FINANCING THE SMALL SCALE INDUSTRIES IN BANGLADESH: THE MUCH-TALKED ABOUT, BUT LESS IMPLEMENTED ISSUE

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Abstract

There has emerged a greater interest in understanding firms' access to finance and the financing of small scale industries (SSIs) in particular. Various studies have indicated that one of the major obstacles for the formation and development of SSI is related with the SSI's access to financing. The industrial units belonging to the SSI sector, many of which are having liquidity problems, are finding it difficult to possess the equity needed even to run the day-to-day business. Commercial lenders, on the other hand, having experience - and are still battling with – the effects of "non-performing loans", are cautious in providing loans particularly to the SSIs. Therefore, in Bangladesh, the SSIs face difficulties having access to financial facilities and typically rely on their own savings and loans from friends and relatives, especially during the start-up phase. This paper examines the issues involved and the options related to the financing of SSIs in the country. The first part of the paper aims to provide an understanding of the present financing environment, various financing mechanisms and experiences in the country. Subsequent to this, practical suggestions and options are presented on the ways whereby certain financing mechanisms and supports can promote greater access to financial services and efficient use of funds provided. The issue of financing the SSIs is probably the most talked about one, but compared to the demand, very less has so far been done in this area.

INTRODUCTION

Most growth theories imply that industrialization is a carrier of economic growth. Nonetheless, for a developing country such as Bangladesh, whose economy is still very much agrarian, the emphasis on industrialization should not be stressed by undermining the role of agriculture in the economy, rather a complementary balance has to be established between these two sectors to reap the relative benefits accruing to each other, resulting in acceleration of the economic growth. While pursuing the industrial development efforts, the major objectives and strategies are focused on optimum utilization of resources, creating employment opportunities and catalyzing the growth of production and exports. The development strategies in the last fifty years centred on two models of industrialization: the import substitution model and the export oriented manufacturing production model. In any case, it is now recognized that the small and medium enterprises (SMEs) are playing an increasingly important role as engines for economic growth and employment in many regions of the world. Therefore, policies and initiatives to develop SMEs and to increase their competitiveness are a priority for these countries. Ahmed (2006) opined that SME development, as instruments of employment and income generation, human development and poverty alleviation, export promotion, stimulation of private ownership, competition and entrepreneurship and hence the driving forces behind the growth of a vibrant industrial market economy, has generated considerable interest among the policymakers, academics, business circle and the international donor agencies in recent times. Nevertheless, the small scale industries (SSIs) including the cottage industries are of special consideration as these industries mainly serve the domestic market. In addition, the strategy for development of SSIs merits special attention of the policymakers in accelerating industrial development in countries such as Bangladesh. This paper intently focuses on the SSIs of Bangladesh, in general, and their financing aspects, in particular.

Investment is very much essential for the growth of any industry and increased facilities in obtaining credits can enhance that growth. Finance is needed at the starting phase of a business as well as at the enduring phases. The entrepreneurs require mainly three types of finances, namely- (i) equity capital - to finance assets at the start of a business; (ii) debts – to refinance assets; and (iii) working capital – to maintain the day-to-day activities. However, the access to financing is recognized as the leading obstacle to SSI growth in Bangladesh, alike most other developing and under-developed countries. The SSIs, in most cases, manage to start a business with resources from informal sector, but find it extremely difficult to survive and expand without further financial assistance from the institutional lenders. By minimizing the barriers to SSI finance and facilitating the adoption of new financing vehicles, initiatives have to be adopted to improve the business environment for SSIs. A sound business environment is a prerequisite for economic growth and, crucial for the SSI sector to become not only a source of employment but also a source of innovation and productivity.

METHODOLOGY

The purpose of this paper is to highlight one of the major prerequisites, namely financial supports, of the SSI sector in the backdrop of pursuing rapid industrialization strategy underpinning acceleration of economic growth. In addition to the assessment of the current financial supports provided to the SSIs in the country, this paper aims to focus on various other financial aspects as well as provide recommendations in this context. For this purpose, extensive survey of literature has been made and relevant publications, pervious studies and various initiatives taken by the stakeholders (including the government and the development partners) have been consulted. However, lack of reliable and comprehensive industrial statistics, especially regarding SSI sector limited the in-depth analyses. For instance, different institutions in Bangladesh still follow different definitions of small industries though the Industrial Policy, 2005 has declared a single uniform definition of various categories of industries – large, medium and small. However, for the purpose of the analysis the following definitions have been assumed:

- ✓ *In the manufacturing sector, "small industry" means an industry in which the value/ replacement cost of durable resources other than land and factory buildings is under 15 million taka, and "cottage industry" means an industry in which members of a family are engaged part-time or full-time in production and service-oriented activities. In the non-manufacturing sector (trading and other services), "small industry" means an industry in which fewer than 25 workers work (unlike family members in a cottage industry).* [Industrial Policy, 2005]
- ✓ Formal financial institutions include those institutions that are subject to monetary regulation, rules and laws of the central bank, which in this case is the Bangladesh Bank. Accordingly, formal financial institutions include commercial banks, development or specialized banks, non-bank financial institutions, cooperative financial institutions and international financial institutions.
- ✓ Informal financial institutions are those that stay out of the impact of rules of the Bangladesh Bank. These usually include moneylenders, merchants, friends, family members as well as any other saving and crediting associations.

This paper is organized in five sections, of which the present introductory section is the first. The second section highlights the importance of SSIs in the Bangladesh economy with a focus on the future prospect of the sector. Section three then moves on to provide a brief overview on the financing methods available to the SSIs, while underscoring the barriers faced by the small enterprises to have access to these financing mechanisms. The forth section provides some options to enhance the SSIs' access to finance. Section five – the concluding part – provides the summary of the paper in general.

IMPORTANCE OF THE SSI SECTOR FOR THE BANGLADESH ECONOMY

The environment of Bangladesh's economy has been steadily improving since the mid 1990's. The vigorous campaign of privatization and tax reform undertaken by the government is believed to lead to an expanding economic foundation and accelerating the growth of industrialization. Although the economy of Bangladesh is agrarian in nature, the contribution of the industry sector to the country's gross domestic product (GDP) is continuously increasing. However, the contribution of the SSIs to the GDP is oscillating between a meagre 4-5% [Table 1].

Table 1: Contribution of Industry Sector to GDP (in %)

	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Industry	25.69	25.70	26.20	26.75	27.23	27.69	28.32	29.03	29.45	29.67
MLI	11.20	11.01	11.13	11.16	11.29	11.41	11.66	12.14	12.47	12.60
SCI	4.40	4.39	4.46	4.60	4.68	4.76	4.85	4.94	5.08	5.16

Source: Bangladesh Economic Review, 2008
Note: MLI – medium and large industries; SCI – small and cottage industries

Center for Economic Development [2001] revealed a SWOT analysis for the SME sector to highlight its importance in the national economy. The analysis is valid for the SSI sector as well. On this basis, the following SWOT matrices are sketched to portray the dynamics of the Bangladesh SSI sector in the national economy.

Some of the well-recognized *strengths* of the SSIs are:
- ✓ source of new employment opportunities
- ✓ more flexible in terms of internal organisational structure
- ✓ comparatively flexible in adopting, more rapidly and readily, innovations and new technologies
- ✓ able to provide favourable environment for development of entrepreneurial skills and business culture
- ✓ closer to the ultimate consumers and can respond to their demands more rapidly and efficiently
- ✓ in some cases, generator of higher competitiveness on the market
- ✓ primarily focused on domestic demand and the local market
- ✓ in recent times receiving all-out support from the government and, accordingly, to create favourable conditions for the development of the SSI sector is among the priorities in the policy of the government
- ✓ the development partners are also focusing on mitigating hindrances to foster this sector

At the same time, some of the SSI weaknesses need to be pointed out, for instance
- ✓ due to difficult access to financing, a great part of the SSIs are engaged with activities which are characterised by higher labour intensity than invested capital and, thus, leading to sub-optimal use of resources
- ✓ a substantial part of the entrepreneurs do not have sufficient marketing, financial, accounting and legal knowledge, which hinders smooth-running of their business and reduces the efficiency of the enterprises

- ✓ low access level and disregard of the real needs for information and consultation
- ✓ underestimating of the quality requirements and lack of knowledge on standard specifications
- ✓ some entrepreneurs are not well acquainted with the current effective international agreements and requirements

The importance of SSI for the national economy could also be outlined in terms of the opportunities for further strengthening and development of the sector and its impact on the economy toward:

- ✓ reduction of the unemployment rate
- ✓ increase of economic competition
- ✓ development of new high-technology industries
- ✓ reduction of regional economic discrepancies
- ✓ possibility to loop the production cycle and achieve higher efficiency by setting up clusters (related production) on regional or branch principle
- ✓ increase of the welfare of the nation

The potential threats for the successful development of the SSI sector are mainly in the following directions:

- ✓ impossibility to extend an individual enterprise by modernisation, expansion of activities and employment of new workers because of the adverse external (macroeconomic) environment - high taxation and insurance liability, difficult access to financing, administrative barriers etc. - and also due to the inability of the entrepreneurs to deal with its challenges
- ✓ insufficient managerial skills of the entrepreneurs, inability to react adequately to liberalised markets and reshaping the manufactured produce and provided services in compliance with the international standard requirements

In Bangladesh, the importance of SSIs in the economic development process has been recognized in all official documents relating to policy prescriptions for the industry sector. The development of SSIs can be rationalized in terms of a numerous reasons including (i) labour intensity (ii) use of indigenous raw-materials, (iii) lower capital-output ratio (iv) generation of employment at minimum investment cost (v) equitable distribution of income, (vi) regional distribution of industrial investment, (vii) reduction in fixed investment costs through sub-contracting tie-ups, (viii) foreign exchange earnings through exports, (ix) foreign exchange retention through imports substitution, (x) building up entrepreneurial base through trial and error at low cost, (xi) introduction of innovations or appropriate technology at low cost and so on. Though the contribution of SSIs to GDP has remained almost static for more than a decade, the growth rate witnessed a rise over the period [Table 2].

Table 2: Growth of Industry Sector (in %)

	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Industry	3.19	4.76	6.68	5.48	6.75	7.10	8.19	10.77	11.19	11.23
MLI	4.19	4.35	6.55	4.60	6.56	6.95	8.30	11.41	11.56	12.01
SCI	0.75	5.80	7.02	7.69	7.21	7.45	7.93	9.21	10.28	10.56

Source: Bangladesh Economic Review, 2008

The contribution of SSIs towards employment generation also appears higher. The sector employed 5 million people directly and indirectly which accounts for 82 percent of the total industrial labour force [Fifth Five Year Plan, 1997-2002]. Again, various estimates reveal that the difference in fixed investment cost in the creation of one unit of employment generation amounts to nearly Taka 100,000 between SSI and large scale industry. In the absence of availability of any current national level estimates about the nature and magnitude of contributions of the SSIs, it is difficult to provide any dependable basis about their importance on the economy. Despite their contributions in the economy in terms of employment and value addition, the SSIs suffer from numerous operational constraints resulting from the scale barriers and resource constraints. Comprehensive policy support including various fiscal and financial incentives are thus required to foster an enabling environment to improve competitive strength of these industrial units.

THE FINANCING ENVIRONMENT FOR THE SSIS

The SSIs do not have a dominant presence in the Bangladesh economy compared to medium-sized industries and, in general, lack the capabilities of being dynamic firms in the process of economic development. However, considering the scope of employment generation and making use of relatively lower capital-intensive technologies, these industrial units are indeed important. Nonetheless, these firms often face economic, institutional and legal obstacles. Such restraints include limited ability of acquiring sufficient amount of credit (including initial capital and longer term credits), inadequate infrastructure support, high transaction costs, limited managerial and technical know-how and so forth. Despite of these obstacles, which are mostly interdependent, the general opinion on which SSI supporting policies are based, stems in the fact that lack of finance makes up the principal restraint in their growth and intensification. The SSIs' barriers in obtaining access to formal finance emerged from multi-faceted, but interrelated objective vis-à-vis subjective factors. Before discussing the prevalent financial mechanisms available for the SSIs, some of the barriers to SSI's access to finance are highlighted below.

Barriers to Finance

Most formal financial institutions prefer to hold mostly risk-free and high-income generating assets. The SSI lending is unattractive due to an anticipated risk associated with this type of business units. At the same time, there is high transaction costs involved in extending smaller chunks of loan. By nature, the SSI sector is not homogeneous and, therefore, the attractiveness of an enterprise to financial institutions varies with the size of the firm, maturity of the firm, type industry the firm belongs to and so forth. The basic problems encountered by the commercial banks in lending to SSIs are: the bank capital adequacy requirements, assessment of the risk-bearing exposures and making risk-covering provisions.

Besides, there are some inherent factors that make SSI financing less motivating to the financial institutions. One of the main criteria for loan disbursement in the country is the sound financial condition of the company and its economic history. But the SSI units usually do not have credit history. This criterion poses an insurmountable barrier to all small enterprises that are not in a position to satisfy such condition. Even the ones that were set up a couple of years ago and have good economic indicators find it difficult to meet the requirement as some of the entrepreneurs' underreporting or non-reporting of the profit to avoid taxes. More often than not, the companies do not have any business plans or accounting records, which they need to attest their turnover. The SSIs cannot make long-term financial projections, nor can they guarantee any stable income. In addition, when seeking medium or long-term loans, SSIs are often not in a position to offer sufficient collaterals that fulfil the requirements of financial institutions.

One of the major hindrances faced the SSIs is the interest rate levels charged the financial institutions. The average lending rate ranges between 14% and 18%. According to entrepreneurs, most SSIs cannot afford this rate, since their average profit is far lower than this. Even the interest rate charged by Bangladesh Small and Cottage Industries Corporation (BSCIC) - which was specially set up to assist the development of such enterprises – ranges between 10-12%. In a recent drive, the Bangladesh Bank set the lending rate to be 5% plus the bank rate for the women entrepreneurs with an aim to encourage the latter's enhanced participation in economic activities. But the move has not been that successful till to-date. The financial institutions claim that given the market set-up, whatever lending rates they charge is logical, and that the international financial institutions impose explicit conditions concerning the market interest rate levels. Regardless of the high interest rate spread (approximately between 9.5% and 10%), the financial institutions also assert that they face difficulty covering the lending risk, their expenses and taxes at lower rate levels. The fact that the bank did not have knowledge of the entrepreneur was another frequently cited factor. Furthermore, evidences showed that the association between loan application and size of the firm remains positive and statistically significant, even when location and sector are included [Centre for Development, 2001].

Hence, for a number of reasons the small-sized enterprises run into many difficulties when they apply for a bank loan or any sort of credit facility from the formal sector. The SSIs cannot even mobilize resources from the country's capital market. Still, the most common sources of capital, especially at start-up phases, are savings and loans from the family and friends. According to a SEDF survey (2006), 62% SMEs did not approach to formal financial institutions to seek financing.

Over the years some development partners tried to assist the SSI sector along with the government. These financing types are mainly used to finance credit lines to SSIs accompanied with technical assistance. The credit line funds are given from donors as soft loans and the government allocates them to banks to be used as commercial loans without harming banking practice and the use of own bank capitals. As a consequence, the greater part of financial crediting sources is converted into commercial funds and, again the SSI units face difficulties in obtaining those funds.

In brief, various studies showed that the most important financial barriers faced by the SSIs are the high cost of credit and loans; the lack of access to equity capital; banks not being interested in small firms; the lack of access to venture capital; the delays in obtaining loans; the refusal of bank finance; high collateral requirements; banks' bureaucratic procedures; the cost of preparing a business plan; and too high bank charges and fees.

Existing Financial Mechanisms

The SSIs have to rely on a limited range of financial sources, and typically rely on their own savings and loans from friends and relatives, especially during the start-up phase. Institutional credits (mainly from the commercial banks) are available mostly when the firms become larger. Informal lenders and other similar sources traditionally also provide finance for the expansion of the SSIs. Reinvested earnings are also a major source of funds for the fixed capital. From the formal sector, the flow of credit to SSIs mainly comes from the Bangladesh Small and Cottage Industries Corporation (BSCIC), nationalized commercial banks (NCBs), development financial institutions (DFIs), private commercial banks (PCBs) and other financial institutions such as non-bank financial institutions (NBFIs). However, the foreign commercial banks (FCBs) have very negligible participation in providing credit to SSIs.

Table 3: Scheduled Banks' Term Loans to SSIs

(in million Taka)

Banks	2003	2004	2005
Nationalized Commercial Banks	1,272.1	2,408.8	4,968
Private Commercial Banks	1,928	3,011.8	5,785.4
Foreign Commercial Banks	0	0	0
Development Financial Institutions	1,120.9	1,088.4	1,507.2
Total	4,321	6,509	12,260.6

Source: Bangladesh Bank (2006)

Financial support to SSIs, especially after 1990, is provided through various donors' project as well as from bank loans, side-by-side the government assistance through the Bangladesh Bank. Although the earlier focus was on small and cottage industries, now the small and medium industries (SMEs) are grouped together for the purpose of providing financial supports. The SSIs obtain financial supports from either the internal sources (the government, the Bangladesh Bank, commercial banks or other financial institutions) or the external sources (the development partners). With regard to the financial instruments, the experience shows that in most cases small enterprises require very small loans and are somewhat indifferent to what currency finance is available in. The state owned banks have network branches but lack in skill or commitment to lend to SSIs, whereas a greater part of remittances, which are only partly intermediated by the banking system, directly used to finance consumption while a part is used as start-up capital requirements of the SSIs.

In the past, the government attempted to provide SSIs with access to finance through targeted lending. There was a government directive that 5 percent of a bank's loan portfolio be set aside for small and cottage industry financing. However, in recent times, the stakeholders, including the government, focus more the SME sector encompassing, necessarily, the SSI sector. Some of the initiatives by the government, the development partners and various financial institutions in Bangladesh to provide financing facilities to the SME sector (including, of course, the SSI sector) are:

- In the budget for FY08 that BSCIC has taken initiatives to create a Trust Fund for providing industrial loans to which the government will allocate Taka 230 million. In addition, an endowment allocation of Taka 1.0 billion has been given to SME Foundation.

- The FY08 budget also allocated credit support to the tune of Taka 1.50 billion for the development of agro-based industries. This credit will be channelled through Bangladesh Krishi Bank, Rajshahi Krishi Unnayan Bank, BASIC Bank and Karma Sangsthan Bank.

- To overcome the financial constraints of SME sector and persuade banks and other financial institutions to provide credit facilities to this sector, the Bangladesh Bank has introduced refinance scheme for from May 2004 using three sources of funds - Taka 100 million of Bangladesh Bank's own fund, US$ 20 million from International Development Association (IDA) and Taka 30 million from the Asian Development Bank (ADB). So far, fourteen banks and twenty non-bank financial institutions have availed this facility to support a total of 7,598 SMEs with an assistance of Taka 6.17 billion. And almost eighty percent of the funds under these refinancing facilities channelled to small industries. Recently, the BB has especially emphasized on making the refinancing facilities available to the women entrepreneurs at a comparatively lower rate.

- Considering the importance of small enterprise financing the SME cell of the Ministry of Industries has announced that 80 percent of total resources available for SME would be allocated specially for small enterprises.
- The Equity Entrepreneurship Fund (EEF) of the Bangladesh Bank worth Taka 2 billion has been established in 2000 to provide equity to SMEs in agro-based industry and ICT sector through commercial banks. In budget for FY08, this EEF has been split into two funds, namely, Agriculture Equity Entrepreneurship Fund and IT Equity Entrepreneurship Fund with an allocation of Taka 1.0 billion for each fund.

- The SME cell also decided that BASIC and BRAC bank will be working together as lead banks and will be responsible for distribution of credit and venture capital fund in the short run.

- BASIC Bank Limited (Bangladesh Small Industries and Commerce Bank Limited) was established in 1988 with the foremost objective of financing the small and cottage industries (SCI). The Memorandum of Articles of BASIC contains that at least 50 percent of its loanable fund should be invested in small scale industries. The bank also offers below market interest rates on SCI lending compared to most other banks.

- BSCIC also provide credit support for both fixed and working capital – but the loan amount is not too high like other financing institutions. The credit facilities provided by the organization are self-employment through small and cottage industries, women entrepreneur development programme and poverty reduction through income generation. BSCIC offers loan amount ranging from Taka 50,000 to Taka 500,000.

- The Bangladesh Bank has introduced factoring to ease the working capital problem that will guarantee SMEs to enjoy consistent cash flow, lower administration costs, and reduced credit risks.

- Earlier Sonali bank, Agrani Bank and Janata Bank jointly started a Credit Guarantee Scheme with assistance from the Bangladesh Bank. A substantial amount of loan was disbursed under this scheme; but much of that loan went to non-viable projects and turned into bad debts.

- Some PCBs such as BRAC Bank, Eastern Bank, Dhaka Bank, Bank Asia and Premier Bank as well as FCBs such as Standard Chartered Bank and HSBC are currently offering special services styled SME banking.

Besides the direct credit, the organizations such as "South-Asia Enterprise Development Facility (SEDF)" provides support to partner financial institutions through a combination of technical assistance and policy related works so that the latter are able to make financing more readily available for SMEs.

Effectiveness of the Existing Financial Support

Public institutions including the Bangladesh Bank, NCBs and DFIs, engaged in extending loans to the agriculture and industry sectors, currently have financing facilities for SMEs, the performance and effectiveness of which have been uneven. These facilities have varying features and terms. Some of the facilities are targeted at certain industries or subject to limited geographic coverage. For example, the Bangladesh Bank's Rural-based Agro-Processing Industries Refinancing Facility, originally set up for Taka 1.5 billion, had a low utilization rate owing mainly to the restriction on use of funds to agro-processing industries located outside the major cities. Later on the size of the facility was reduced to Taka 0.5 billion and the rest, Taka 1.0 billion, was reallocated to set up the Small Enterprise Fund (SEF). The

Entrepreneurship Enterprise Fund was set up by in 2001 as a venture capital fund to co-invest in projects in software, food processing and agro-based industries. Since its establishment, the utilization rate has not been that much satisfactory. On the other hand, some credit facilities provided by NCBs and DFIs impose ceiling on loans to sub-borrowers in certain sectors, such as agricultural credit, thus distorting interest rates and further exacerbating the vulnerable financial position of these entities. There is no indicator to measure the effectiveness, outreach, or impact of these facilities. Thus, an in-depth study needs to be conducted to identify ways to rationalize the existing government assistance and to ensure efficient and effective delivery mechanisms.

The credit flow to SSIs by majority banks taken together is not very significant compared to the MLIs. One reason is that the MLIs' requirement for capital is far greater than that of SSIs. One the other hand, as mentioned earlier, formal financial institutions prefer to extend credit facilities to bigger firms or to those firms which are gradually expanding and have a viable business record. The available data show that outstanding amount of SSIs is very low as compared to total outstanding. This may be due to the fact that SSIs occasionally approach to the financial institutions for financing as well as small amount of money are disbursed to the SSIs. It has also been observed that classified loans to the SSIs are higher for the DFIs than PCBs or even NCBs. The amount of FCBs' loans extended to the SSIs is negligible compared to the amount extended to the MLIs and, accordingly, classified loans on the accounts of SSIs are also minimal. In addition, given the fact that the SSIs are now in need of complex financial products, there can be an initiative to tie up with various FCBs for providing a wide range of the derivative products.

Various studies and experience suggest that the enabling environment for the growth of SSIs has been limited to official documents only, in reality much less has been done to promote the small-industry-oriented industrialization in the country. In addition, the environment for the growth of the sector has been somewhat adverse due to the ever increasing competition from other industrial units – both domestic and foreign – emerging from the trade liberalization policies of the government. The protective regime has largely been discontinued leaving the SSIs to stiff competition arising from the influx of foreign goods through both official and unofficial channels. It is true that SSIs are afflicted with a number of built in constraints resulting from entrepreneurial and managerial deficiencies. This has also inhibited their access to formal credit. Various studies revealed that lack of working capital has been the single most important cause, among all the external factors, that make an industrial unit sick. Although sickness in the industrial units is not a new phenomenon as is evident in the developing countries and an industrial unit may face a number of odds during its implementation and operation stage because of a number of factors in the environment – internal and external – leading to sickness, experience suggests that SSIs are more prone to sickness as compared to medium and large scale industries. The BIDS Sick Industries Study (1998) revealed that ‘small scale’ industries is at the top (72.5%) in terms of incidence of sickness, followed by "medium" and "large" scale industries – 19.7% and 4.1% respectively. In bid to strengthen the SCI sector of the country, during 2001, the National Association of Small and Cottage Industries of Bangladesh recommended to introduce special credit scheme and simplified credit policy, establish separate bank or leasing company, adopt special measures for sick industries and retain 10 percent of the total industrial credits for SSIs.

The high cost of fund is another issue raised by the small scale entrepreneurs. For entrepreneurs, though the supply of and access to finance is very important, the cost of fund is also a factor for their sustainability and expansion. Very often it is argued that the interest rate on SSI loan is too high and needs to be lowered. In today's liberalized market, it is up to the banks and financial institutions to consider the fact that if the rate of interest is too high, then the profitability of entrepreneurs, especially for those of the innovative projects will be adversely affected. The high cost on SME finance also contradicts the government industrial policy that is committed to boost small business sector. A recent study of the SME Foundation had found rates of interests for the SME financing ranged between 14 percent and 22 percent. Interest rates are not declining although many banks and financial institutions are opening separate windows for the SME financing. Such high rates of interests force SMEs, especially those involve in manufacturing activities and especially smaller in size, to become sick and go out of business. Overseas funds at 2 percent rate and the Bangladesh Bank fund at 5 percent rate still could not help lower the lending rates for the small entrepreneurs. Entrepreneurs have to pay interest to retail bankers at rates three to four times higher than the rate offered by the Bangladesh Bank. Currently, the SME Foundation is working with the government to formulate guidelines to bring down interest rates to a single digit for the SMEs. Once enacted, the SME credit wholesaling guidelines will help banks and financial institutions to channel low cost finance in small ventures. Such guidelines would also facilitate the Foundation to work as an apex body such as Palli Karma Sahayak Foundation and channel funds into small businesses more prudently through a network of banks and NBFIs. The SME Foundation feels that the proposed SME credit wholesaling guidelines would enable it to reserve refinancing funds and give it to banks and financial institutions at rates lower than that of the Bangladesh Bank.

FINDING NEW AVENUES

SSIs operate in an environment whereby barriers to their establishment and growth are very evident. Strengthening the financial sector is one of the most important issues for enabling SSIs to perform successfully. Most of the commercial banks as well as other financial institutions are somewhat reluctant to provide loans from own funds to SSIs due to the high credit risk associated with such lendings. To overcome this problem a mechanism can be devised to set up a special insurance scheme with funds from the government, donors and, even, may be contributions from local financial institutions. This fund can be used to cover, say 70%, of the risks. Though there already exist various guaranteed financing mechanisms for the SSIs, their implementations have to be enhanced to opt for the desired level of success. It is argued that differences in the financial institution structure and lending infrastructure significantly affect the availability of funds to SSIs by affecting the feasibility with which financial institutions may employ the different lending technologies in which they have comparative advantages to provide funds to different types of SSIs. Ahmed [2006] argued that financial services for the poor have proved to be a powerful instrument for poverty reduction enabling the poor to build assets, increase incomes and reduce the vulnerability to economic stress. However, while formulating effective financing mechanisms for the SSIs the following three issues need to be considered:

- ◊ To highlight the most effective SSI finance practices and programs, especially in the region, and to inform both private and public sector institutions about the impact of these policies and practices
- ◊ To properly implement innovative SSI finance policies and vehicles
- ◊ To identify mechanisms to solve common SSI finance obstacles and encourage SSI development

It is generally recognized that guaranteed schemes is various forms are required by the SSIs along with customized financial products. The SSIs are in especial need for longer-term resources. The Bangladesh Bank propagated some options for enhancing financial facilities to the SME sector of the country [Box-1], which are also applicable for the SSIs. In addition, banks and financial institutions can be encouraged to offer more and more innovative financial products such as factoring, venture capital, etc. However, the SSI entrepreneurs as well as the financial instruments providers should be well acquainted with such products. Academicians and experts, time and again, opined for a dedicated new financial institution for SME, which will also look after the SSIs, to provide sufficient, long-term, low-interest funds with liberal terms of collateral.

Box-1: Enhancing SME Funding

Lack of efficient inter-bank market to channel excess liquidity, lack of legal framework for development of alternatives for long-term financing such as securitized debt securities, lack of term funds at reasonable interest rates, high interest rates offered for government bonds often crowd out long-term borrowing for SMEs by Financial institutions. The following factors deserve consideration

- Like the developed countries government can use grants as a major instrument to support the SMEs financially, which can be used as a subsidy.
- Government can provide credit guarantee schemes to SMEs that is a common feature both in developed and developing countries. Such guarantee ensures repayment of any default loan taken by an SME.
- Government can directly guarantees loans up to a certain limit to small businesses to purchase land, buildings or equipment. Loans may be made through banks or other financial institutions.
- By implementing analytical software like credit scoring model based on available data from reliable sources, banks and financial institutions can provide loans to SMEs with growth potential and good track record.
- In case of providing refinance to the banks and NBFIs government should have some directives related to collateral requirement and high interest rate.

Source: Financial Sector Review, Bangladesh Bank

CONCLUSION

Financing SSIs is one of the key prerequisites for the achievement of growth of the sector. Evidences from around the world demonstrate that access to finance is a key problem that much of the private sector and, in particular, the smallest enterprises face in both developed and developing countries. In case of Bangladesh also the small entrepreneurs - both entrants and existing entrepreneurs - significantly face obstacles in relation to the cost and lack of access to investment capital in spite of the efforts which have been made to alleviate them. To maximise the benefits of financial structures, the provision of finance should be accompanied by parallel efforts to improve the investment climate and to develop other SSI support services. This paper does not, however, propose for generous assistance to be provided to the SSIs. Various studies revealed that financial opportunities or higher effective rates of assistance provided earlier to the SSIs have contributed to the inefficiency in the sector. Hence, a well-orchestrated financial mechanism supported by other support services such as promotional, human resources development and so forth are required to foster an enabling environment for the SSI sector. Recognizing this fact, the Industrial Policy, 2005 stated that *conduct a survey to determine the demand in the local market of goods produced in sick industries as a primary step towards the rehabilitation and development of those industries. In view of competition in the local market, take action to reduce the production cost of goods in sick industries in a cost-effective way so that the qualitative standards of goods and productivity are ensured*.

Informal financial institutions still play an important role in many developing countries. Particularly in the rural areas they importance is higher. For the formal financial institutions the market presence of different types of institutions and the competition among them have important effects on SSI credit availability because institutions of different types may have comparative advantages in different lending technologies. On the other hand, the lending infrastructure – the information environment, the legal, the judicial and bankruptcy environment, and the tax and regulatory environments – may directly affect SSI credit availability by affecting the extent to which the different lending technologies may be legally and profitably employed. The lending infrastructure may also restrict SSI credit availability indirectly by constraining the potential financial institution structure through a restrictive regulatory environment. Ahmed [2004] argued that the SMEs are unwelcome customers to the profit seeking and collateral oriented commercial banks even when there is credit boom and availability of loanable funds is not any constraint. From the discussion it can concluded by saying that the financing mechanisms required by the SSIs do exist, although there is still scope for more innovative and customized products, what is now required is their effective implementation and a system to monitor that effectiveness.

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