be drawn, primarily from the 2013 Government Economic Census and the Enterprise Survey (World Bank 2013).

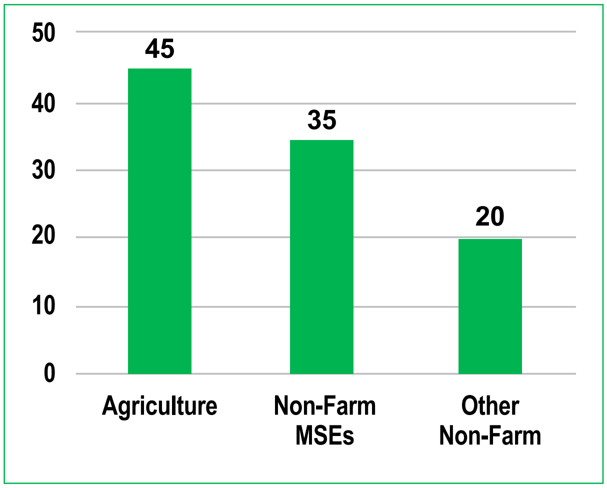
MSMEs are the backbone of non-farm job creation in Bangladesh (which is broadly in line with other countries in the region). The 2013 Economic Census counts a staggering 7.8 million enterprises, of which almost 89 percent belong to the cottage and microenterprise segment, and 11 percent to the small enterprise segment. Some 99 percent of all non-farm enterprises fall into the micro and small segments, providing employment to 20.3 million in 2013. As such, this makes them the largest source of employment apart of agriculture (figure 1) — and a key contributor to poverty reduction. The MSME sector overall provides 86 percent of total employment outside of agriculture and the public sector. Notably, the 2013 Labor Force Survey (LFS) shows that informal employment in services and manufacturing accounted for almost 87 percent of total employment. (Table 11 in annex 2 provides an overview of the size distribution and employment data for 2013.)

Most of these enterprises are informal, that is, they are not registered with the government. Informality is prevalent in the private economy and especially among small firms. Some 90 percent of microenterprises and 95.5 percent of small enterprises are engaged in providing informal services for the domestic market. The average size of these firms — while slightly increasing — is still low, at 4 employees in urban areas, and even lower in rural areas. There is limited value chain integration among this enterprise segment, and negligible contribution to the export market.

The MSME sector, in particular micro and small enterprises, is dominated by trading activities. The distribution of enterprises by broad economic activities and size (table 12 in annex 2) reveals that more than 87 and 94 percent of the micro and small enterprises, respectively, are engaged in non-manufacturing services, mostly in trading. However, medium and large enterprises are heavily involved in industrial activities, with almost 50 and 53 percent of the medium and large enterprises, respectively, involved in manufacturing activities. Reorienting the SME sector away from trading to higher value-added economic activity remains an important challenge.

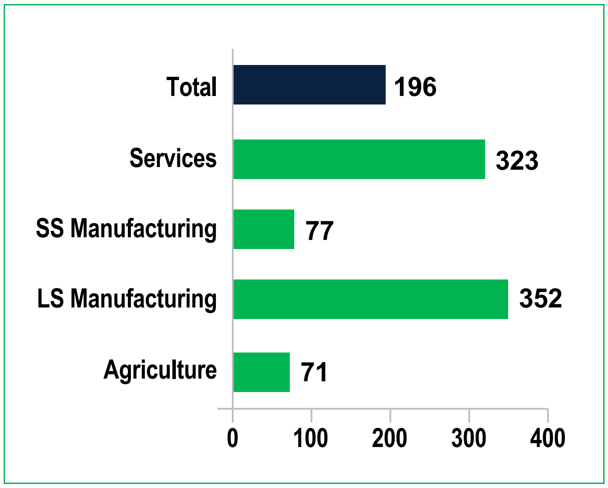
The productivity challenge for micro and small enterprises is substantial. Evidence from the manufacturing sector suggests that the micro and small enterprises tend to have low value-added per worker and low average wages. Figure 2 shows that the average labor productivity in micro and small manufacturing is barely above the low productivity of the agriculture sector.

Figure 1: Distribution of Employment (%)



Source: BBS, LFS 2013 and Economic Census 2013.

Figure 2: Average Labor Productivity 2013 (Tk `000)



Note: LS=Large Scale. SS=Small Scale.

Women's participation in economic activity lags behind most low-income countries according to the 2013 Enterprise Survey. The share of women in ownership and management is less than half that of low-income countries across all firm sizes. Although women's participation in the workforce is higher (16 percent), especially for larger firms, it is still significantly lower than the average (34 percent) and that of low-income countries (25 percent).

The Financing Challenge

MSME financing constraints

Small firms' use of formal finance is limited compared to larger firms, as well as in comparison with the average for the South Asia region. The 2013 Enterprise Survey estimates that only 27.5 percent of small firms have bank loans/ lines of credit compared to 44 percent of large firms and 30 percent observed in the region. Small firms rely more on internal funds to finance investments. They face higher collateral level requirements relative to the value of loans received.

Small and medium firms perceive access to finance as the third most important obstacle in the business environment. According to the 2013 Enterprise Survey, all firms perceive political instability and electricity as the top obstacles to the business environment. Unlike smaller firms, large firms rank corruption — not access to finance — as the third most important obstacle. Notably, there appears to be a segment, known as the 'missing middle', of small firms and firms at the low-end of the medium-sized enterprises that have the most difficulty in accessing bank finance.

Financial constraints faced by MSMEs in Bangladesh are widely recognized in the academic literature and other studies.[4] The 2017 International Finance Corporation (IFC) SME Finance Gap Study observed that 55 percent of all MSMEs reported at least being partially financially constrained, of which 39 percent reported being "fully constrained". Daniels (2003) reported the availability of financing as the top problem faced by MSMEs (based on a nationwide survey of private enterprises), with limited credit from formal sources. In another study, Alam and Ullah (2006) also identified the lack of medium to long-term credit among the reasons for slow growth among MSMEs. Likewise, Haider and Akhter (2014) found that 50 percent of SMEs did not have any access to bank financing. Focusing on the manufacturing sector, a survey conducted by the Bangladesh Integrated Support to Poverty and Inequality Reduction through Enterprise Development[5] found that 69 and 45 percent of small and medium enterprises, respectively, identified access to finance as a major constraint (Bakht and Basher 2015). Finally, a 2016 study by the Institute for Inclusive Finance and Development concluded that, despite the growth of micro-finance, access to credit remains a major constraint for microenterprises. It is exacerbated by the high interest rate elasticity of demand. In this context, a one percent reduction in interest rate increases demand for microenterprise credit by 5.6 percent.

Globally, several factors on the demand and supply sides can explain the large financing gap for MSMEs. On the demand side, the lack of financial capabilities and low level of formalization are key constraints. High financing costs also act as a deterrent to demand for financing. On the supply side, the lack of appropriate credit appraisal policies, credit infrastructure and risk management tools lead to a high risk-aversion on the part of financial institutions in lending to MSMEs. The crowding-out of commercial bank financing to MSMEs by public sector organizations also leads to further credit constraints for MSMEs.

Bangladeshi MSMEs are subject to a number of financing constraints, among them, poor quality of collateral, inadequate documentation and ill-defined business plans. Several studies found that commercial banks regard MSMEs as high-risk borrowers because of their low capitalization, insufficient assets and high mortality rates (Bhattacharya and others 2000; Hossain 1998; and Sia 2003). One of the major obstacles for micro and small enterprises is the banks' reliance on 'collateral-based lending', whereby banks consider fixed asset ownership, especially land, as the basis for credit extension — irrespective of the worthiness of the borrower or project (Bhattacharya and others 2000; Challenges Consulting 2012; Meagher 1998). Whereas some commercial banks have innovative products or services for MSMEs, most banks repackage their existing products as MSME products (Siddique and others 2007). The same study also found that commercial banks disburse loans to small enterprises only when the government introduces credit guarantees.

Formal Credit Supply for MSMEs

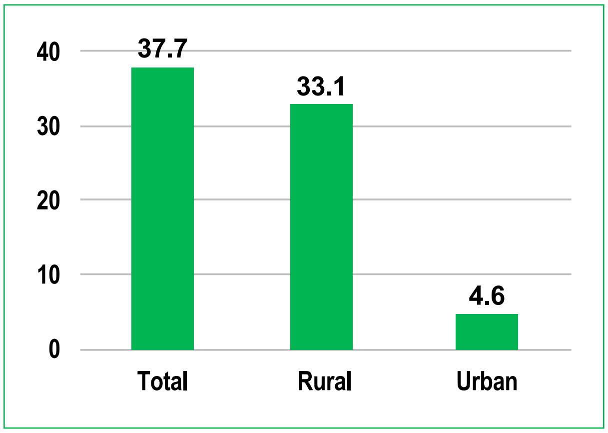
The financial system is bank dominated, along with a vibrant microfinance sector. Banks account for about 70 percent of total financial system assets and 73 percent of gross domestic product (GDP). Among the 57 scheduled (licensed) banks, there are six state-owned commercial banks, two state-owned specialized developmental banks, nine foreign commercial banks, and 40 domestic private commercial banks, including eight Islamic finance banks. In addition, there are four nonscheduled specialized public banks, which operate under their own individual laws. The financial sector also consists of microfinance institutions (including 784 licensed institutions, dominated by 10 large microfinance institutions [MFIs] and Grameen Bank), non-bank financial institutions (34 in total), the capital market (with two stock exchanges) and the insurance sector (with 78 insurance companies). The capital market and insurance sector account for about 20 and just 3 percent of financial system assets, respectively. Capital markets are equity driven, very shallow and small, thereby restricting diversification of funding and access to long-term finance.[6] Market capitalization of all listed securities stands at roughly 20 percent of GDP, with a dominance of equity securities. There are only 2 corporate bonds and 8 debentures among a total of 564 listed securities, and there is no active trading of the 221 government Treasury (T)-bonds listed on the two stock exchanges.

In line with its Vision 2021, the Government of Bangladesh has increasingly focused on MSMEs, including access to finance. Under the Bangladesh Bank's leadership, the initial focus was on micro-credit, with an increasing emphasis on SMEs since 2011.

Bangladesh is famous for pioneering the global micro-credit revolution based on group guarantees through the Nobel-prize winning Grameen Bank initiative.[7] This is further supported by the Government through several initiatives, including the establishment of the Palli Karma Sahayak Foundation (PKSF), a second-tier not-for-profit company providing services through partners (non-governmental organizations [NGOs]/ MFIs) and the Micro-Credit Regulatory Authority (MRA). The role of micro-credit as a major policy instrument has also been incorporated into the national development plans as well as the national budget. MFIs are not permitted to take any collateral from borrowers. Rather, they use group guarantees. In this context, microenterprise loans are usually given to repeater borrowers with credit histories (for instance, those who have repaid a microloan). Available evidence suggests that the spread of microcredit has contributed to poverty reduction by facilitating higher consumption and helping the poor to build assets.

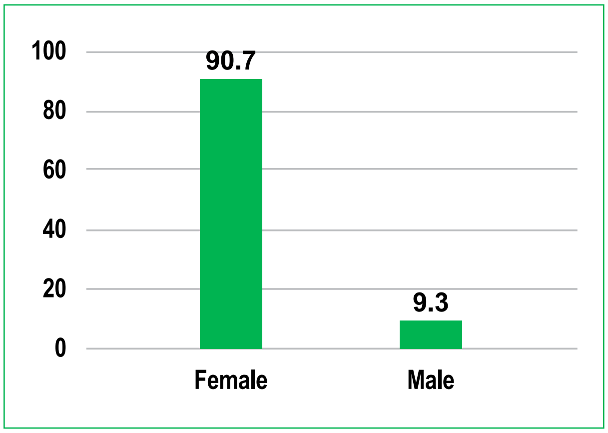
As of June 2016, a total of 37.7million members have benefitted from microcredit programs, of which over 80 percent are rural female members. The main features of the microcredit expansion are illustrated in figures 3-6. Total loans disbursed through microcredit schemes have grown to Tk 956 billion (US$11.4 billion) (or 5.6 percent of fiscal year [FY]16 GDP), with an average size of Tk 29,600 (US$354). Agriculture, livestock and fisheries account for 50 percent of the loans, followed by 30 and 4 percent for trading and transport, respectively. Borrowing for manufacturing activities is small at just 2 percent.

Figure 3: Microcredit Members, June 2016 (Million)



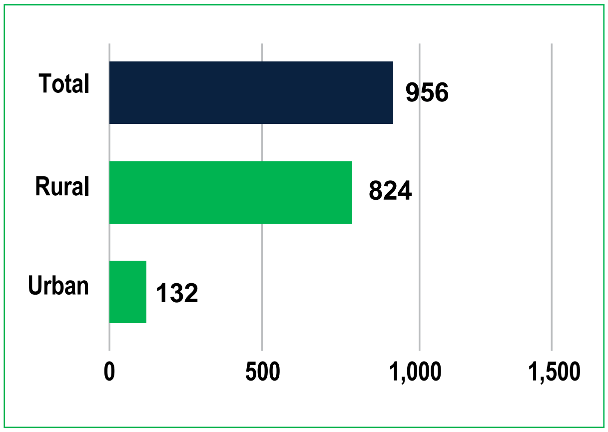
Source: Credit and Development Forum, 2016.

Figure 4: Distribution of Membership by Gender (%)



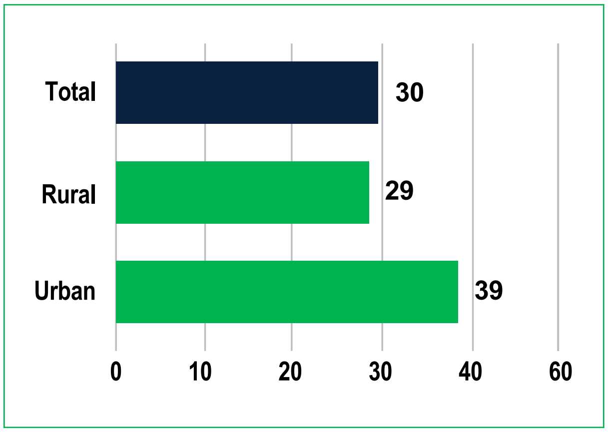
Source: Credit and Development Forum, 2016.

Figure 5: Loans Disbursed, June 2016 (Tk Billion)



Source: Credit and Development Forum, 2016.

Figure 6: Average Loan Size, June 2016 (Tk `000)

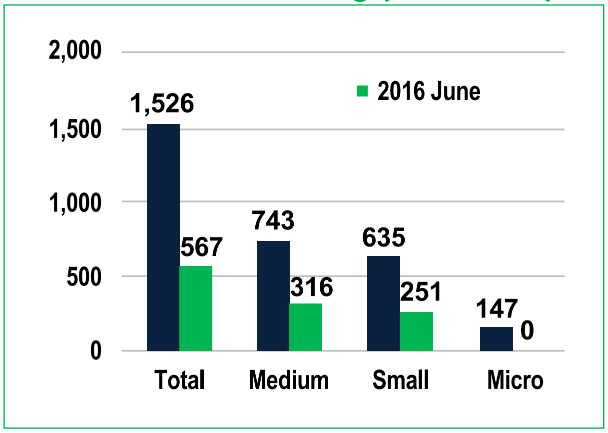


Source: Credit and Development Forum, 2016.

Total MSME lending from the formal banking sector nearly tripled from 2010 to 2016, with an 18 percent annual growth rate. Unlike microcredit, the focus on SME lending is more recent and has been spearheaded by the Bangladesh Bank. The market dynamics are illustrated in figures 7 and 8. MSME credit as a share of total private sector credit grew from 20 to 25 percent from mid-2010 to mid-2016. In this regard the credit share of micro and small enterprises in the total MSME portfolio grew from 44 percent to 51 percent. In terms of economic activities, although the Bangladesh Bank's policy accorded priority to manufacturing and services, the bulk of credit was channeled to trading activities (60 percent overall, with 74 percent for small enterprises).[8] This is consistent with the dominance of "trading" in SME activities as compared to industry, manufacturing, and value-added services.

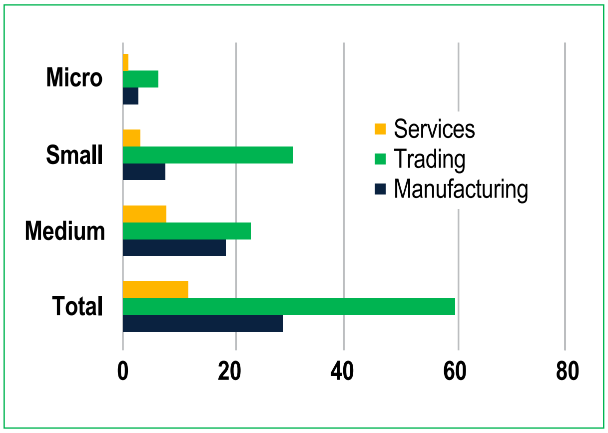
Domestic private commercial banks account for 76 percent of the total outstanding MSME loans, and MSME loans in turn account for about 27 percent of their portfolios. The public commercial banks account for 19 percent of the total outstanding MSME loans, and non-bank financial institutions (NBFIs) and foreign private banks have a nominal presence. Table 3 shows the total portfolio of outstanding MSME loans compared to the total amount of loans provided by all five categories of financial institutions as of June 2016. However, it should be noted that there has been a rise recently in the non-performing loan (NPL) rate for SME loans, particularly among state-owned banks (estimated at about 40 percent).

Figure 7: Expansion of Banking Sector MSME Lending (Tk billion)



Source: Bangladesh Bank.

Figure 8: Distribution of Formal MSME Credit by Economic Activities, June 2016 (%)



Source: Bangladesh Bank.

Table 3: MSME Loans Outstanding as a Share of Total Loans

Bank Category	Total Loans (Tk Billion)	MSME Loans (Tk Billion)	Percentage of MSME Loans	Percentage Share of SME Loans
Public Commercial Banks	84,039.89	285.6	18.4	18.7
Public Specialized Banks	31,213.60	12.4	29.7	0.8
Foreign Banks	23,853.26	18.6	9.5	1.2
Private Commercial Banks	315,328.57	1,152.2	27.1	75.5
Non-bank Financial Institutions (NBFIs)	31,449.30	56.8	11.4	3.7
Total	485,884.62	1,525.6	23.9	100

Source: Bangladesh Bank.

Estimated Financing Gap for Microenterprises

Estimated Credit Demand

The total loan demand for cottage and microenterprises is estimated at Tk737 billion (US$8.8 billion). A 2016 comprehensive survey of 600 microenterprises conducted by the Institute for Inclusive Finance and Development (InM) estimated the average demand for credit by cottage and microenterprises in rural and urban locations. The survey found that enterprises with higher employment or those located in urban areas have, on average, higher loan demand, which is consistent with conventional wisdom.[9] The 2013 Economic Census is then used to estimate the total demand for credit based on employment size and spatial distribution. Multiplying the average loan demand by the number of enterprises provides an estimate of the total loan demand (see table 4).

Estimated Financing Gap

There appears to exist a sizable financing gap of Tk 170 billion (US$2 billion equivalent). The 2016 Credit and Development Forum shows the amount of credit disbursed by source, as compiled by with the total credit, amounting to Tk 566.5 billion. (table 5).[10] Comparing supply with demand shows a sizeable financing gap of Tk 170 billion (US$2 billion). However, this may be a substantial underestimation, as it is based on prevailing interest rates and does not account for the high interest rate elasticity of loan demand by microenterprises.[11]

Estimated Financing Gap for SMEs

Estimating the demand for credit by SMEs is difficult due to data constraints. The absence of firm-level demand data, or time-series/ cross-sectional data on enterprise profitability, income, costs, or production prohibits the estimation of demand functions based on secondary data.

SME financing gap estimate by IFC[12]

IFC attempted to formulate an estimate of the SME financing gap in Bangladesh in 2011, and projected it to be Tk 237 billion (US$2.8 billion). The average financing gap per SME was estimated at US$2,288 — which when combined with an estimated total number of SME enterprises of 804,041 — yields a total financing gap estimate of about US$1.8 billion (Tk 150.5

Table 4: Average Demand for Loans Among Microenterprises

Number of Employees		Average Loan Demand (Tk)		Number of Microenterprises			Total Loan Demand (Tk Billion)		
		Urban	Rural	Urban	Rural	Total	Urban	Rural	Total
Cottage	1-9	107,710	104,283	1,730,150	5,112,734	68,42,884	186.4	533.2	719.6
Micro	10—24	228,750	133,333	41,112	62,895	1,04,007	9.4	8.4	17.8

Source: InM Microenterprise Survey, 2016, and Economic Census, 2013.

Table 5: Loan Supply for Microenterprises, June 2016

Supply Source	Total Amount Disbursed in 2015-16 (Tk Billion)	Amount Disbursed to Microenterprises (Tk Billion)	Percentage Share
Banks	63.1	63.1	11.1
Public Institutions	11.8	11.8	2.1
MFIs	955.8	491.6	86.8
Total	1,030.7	566.5	100.0

Source: Credit and Development Forum, 2016.
Note: MFIs= Microfinance Institutions.

billion) (table 6). Not surprisingly, the largest gap emerges for the very small enterprises. Estimating the financing gap for 2017 by inflating the Tk financing gap with the domestic rate of inflation increases it to Tk 193 billion (US$2.3 billion). The IFC survey uses enterprise data for 2011, which had a lower enterprise headcount than the 2013 Economic Census. Thus, adjusting it to the 2013 data increases the financing gap to Tk 237 billion (US$2.8 billion).

In 2017, the IFC MSME financing gap improved on the 2011 methodology by defining the counterfactual more concretely,[13] as well as by clearly defining the regulatory and macroeconomic changes required for the gap to become evident. Thus, it estimated the MSME financing gap at $US39 billion.

Table 6: IFC Estimates of Financing Gap, 2011 versus 2017

Enterprise Type	Number of Enterprises	Average Value Gap ($)	Total value gap (US$ billion, 2011)	Total value gap (Tk billion, 2011)	Financing Gap (Tk billion, 2017)
Very small	727,840	1,989	1.44	102.5	151.7
Small	72,935	3,489	0.25	17.8	26.4
Medium	3,266	42,033	0.14	10.1	15.0
Total SME	804,041	2,288	1.83	130.4	193.1

Source: IFC, 2013.

II. MSME POLICY, FINANCIAL INFRASTRUCTURE GAPS AND ALTERNATIVE SOLUTIONS

The Regulatory and Financing Policies

The effectiveness of past and ongoing MSME finance policies appears modest. Improvements in MSME policy making, focused on the strategic vision and coordination among several agencies, can yield significant results. A central coordinating, multi-party body would benefit Bangladesh by promoting MSME development and financing. Bangladesh Bank would also benefit from undertaking an evaluation of past schemes, guidelines and success stories to inform future MSME finance policies. Notably, it should refocus attention on the most constrained segments among MSMEs, and shift the weight of policy beyond the banks. The authorities should also redouble their efforts in addressing persistent underlying financial infrastructure weaknesses, clarifying the mandates, objectives and the long-term goals of the state-owned financial institutions.

Institutional Coordination

MSMEs are multi-sectoral and involve several agencies in setting policy, including the Ministry of Finance, the Ministry of Commerce, the Ministry of Industry (MOI) and the Bangladesh Bank. Several special bodies have also been established to support the MSMEs, including the SME Foundation (SMEF), the Bangladesh Small and Cottage Industries Corporation (BSCIC), the Bangladesh Industrial Technical Assistance Centre, the Bangladesh Council of Scientific and Industrial Research, the Business Promotion Council and the Bangladesh Bank's MSME Department (see annex 4).

Currently, there is very little institutional coordination and no strategic vision or overarching policy framework to support MSMEs. Among the three concerned line ministries, the MOI has taken central stage, with its new industrial policy focused on the development of SMEs in manufacturing in particular. Most of these specialized agencies are managed by the MOI. On the financing side, the government established the Bank for Small Industries and Commerce (BASIC) in 1988. In this context, the Bangladesh Bank has played the most important role in deploying various regulatory actions and financing schemes to support the market segment. The MOI is of the view that it could implement a more effective financial support program through the SMEF and the BSCIC, and strongly favors subsidized interest rates.

Other countries have a more focused and coordinated approach to MSME financing and development. The United States has the Small Business Administration (SBA), a dedicated agency that provides coordinated comprehensive support to small business entrepreneurs. In Malaysia, the National SME Development Council (NSDC) is the highest policy-making body for the development of SMEs. It is chaired by the Prime Minister and is comprised of 13 Ministers, as well as the Chief Secretary to the Government, the Director-General of Economic Planning Unit and the Governor of Bank Negara Malaysia.[14]

Regulatory Policies

The Bangladesh Bank has been designing and implementing initiatives for SME sector development, including women entrepreneurs.[15] It adopted the Small and Medium Enterprise Credit Policies and Programs in 2011. This included a formal definition of MSMEs, targets for MSME lending by commercial banks, a refinancing scheme, priority MSME activities, and an emphasis on lending to female entrepreneurs.[16]

It also eased the procedures and requirements for lending to small enterprises, including the relaxation of collateral requirements. A new department, the "SME and Special Programs Department", was also created in the Bangladesh Bank to accelerate MSME activities and provide effective monitoring. The main regulatory support policies are as follows:

Loan provisioning. The Bangladesh Bank offers attractive loan-provisioning options to support MSME financing, with only 0.25 percent for general provisioning. The equivalent rates for housing, consumer and corporate finance are 2, 5, and 1 percent, respectively.

Capital allocation. Capital is charged against risk-weighted assets. A loan of less than Tk 3 million (US$35.9 thousand) to an MSME with unrated assets receives a 75 percent risk weight. If the loan is above Tk 3 million, then the risk weight is 100 percent. For any large unrated group, the risk weight is 125 percent.[17]

Cluster approach to MSME financing. Banks and NBFIs have received advice from the Bangladesh Bank regarding the development of customized financing solutions to suit 50 MSME clusters that it identified based on locations conducive to the development of an industry.

Credit rating. The Bangladesh Bank has recognized a specialized credit rating agency for MSMEs called the Bangladesh Rating Agency Limited. It has established the guidelines for the credit rating of MSMEs, known as the "Credit Rating Methodology for Small and Medium Enterprises".[18]

Directive to increase MSME loans. The Bangladesh Bank has also issued directives that 20 percent of all bank/ financial institution loans should be to MSMEs. This will be increased to 30 percent by 2021. The Bangladesh Bank's SME and Special Programs Department has been charged with the responsibility of formulating financial policy, facilitating credits and monitoring the development of MSMEs. The formulated guidelines are as follows:

- The Bangladesh Bank sets an indicative target for MSME loan disbursement for a year and coordinates closely with the banks and financial institutions to achieve it.
- Following an 'Area Approach Method', banks and financial institutions try to attain their indicative targets separately by dividing them by branch, region and sector.
- Each bank/ financial institution can follow a separate business strategy with the least formalities in executing documentation for easy and speedy loan sanction and disbursement.
- For small entrepreneurs, the credit limit ranges from Tk 50,000 to Tk 5 million (US$600 to US$60 thousand). At least 40 percent of the total disbursement target should be reserved for small entrepreneurs. Priority is given to potential women entrepreneurs.
- Each bank/ financial institution is to establish a separate 'Women Entrepreneurs' Dedicated Desk' with the requisite, suitable manpower. It should provide staff with training on MSME financing and also appoint a woman officer as chief of the dedicated desk.[19] Banks and financial institutions may approve loans of up to Tk 2.5 million (US$30 thousand) to women entrepreneurs against personal guarantees. In that case, group security/ social security may be considered. Overall, 15 percent of the total MSME credit would be allocated to women entrepreneurs.
- The Department of Banking Inspection-3 of the Bangladesh Bank conducts regular on-site inspections to monitor compliance with the above guidelines. The success of MSME loan disbursements is considered to be a yardstick for further approval of new branches of the concerned bank. Licenses for new branches will be issued for financing priority sectors, such as MSMEs and agriculture. (From 2010, these were provided under the name of the 'MSME/Agriculture Branch' instead of the 'MSME Service Centre'.)
- Each bank/ financial institution can set the interest rate on MSME loan sector/ subsector. However, for women entrepreneurs, it would be the bank

rate +5 percent, not exceeding 10 percent.[20] As noted, the Bangladesh Bank also instructed banks and NBFIs to reserve 15 percent of total MSME funds exclusively for women entrepreneurs.[21]

Financing Policies and Schemes

The Bangladesh Bank opened an equity fund and refinancing windows to channel low-cost credits received from various donor and international organizations. These funds, in addition to its own resources, are used as the banking channel for disbursements.[22] Some 46 banks and NBFIs have signed a participation agreement with the Bangladesh Bank under the following schemes:

Refinance schemes with assistance from various donors and the Bangladesh Bank's own fund.

- ***The World Bank's "Enterprise Growth and Bank Modernization Project" (EGBMP):*** This project aimed to stimulate investments through small enterprises to offset employment losses from closed SOEs (for example, Adamjee Jute Mills). The Small Enterprise Fund included Tk 6 billion (US$72 million equivalent) from the Bangladesh Bank, US$10 million from the World Bank through the EGBMP, and Tk 0.6 billion (US$7.2 million) from the Government, for a total of Tk 1.2 billion (US$14 million). The scheme was extended to banks and NBFIs at the bank rate against their financing to small entrepreneurs, and demonstrated high market demand. Recovery against refinanced loans is used as a revolving fund for financing MSMEs. In this context, Tk 3.1 billion (US$37 million) has been provided to 32 banks and NBFIs to support 3,160 enterprises on a revolving basis. Disbursement was completed in mid-2011 and, as of mid-2014, Tk 3.0 billion (US$34.8 million) had been recovered.
- ***Asian Development Bank (ADB) Fund-1 "Small and Medium Enterprise Sector Development Project" (SMESDP):*** Subsequently, the ADB placed an additional US$30.0 million in the Small Enterprise Fund (SEF) in 2005. An amount of Tk 3.4 billion (US$40.7 million) was provided to banks and NBFIs for a total of 3,264 enterprises, completing its disbursement in September 2009. As of mid-2014, Tk 3.3 billion (US$39.5 million) had been recovered.
- ***ADB Fund-2 "The Small and Medium-Sized Enterprise Development Project" (SMEDP):*** The fund aimed to enhance medium- to long-term financing to eligible MSMEs. The total fund amounted to US$95.0 million, of which ADB provided US$76.0 million and the Government of Bangladesh (through the Bangladesh Bank) US$19.0 million, which was transferred from the balance of the earlier ADB-1 (SMESDP) Fund. Disbursements were completed in end-2013, with Tk 7.5 billion (US$89.7 million) to banks and financial institutions for a total of 13,645 enterprises. As of mid-2014, Tk 2.6 billion (US$31.1 million) had been recovered.
- ***Japan International Cooperation Agency (JICA) Two-Step Loan (TSL) Fund, "Financial Sector Project for the Development of Small and Medium-Sized Enterprises" (FSPDSME):*** The objective is to create a medium- to long-term finance market for MSMEs, especially for productive investments. The fund size amounts to Japanese Yen (JPY) 5 billion (US$45.5 million equivalent), including technical assistance, as well as the TSL of JPY 4.79 billion (US$43.5 billion). Some 25 banks and 21 NBFIs signed participating agreements. As of mid-2014, a total of Tk 2.0 billion (US$23.9 million) had been refinanced for 271 enterprises. The TSL was later extended to provide up to Tk 100 million (US$1.2 million) for retrofitting, rebuilding and relocation of factory buildings of the ready-made garment (RMG) and knitwear factories as part of the FSPDSME.

Agro-based product processing industries. The Bangladesh Bank launched a scheme in 2001 from its own funds for agro-based product-processing industries outside the Divisional Head Quarters and Narayanganj town. It was increased from an original amount of Tk 1.0 billion (US$12 million) in 2001 to Tk 2.0 billion (US$23.9 million) in 2012 — and then again to Tk 4.0 billion (US$47.8 million) in 2013. Refinancing is provided to banks and NBFIs at the bank rate. Since mid-2014, a total of Tk 5.0 billion (US$59.8 million) has been disbursed to 1,897 enterprises on a revolving basis.

New entrepreneurs in the cottage, micro and small segment. The Bangladesh Bank has created a fund of Tk 1.0 billion (US$12 million) from its own sources to provide start-up capital to new cottage, micro and small enterprises. The entrepreneurs are selected and trained by recognized public and private training providers and will receive financing at the bank rate +5 percent. Refinancing from this fund is expected to start soon.

Islamic Finance (Sharia-based) refinance scheme for Islamic banks. The Bangladesh Bank created this fund with the objective of enhancing the role of Islamic banks in SME financing. Specifically, it will do so by refinancing the loans provided by Islamic banks to agro-based industries and small entrepreneurs (including women-led enterprises).

At the same time, state-owned financial institutions — which would traditionally support MSME development — are faced with significant challenges. State-owned banks include four state-owned commercial banks, and two state-owned specialized banks. They account for a quarter of the total banking system assets and are significantly weaker than private banks, thereby posing a financial and fiscal stability risk. Measurement issues aside, they underperform on profitability, capital adequacy, and non-performing loans.[23] They suffer, among other things, from poor governance practices, weak internal controls and

Box 1: An Approach Framework to State Intervention and State-owned Banks

Governments justify state ownership in the financial sector based on various grounds (table 7). A frequently used justification in the academic literature is the effort to address a set of market failures attributable to asymmetric information problems and externalities (World Bank, 2012; Cull, Martinez Peria, and Verrier, 2017). State intervention has also been justified based on its contribution to social goals, specifically by financing projects with negative net present value — but with positive social returns (Levy-Yeyati, Micco, and Panizza, 2004). The justification is that the state has the ability to overcome coordination failures (De la Torre, Gozzi and Schmukler, 2017), or that it can be a way to promote better competition in the financial sector.

The recent literature has also identified the important countercyclical and safe-haven role that state-owned financial institutions (SOFIs) can play during financial crises or economic recessions (World Bank, 2012; Rudolph, 2009; Micco and Panizza, 2006; Bertay, Demirgüç-Kunt, and Huizinga, 2015; Choi et al., 2016; Coleman and Feler, 2015; Brei and Schclarek, 2013). Although not frequently reflected in the academic literature, governments have also promoted SOFIs as world-class champions—a matter of national pride and global outreach—or simply as a source of returns through their shareholding position. Nonetheless, evidence on the countercyclical role of banks is mixed (Luna-Martinez and Vicente, 2012; Cull and Peria, 2013) and, if credit allocation is poor, SOFIs' countercyclical role becomes questionable (Bertay, Demirgüç-Kunt, and Huizinga, 2015; Coleman and Feler, 2015).

Several studies also convey the criticisms of state ownership in the financial sector. Agency problems (Shleifer and Vishny, 1998; Iannotta, Nocera, and Sironi, 2007; Dinç, 2005; Acharya et al., 2010, Iannotta et al. 2013) may exacerbate the efficient delivery of financial products and services, damaging banking system performance (Barth, Caprio, and Levine, 2006). These arguments emphasize the need to resolve the underlying market failure directly. For example, credit or collateral information weaknesses should be addressed by strengthening the country's financial infrastructure, and long-term finance should be promoted by reforms related to capital markets and institutional investors.

Table 7: State Intervention Rationales

State Intervention Rationale	Example
(i) Market failures, leading to a lack of competition and underserved segments. Financing financially profitable projects that would not receive financing due to market failures (for example, asymmetric information).	SMEs, agriculture, research and development (R&D) and capital-intensive sectors. International trade. Long-term finance (including infrastructure). Broader commercial banking.
(ii) Promoting social/ developmental goals. Financing financially unprofitable projects that are socially valuable. This encompasses socio-economic, environmental and/or other goals.	Rural and isolated areas.
(iii) Countercyclical/ safe haven issues. Financing financially profitable projects that do not receive financing when private bank risk appetite declines in reaction to recessions. Reduce employment volatility. Provide a safe haven for depositor flight and contagion circuit breaker during a crisis.	Labor-intensive sectors. Wide geographic branch presence. Broader commercial banking.
(iv) Promoting state champions. Promoting the creation of globally relevant institutions as a matter of national pride and global outreach.	Broader commercial banking.
(v) Enhancing returns. Provide returns to the state as shareholder.	Broader commercial banking.

SOFIs encompass a broad range of financial intermediaries and can be classified from the purely commercial to the purely developmental. Although trying to categorize state ownership of financial institutions into strict types is difficult, in broad terms one can differentiate among three key types of SOFIs (see Table 8). At the one extreme, pure state commercial banks are practically full-fledged, profit-maximizing, taking deposits from the general public and extending loans directly to the final customers, without a policy mandate. At the other end of the spectrum, pure state development financial institutions operate under a narrow policy mandate. They may not collect deposits and rely on direct lending instruments and the provision of technical assistance. The underlying rationale is important in defining performance expectations. For example, the social goal focus of a state development-oriented institution could emphasize capital preservation rather than profit maximization. In any case, government transfers in support of social goals and their transparency are fundamental to sustainability.

Table 8: SOFI Institutional Typologies

Typology	State Intervention Rationale
(i) State commercial banks. They do not have a policy mandate. They are profit maximizers with operations practically indistinguishable from those of private commercial banks. They collect deposits from the public and use them to lend directly to firms and individuals. In many cases, they are universal banks, either directly or through affiliates.	(i) Return; (ii) Countercyclical/ safe haven; (iii) Competition; (iv) State champions.

Typology	State Intervention Rationale
(ii) State hybrid banks. They have a policy mandate. They perform commercial banking activities. They collect deposits from the public and use them to lend directly to firms and individuals. They act as a government agent in administering state subsidies and other programs.	(i) Return; (ii) Countercyclical/ safe haven; (iii) Competition; (iv) State champions; (v) Market failures; (vi) Social goals.
(iii) State development financial institutions. They have a policy mandate. They usually do not take deposits and are funded by international financial institutions (IFIs), bonds or government transfers. They lend directly or on-lend to firms in specific sectors (SMEs, exports, agriculture, and so on), as well as deploy partial credit guarantee schemes or other financial instruments.	(i) Market failures; (ii) Social goals; (iii) Countercyclical.

Table 9 summarizes a range of financial instruments. The selection of instruments by SOFIs should depend on the intervention rationale, whereas the structure and degree of institutional development of the country's financial system is an important determinant. In general, direct lending by state development-oriented institutions should be undertaken according to market segments (for example, client type, location, maturity, underlying security, and so on) not covered by the private sector. Importantly, direct lending requires highly specialized risk management, strong credit underwriting skills, and operational efficiency. However, on-lending by state development-oriented institutions through other financial intermediaries limits the scope for political interference and competition distortion. At the same time, it enables the channeling of a higher volume of resources at lower costs by leveraging the infrastructure of other institutions. Risk-sharing facilities are another indirect and market-friendly means of state intervention, with the additional benefit of further leveraging public resources. In this regard, capacity-building and training programs can increase the sustainability of state financing.

Table 9: SOFI Instrument Typologies

Typology	Benefits
(i) Direct lending (also known as first-tier, retail). Direct provision of finance to the ultimate beneficiary. Finance can be a regular loan, leasing, or factoring.	Targeted approach, used when the ultimate beneficiary or location is too expensive for private financial intermediaries to serve.
(ii) On-lending (also known as second-tier, wholesale, apex). On-lending to financial intermediaries for their direct provision of finance to the ultimate beneficiary. Finance can be a loan, leasing, or factoring.	Lower cost and risk management burden. Limited scope for political interference and market distortion. Can promote competition among private sector participating institutions and lead to a higher demonstration effect.
(iii) Partial credit guarantee schemes (also known as risk-sharing facilities). Offering of partial credit guarantees that partially offset loan losses by private financial intermediaries upon the ultimate beneficiary's default (for example, infrastructure projects, MSMEs, gender targeting, and so on).	Leverage public resources. Alleviate enterprise collateral constraints, reduce project risk, and financial intermediary risk aversion.
(iv) Grants. Direct or indirect (through third parties) provision of grants.	Achieve socially desired objectives, ensure equitable income distribution.
(v) Other financial products, such as venture capital and equity financing.	Typically deployed to develop segments of the capital markets. Targeting seed start-up and early-stage enterprises.
(vi) Non-financial products. Offering advisory services, capacity building, and training programs to financial intermediaries or ultimate beneficiaries, or market creation services, such as reverse factoring platforms.	Strengthen financial intermediaries or ultimate beneficiaries, typically complemented by financing.

risk management practices, as well as significant inefficiencies. Importantly, there is little clarity in defining ownership purpose and rationale, as well as in setting criteria for developmental impact, and commercial and operational success. Consequently, any potential for fulfilling a developmental role, such as MSME support, is significantly undermined. Box 1 describes a framework for state intervention, its rationales and typologies of state-owned banks and their instruments of intervention.

Effectiveness

The Bangladesh Bank's efforts appear to have increased MSME financing. The Bangladesh Bank's existing refinancing schemes for SME lending have been self-financed as well as donor financed. Donor financing includes multilateral and other bilateral donor partners such as the ADB and JICA. The Bangladesh Bank then channels low-cost funds to SMEs through other partner financial institutions (PFIs), with often prescribed maximum interest rates to be charged by these PFIs to specific targets (such as women entrepreneurs). It is understood that around 25 percent of the consolidated loan book of the commercial banks is dedicated to SME loans. This is notable given that in many countries this ratio is in the single digits or in the tens. Two evaluation studies of SME finance programs were conducted in 2016 and 2018. They noted that SME sales, profits and employment increased over 2012-2014.[24] The increased SME lending over the same period is mainly attributed to commercial banks, although lending from NBFIs also increased at a higher rate.

Box 12: MSME Segmentation and Prospects from a Bank's Perspective

According to the banks, there are 3 distinct segments in the micro and small enterprise lending market. They are as follows:

1. Firms to which banks lend amounts of Tk300 thousand to Tk 1.5 million (US$3.6 thousand to US$17.9 thousand equivalents). These are referred to as micro/ cottage firms. This segment is dominated by the MFIs. Although bank finance could increase maturity, lower rates and formality, there are drawbacks as the operational and supervision costs are high and there are several regulatory restrictions.

2. Firms to which banks lend amounts of Tk1.5 to Tk30 million (US$17.9 thousand to US$358.8 thousand) are referred to as small firms. This is considered a large segment with substantial opportunities. Firms are relatively dominant in their line of business. They include small retailers and suppliers of raw materials. Nevertheless, this segment is also known as 'the missing middle' — that is, firms that have difficulty in accessing bank finance because of collateral and other constraints (for example, the lack of proper accounts). They are also too big to qualify for loans from MFIs. Additional constraints to bank finance include being in business for an insufficient amount of time to build a credit history, or operating in rural areas.

3. Firms to which banks lend amounts of Tk30 to Tk200 million (US$358.8 thousand to US$2.4 million) are referred to as emerging small firms. This segment includes the wholesalers, large retail outlets, the large flour and rice mills, oil-ginning mills, and so on. Small firms are usually the suppliers to these emerging small firms that are more involved in the manufacturing sector. Some examples include large distributors of Grameenphone (leading telecommunications operator), BKash (mobile financial services company), and so on. This segment also has access problems, especially in rural and peri-urban areas away from Dhaka.

The last two segments, unless under a mortgage, present a significant risk for banks since lending without collateral requires a solid customer assessment. Collateral-free lending is done up to amounts of Tk1.5 million (US$17.9 thousand) (and in exceptional cases of creditworthy customers, up to Tk1.5 million [US$17.9 thousand]). Nevertheless, based on the experience of BRAC, IDLC, and more recently Prime Bank, small and emerging small firms often prioritize the loan repayment. They do so because they place a premium on their bank relationship, as well as to ensure that their Credit Information Bureau (CIB) report remains clean.

Most of the success has been with medium enterprises (that do not, necessarily, face the strongest financing constraints) and most of the financing that has been provided is short-term in nature. In some cases, banks may have also circumvented the MSME lending targets by accommodating multiple accounts for medium enterprises. Despite high MSME credit demand and high bank liquidity, few financial institutions have embedded MSMEs in their mainstream business (see box 2). Most banks are also focused on corporate lending based on fixed asset collateral (that is, land and buildings). Making the shift from corporate to SME lending, which is frequently based on movable collateral, represents a considerable cultural change for traditional commercial banks. In addition, most of the financing is short term and does not meet the medium to longer term financing needs of non-trading enterprises in the manufacturing and industrial sectors.

The Bangladesh Bank's policy emphasis on commercial banks for MSME finance does not appear to be fully internalized. Most banks/ NBFIs have complied with Bangladesh Bank's guidelines by opening a MSME Department at their Dhaka headquarters, followed by some internal and external public relations efforts. Targets set by the Bangladesh Bank on SME lending appear "indicative", with no penalties or incentives attached. As such, they would benefit from being more grounded in an analysis of what is achievable. Overall, the banks' response to the Bangladesh Bank's efforts may best be characterized as one of passive compliance.

According to industry professionals, the key reasons for the underperformance of banks in the MSME market segment include: the fear of the unknown (negative perception(s) of MSME lending, reinforced by an increase in MSME defaults);[25] a bank's desire to be associated with well-known names in the industry in terms of their loan portfolios (that is, brand names among corporates and institutions); tedious credit appraisal and operation systems that suit a few big ticket customers only; collateral-based lending that appears safer than weighing cash flow and business sustainability;[26] the high level of bureaucracy in banks that prevents innovation and risk taking; the lack of market know-how regarding financial products in the MSME segment; familiarity with paper-based internal activities rather than technology-driven, simplified procedures. In addition, interest rate caps associated with the low-cost refinancing lines reduce the banks' incentives to participate, also affecting the credit lines focused on women entrepreneurs.[27]

Nevertheless, there are cases, such as of Brac Bank, IDCL, and Prime Bank that have been more positive in their activities vis-à-vis MSME expansion. These are illustrated in box 3.

Policy Recommendations

Promote the use of a unified definition at the policy level and improve data collection and analysis. The MSME definition set by the 2016 Industrial Policy is already broadly accepted and should be widely promoted. Improving data collection and analysis is urgently needed. This could entail revamping the SME database that was created by the Bangladesh Bank leveraging existing technology solutions.

Establish a multi-party central coordinating body to promote MSME development and financing. A pragmatic option would be to assign clear responsibilities among the two primary agencies for MSMEs. The SME Foundation under the Ministry of Industry would focus on research, overall development policy, and monitoring and evaluation. It will also be important to promote the formalization of MSMEs, adjust the policy to account for informal MSMEs, and simplify business procedures for MSMEs.[28] All finance-related policy and implementation would be under the SME Department of the Bangladesh Bank. A coordinating committee/ body would involve other relevant ministries with oversight by the Ministry of Finance or the Prime Minister's Office.

Refocus attention on the most constrained among the MSMEs, that is, the 'missing middle'. Except for the low-end of medium enterprises, most of the firms in the medium-size group face a similar

Box 3: Lessons of Positive Adaptive Experiences

Brac Bank and Industrial Development and Leasing Corporation (IDLC): The two financial institutions are acknowledged leaders in MSME financing. Brac Bank's MSME asset portfolio reached Tk73 billion (US$873.1 million) and IDLC's Tk 30 billion (US$358.8 million) by September 2017 (with a non-performing loan [NPL] ratio below 4 percent). They have included MSMEs as a strategic business goal and adjusted their risk functions to the market segment. Each has adopted different structures and processes to suit their competitive advantages in achieving lower costs.

IDLC is the largest NBFI in the country. As it cannot offer financial products that larger customers need (such as guarantees, letters of credit, foreign exchange loans, and so forth) due to regulatory constraints, it has invested in the SME and the small enterprise segment. IDLC relies on software. The approval authority lies with the principal branch, whereas the acquisition and other functions are with the local branches (that also have a representative from credit risk management).

Expanding geographical coverage is the main challenge for NBFIs serving SMEs, as almost all NBFIs are urban centric whereas the financing gap is higher in rural and semi-urban areas. However, Brac Bank works with hard copies and 60 area credit managers across the country. Its success is attributed to a "go to [the] customer approach", including agent banking for both secured and unsecured lending to SMEs. Its system is completely decentralized with an equal number of credit document checkers, called hubs or regional operating centers. These centers hold the initial screening process, that is, before a signal is sent for disbursement advice to the principal branch.

Both Brac and Brac Bank have developed a very solid reputation in the micro finance space. However, Brac Bank is now contemplating helping micro enterprises to develop into the small (and even into the medium) enterprise space. Although Brac Bank has struggled with this new orientation, they now appear to be experiencing excellent growth in their SME portfolios — with surprisingly low levels of non-performing assets. They are now committed to ensuring that 50 percent of their loan book is focused on SMEs in Bangladesh (presently they are at 41 percent). One issue of concern that remains, however, is the major focus on trading companies rather than manufacturing, industry, and value-added services.

Prime Bank: The bank made a strategic shift in 2016 to increase its MSME portfolio share. It adopted policies and guidelines, along with a well-crafted MSME vision, organizational structure, and suitable human resources. The bank established a special unit (the MSME Banking Division), and launched a MSME enabling End2End credit delivery process, standard operating procedures and customized product program guides. It hired MSME banking professionals, relationship managers, credit analysts and collection executives. The MSME relationship managers were deployed in selected business hubs, identified as 'core MSME markets'. The bank also established 'Credit Processing Hubs' in 7-8 key locations across the country. Within a year, the bank's MSME portfolio grew by Tk 5.2 billion (US$62.2 million).

The bank's vision is to position itself as the 'Best MSME Bank in Bangladesh' by 2020. In this context, further investments and changes in the areas of staffing, technology, policy, processes, products, and distribution are in progress. Prime Bank has had a significant demonstration effect, and other leading banks (such as City Bank, UCB and Dutch Bangla) have also started to invest heavily in the MSME segment.

Source: PRI (2017)

environment to that of the large enterprises. This distorts policy efforts, such as the Bangladesh Bank's financial schemes, thereby reducing their impact. Additionally, safeguards must be put in place to prevent the use of multiple accounts by the same firm and/or use of accounting techniques by large firms to access financing facilities targeting MSMEs. One option is to focus policy on micro and small enterprises, with some adjustment for the low-end of the medium cluster. However, this should be focused at the program level, as a re-definition of MSMEs would, once again, disrupt the available information base that should guide decision making.

Undertake an evaluation of past schemes and the Bangladesh Bank's guidelines to inform future MSME finance policies. There is a need to assess these schemes and guidelines, as well as to draw lessons to better formulate future schemes and strategies. The authorities should consider expanding the use of market-oriented solutions to leverage private sector capital (such as partial credit guarantee schemes, see Section F).

Clarify the long-term goals of the government and the mandates and objectives of the state-owned financial institutions. The authorities should consider undertaking an in-depth study regarding the role of state intervention in the financial sector. Irrespectively, policy makers should also improve corporate governance arrangements, strengthen the capacity of the Ministry of Finance's Bank and Financial Institutions Division (BFID) to act as owner, focus efforts on development (including MSMEs) and undertake the necessary restructuring. As state-owned financial institutions strengthen, the Bangladesh Bank should migrate financing schemes to these institutions, thus avoiding any perceived conflicts of interest as regulator, supervisor and on-lender to financial institutions.

The Financial Infrastructure Gaps

Addressing financial infrastructure weaknesses is critical. The quality of financial infrastructure determines the efficiency of intermediation, as well as the ability of lenders to evaluate risk and of borrowers to obtain credit, insurance and other financial products at competitive terms. The credit bureau coverage should include all commercial loans, regardless of value, and mine all available data. The registry's mandate should include movable collateral. In addition, the Secured Transactions Law needs to be enacted. To overcome difficult and costly insolvency and debt resolution challenges, the authorities should amend the Small Cause Courts Act, codify and operationalize mediation within the Money Loan Courts and the general courts, and institutionalize Alternative Dispute Resolution mechanisms. Payment systems hold promise in expanding MSME financial access through the DFS. To achieve deeper and broader penetration of financial services, the Bangladesh Bank needs to review its strategy and policy relating to DFS and making the eco-system more supportive of the growth of Fintech.

Credit Reporting

Credit reporting addresses asymmetric information issues in determining the borrowers' repayment capacity, as well as their willingness to repay loans. Information asymmetries may lead to adverse selection, credit rationing, and moral hazard problems. Annex 5 describes the General Principles for Credit Reporting Systems, a core set of general principles to guide credit reporting systems developed by the World Bank, with support from the Bank for International Settlements.

The World Bank Group's 2018 Doing Business

Table 10: Efficiency of the Bangladesh Regulatory Regime, 2018 — Getting Credit

Getting Credit	Bangladesh	China	India	Indonesia	Pakistan	Sri Lanka	Vietnam	South Asia (average)	Best Performer
Strength of legal rights index (0-12)	5	4	8	6	2	2	8	5.3	12
Depth of credit information index (0-8)	0	8	7	6	7	6	7	4	8
Credit registry coverage (percent of adults)	0.9	95.3	0	55.3	9.9	0	51	3.8	100
Credit bureau coverage (percent of adults)	0	21.4	43.5	18.3	6.7	35	19.7	14.1	100

Source: *Doing Business 2018*, International Finance Corporation.

survey ranks Bangladesh at number 159 (of 190 countries) for 'Getting Credit' (a measure of credit information sharing and legal rights of borrowers and lenders). This puts Bangladesh behind regional comparators, such as India (at 29), Sri Lanka (at 122) and Bhutan (at 77). The poor performance stems from low scores in three key indicators (table 10) related to the depth of credit information (with a score of 0 as compared to 8 for China),[29] credit registry coverage (with 0.9 percent of adults versus 95.3 percent for China), and credit bureau coverage (with 0 percent of adults versus 21.4 percent for China).

Credit bureau coverage should include all commercial loans, regardless of value, to benefit MSMEs. The Bangladesh Bank established a Credit Information Bureau (CIB) in 1992, which, according to the 2015 policy guidelines, is responsible for the collection, processing and maintenance of an updated database of credit information supplied by participants and institutions that extend credit. Nevertheless, while CIB reports have been particularly helpful for the relatively larger and corporate enterprises, the majority of MSMEs are still not included in the CIB list. The thresholds for the loans included in a credit bureau's database are high, and retail and small business loans are also excluded.[30] Notably, there is no private sector credit information provider, as in many other countries. The experience of India is especially useful in this regard. It is a good functional example of a private sector-led CIB (see box 4).

The Bangladesh Bank should also work with other institutions to help mine all available data to strengthen credit information relevant to MSMEs. MFIs, utility, trade credit data, retailers and telecommunications companies are significant sources of data. Such data can be used to assess behavioral patterns for existing MSMEs, as well as new entrants.

Allowing private firms and individuals to access credit information would also be a positive step. Changes in the Banking Act to allow the Bangladesh Bank to share credit information with other/third parties would serve two valuable functions. First, retailers would be able to judge the creditworthiness of customers based on past lending history, rather than traditional (and less accurate) metrics, such as family connections or previous transactions with that firm. This is particularly important for retailers of high-value goods, such as automobiles. Second, individuals could access their own information. This would allow borrowers to check and confirm the accuracy

Box 4: India's Experience with Private Sector-led CIBs

The credit information companies in India are led by the private sector. The Credit Information Bureau (India) Limited, commonly known as CIBIL, was incorporated in 2000 and launched its operations in 2004. It maintains records submitted by registered member banks and other financial institutions on a periodic (usually monthly) basis. Based on this data, the CIBIL issues credit reports and a credit score.

Shareholders in CIBIL include TransUnion International (a global credit bureau provider), the ICICI Bank, the State Bank of India, the Indian Overseas Bank, HSBC, the Union Bank of India, the Bank of India, the Bank of Baroda, and Allahabad Bank.

CIBIL has two focus areas, namely a Consumer Bureau that deals with consumer credit records and a Commercial Bureau that deals with the records of companies and institutions.

Following the enactment of the Credit Information Companies (Regulation) Act in 2005, three other Credit Information Companies (CICs) were licensed in 2010, namely, Equifax, Experian and CRIF Highmark. There are currently efforts underway to further reform the credit information industry, specifically by increasing the coverage of the credit information business. This would be accomplished by allowing alternate data sources to be collected, establishing a credit registry for supervisory and financial stability purposes, and putting in place best practices for CICs and credit institutions.

Source: PRI (2017)

of the data and, if necessary, to have it corrected.

Secured Transactions and Collateral Registries

Modern secured transactions laws and collateral registries can increase the availability of credit and reduce its cost. Collateral provides the basis for free-flowing credit markets, reducing the potential losses lenders face from non-payment. Whereas land and buildings are widely accepted as collateral for loans, the use of movable assets (such as inventory, accounts receivables, livestock, crops, equipment, machinery, and shares) as collateral for loans tends to be restricted by the lack of a legal and institutional framework for secured lending and collateral registries. Reforming the framework for movable collateral lending would allow businesses (particularly SMEs) to leverage their assets into capital for investment and growth (see box 5 for some international examples).

Loans in Bangladesh are primarily secured through property-based collateral, but face a challenge regarding property rights — particularly in the lengthy and sometimes non-transparent process linked to establishing a land title. Discrepancies and uncertainties in the legal framework governing security rights, as well as shortcomings in the institutional framework of the registration system of security interests, require significant improvements.

The expansion of the registry's mandate to include movable collateral could increase financing to MSMEs.[31] Most small enterprises do not have immovable assets to present as collateral.[32] Challenges related to the development of the movable collateral registry include: (i) the lack of an adequate legal and regulatory framework for secured lending against movable collateral;[33] (ii) limited availability of movable finance products across the financial sector, as well as in conducive regulation to support movables-based lending; (iii) a relatively limited understanding of secured lending reform and its importance; and (iv) a credit bureau that still needs significant upgradation and capacity building. The draft Secured Transaction Law (STR) was presented and accepted in principle in March 2017 by a Monitoring Committee with representatives of BFID and the Bangladesh Bank. There is a consensus and commitment to obtain Cabinet approval of the STR Law in 2018, and for the Ministry of Finance to then present the law before Parliament. Furthermore, Bangladesh does not have a secured transaction register, although various development partners have assisted in the drafting of a law to facilitate the formation of such a register.

Box 5: International Examples of Successful Secured Transaction Reforms

Colombia: The country enacted a new Secured Lending Law in 2013 and a new centralized collateral registry in 2014. As a result, more loans were registered in six months than in the previous 30 years. More than 58,000 loans were registered with a value of more than US$10 billion.

China: The country enacted a legal reform (2007) and a new centralized online registry for accounts receivables and leasing (2008). This resulted in more than US$6 trillion in financing with receivables (mostly to SMEs), as well as the development of the factoring and leasing industries.

Vietnam: The country enacted a legal reform and new centralized online registry (2012). As a result, 400,000 loans were granted to more than 215,000 SMEs and 15,000 microenterprises. The total volume of financing through the registry is US$13.7 billion.

Mexico: The country enacted a legal reform and a new centralized online registry (2011). Over 150,000 loans were registered for a total secured amount estimated at over US$200 billion. Loans secured with movables multiplied by a factor of four, with 45 percent in the agricultural sector and 95 percent in the SME sector. Businesses have also saved US$4 billion in fees.

Source: De la Campa, A. (2015) "*Secured Lending and Collateral Registries: A global perspective*", World Bank Group Presentation, Dhaka

Insolvency and Debt Resolution

Ineffective debt recovery and weak mechanisms for business exits create a higher cost of capital and heightened perception of risk among investors and financial institutions alike. Well-functioning legal, regulatory, and institutional frameworks are crucial for commercial banks and companies. Specifically, they are needed to resolve non-performing loans, facilitate business exits as well as reorganizations, settle commercial disputes, and collect debts. Legal and regulatory frameworks that inhibit corporate restructuring prevent many viable businesses in financial distress from continuing to function as ongoing concerns when they are in a state of insolvency.

Notwithstanding several legal mechanisms currently in place, loan recovery, insolvency resolution and contract enforcements are, in practice, very difficult and involve high transaction costs in terms of both time and resources. The legal mechanisms include: (i) the Artha Rin Adalat (Money Loan Court) Act of 2003;[34] (ii) the Arbitration Act of 2001 for out-of-court resolution of commercial disputes through arbitration; (iii) the privately provided and institutionalized ADR mechanism provided by the independent Bangladesh International Arbitration Center (BIAC); and (iv) the procedure for contract enforcement under the Civil Procedure Code. Nevertheless, the World Bank Group's Doing Business 2018 report ranks Bangladesh at number 189 (out of 190 countries survey) for enforcing contracts, and number 152 for resolving insolvency. It also estimates that loan recovery rates are low, at 28.3 cents on the dollar.[35]

A Small Claims Court could lead to faster adjudication with lower costs for cases relating to MSMEs; it is important to codify and operationalize mediation within both the Money Loan and general courts. Court-connected mediation is envisaged as an option under both of these procedures, but it has not been operationalized because of lack of implementing rules and capacity within the judiciary. Out-of-court mediation is virtually nonexistent because there are no legal provisions for the enforcement of out-of-court mediation settlements that can be handled by an institution such as the BIAC, for example. Only the court enforcement of arbitration awards is currently regulated. However, arbitration is often equally lengthy and expensive as in regular court proceedings. Therefore, it does not cater to the specific needs of MSMEs.

To settle disputes involving small claims or recover of loans to small enterprises, Bangladesh has the Small Cause Courts Act, 1887 (Act No. IX of 1887), but there is a need for amendments. This could be the court system through which smaller denomination defaulting debts could be adjudicated, if the process is simple and straightforward. As evident from Section 23 of the Act, there are limitations to its ability, if the title of immovable property cannot be proved. Thus, there may be a need for amending the Small Causes Courts Act 1887, particularly to settle commercial disputes and default credit recovery with simpler and least-cost processes. Bangladesh could also consider the procedures and scope of what is known as a Small Claims Court (as found in Australia, Kenya, Singapore, the United Kingdom and the United States, for example), with jurisdiction encompassing private disputes that do not involve large amounts of money.

Institutionalizing Alternative Dispute Resolution mechanisms for commercial dispute settlement could also help address the concerns voiced by the private sector regarding inadequate, inefficient and lengthy contract enforcement processes. An ADR institution would encourage new investments and help to extricate existing investors from business-hindering litigation. A debt resolution intervention could also have a significant impact on improving loan recovery rates. There is an ongoing IFC project on debt resolution in Bangladesh which assisted with the creation of the first Bangladesh ADR Center, the BIAC.[36] The next phase of the project with the BIAC, the Ministry of Law and other stakeholders aims to incentivize the use of arbitration for bank commercial contracts, including the use of mediation for debt recovery actions (before applying to a Money Loan Court).

Payment Systems

Payment systems form a vital part of the financial system enabling funds to be transferred between and among people and institutions. Secure, affordable, and accessible payment systems and services promote economic development, support financial stability, and help expand financial inclusion.[37] A transaction account held with banks or other authorized and/or regulated payment service providers allows individuals and businesses — in particular, MSMEs — to perform most, if not all, of their payment needs (such as making and receiving payments), and to safely store some value. It can also serve as a gateway to other financial services. Globally, electronic payment solutions have contributed to expanding MSME access to credit because of the creation of a digital footprint for MSME transactions. This history can be used to assess MSME creditworthiness. In addition, e-commerce has the potential to help the MSME sector grow.

The Bangladesh Bank has made significant advances toward the development of a digitized payments system. Importance was given to implementing newer payment platforms, that is, the National Payment Switch (NPS), an e-Payment Gateway and Real Time Gross Settlement (RTGS), while also upgrading the required legal and regulatory framework befitting the electronic payment platforms. It currently has in place the Bangladesh Automated Clearing House (BACH), the first ever electronic clearing house. The system has two components, namely the Automated Cheque Processing System (ACPS) and the Electronic Funds Transfer (EFT).

The Bangladesh Bank has also encouraged the development of Mobile Financial Services (MFS), with the objective of expanding access to banking services and expediting the delivery of remittances; however, there are challenges. The current challenge will be to transform this mobile-payments system into a mobile-financial system with a broader range of financial services being offered electronically. Despite 32.2 million users of mobile banking accounts as of June 2016, cash remains the predominant form of payment used in financial transactions. A 2013 survey on "Payment Mechanisms in Bangladesh" indicated that there are issues with the EFT and online banking, including technical glitches, such as network and server failures and the high volume of fees, especially for those firms that use EFT frequently for letters of credit. In addition, the value of transactions through MFS in Bangladesh was only 5.6 percent of GDP in 2015, far lower compared to Kenya at 55 percent. BKash, a subsidiary of BRAC Bank, has been a pioneer in this area. However, Bangladesh has yet to reach its full potential in implementing an effective digital financial service (DFS). The legal and regulatory structure is restrictive by only allowing a bank-led model, which has helped BKash innovate and grow toward the formation of a virtual monopoly.

Small enterprises tend to rely heavily on cash, with cash accounting for 72 percent of all payment transactions in a given year. On the other hand, checks only comprise 24 percent of all payment transactions, EFT 3 percent, and only 1 percent is made through cards, courier, mobile banking and telephone transfers.[38] Business payments are typically categorized as either: (i) Business to Business (B2B), such as for the purchase of goods and services, sales receipts, office rent, transportation, utilities costs, security, and stationery; (ii) Business to Government (B2G), such as for fees, value-added tax (VAT) and taxes; and (iii) Business to Others (B2O), including for salaries, services, consultants, and casual labor. In Bangladesh, checks are predominantly used for all categories of business payments, as well as for 95 percent of B2G payments. A large share of B2B payments (32.3 percent) is made through EFT, which typically pay for purchases of goods through international Letters of Credit using the Society for Worldwide Interbank Financial Telecommunication (SWIFT).

Policy Recommendations

Improve the credit information infrastructure, expanding the reach of the CIB. Credit bureau coverage should include all commercial loans, regardless of value, to benefit MSMEs. MFIs and telecommunications companies could be significant sources of data to assess behavioral patterns (for both existing MSMEs and new entrants). The Bangladesh Bank should consider allowing credible privately-managed credit reporting systems, while ensuring effective regulation and oversight by the Bangladesh Bank or other relevant authorities.

Enact a law and establish a secured transaction register. Pursue efforts to establish a secured transaction register, with a legal framework for secured lending addressing the fundamental features and elements for the creation, recognition, and enforcement of security rights for all types of assets. This would encompass movable and immovable assets and tangible and intangible assets— including inventories, receivables, proceeds, and future property. On a global basis, it would also include both possessory and non-possessory rights.

Establish a Small Claims Court and institutionalize ADR mechanisms. Review and amend the Small Cause Courts Act 1887, adjudicating for small claims disputes between banks/ financial institutions and micro and small enterprise borrowers. Establish a Small Claims Court with a maximum monetary limit to the amount of judgments it can award. Institutionalize ADR mechanisms for commercial dispute settlement, which will also help with inadequate, inefficient and lengthy contract enforcement processes.

Promote an effective payment system and financial infrastructure to support the rollout of DFS. The Bangladesh Bank needs to review its strategy and policy relating to DFS, including making the eco-system more supportive of Fintech growth. A critical element will be to promote access to finance through Fintech, as well as having in place an effective payment system. The creation of a payments and financial infrastructure that will continuously improve the enabling environment to facilitate lending and uptake of DFS would be key. The Bangladesh Bank has also been ushering in regulatory changes, and has issued directives to the banks for starting e-Commerce activities. These can be revisited to lower transaction costs.

Exploring Innovative and Alternative Financing Options

Several innovative and alternative financing options that are currently unexploited hold promise. Appropriately designed and governed risk-sharing facilities can help to de-risk MSME lending decisions. As the necessary enabling environment and financial infrastructure improves and digital technology develops, factoring and warehouse receipt finance are likely to become viable solutions. Public policy can also help to reduce the risks associated with start-up capital.

Risk-sharing Facilities

A majority of countries around the world have established risk-sharing facilities (RSFs) to partially cover the risks of MSME lending — and help de-risk lending decisions by commercial banks. A RSF provides third-party credit risk mitigation to lenders through the absorption of a portion of the lender's losses on the loans made to SMEs in case of default in return for a fee. A well-functioning RSF can contribute to MSME finance in a market-friendly way by sharing risks with financial intermediaries and encouraging the development of appropriate market segment lending and risk management technologies. It can also help to alleviate the collateral constraints of MSMEs.

A RSF can also be complex in design and implementation, as well as subject to moral hazard if operating in an environment characterized by poor governance.[39] There are multiple design options with significant implementation impacts. These include the management structure, the operating rules, and guarantee characteristics. Just as with other instruments of state intervention, weak governance can result in resource misallocation, along with market distortions. Critical design choices,

Box 6: Credit Guarantee Schemes in India and Thailand

India: The Government of India instituted "the Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGS)" to provide collateral-free credit to the micro and small enterprise sector. Both existing and new enterprises are eligible. The Ministry of MSMEs, the Indian Government and the Small Industries Development Bank of India (SIDBI), established a Trust to implement the CGS: Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE). It was formally launched in August 2000. The funding is provided by the Government and SIDBI with a financing ratio of 4:1, respectively. The total funding was amounted to Indian Rupees (Rs.) 25 billion (US$358.3 million) until May 2016, with 24,31,490 approved proposals from micro and small enterprises for an aggregate credit amount of Rs.11.35 billion (US$162.7 million).

Eligible credits are term loans and/or working capital facilities up to Rs.10 million (US$143.3 thousand) per borrowing unit, extended without collateral and/ or third-party guarantee. The maximum guarantee is 85 percent and varies by size and development considerations. For example, the guarantee is 75 percent for credits up to Rs.5 million (US$71.7 thousand); 85 percent for credits to microenterprises up to Rs.500 thousand (US$7,166) provided; 80 percent for micro and small enterprises owned/operated by women; 80 percent for all loans to the Northeast Region, including Sikkim; and 50 percent if the credit amount is between Rs.5 and 10 million (US$71.7 thousand to 143.3 thousands). The tenure is a block of 5 years, if working capital facility on standalone basis is covered under the Credit Guarantee Scheme.

The annual guarantee fee is an all-in of 1.0 percent per year. This is reduced for preferred creditors: 0.75 percent for a credit facility of up to Rs.500 thousand and 0.85 percent for amounts between Rs.500 thousand and 10 million for women, microenterprises and units in the Northeast Region, including Sikkim.

To support startups, India is also proposing a scheme that will provide up to 80 percent risk cover for loans of up to Rs.50 million (US$716.6 thousand) without collateral.

Thailand: The Small Industry Credit Guarantee Fund (SICGF) was established in 1985 and was renamed the Small Business Credit Guarantee (SBCG) in 2005. It is a state-owned specialized financial institution under the supervision of the Ministry of Finance, and the only credit guarantee institution in Thailand. It has a registered capital of Baht 4.4 billion (US$136 million equivalent).

The Shareholding Structure is as follows: the Ministry of Finance holds 93.18 percent; the Private Banks 2.50 percent; the State-owned Banks 1.53 percent; the Government Savings Banks 1.44 percent; The Industrial Finance Corporation of Thailand 1.08 percent; and the Small and Medium Enterprise Development Bank of Thailand 0.27 percent. The Guarantee Fee is 1.75 percent per year of the guaranteed amount, paid in advance, and collected by lenders remitting it to the SBCG. The maximum limit of the outstanding guarantee is five times the capital (that is, Baht 22 billion [US$680.1 million]).

Source: PRI (2017)

such as the responsibility of loan assessment and recovery, the coverage ratio, pricing, claim processing, capital relief of the guarantee, and so on, can influence the developmental impact and the sustainability of the scheme. These choices can potentially have fiscal and financial stability repercussions as well.

Bangladesh had tried to launch guarantee schemes through various state-owned banks (SOBs), but these have faced significant governance problems. The SOBs did not perform the appropriate due diligence, and the schemes suffered from severe moral hazard and significant losses. The Bangladesh Export Credit Guarantee Scheme (ECGS) presents a more positive experience.[40] (See also box 6). Since 1978, this government program has been implemented at the initiative of the Export Promotion Bureau and the ministries of commerce, industry and finance. The scheme encourages exporters to initiate exports of new products and/or to enter new markets by covering the risk of insolvency of buyers — in addition to political risks inherent in foreign trade.[41] The scheme also provides a guarantee for bank loans taken by the exporters for meeting their financial needs during the production time, as well as between the exporting of goods and the receipt of payment from foreign buyers. The Sadharan Bima Corporation, a state-owned general insurance enterprise administered the scheme. However, it is currently inoperative. The government is now planning to create another fund similar to the ECGS, as mentioned in the "Export Policy 2015-18". It is expected to provide rapid financial compensation for incurred losses by exporters.

With support from IFC in 2017, the Bangladesh Bank agreed to design a targeted RSF to address the collateral issues faced by women entrepreneurs in the SME segment. The scheme design will leverage the WBG's extensive experience with public-sector RSFs and ensure the scheme mitigates moral hazard concerns. It will also ensure that it has sufficiently strong governance. The Bangladesh Bank will pilot the RSF with seed funding from the United Nations Capital Development Fund.

At the private sector level, BRAC Bank and the Development Credit Authority of the United States Agency for International Development (USAID) have been involved in an on-going credit guarantee scheme project since 2014. This is targeted toward 20 underserved districts in the southern part of Bangladesh. For an annual fee of US$13,000, the agency covers 50 percent of the BRAC Bank's agri-business loans. The guarantee scheme has encouraged BRAC Bank to expand in areas of perceived high risk.

Lessons should be drawn from past and ongoing experiences with risk-sharing facilities to design a scheme that responds to market needs. The current MSME financing landscape (and 'the missing middle', in particular) lacks an appropriate incentive mechanism for financial institutions to sustainably scale up their lending to this market segment. If appropriately designed, from specific mandate to independent governance, such a scheme could be a catalyst to expanded MSME financing.

Alternative financial instruments

A range of alternative or innovative pre-bank financing options have emerged to support young and dynamic firms reach the bankable stage.[42] In *factoring*, an enterprise receives funds from a specialized institution (factor) by selling its accounts receivable at a discount. In *purchase order finance*, an enterprise obtains financing for inputs to meet the order against the strength of its purchase order against agreed fees and service charges. In *warehouse receipt finance*, the loan is secured by commodities deposited at a certified warehouse, and the commodities cannot be released until the loan is repaid. In *leasing*, an enterprise secures the right to use machineries and equipment for a specified period by paying a rental fee. In *securitization*, a bank packages MSME loans into a portfolio and sells that portfolio to capital market investors (reducing its risk and increasing liquidity). In *crowdfunding*, an enterprise raises funding from a large number of individuals in the same spirit as social marketing (typically using the Internet to mobilize donations, equity or debt). A *mezzanine finance* operation combines two or more financing instruments and sells it to an investor as a single entity. A *venture capital* operation involves equity participation by wealthy individuals in enterprises regarded as having high potential. Since the investor assumes a high level of risk, the internal rate of return on investment projects tends to be very high (on the order of 20-25 percent). *Business angels* are a variant of venture capital. They typically involve a high net-worth individual who provides equity finance to start-up companies (with no family connection) in return for company shares.

For all such operations, the most important success factor is the enabling environment, which is still under development in Bangladesh. An efficient regulatory and legal system that preserves the sanctity of a contract by ensuring its enforceability is critical. Proper documentation and digitized record keeping is also necessary. Without these pre-requisites in place, the risks of fraud are very high — especially for crowdfunding and angel-funding types of initiatives.[43] There are numerous examples in Bangladesh of fraudulent practices with high losses for small investor funds. As a result, such efforts are approached with suspicion.

As the financial infrastructure improves and digital technology develops, asset-based solutions, such as factoring and warehouse receipt finance, are likely to become more attractive. The Bangladesh Bank recently launched an online consultation regarding draft guidelines on factoring, which are being discussed with legal experts and major stakeholders. Presently, the guidelines are under finalization for approval. A feasibility study and other technical studies are also planned for warehouse receipt financing under the World Bank's Financial Sector Support Project, which is being implemented by the Bangladesh Bank. Leasing is in active use, but it is focused mostly on the upper-end of medium and large enterprises.

Start-up capital is much needed, but still absent. Bangladesh has several large firms in the RMG sector at the top end, but few firms in the middle range. Microenterprises have benefited from the microfinance revolution. However, organized non-bank startup financing options for small enterprises are very limited. There have been some efforts by private enterprises to develop equity financing options, but these initiatives have had limited success (ADB 2014).[44] In addition to the absence of an enabling financial infrastructure and the lack of regulations for the venture capital (VC) industry, a major problem is the reluctance of enterprise owners to seek equity financing for the fear of losing control over ownership. Additional challenges include the inability to conduct proper due diligence, the limited availability of quantitative and qualitative information on SMEs, and different perceptions of company valuations between SMEs and VC firms.

Supporting the start-up space could contribute significantly to supporting new, innovative more dynamic, and growth-oriented firms. It could also help the SME sector diversify from "trading" to more value-added activity (such as industry, manufacturing, and value-added services). New start-up enterprise finance support could help in areas such as ICT, mobile-apps/applications, tourism, pharmaceuticals, tourism, and so on.

Box 7: The United States Small Business Investment Company (SBIC)

SBIC is a private company that is licensed by the Small Business Administration (SBA) to provide investment funding to small businesses in the form of debt and equity. SBA supports qualified SBICs by providing funds for approved lines of business. The SBA provides US$2 for each US$1 placed by a SBIC. A typical SBIC loan ranges from US$250,000 to US$10 million and entails interest of 9-16 percent. Equity financing involves joint ownership between the SBIC firm and the business receiving equity financing. Equity participation could range from US$100,000 to US$5 million. A combination of debt and equity financing involves a joint partnership and loan rates of 10-14 percent. The volume of funding is in the range of US$250,000 -US$ 10 million.

Part of SBA's funding relates to the Early Stage Innovation and Social Impact Programs. The former is designed to support companies in the earliest stages (before the company has a significant cash flow or asset base) and financing ranges from US$1-4 million. The latter is designed to provide funding for businesses that have at least 35 percent of employees residing in low- or moderate-income areas, or that operate in the clean-energy or education sector.

From 2011 to 2015, SBIC-licensed funds invested US$21 billion in more than 6,400 companies, 20 percent of them located in low- to moderate-income areas. A majority of SBIC-licensed capital went into states other than California, New York or Massachusetts. Evidence also shows that the SBIC program funded more women and minority-led companies than a standard private equity fund. Apple, Intel, FedEx, Costco, Staples, and even Build-a-Bear, are just a few of the companies that received early stage investment from a SBIC license holder.

Source: PRI (2017)

Public policy can help reduce the risks associated with this market segment. Examples include the Small Business Investment Company (SBIC) supported by the SBA in the United States (Box 7) and the Youzma Fund in Israel. Learning from these experiences, Australia, Canada and countries in Western Europe have also established similar support institutions. There is already a good experience in Bangladesh pioneered by the Industrial Development Leasing Company (IDLC), the largest NBFI. The IDLC uses Bangladesh Bank refinancing money to finance start-ups and micro and small enterprises at low interest rates.[45] The IDLC could consider establishing similar windows as the SBIC, attracting donor and government funding to provide market incentives for financing NBFIs that are willing to provide start-up financing.

Fintech Solutions

Technology is transforming the global economy and MSME financing. Fintech companies (a short form for the use of technology in financing solutions, and increasingly used interchangeably with DFS) hold a promise of providing a new set of products tailored to the needs of smaller businesses. The main use cases of Fintech are provided in annex 7. Fintech companies have emerged with innovative solutions that can substantially improve efficiencies at each step of the lending process, including loan origination, underwriting, disbursements and collections, along with service and monitoring. Marketplace (peer-to-peer) lending provides credit to MSMEs through online platforms that match lenders (savers, investors) with borrowers. It has significant advantages in terms of speed, convenience, and terms (for example, no collateral needs). Technology platforms for invoice and value chain finance can streamline processes, allowing, for example, small business owners to directly connect their accounting software to the invoice finance platform, apply for a loan, and receive payment almost instantly. Access to credit can also be expanded using the digital footprint created by MSME transactions using e-commerce or e-payments to assess the borrower's creditworthiness.

Several enabling factors are critical to the success of Fintech, and the regulatory environment is particularly important.[46] The main regulatory issues center on financial stability, prudential regulation, conduct and fairness, and competition and development. Ensuring a level playing field between market players, banks and Fintech remains a key challenge. From a risk perspective, the traditional risks pertaining to the underlying product remain, whereas some risks have increased, such as money laundering/ financing of terrorism, data privacy and consumer protection.

The fact that many of these developments are rapidly evolving, coupled with the lack of adequate analysis, raises the question of when and how to regulate. Several central banks and other regulators are establishing regulatory sandboxes to encourage experimentation and allow regulators to become more familiar with the innovations. With this knowledge, they can better assess the risks and calibrate the regulatory frameworks. For example, the People's Bank of China and Bank Negara Malaysia are establishing regulatory sandboxes to encourage and guide innovations. Some countries are going further and establishing innovation hubs and accelerators. In this context, the Central Bank of Mexico has established an innovation hub, and there are also efforts being made to develop a new legal and regulatory framework for Fintech companies. Both China and the United Kingdom (UK) have sought ways to preserve financial stability, while providing an enabling environment for Fintech companies to work in a competitive environment. In the UK, the Financial Conduct Authority has established an Innovation Hub. In Singapore, the Monetary Authority of Singapore has earmarked S$ 225 million (US$165.2 million equivalent) for research to support the growth of Fintech solutions. Also, the Australian Securities and Investments Commission has created open office hours to support Fintech. Finally, in several African countries (for example, Kenya presented in box 8, or Senegal), the regulators have been very supportive, allowing a domestic Fintech industry to blossom.

The International Monetary Fund and the World Bank Group launched the Bali Fintech Agenda in October 2018. It is a set of 12 policy elements aimed at helping countries to harness the benefits and opportunities of rapid advances in financial technology that are transforming the provision of banking services, while at the same time managing the inherent risks. Agenda topics covered relate broadly to enabling Fintech, ensuring financial sector resilience, addressing risks, and promoting international cooperation (see annex 7).

In Bangladesh, the rapid growth of ICT services has led to the growing use of technology for the delivery of financial services. Banks and NBFIs have adopted ICT for a range of services, including e-banking. Several NBFIs, such as IDCL, are using technology to simplify loan applications and approvals using online transactions. The spread of mobile phone ownership (and the growing use of smart phones) has supported the rapid growth of mobile financial services (MFS). The Bangladesh Bank defined the regulatory policies for MFS in 2011, and the response has been positive in terms of electronic money transfer operations (Ahmed 2017).[47] The Bangladesh Bank has also begun making regulatory changes and issuing directives to banks for starting e-Commerce activities.

Successful MFS providers include Bkash of BRAC Bank and Rocket of Dutch Bangla Bank Limited, and a number of other new players are emerging.[48] These include CloudWell, founded in 2012, which offers several payment solutions under its brand name. PayWell offers prepaid debit cards, payment gateways, and point-of-sale systems. It has a network of more than 5,000 retail shops, and its main customers include big enterprises across the financial services, telecommunications, and e-commerce industries. SmarTKompare, launched in 2015, lets users compare financial products from numerous financial institutions (including loans, insurance, credit cards, and deposits). Projekt.co, launched in 2015, is a platform that provides innovators, artists, and change-makers with the opportunity to raise funds from their friends, family and the community. SureCash provides mobile banking and mobile payment network solutions, connecting people, banks, and businesses. It works

Box 8: Kenya's Success with Fintech companies

Kenya has emerged as a Fintech hub in emerging markets, with M-Pesa's success spurring several innovative digital financial products. M-Pesa, led by the telecoms giant Safaricom, revolutionized financial inclusion by offering a broad range of financial services (including deposits, loans, money transfers and e-payments for services). Over 85 percent of the adult population uses such services regularly to pay for products and amenities, such as household bills and school fees — with only 38 percent using a traditional bank account. Spurred by the success of M-Pesa, many Fintech companies have sprung up, including companies that offer MSMEs small loans through mobile phones within a matter in seconds. Others facilitate digital payments and smallholder farmers to purchase insurance for their crops.

Several factors explain this success. First, in recent years, there has been an expansion of innovation hubs that are helping new Fintech companies to both start and grow. Incubators such as iHub, the Nairobi Garage, m-lab and Nailab offer low-cost, collaborative opportunities for start-up companies to share and refine their ideas. Second, the financial regulator has played a strong supportive role in providing an enabling environment for the growth of Fintech companies. This has been done without any restrictions on entry or requirements that these initiatives be led by a bank. Indeed, the traditional financial institutions have taken a back seat in this endeavor. Third, Kenya has undertaken reforms to simplify and deregulate the business environment for the private sector. For example, *Doing Business year?* ranks Kenya at 80 (of 190 countries), improving rapidly from a rank of 129 in 2014. Finally, the availability of fixed telecommunications infrastructure and the rapid adoption of smart-phone use played a strong enabling role for the users of Fintech services.

Source: Blythin and Cooten 2017.

with 6 local banks, 350 payment partners and over 41,000 retail agents. Finally, UCash of the United Commercial Bank Limited is a mobile financial service. An increasing number of banks are providing online Internet banking. E-commerce is also growing with chadal.com, dugdugi.com, bikroy. Ride-sharing cabs, such as BD cabs, have also emerged.

A number of challenges remain. First, there has been only limited penetration and usage of digital payments. Despite the opportunities brought by some government initiatives (such as "Digital Bangladesh", "A2I", digitization of government payments, upgrades of BACH and national switch [implemented under a World Bank project]), the use of mobile banking and the Internet to pay bills or for purchases remains lows. So too, the ownership of debit and credit cards remain low compared to other countries in the region, such as India or Sri Lanka. Second, there has been limited adoption of technology by businesses as measured by the low percentages of firms with their own website (at about 25 percent), as well as of firms using email to interact with clients/suppliers. Third, there is a lack of capacity, scale and coordination in the digital entrepreneurship ecosystem.

Policy Recommendations

Introduce a RSF for SMEs. This should incorporate lessons learned from global experience, as well as any insights from the pilot for targeted RSFs for women-led SMEs. The RSF should have an explicit goal of financial sustainability, operational transparency, and full disclosure. Whereas the Bangladesh Bank may take the lead in the short run, in the medium-term, the authorities should consider creating an independent professional company with an appropriate governance structure. This could be funded by the government, participating banks/ NBFIs, international development organizations, or other entities.

Pursue the necessary legal and infrastructure needs for the introduction or expansion of alternative finance. The Bangladesh Bank should continue its efforts to promote factoring and warehouse receipt financing. The authorities could also support start-up capital financing and its ecosystem. Furthermore, the IDLC experience can be mainstreamed by establishing a similar window as the SBIC, pooling donor and Government funding.

Support the evolution of Fintech. The Bangladesh Bank could issue necessary Circulars to support Fintech and bank/ financial institution partnerships, which is the most pragmatic means in the short term. In the medium term, the Bangladesh Bank should consider moving beyond a bank-centric Fintech model. Instead, it should consider forming a dedicated Fintech Support Department that could collaborate with the National ID issuing authority, the Security Exchange Commission, Prime Minister's Office, the Bangladesh Telecommunication Regulatory Commission (BTRC), and the ICT-related regulator. The goals would be to educate, observe and guide Fintech activities, and encourage experimentation within a regulatory sandbox, for instance, by better assessing the risks and support for Fintech-friendly regulations. The policy and regulatory framework for data aggregators from multiple sources (MFIs, telecommunications records, utility payments, and so on) should be developed to allow for full leverage of alternative data for credit decisions, As such, it would help to promote the development of the Fintech sector beyond its current focus on person-to-person transfers and retail payments. In addition, encouraging open API-based integration with existing financial institutions will allow Fintech to offer targeted financial products. The suggested Fintech Support Department can take the lead with other relevant Bangladesh Bank counterparts, as well other public-sector counterparts, to operationalize the required infrastructure.

III. CONCLUSIONS

This is an opportune time to reexamine MSME finance policy in Bangladesh. MSMEs are undoubtedly critical for job creation and economic growth, and access to finance has rightly been the focus of policy makers in Bangladesh. However, MSME financing gaps remain very high, even compared with other South Asian economies. Thus, the authorities have focused on this challenge. However, just as with all policies, a frequent reevaluation is warranted. This is an appropriate time, as past approaches can be objectively evaluated, and innovative and alternative instruments are emerging that present a unique opportunity to address remaining challenges.

This report presents a desk review of the financing gap, constraints and policies related to MSME financing, offering recommendations for policy makers to plan for the future. Recommendations are as follows:

- **Improvements in the strategic vision and policy implementation require institutional coordination.** Bangladesh would benefit from establishing a central coordinating multi-party body to promote MSME development and financing.
- **The Bangladesh Bank would benefit from undertaking an evaluation of past schemes, guidelines and success stories to inform future MSME finance policies.** The Bangladesh Bank should refocus its attention on the most constrained among MSMEs and broaden its policy emphasis beyond the banks.
- **It is important that the government clarifies the long-term goals, mandates and objectives of the state-owned financial institutions**, and undertakes the necessary reforms.
- **Addressing the significant financial infra-structure weaknesses is fundamental.** These include outstanding policy actions regarding credit reporting, secured transactions and collateral registries, and insolvency and debt resolution.
- **Payment systems, in particular, hold the promise of expanding MSME financial access through Digital Financial Services (DFS).** The Bangladesh Bank has made significant advances toward the development of a digitized payment system. It needs to now review its strategy and policy in transforming the mobile-financial system to one offering a broader range of services.
- **The time is ripe to explore and plan for several innovative and alternative financing options.** A MSME-focused RSF can learn from past experiences by addressing governance and design concerns. As financial infrastructure improves and digital technology develops, asset-based solutions, such as factoring and warehouse receipt finance, can be promoted. Finally, public policy can help reduce the risks associated with start-up capital.

ANNEXES

Annex 1. Definition and Classification of MSMEs

The following summarizes the various definitions and classifications of MSMEs adopted in Bangladesh:

2003 – Economic Census: The Bangladesh Bureau of Statistics (BBS) used full-time employment as the classification basis for the 2003 Economic Census (table 1).

2010 – Industrial Policy: The Ministry of Industry used the value of fixed assets (excluding land and buildings) and the number of employees for the 2010 Industrial Policy (table).

2011 – Bangladesh Bank: As a part of its effort to promote the financing of MSMEs, the Bangladesh Bank followed a similar definition to that of the 2010 Industrial Policy. However, it changed the parameters (table).

Table 11: Definition of MSME in the 2003 Economic Census

Type of Firms	Number of Employees
Micro	0-9
Small	10-49
Medium	50-99
Large	100 and above

Source: Economic Census 2003, BBS.

Table 12: Definition of MSMEs in the Bangladesh 2010 Industrial Policy

Types of Enterprise	Total Fixed Assets (Excluding Land and Factory Buildings)	Total Number of Employees
A. Medium Enterprise		
Service Concern	Tk 10 to 150 million	50 to 100 employees
Manufacturing Concern	Tk 100 to 300 million	100 to 250 employees
B. Small Enterprise		
Service Concern	Tk 500,000 to 10 million	10 to 25 employees
Manufacturing Concern	Tk 5 to 100 million	25 to 99 employees
C. Micro Enterprise		
Service Concern	Tk 500,000 or less	10 or less employees
Manufacturing Concern	Tk 500,000 to Tk 5 million	10 to 24 or less employees

Source: *Doing Business 2018, International Finance Corporation.*

Table 13: Bangladesh Bank Definition of Small Enterprises

Types of Enterprise	Sector Fixed Asset (other than Land and Buildings) (Tk)	Employed Manpower (Not Above)
A. Medium Enterprise*		
Service	5,000,000 – 100,000,000	50
Business	5,000,000 – 100,000,000	50
Industrial	15,000,000 – 200,000,000	150
B. Small Enterprise		
Service	50,000 – 5,000,000	25
Business	50,000 – 5,000,0000	25
Industrial	50,000 – 15,000,000	50

Source: Bangladesh Bank, 2011.
Note: *Bangladesh Bank also defines medium enterprises as those that are not public limited companies.

2013 – Economic Census 2013: BBS adopted the definition of the 2010 Industrial Policy, which introduced consistency for policy-making purposes. However, it made census data uncompilable across time.

2013 – WBG Enterprise Survey: The survey uses three levels of stratification: industry, size, and region. Size was defined based on employment: small (5 to 19 employees), medium (20 to 99 employees), and large (more than 99 employees).

2016 – Updated definition by the Bangladesh Bank (see table 14).

Annex 2. MSME Structure and Roles (2013 Bangladesh Economic Census)

MSME Employment

Since the classification changed from 2003, a strict intertemporal comparison is not possible.

Table 14: Updated Definition of MSMEs by the Bangladesh Bank, 2016

Categories	Sectors	Fixed Assets (other than land and buildings) (Tk)	Employed manpower
Micro Enterprise	Manufacturing	500,000 – 5,000,000	10-24
	Business	Less than 500,000	Less than 10
	Service	Less than 500,000	Less than 5
Small Enterprise	Manufacturing	5,000,000 – 100,000,000	25-99
	Business	500,000 – 10,000,000	6-10
	Service	500,000 – 10,000,000	10-49
Medium Enterprise	Manufacturing	100,000,000 – 300,000,000	100-150
	Business	10,000,000 – 150,000,000	11-50
	Service	10,000,000 – 150,000,000	50-100

Source: Credit and Development Forum, 2016.
Note: MFIs= Microfinance Institutions.

Table 15: Size and Employment of Enterprises in Bangladesh, 2013

Enterprise Type	Number of Enterprises	Percent of total	Number of persons employed	Percent of Total	Average Employment
Cottage and Micro	6,942,891	88.8	13,727,197	56.0	2.0
Small	859,318	11.0	6,600,685	26.9	7.7
Medium	7,106	0.1	706,112	2.9	99.4
Large	5,250	0.1	3,466,856	14.1	660.4
Total	7,818,565	100	24,500,850	100.0	3.1

Source: BBS, Economic Census 2013.

Nevertheless, examining aggregates, the total number of enterprises more than doubled from 2003-2013 (from 3.7 million to 7.8 million), suggesting an annualized growth rate of around 11.3 percent. Independent data from the number of microcredit borrowers suggests that most of the growth came from the cottage and microenterprise segments. Similarly, employment also doubled (from 12.3 to 24.5 million), registering an annual growth rate of 7.1 percent. (See table 15).

MSME Activities

Table 16: Distribution of Enterprises by Major Economic Activities, 2013 (numbers in `000)

	Micro		Small		Medium		Large		All	
	#	%	#	%	#	%	#	%	#	%
Manufacturing	831.2	12.0	30.9	3.59	3.0	42.1	3.12	59.4	868.2	11.1
Other industrial activities	26.1	0.4	7.8	0.91	0.3	4.6	0.17	3.2	34.3	0.4
Trading and related activities	3,057.7	44.0	531.0	61.80	0.6	8.9	0.08	1.5	3,589.5	45.9
Transport and storage	1,265.9	18.2	37.7	4.39	0.2	2.3	0.04	0.8	1,303.8	16.7
Other services	1,766.0	25.4	251.9	29.32	3.0	42.2	1.84	35.0	2,022.7	25.9
Total	6,946.9	100.0	859.3	100.0	7.1	100.0	5.25	100.0	7,818.6	100.0

Source: BBS, Economic Census 2013.

Annex 3. Estimation of the Small Enterprise Financing Gap Using Bangladesh Bank Loan Data

One possibility of estimating the small enterprise financing gap is to look at the present structure of the banking sector loans.

Table 17 presents the total banking sector loan disbursements to SMEs for FY2016-17. The total number of accounts for medium enterprises

Table 17: Banking Sector Loan Disbursements to SMEs

	Total Amount (Tk billion)	Number of Accounts	Average per Account (Tk million)	Number of Enterprises	Average per Enterprise (Tk million)
Small	328.31	163,482	2.01	859,318	0.4
Medium	392.1	49,881	7.86	7,106	55.2
SME	720.41	213,363	3.38	866,424	0.8

Source: Bangladesh Bank and BBS 2013 Economic Census.

Table 18: Small Enterprise Financing Gap

	Average Demand (Tk million)	Number of Enterprises	Total Demand (Tk billion)	Demand-Supply Balance (Tk billion)
Demand	2.01	859,318	1,727.2	1,727.2
Supply				328.3
Financing Gap				1,398.9

Source: Bangladesh Bank and BBS 2013 Economic Census.

exceeds the total number of medium enterprises in the 2013 Economic Census by a factor of 7, suggesting multiple accounts by medium enterprises — and/ or access to the facility by large enterprises using smaller accounting units. The average loan disbursement per enterprise is Tk 55 million (US$657.8 thousand equivalent), which implies the absence of a credit constraint for medium enterprises (on average).[49] However, the total loan accounts for small enterprises amount to a mere 19 percent of the enumerated small enterprises in the 2013 Economic Census, which suggests that there are many financially unserved small enterprises.

Table 18 provides an estimate of the small enterprise financing gap. If the average loan disbursed in FY2016-17 is a fair representation of the average loan demand (from small enterprises that have access to banking credit), multiplying this with the total number of small enterprises yields an estimate of Tk 1,727.2 billion (US$20.7 billion equivalent) (or 10 percent of GDP) as the potential credit demand. In turn, the financing gap stands at Tk 1,398.9 billion (US$16.7 billion equivalent) (or 8.5 percent of GDP).

Annex 4. Roles and Activities of Agencies Supporting MSMEs

Agencies	Activities and Services
Ministry of Industry	• Formulates National Industrial Policy, including definitions of Cottage, Micro, Small and Medium size industries. • Handles matters related to micro, cottage industries and SMEs. • Supervises the functioning of the Bangladesh Small and Cottage Industries Corporation (BSCIC) and the Bangladesh Industrial Technical Assistance Centre; and also has the SME foundation under its authority (see below)
SME Foundation (under the Ministry of Industry)	• Helps implementation of SME policy strategies adopted by the Government. • Provides collateral-free loans to the targeted entrepreneurs of selected clusters and segments through partner financial institutions. • Organizes national and regional SME product fairs. • Conducts initiatives to create and develop women ICT entrepreneurs/freelancers/ workforce in collaboration with the Access to Information (a2i) Program and the Bangladesh Women in Technology (BWIT). Provides various support and capacity building to women entrepreneurs. • Conducts studies on various SME sectors in line with the Industrial Policy, including a needs assessment program to design and implement a cluster development action plan. • Supports the SMEs with various kinds of services, including helping SMEs identify and address the challenges in legal and administrative regimes, such as regulatory barriers on trade licenses, patents and trademarks, product certification, environmental issues, and so on; Supports technology up-grading, adaptation of advanced/appropriate technologies, and compliances and certification.
Bangladesh Small and Cottage Industries Corporation (BSCIC)	• Helps entrepreneurship development through counseling and training. • Provides infrastructure facilities by establishing industrial estates. • Extends credit facilities to entrepreneurs, prepares project profiles and project appraisal proposals. • Innovates and adapts appropriate technology in the small and cottage industry (SCI) sector, and develops and distributes new designs and prototypes. • Conducts research, studies and surveys in the SCI sector; collects, compiles and disseminates technical and other information leading to investments, production and marketing of SCIs. • Provides technical and consultancy services for establishing new industrial units and quality improvements in SCI products. • Provides registration services for small and cottage industrial units.
Bangladesh Industrial Technical Assistance Centre	• Upgrading the skills of the industrial personnel in technical fields (light engineering sector). • Disseminates modern technical know-how among industrial personnel. • Collects and circulates information relating to industrial productivity. • Provides consulting services to industrial organizations and industries, mainly in the private sector. • Organizes capacity-building programs in the SME sector.
Ministry of Commerce	• Supervises the functioning of the Business Promotion Council (BPC) and the Export Promotion Bureau (EPB).
Business Promotion Council	• Supports the growth of potential industrial sectors that have yet to take off. • Facilitates capacity building among the industries involved in BPC. • Facilitates market research.

MSME Department of Bangladesh Bank	• Formulates and implements policies for the development of the SME sector including through SME financing policies and women entrepreneurship development polices. Issues guidelines for financing of the SME sector through the banks and NBFIs.Monitors SME loan disbursements, recovery, and so on. Operates various refinancing windows supported by multilateral donors (such as by ADB, the International Development Association [IDA]) as well as from its own sources for small entrepreneurs, for example, implementation of the Financial Sector Project for the Development of SME with the assistance of the JICA TSL Fund.Promotes financial facilities through banks and financial institutions for SMEs, women entrepreneurs, and new entrepreneurs. Extends support for entrepreneur development.
Small and Cottage Industries Training Institute (SCITI)	• Provides training on various topics related to entrepreneurship and Small and Cottage Industries.
Palli Karma Sahayak Foundation (PKSF): APEX organization established by the Government of Bangladesh	• Provides financial assistance and institutional development support to appropriate organizations for implementing sustainable, inclusive financial programs for reduction of poverty for the moderate and ultra-poor, small and marginal farmers and micro-entrepreneurs. • Builds and strengthens the institutional capacity of partner organizations. • Programs include: the Enterprise Development Program; the Finance for Enterprise Development and Employment Creation (FEDEC) Project, and the Promoting Agricultural Commercialization and Enterprises (PACE) Project.
Bangladesh Council of Scientific and Industrial Research	• Issues, develops and guides science, industry and technology research to solve the issues related to the establishment and development of industries. • Conducts research and development of laboratories, institutes and organizations for the management of science and industry research activities. • Takes steps to commercialize the discovery and innovation arising from research conducted by the University or any other research institute. • Takes necessary actions to use newly invented methods in the industrial establishment.
Department of Youth Development under the Ministry of Youth and Sports	• Arranges skills development training programs for various vocational activities. • Supports self-employment and entrepreneurship development.
Other agencies focusing on specific sectors:	
Jute Diversification Promotion Centre	• Arranges various training programs for upgrading of skills. • Organizes fairs and exhibitions, buyer-seller meetings, exposure trips, workshops, seminars, exchanges of ideas, and so on. • Provides technical information, technology and know-how, design and product development services, and raw materials through the Raw Materials Bank (RMB), and so on. • Helps entrepreneurs in selecting the right type of machinery and adopting the appropriate technology.
Bangladesh Sericulture Development Board	• Supports and formulates plans for development of sericulture and the silk industry. • Supports improved methods of mulberry cultivation, castor cultivation and other related plants, and provides technical advice to the entrepreneurs. • Provides training facilities to silk spinners, weavers and printers, and promotes and supports facilities for the standardization of silk products for exportProvides arrangements of credit facilities for Seri culturists.

Annex 5. General Principles for Credit Reporting Systems

To provide a core set of general principles to guide credit reporting systems, the World Bank with support from the Bank for International Settlements constituted “the Credit Reporting Standards Setting Task Force”. Box 9 lists the World Bank recommended five General Principles for a Credit Reporting System and Box 10 contains the recommendations for their effective oversight.

Box 9: General Principles for Credit Reporting Systems (CRS)

The General Principles seek to ensure that CRS effectively support the sound and fair extension of credit. As such, they should also be safe, efficient, and supportive of data provider and consumer rights.

Data

General Principle 1: CRS should have relevant, accurate, timely and sufficient data collected on a systematic basis from all reliable, appropriate and available sources, and should retain this information for a sufficient time.

Data Processing: Security and Efficiency

General Principle 2: CRS should be efficient and have rigorous standards of security and reliability.

Governance and Risk Management

General Principle 3: The governance arrangements of credit reporting service providers and data providers should ensure accountability, transparency and effectiveness in managing the risks associated with the business, as well as fair access to the information by users.

Legal and Regulatory Environment

General Principle 4: The overall legal and regulatory framework for credit reporting should be clear, predictable, non-discriminatory, proportionate and supportive of the data subject and consumer rights. The legal and regulatory framework should include effective judicial and/or? extrajudicial dispute resolution mechanisms.

Cross-Border Data Flows

General Principle 5: Where appropriate, cross-border credit data transfers should be facilitated, provided that adequate requirements are in place.

Roles of Key Players

Role A: Data providers should report accurate, timely and complete data to credit reporting service providers on an equitable basis.

Role B: Other data sources, particularly public records agencies, should facilitate access to their databases by credit reporting service providers.

Role C: Credit reporting service providers should ensure that data processing is secure and that is provides high quality and efficient services. All users having either a lending function or a supervisory role should be able to access these services under equitable conditions.

Role D: Users should make proper use of the information available from credit reporting service providers.

Role E: Data subjects should provide truthful and accurate information to data providers and other data sources.

Role F: Authorities should promote a credit reporting system that is efficient and effective in satisfying the needs of the various participants. They should also be supportive of data subject/consumer rights, as well as the development of a fair and competitive credit market.

Source: World Bank.

Box 10: Recommendations for Effective Oversight

Recommendation A: Credit reporting systems should be subject to appropriate and effective regulation and oversight by a central bank, a financial supervisor, or other relevant authorities. It is important that one or more authorities exercise the function as primary overseer.

Recommendation B: Central banks, financial supervisors, and other relevant authorities should have the powers and resources necessary to effectively carry out their responsibilities in regulating and overseeing credit reporting systems.

Recommendation C: Central banks, financial supervisors, and other relevant authorities should clearly define and disclose their regulatory and oversight objectives, roles, and major regulations and policies with respect to credit reporting systems.

Recommendation D: Central banks, financial supervisors, and other relevant authorities should adopt, where relevant, the general principles for credit reporting systems and related roles, and it should apply them consistently.

Recommendation E: Central banks, financial supervisors, and other relevant authorities, both domestic and international, should cooperate with each other, as appropriate, in promoting the safety and efficiency of credit reporting systems.

Source: World Bank 2011.

Annex 6. Principles for Credit Guarantee Schemes for SMEs

The World Bank Group and its Financial Sector Reform and Strengthening Initiative (FIRST) have launched a new tool to help governments implement public credit guarantee schemes. The tool is intended to become the standard for effectively and efficiently establishing and running public Credit Guarantee Schemes (CGSs) for SMEs around the world. The 16 principles cover four key areas that are critical for the success of CGSs.

Legal and regulatory framework

1. Establish the CGS as an independent legal entity.
2. Provide adequate funding and keep sources transparent.
3. Promote mixed ownership and treat minority shareholders fairly.
4. Supervise the CGS independently and effectively.

Corporate governance and risk management

5. Clearly define the CGS mandate.
6. Set a sound corporate governance structure with an independent board of directors.
7. Design a sound internal control framework to safeguard operational integrity.
8. Adopt an effective and comprehensive enterprise risk management framework.

Operational framework

9. Clearly define eligibility and qualification criteria for MSMEs, lenders, and credit instruments.
10. Ensure the guarantee delivery approach balances outreach, additionality and financial sustainability.
11. Issue partial guarantees that comply with prudential regulations and provide capital relief to lenders.
12. Set a transparent and consistent risk-based pricing policy.
13. Design an efficient, clearly documented, and transparent claims management process.

Monitoring and evaluation

14. Set rigorous financial reporting requirements and externally audit the financial statements.

15. Publicly disclose non-financial information periodically.
16. Systematically evaluate CGS performance and publicly disclose the findings.

Annex 7. Fintech Solutions

Fintech companies have emerged with innovative solutions that can substantially improve efficiencies at each step of the lending process.

Loan origination. Fintech can reduce the costs for banks to originate loans. For instance, an aggregator's platform or an online loan comparison platform can be used as alternate channels for customer origination. Sophisticated e-Know Your Customer (KYC) solutions can be embedded for digital on-boarding and verification of customers, and chatbots can improve customer experience.

Underwriting. Fintech can leverage alternative data (such as utility bill payments, social data, mobile phone data [such as call records], text messages, psychometric data, and so on) to determine the creditworthiness of potential borrowers through alternate credit scoring solutions. Manual intensive tasks such as an analysis of a borrower's bank statement, or a company's financial statements and tax documents can now be automated through Fintech solutions, thereby drastically reducing the credit assessment time. Other solutions such as geo-tagging can provide additional information about the existence of the borrower's property. These can help financiers access additional information about small businesses, make more informed credit decisions, and potentially reduce collateral requirements.

Disbursements and collections. For instance, the National Payments Corporation of India has developed innovative products that can be leveraged to automate installment collection. E-mandate and pull payment facilities are helping financial institutions to collect payments on time with minimal manual intervention. Aadhar e-sign can facilitate loan disbursements.

Service and monitoring. Early warning systems that use multiple structured and unstructured data points assist financial institutions in loan monitoring by assessing the potential to default.

Fintech models can also provide end-to-end solutions for the lending value chain or "full stack lending models".

Marketplace (peer-to-peer) lending. This is a full stack disruptor across the lending value chain. It provides credit to MSMEs (and individuals) through online platforms that match lenders (savers, investors) with borrowers. The speed and convenience of such loans, as well as the absence of a need for collateral, are important advantages. They can also result in lower interest rates if the low cost of structures is passed on because they are technology based. As such, the need for physical facilities and staffing is much more limited. Moreover, the regulatory environment is also far-less expensive in terms of capital adequacy, reserve requirements, and so on. Marketplace lending to MSMEs has taken off (World Economic Forum 2015). In 2016, the peer-to-peer (P2P) lending market in China, the United Kingdom and the United States was estimated to be around US$89 billion, with China alone accounting for US$66 billion. It is estimated that 60-80 countries now have marketplace lending for MSMEs. In Africa, marketplace lending is increasing, particularly in Kenya, Ghana, Tanzania and Zambia.

Technology platforms for invoice and value chain finance. Platforms can streamline factoring solutions, allowing MSMEs to sell accounts receivable to third-party financial institutions more efficiently. Small business owners can directly connect their accounting software to the invoice finance platform, apply for a loan, and receive payment almost instantly as the application is processed mostly automatically. Fintech companies such as MarketInvoice (based in the UK), Fundbox (United States), NoviCap (Spain) and Finexkap (France) have grown significantly in recent years. Receivable exchanges using digital platforms such as NAFIN in Mexico, TREFI in Peru and TREDS in India are also on the rise.

Furthermore, useful information is generated about the MSMEs that can benefit lenders, for instance the value and frequency of purchases, which is also a proxy for sales; the number of years in business; the location of the business, and so on.

Access to credit can also be expanded using the digital footprint created by MSME transactions. Leading e-commerce enterprises such as Amazon, Alibaba and e-Bay have entered the lending market by offering lines of credit to MSME vendors. Payment processors such as PayPal and telecommunications companies are also engaged in this segment. As transactions are online and customers are well-known to the creditors through their transaction data, working capital and expansion programs can be supplied at a relatively low cost. The acceptance of electronic payments, such as M-Pesa, enables merchants to leverage data to obtain access to finance. All digital transactions of merchants can be tracked and provide information about the merchants' operations and creditworthiness. This source is utilized, among others, by Amazon (USA); Alibaba (China); Rakuten (Japan); PayPal (USA); Square Capital (USA); iZettle (Sweden); and Telemex (Mexico). The market is very lightly regulated, which also lowers the transaction costs.

Technology can also help to improve MSME operational efficiency and become more competitive, consequently improving opportunities to acquire external financing. This includes virtual support in the preparation of business plans, the running of their businesses, improvements in business processes, inventory management controls, and so forth. Complementary analytical applications can process the data generated by firms' transactions in order to provide valuable insights for financial planning, inventory management, and sales strategy purposes.

The Bali Fintech Agenda: A Blueprint for Successfully Harnessing Fintech's Opportunities. The Bali Fintech Agenda, developed jointly by the International Monetary Fund and the World Bank Group, proposes a framework of high-level issues that countries should consider in their own domestic policy discussions with regard to Fintech. It is a set of 12 policy elements (listed below) aimed at helping countries to harness the benefits and opportunities of rapid advances in financial technology that are transforming the provision of banking services, while at the same time managing the inherent risks.

- Embrace the promise of Fintech.
- Enable new technologies to enhance financial service provision.
- Reinforce competition and commitment to open, free, and contestable markets.
- Foster Fintech to promote financial inclusion and develop financial markets.
- Monitor developments closely to deepen the understanding of evolving financial systems.
- Adapt the regulatory framework and supervisory practices for orderly development and stability of the financial system.
- Safeguard the integrity of financial systems.
- Modernize legal frameworks to provide an enabling legal landscape.
- Ensure the stability of the domestic monetary and financial systems.
- Develop robust financial and data infrastructure to sustain Fintech benefits.
- Encourage international cooperation and information-sharing.
- Enhance collective surveillance of the international monetary and financial systems.

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ENDNOTES

1. Throughout this document, all amounts have been converted from and to US$, using the effective exchange rate as of December 31, 2018.

2. Given resource limitations, it consolidates background literature research, and relies on available data and focused interviews with government officials and stakeholders. The interpretation of quoted data varies based on the MSME definition deployed by each source. Conclusions are feasible from drawing on overall trends, and should be approached with caution. Recommendations draw on global experience, adjusting for Bangladesh's present socio-economic context, policy and regulatory environment, as well as an assessment of reform feasibility in the short to medium term.

3. Knowledge gaps include the number and type of MSMEs, value added and growth, employment size and growth, and so on.

4. There is a wide literature about the broader MSME financing challenges. For example, Beck and Demirguc-Kunt (2005) provide evidence from a study of 70 countries that small firms face larger growth constraints and have less access to institutional finance.

5. This is a program funded by the Government of Bangladesh and the European Union.

6. Long-term finance and capital markets development are the subject of an ongoing World Bank-IFC exercise called the Joint Capital Markets Initiative (JCAP). Fundamental impediments to development include: (i) the distortionary effects of National Saving Certificates on government security issuance (and the establishment of a risk-free yield benchmark) and on the distribution of long-term savings (excluding institutional investors); (ii) the high dominance of and liquidity in the banking sector, resulting in competitive yet short-term funding, which leads to restrictions in other forms of corporate fundraising; and, (iii) cultural constraints, whereby family-centric ownership structures raise obstacles to equity stake dilution; (iv) court system strengthening, and removal of tax distortions and legal impediments; and (v) the existence of very few institutional investors, with the market dominated by merchant banks.

7. Depending on their sizes, loans can be considered microloans or microenterprise loans.

8. It is understood, for example, that 80 percent of BRAC Bank's loan book to SMEs is currently provided to the "trading" sector.

9. Firms with higher employment are likely to have higher capital intensity of production per worker, as well as higher production volume per worker to benefit from economies of scale. Microenterprises in urban areas are likely to have higher production costs per worker —and a larger scale of production per worker to offset the cost effects.

10. The total loans disbursed in Table 5 includes loans for all purposes (that is, personal loans, home loans, education loans, agriculture loans, and so on). They are not just direct support to microenterprises. However, these loan disbursements can be regarded as beneficial support to cottage and microenterprises.

11. Some 87 percent of the credit comes from MFIs, charging an average interest rate of 23-24 percent. The prevailing market interest rate from the commercial banks is in the 10-12 percent range.

12. Annex 3 describes an estimation of the small enterprise finance gap using BB loan data.

13. It estimated how much credit-constrained firms would borrow to define the counterfactual under which the gap exists, as well as the bankability of those currently un-/under-served, that is, how much financial institutions would want to finance to define the gap on the supply side.

14. The NSDC was established in 2004. Its main goal is to ensure the comprehensive and coordinated development of SMEs across all sectors. Among its key achievements are the following: (i) setting a common definition for SME (2004) and redefinition (2014); (ii) establishing a periodic census for statistical updates; (iii) crafting the SME Development Framework, the SME Master Plan and the SME Act Framework; and (iv) establishing a Central Coordinating Agency (CCA) as a platform to gather the latest information and monitor the SME programs by the Ministries and Agencies.

15. Several articles, including Aziz and Siddique, "The role of Bangladesh Bank in promoting SMEs' access to finance in Bangladesh", *International Journal of SME Development Issue 2*, 2016, review the role of the Bangladesh Bank in promoting SME financing and development.

16. The Bangladesh Bank recently updated its definition of micro, cottage, and small and medium enterprises in line with the National Industrial Policy 2016 (see annex 1), including an update of the lending targets for MSMEs.

17. In each rating scale, the risk weights vary for MSMEs and large firms. Rating 1 is for the best client and Rating 6 is for the riskiest client, that is, the one with the lowest rating. It is observed that the risk weight is always higher for large firms compared to MSMEs under similar ratings with two exceptions (firms under Rating 1 and Rating 6 have similar risk weights regardless of size). Computing ratings for firms is not always feasible since it is a very costly process, even for large firms. Even if a rating is not determined, the capital gains of lending to even an unrated MSME are significantly higher than lending to an unrated large firm. Additionally, large firms under Rating 1 and Rating 2 are hard to find.

18. Currently, most credit rating agencies are providing rating services for SMEs.

19. Accordingly, all banks/financial institutions have established a dedicated desk for women entrepreneurs.

20. Bangladesh Bank offers several refinancing schemes for women entrepreneurs in cottage, micro and small enterprises, as well as agro-businesses. Under these refinancing schemes, loans for women can be taken at 4 percent interest, including a 5 percent bank rate, that is, 9 percent in total.

21. An amount of Tk 8.2 billion (US$98 million equivalent) had been refinanced to women entrepreneurs until mid-2014 for a total of 10,214 enterprises.

22. Aziz and Siddique, "The role of Bangladesh Bank in promoting SMEs' access to finance in Bangladesh." *International Journal of SME Development*, Issue 2, 2016, reviews the role of the Bangladesh Bank in promoting SME financing and development. It also summarizes the various financing support provided by the Bangladesh Bank.

23. Their capital shortage has significantly increased since 2016, with negative capital to risk weighted assets in three cases. Non-performing loans vary from 20 to 55 percent, including a failure to keep the required loan-loss provisions in three cases.

24. United Kingdom Department for International Development (DFID) Bangladesh, "Research study on review of SME credit-related policies of Bangladesh Bank: Areas of further improvement with a focus on micro and small enterprises", 2016, and World Bank, "The impact study on financial sector project for the development of small, medium enterprises (FSPDSME)", 2018.

25. According to a 2017 Bangladesh Institute of Bank Management report, default loans in the SME sector have increased by more than eight times in the last seven years. Notably, in

line with the performance of their overall loan operations, the rate of SME non-performing loans (NPLs) in the case of state-owned banks is very high. This has given rise to views that the main culprit is SME loan disbursement targets in the presence of unmitigated adverse selection.

26. According to the Bangladesh Bank guidelines, unsecured lending is permitted for loans smaller than Tk 1 million (US$12 thousand) (and smaller than Tk 2.5 million [US$29 thousand] for loans to women entrepreneurs).

27. A recent IFC study focused on the issue of increasing financing for women entrepreneurs in Bangladesh (IFC 2016). The study was entitled: "Mapping the market potential and accelerating finance for women entrepreneurs in Bangladesh". Notably, non-direct-finance activities could be important in yielding results, such as business development services, or the establishment of the secured transactions registry (as women are more likely to hold moveable property).

28. An expert team comprised of representatives from the National Board of Revenues (NBR), the Ministry of Finance and the Bangladesh Bank could be established to look specifically at formalization solutions to the MSME segment.

29. The score is zero because the coverage of the credit registry is less than 5 percent of the population.

30. The current regulation of the CIB in Bangladesh takes stock of loans over Tk 50,000 (US$598 equivalent) and credit cards over Tk 10,000 (US$120).

31. There is an ongoing IFC project regarding movable collateral registry reform. It aims to establish the requisite legal and institutional frameworks, as well as raise awareness and capacity to promote the use of the registry among stakeholders.

32. Banks do use other personal guarantees, hypothecation of goods, and cash flows to secure loans. However, a bank lending against the personal guarantee of a borrower or a third person or cash flow is not regarded as a secured creditor.

33. From the most recent *Doing Business 2018* rankings for Getting Credit, Bangladesh scored 5 out of 12 points on the strength of its legal rights index, which measures the effectiveness of regulations on non-possessory security interests in movable property (see table 10).

34. Bangladesh has long had in place laws related to insolvency, such as the Insolvency (Dacca) Act of 1909, the Insolvency Act of 1920, and the Bankruptcy Act of 1997.

35. The survey indicates that the enforcement of a secured claim can take an average of four years, cost eight percent of the value of the collateral, and return no more than 28 cents on the dollar to the secured creditor. By comparison, the South Asian average is a duration of 2.6 years, a cost of nine percent of the collateral value, and a return of 32.7 cents on the dollar. No direct evidence is available as to the enforcement of unsecured claims, but in the comparable process of contract enforcement, the *Doing Business 2018* report indicates that the process can, on average, take 1,442 days, and cost 66.8 percent of the value at issue. This would place Bangladesh as the second worst country in the world in terms of enforcing a contract in a civil court. Again, by comparison, the South Asian average is 1,101 days, and 29.6 percent of the claim value.

36. The ground work for establishing ADR was completed; important changes in the three major tax laws to include alternative dispute resolution of tax appeals were enacted (unlocking US$ 289 million in government revenues); amendments to the Civil Procedure Code to include mandatory mediation of commercial disputes were passed; and awareness about the impact of an effective out-of-court workout framework for distressed debtors was raised.

37. Improving the safety and efficiency of, as well as access to, electronic retail payment services can bring important benefits to commerce and overall business activity. Specifically, it can achieve this through the distribution and collection of payments made by/to government agencies, and to payments between individuals, among other possibilities.

38. Bangladesh Investment Climate Fund, "Payment Mechanisms in Bangladesh: A Baseline Study". World Bank, 2013

39. Annex 6 summarizes the "Principles for Credit Guarantee Schemes for SMEs", a tool developed jointly by the World Bank and the Financial Sector Reform and Strengthening Initiative (FIRST) initiative to help governments implement public credit guarantee schemes.

40. The scheme, nevertheless, can be improved by upgrading management and staff skills, providing a better orientation for the exporters and commercial banks, and introducing operational improvements to product quality and improving service delivery promptness.

41. Both pre-shipment and post-shipment guarantees are made. Risk coverage varies from 75 to 80 percent in the case of commercial risks and 95 percent in the case of political risks. Guarantees issued during 1978-1995 numbered 5,223, covering an amount of Tk 64.23 billion (US$268.2 million equivalent). The premium income was Tk 2.28 billion (US$27.3 million), claims paid amounted to Tk 1.18 billion (US$14.1 million) and claims outstanding amounted to Tk1.64 billion (US$19.6 million).

42. These options include debt, equity or a hybrid of debt and equity financing packages. A detailed review of these financing options in Organisation for Economic Co-operation and Development (OECD) countries can be found in OECD (2015).

43. There have been reports of some angel funding. For example, angel investors are reported to have funded Chaldal.com, a Bangladeshi startup, which was launched three years ago. There is also some crowd funding. A crowd-funded documentary titled 'Startup Dhaka' inspired a lot of youth to engage in entrepreneurship. The documentary, produced by SD Asia, creates content about startups, entrepreneurs, and businesses. It raised over US$9000 from 56 backers from around the world.

44. Examples include the Frontier Private Equity Fund; Tindercapital; SEAF; Bangladesh Venture Capital Limited; Venture Investment Partners Bangladesh; and BD Ventures (ADB 2014; Challenges Consulting 2012).

45. The main features include loan limits of up to 2.5 million (US$29.9 thousand); loan tenures of up to 5 years; grace periods of 3 to 6 months; and repayment methods equal to monthly installments or structured payments.

46. These include the availability of data; a supportive regulatory environment; the availability of sufficient investor capital; and the spread of financial education to the relevant stakeholders. The data requirements are becoming simplified through technology that has developed user-friendly online application forms and computer-based risk assessment models. There is also a growing source of private capital based on the willingness to take some risks for higher returns, as compared with low returns from deposits and other financial instruments.

47. In this first phase, the Bangladesh Bank took a cautious stand regarding the eligibility of MFS service providers. As a result, competition has been inadequate, and the range of services offered by MFS is very limited (Ahmed 2017).

48. See: https://www.techbullion.com/popular-fintech-companies-bangladesh/

49. This is corroborated by other studies (for example, Khalily and Khaleque 2013), suggesting that there is little meaningful distinction between medium and large enterprises, other than that the former are not likely registered with the stock exchange as public limited corporations.

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