Business Finance
for the Poor
in Bangladesh

Policy Brief

CLUSTER AND VALUE CHAIN FINANCING IN BANGLADESH: **CURRENT PRACTICES AND WHAT CAN BE DONE**

March, 2018

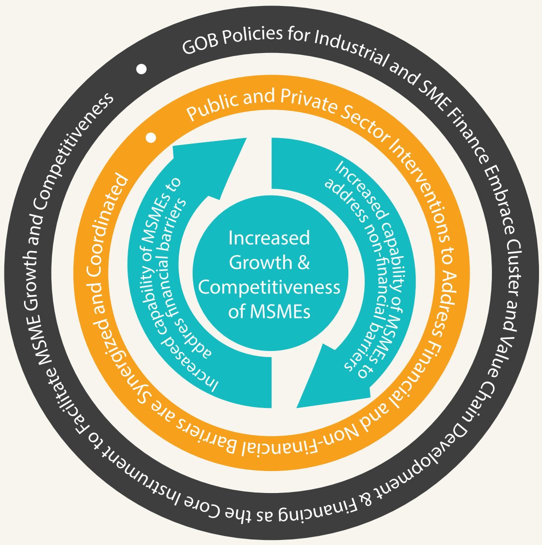
What is this Policy Brief About?

75% of the non-agricultural employment in Bangladesh is accounted for by the Micro, Small and Medium Enterprises (MSMEs). The MSMEs account for 25% of the Gross Domestic Product (GDP). These enterprises do not work in isolation. They are part of a cluster or a value chain. Government and development sector partners have thus been using cluster and value chain development strategies to facilitate product and marketing innovation, technological up-gradation, certification, export market readiness, skill development and such to foster MSME competitiveness. One of the major constraints impeding MSME competitiveness is their inability to secure finance in terms and conditions that suit their needs. Furthermore, financial barriers (for instance MSME's financial knowledge, availability of and accessibility to suitable financial services) and non-financial barriers (for instance, productivity, market access, product quality, worker's skills, technological up-gradation and innovation) create a vicious cycle of challenges that constrain the MSME's growth. This means interventions that attempt to address financial barriers would largely be ineffective if interventions to address non-financial barriers are not addressed concurrently. Cluster and value chain financing in this context provides an opportunity to take a holistic, synergistic and coordinated approach to address financial and non-financial barriers of the MSMEs. This policy brief summarizes the rationale for cluster and value chain financing in Bangladesh. Based on the findings from a quantitative and qualitative survey on 2038 MSMEs and 17 national organizations working on MSME development, this policy brief explains the challenges that impede the application of cluster and value chain financing for MSME competitiveness and the policy measures that could be taken to facilitate cluster and value chain financing to foster MSME competitiveness in Bangladesh. This policy brief provides a road map that could be adopted to synergize the financial and non-financial interventions undertaken by the Government of Bangladesh and its development partners.

MSMEs ARE THE BACKBONE OF THE ECONOMY OF BANGLADESH. FINANCIAL AND NON–FINANCIAL BARRIERS CREATE A VICIOUS CYCLE OF SYSTEMIC CHALLENGES THAT RESTRICT MSME GROWTH AND COMPETITIVENESS. IMPACT OF INTERVENTIONS FOR FINANCIAL INCLUSION WILL NOT BE EFFECTIVE IF THESE DON'T FACILITATE SOLUTION TO NON–FINANCIAL BARRIERS. THIS POLICY BRIEF AIMS TO BRIDGE THE GAP BETWEEN FINANCIAL AND NON–FINANCIAL INTERVENTIONS BY PROVIDING A ROADMAP TO UTILIZE CLUSTER AND VALUE CHAIN FINANCING AS A HOLISTIC APPROACH TO FOSTER GROWTH AND COMPETITIVENESS OF THE MSMEs IN BANGLADESH. IT OUTLINES THE SCOPE FOR CLUSTER AND VALUE CHAIN FINANCING AND DEFINES THE ROLES OF THE PUBLIC AND PRIVATE SECTOR STAKEHOLDERS IN IMPLEMENTING THE POLICIES FOR CLUSTER AND VALUE CHAIN FINANCING IN BANGLADESH.

Figure 1:

Theoretical framework:
How does cluster and value chain finance facilitate MSME growth and competitiveness



Cluster and Value Chain Financing can be used as a holistic approach to solve financial and non-financial barriers of the MSMEs and drive MSME growth and competitiveness in Bangladesh.

What do we mean by cluster and value chain financing?

Cluster and value chain financing is not defined in the policy documents regulating the financing of the MSMEs in Bangladesh. The Reserve Bank of India (RBI) defined cluster financing as "full service approach that is intended to cater to the diverse needs of the MSE sector which may be achieved through extending banking services to recognized MSE clusters." We adopted this definition for the purpose of this policy review. USAID Micro Links defines value chain financing as "…financial products and services that flow to or through any point in a value chain that enable investments that increase actors' returns and the growth and competitiveness of the chain." We adopted the USAID microlinks definition of value chain financing for this policy review.

How can cluster and value chain financing facilitate MSME growth and competitiveness?

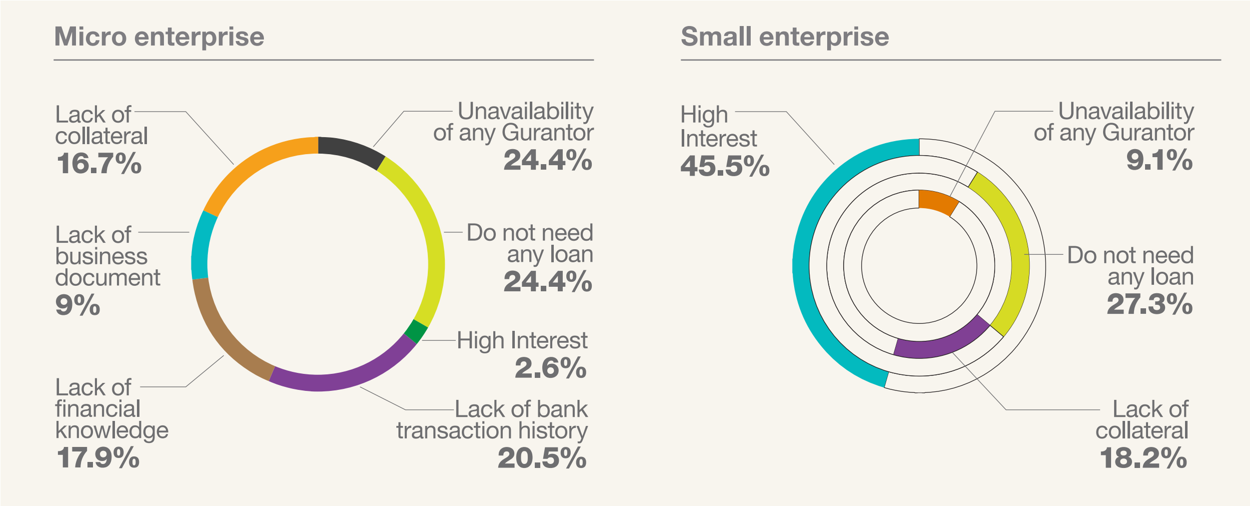
MSMEs in the clusters and the value chains are heterogeneous business enterprises with diversified business and financing needs; cluster and value chain financing approach could help us understand the MSME financing needs and tailor the financial instruments.

70% of the manufacturing enterprises in the clusters in Bangladesh are micro-enterprises. In the forward and backward linkages of the value chains, micro enterprises constitute 93% of the enterprises. There is wide diversity amongst the enterprises with respect to their business registration, base of operations and ownership of the business premise. 89% of the enterprises are sole proprietorship while 11% of the enterprises are partnership businesses. 42% of the enterprises are based in the owner's home. 43% are located in commercial area and 15% are located in industrial area.

Findings show that there is a direct correlation between MSME business registration, business premise and ownership of the premise. Sole proprietorship businesses are more reliant on Non-Bank Financial Institutions (NBFIs) and Micro Finance Institutions (MFIs); partnership businesses are more reliant on banks. Average loan size of enterprises operating from home is just 6% of the average loan size of those operating in the industrial area and 5.6% of those operating in the commercial area. The average loan size of enterprises operating from their own premise is three times than that of the enterprises operating from rented premise.

Most of the enterprises (90% of the manufacturing enterprises and 86% of enterprises in the forward and backward market linkages) in the clusters and in the value chains are seeking finance for working capital. Manufacturing enterprises have higher demand for loan for capital machineries than the enterprises in the forward and backward market linkages. 36% of the manufacturing enterprises

Figure 2: Reasons for MSMEs not securing external finance



are seeking external finance for capital machineries. In contrast 16% of the enterprises in the forward and backward market linkages are seeking finance for capital machineries. There is also demand for finance for stocking. 30% of the manufacturing enterprises and 34% of the enterprises in the forward and backward linkages are seeking finance for stocking. The heterogeneity in the size, scale and mode of operations means that lending instruments need to be tailored for the MSMEs. Term loans are more suitable for stocking than overdraft. Lease financing is suitable for capital machineries while time loan or demand loan is suitable for working capital. Time loans or demand loans are more suitable for working capital financing. However, most of the MSMEs are sole-proprietorship and thus banks are reluctant to provide term loans without mortgage which most of the enterprises are not able to provide.

For time loan, it is essential that the MSME cash cycle is predictable. Most of the MSMEs do not have control on their cash cycle. MSMEs also often do not have formal contracts or work orders. To mitigate these challenges hybrid financing models that combine term loans and overdrafts could be more suitable for working capital finance and stock finance.

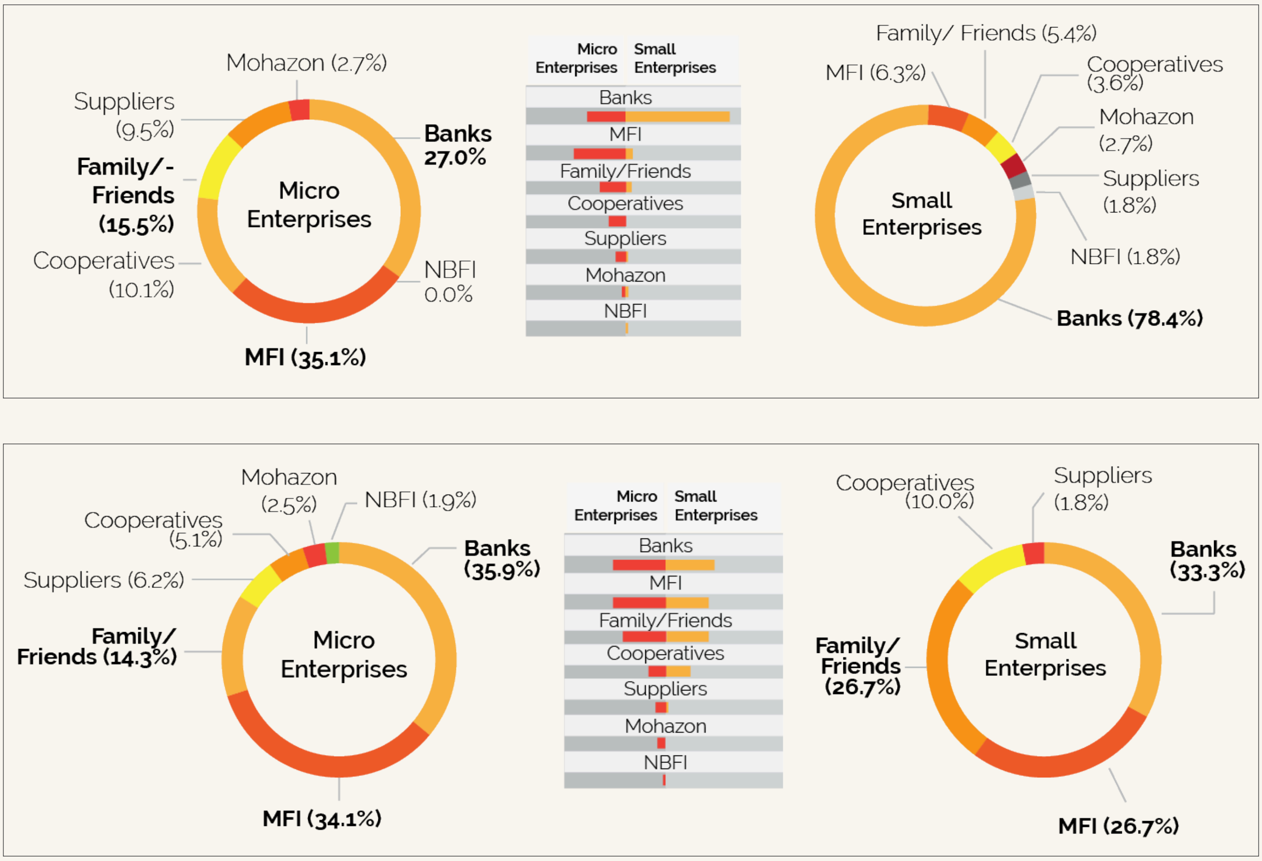
Large number of MSMEs are not securing external finance; cluster and value chain approach to financing could help us understand the underlying reasons.

34.7% of the surveyed enterprises never secured any external financing. The incidence is higher amongst the micro enterprises in comparison to small enterprises. Of those who never secured external financing, 71% are micro enterprises. Findings further show that almost half of the manufacturing enterprises and the enterprises in the forward and backward market chain do not have active loans. The key reasons for the micro enterprises for not securing external finance are (i) lack of bank transaction history (20.5%); lack of collateral (16.7%) and lack of financial knowledge (17.9%). Large number of micro enterprises reported that they do not need external finance (24.4%). The key reasons for the small enterprises for not securing external finance is high rate of interest (45.5%) which is followed by lack of collateral (8.2%). About 27.3% of the small enterprises reported that they do not need loan for their business. Based on the findings from the FGDs we can attribute the lack of demand for financing to the fact that large number of enterprises prefer to do business on cash and therefore prefer to have shorter business cycle.

SMEs that secure external finance rely on a range of providers that include both formal and informal sources. By adopting a cluster and value chain approach to finance, we can determine the MSME preferences for finance

MSMEs in the clusters meet their financing needs through diverse sources. This include the formal financing sources (banks, NBFIs, MFIs) and informal sources (friends and family members, mohazons, relatives). We can observe variance amongst the micro enterprises and the small enterprises with respect to their sources

Figure 3: Source of finance for the manufacturing enterprises in the clusters and the value chains



of finance. Micro enterprises are more reliant on MFIs while small enterprises are more reliant on Banks. Micro enterprises also have higher incidence of securing finance from family and friends, cooperatives and suppliers. In the backward and forward market linkages, micro enterprises are reliant on both banks and MFIs. Similar trends are being observed with small enterprises in the backward and forward market linkages.

However, small enterprises are more reliant on banks in comparison to MFIs. Interestingly, higher percentage of small enterprises are reliant on family and friends. Family and friends are also a major source of finance for micro enterprises in the backward and forward market linkages. This can be attributed to the fact that the enterprises in the backward and forward market linkages have short term cash requirement which they try to fulfil through their friends and families even if the interest rate is higher.

inance is a challenge but not the only challenge that restrict the MSME's growth. Non-financial challenges influence the MSMEs access and usage of financial instruments.

Findings show that finance is one of the barriers but not the only barrier that restricts the MSMEs to grow their businesses. There are other non-financial barriers that limit their growth prospect. This includes high cost of the raw materials, unskilled manpower, high cost of machineries, high competition in the market, lack of space for business expansion and declining demand. These constrains the MSMEs capability to access and use finance to improve their business performance. Financial needs of the MSMEs would remain unserved if the MSMEs are not supported to address these challenges. By adopting a cluster and value chain approach, financial support to the MSMEs could be directed towards solving the challenges that constrains the MSME's growth and competitiveness.

Figure 5:
Financial barriers faced by the MSMEs

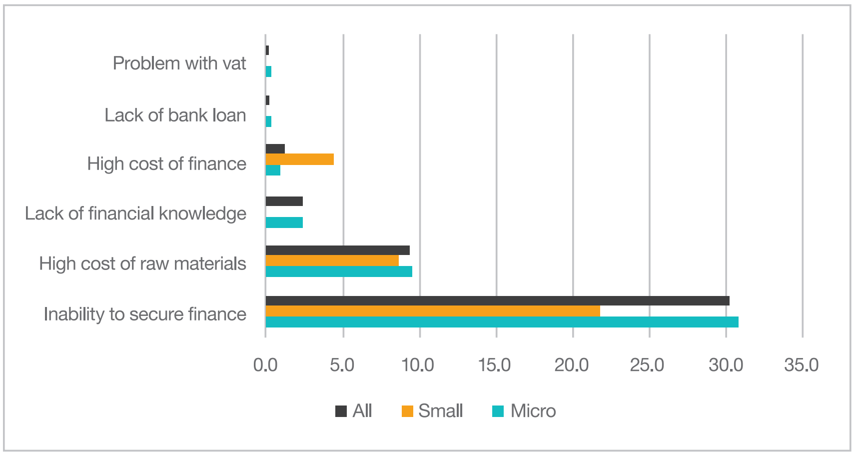
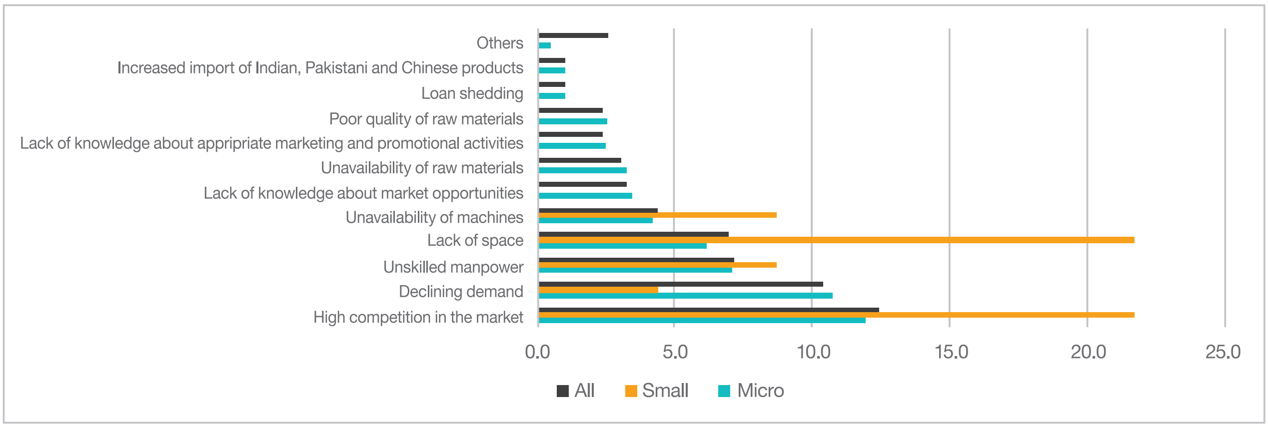


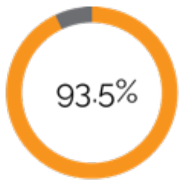
Figure 6:
Non-financial barriers faced by the MSMEs



luster and value chain financing approach could help us better understand the financial needs and barriers of the women led enterprises

93.5% of the female enterprises in the clusters and value chains belong to the micro-enterprise category. The female led enterprises have significantly lower fixed assets (BDT 612,980) if compared to male led enterprises (BDT 13,82,005). 98.7% of the female led enterprises are sole proprietorship. In contrast 87.8% of the male led enterprises are sole proprietorship. 92.2% of the female led enterprises operate from home. In contrast, 34.8% of the male led enterprises operate from home. 76.6% of the female led enterprises do not have trade license while 27.4% of the male led enterprises do not have trade license. 72.7% of the female led enterprises do not have membership with any trade association. In contrast, 50.6% of the male led enterprises do not have membership with trade associations. Female led enterprises are more dependent on MFIs and friends and family for financing. 42% of the female led enterprises secure finance from MFIs; 21.1% secure finance from friends and family; 23.7% secure finance from Banks. The data shows that female led enterprises are lagging behind if compared to male led enterprises in terms of both business performance and their access and usage of financial services. Women entrepreneurs are mostly concentrated in small low value added clusters

Figure 7:
Source of finance for the female lead enterprises



of the respondent female enterprises belong to the **micro-enterprise** category.

Female led enterprises are more dependent on MFIs and friends and family for financing.

42%
of the female led enterprises secure finance from MFIs;

21.1%
secure finance from friends and family;

23.7%
secure finance from Banks.

where they work primarily as wage earners. The capacity of the women entrepreneurs to scale up their business operations through cluster or value chain financing is low in this context.

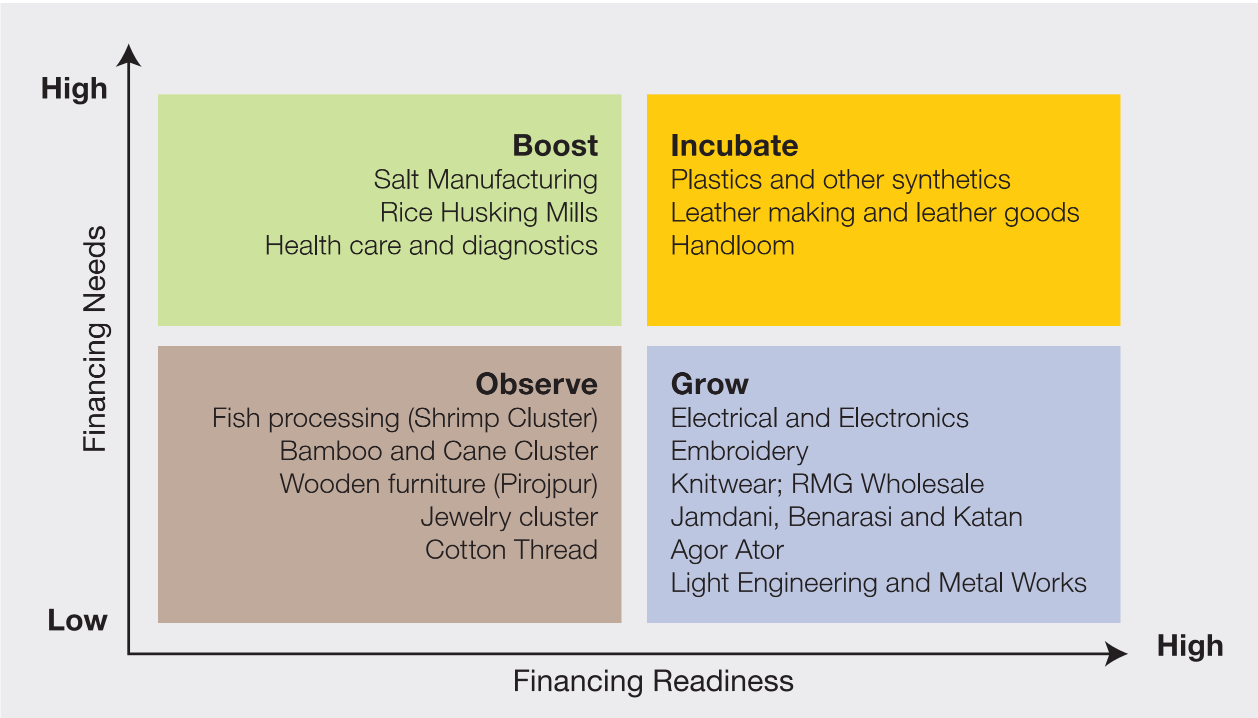
We can define the unmet market for finance amongst the MSMEs in the clusters and the value chains and assess the degree to which the existing financial instruments are being effective

Extrapolation of our field data shows that the MSMEs in the clusters in the 10 selected sectors have secured finance worth BDT 17,553 crores from the formal financial institutions. In contrast they have secured finance worth BDT 39,589 crores from informal financial institutions. Our findings show that there is a prospective market for factoring worth BDT 3961 crores. The prospective market size for working capital financing is worth TK 8178 crores. The prospective market size for warehouse receipt is BDT 4995 crores while the prospective market for machineries financing is BDT 9408 crores.

We can map the MSME clusters and value chains with respect to their financial needs and readiness and define the attractiveness of the clusters and value chains for financing

To analyse the prospect for cluster and value chain financing we used two indicators. Financial readiness and unmet financing needs. The clusters that were investigated were scored in a scale of 1-5 with 1 being low and 5 being how. The scores were used to plot the clusters on a matrix scale using two coordinates- (i) financial readiness on the X axis and financing needs on the Y axis.

Figure 6:
Attractiveness of cluster and value chain financing: Review of selected MSME clusters and value chains



Boost: The opportunity is immediate and the financial institutions could promote cluster and value chain financing products without significant institutional support from government agencies.

Grow: The opportunity is immediate but the financial institutions require institutional support from the government agencies to create a market for the cluster and value chain financing.

Incubate: The prospect for cluster and value chain financing is not immediate. Infrastructural and capacity development support by BB and SMEF could facilitate demand for cluster and value chain financing in the long run.

Observe: Financial institutions will not be able to create a market for cluster and value chain financing in these clusters given the current and prospective growth of these clusters.

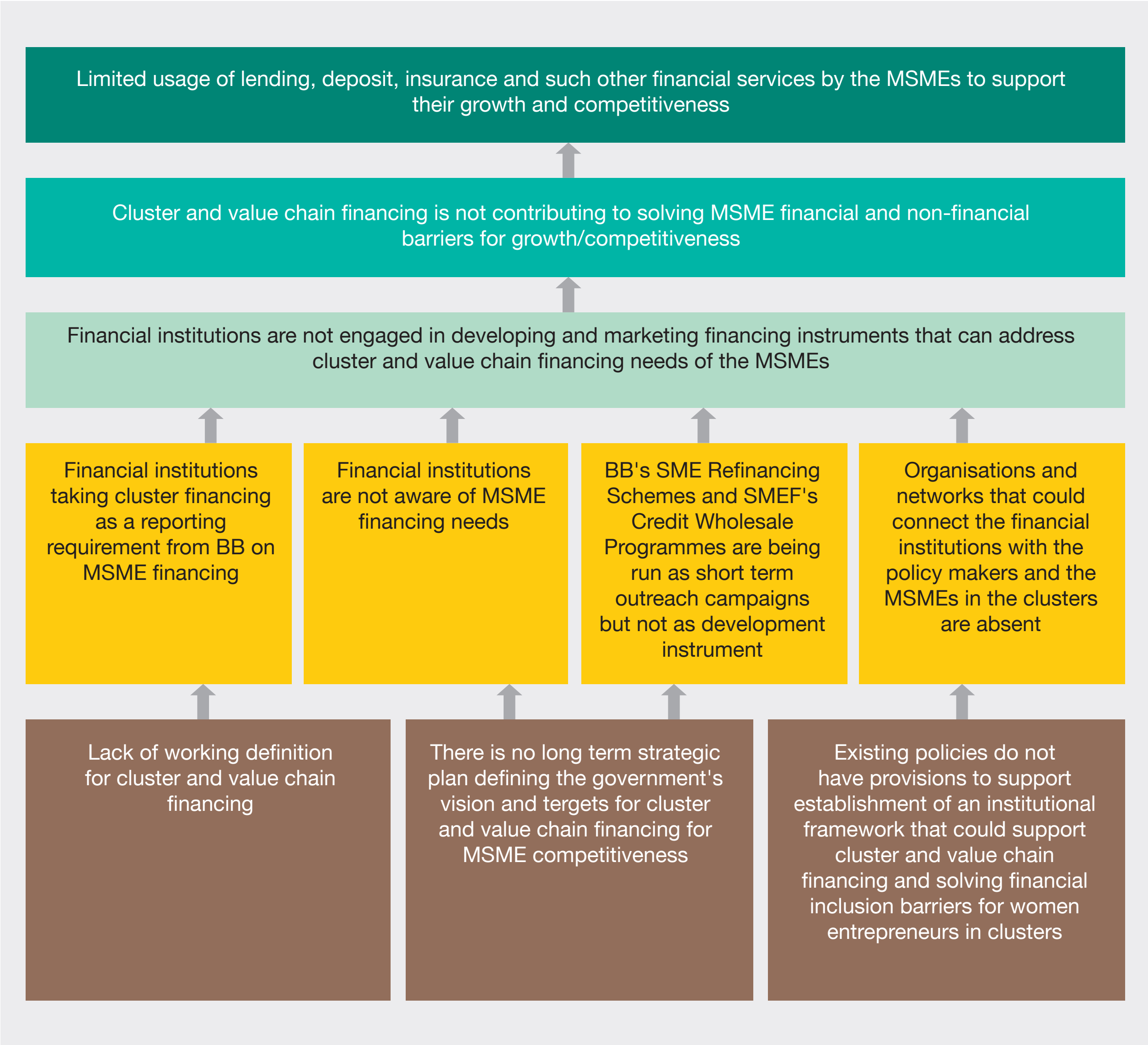
We used the quantitative data and qualitative information collected from the field to grade the clusters that were selected for the purpose of the study. The review suggests that the immediate prospect for cluster and value chain financing exist in the salt manufacturing, rice husking mills and health care and diagnostics clusters. The regular financial instruments (term loans, CC loans etc.) could be promoted in these clusters in addition to factoring, warehouse receipt and such. The opportunity for cluster and value chain financing is also immediate in the electrical and electronics, embroidery, knitwear, RMG wholesale, Jamdani, Benarasi and Katan, Agor Ator and Light Engineering and Metal works clusters. But these clusters would require public and private sector intervention to develop common facilities, common infrastructure and alternative financing instruments (For instance Special Purpose Vehicles) to support the enterprises grow. The prospect for value chain and cluster financing is not immediate in the plastics and other synthetics, leather making and leather goods and handloom clusters. The enterprises in these clusters face significant non-financial barriers that need to be addressed. For instance, investment in the leather and leather shoe making cluster is currently limited due to uncertainty resulting from planned relocations. The prospect for cluster and value chain financing is not immediate and relevant to several clusters. This includes fish processing cluster in Rupsha (Khulna), Bamboo and Cane Cluster (in Jessore), Wooden Furniture (in Pirojpur), Jewellery Cluster (in Mymensingh) and the Cotton thread cluster (in Comilla). These clusters face varying degree of challenges that cannot be solved through cluster and value chain financing. For instance, the women crafts producers (basketry) in Jessore are engaged in production of handmade export oriented baskets. The demand for the product is low and the ability of the enterprises to expand their business is limited since the business is dependent on their own manual labour. In the shrimp cluster, the government's special subsidy programmes already exist to facilitate finance for the enterprises. This also means that the enterprises primarily transact with state owned banks since the subsidies are provided by the state owned banks.

What policy barriers need to be addressed to facilitate cluster and value chain financing in Bangladesh?

Based on the findings from the field interviews with the stakeholders we can ascertain that MSME financing is a key agenda for the formal financial institutions. However, their capacity to serve the MSMEs vary. State owned banks are operating within the purview of the BB policy. They are preferred by MSMEs operating in the export market. These banks are unlikely to invest in developing the MSME capacity for financial readiness if not directed, mandated and capacitated by the central bank. Private commercial banks are being increasingly competitive with expanding network and diversified products. The competition could drive them further to invest on building MSME capacity for financial readiness. However, they would require state support to sustain the investment. NBFIs are more suitable for certain type of products and clusters (for instance those requiring capital machineries). However, they have limited national outreach. They are more likely to deepen their engagement with clusters that they are currently serving. Foreign commercial banks are unlikely to invest on capacity development of the micro enterprises given the cost of business and their global strategy for risk mitigation. They are more likely to deepen their engagement through MFIs. MFIs are more suitable for MSME development through cluster and value chain based financing approach. But they are yet to take up national level intervention for investment on collective development needs. Focus remains individual enterprises.

For the MSMEs to grow, they need to be able to use the financial instruments to support their competitiveness. Our study shows that the majority of MSMEs are using financial services. But these are not essentially contributing to their growth/ competitiveness as the available instruments are not tailored to solve the MSME financial needs and challenges. Our study suggest that the existing policy is supply

Figure 8:
Review of policy barriers underlying MSME access and usage of financial instruments



driven whereby the performance is measured by outreach and value of total lending. The policies are thus designed to ensure that the government's financial stimulus are reaching out to wider number of sectors and clusters at the cost of deeper impact per enterprise per cluster. The existing policies neither capacitate nor dictate financial institutions to be proactive. The institutions are mostly taking reactionary measures for cluster and value chain financing. As such the promise remains unexplored.

We do not have a detailed policy on cluster and value chain financing which explains why and how these should be adopted for MSME financing. Cluster and value chain financing is loosely defined to induce regular MSME financing schemes to specific clusters and value chains. The development agenda of cluster and value chain financing is not duly underscored. As such, the potential of cluster and value chain financing in solving the systemic barriers for growth of MSME clusters and value chains is not realized. Though the BB policy identifies some key policies with regards to diagnostics and mapping of clusters and setting up cluster development committees, we are yet to see these in actions.

The incentive schemes are loosely implemented without any long term strategic direction. The schemes are accessed by limited number of MSMEs in a cluster for a limited period of time after which the financing scheme is withdrawn from the cluster and allocated to the MSMEs in a separate cluster. Thus the MSMEs availing single digit interest loans are again exposed to double digit interest loans in a short period of time. This short term push is not enough to trigger systemic change across a cluster or a value chain. On the contrary, if such schemes were used to attract investment of the private sector on unmet development needs of the cluster or a value chain (for instance training centre, common facilitation centre, warehouse facility and such), the impact could have wider impact as the benefit would have reached out to large number of enterprises in the cluster.

Lastly, the policies do not take into consideration that the financing needs of MSMEs vary with respect to their cluster and to their position in the value chains. Further to that, the policies are blind to MSMEs in the backward and forward market linkage of the value chains and are designed with the assumption that the MSMEs are only concentrated in the production function of a value chain. This myopic focus means that finance is targeted towards enterprises that might have lesser benefit from financing and lesser impact on the overall growth and competitiveness of the clusters and the value chains. In light of these challenges, we undertook a review of the existing policies of the Government of Bangladesh that dictate the financing of the MSMEs. We recommend the following changes and amendments to the policies to facilitate inclusive MSME financing through cluster and value chain approach.

Recommended Policy Changes for Cluster and Value Chain Financing

SL no.	Broader recommendation	Specific Recommendation	Timeline	Relevant Agency
1.	**Introduce cluster and value chain development as a key objective under the Industrial Policy 2016**	Amend section 2.4 under the industrial policy to incorporate the following objective: ‘Take necessary measures to create the enabling environment for cluster and value chain development.’ Amend section 2.5 under the industrial policy 2016 to incorporate the following strategy: Section 13:‘Utilize cluster and value chain financing as an instrument to facilitate cluster and value chain development in Bangladesh.’	Immediate	Ministry of Industries (MoI)
2.	**Revise the SMEF definition of clusters to incorporate interconnected enterprises in the backward and the forward market linkages**	The current definition is not sufficient since it focuses solely on manufacturing enterprises within the cluster and ignores the enterprises in the backward and forward linkages and the support functions related to the products produced by the enterprises in the cluster. Sporadic and non-strategic financial stimulus to manufacturing enterprises within the clusters will not help to stimulate growth of the overall cluster and increase the financial appetite of the enterprises in the cluster. Old definition of Clusters: *“A Cluster is a concentration of enterprises producing similar products or services and is situated within an adjoining geographical location around 5 km radius and having common strengths, weaknesses, opportunities and threats”*. Proposed New Definition of Clusters: *“A cluster is a concentration of interconnected enterprises that are all contributing to the conceptualization, production and marketing of similar products or services and is situated within an adjoining geographical location around 5 km radius.”* Proposed Definition of Cluster Development: *“Initiatives undertaken by the government agencies, development partners, NGOs and the private sector in relation to the SMEF strategy for cluster development or in relation to any strategy that is developed by a development partner, a financial institution or a business membership organization or any other entity for the collective development of clusters in Bangladesh.”*	Immediate	Small and Medium Enterprise Foundation (SMEF)
3.	**Introduce the definition of value chain and value chain development in conjunction with clusters and cluster development in the SMEF Strategy for MSME development**	The existing policy documents related to SME development and SME financing in Bangladesh does not recognize value chains, value chain development and value chain financing as a strategy for MSME development. We propose the following definition of value chains and value chain development in line with the definition of cluster and cluster development. *“Value chain means the entire network of activities related to conceptualization, production and marketing of a product or service to the end consumers. A value chain involves all interconnected actors within and outside a cluster for a specific product or service. A value chain for a product or service may or may not be limited to the geographic boundary of a cluster. A value chain might also involve several clusters which are all contributing to the market for the same product or service but are located in isolation.* *Value chain development refers to all development initiatives undertaken by the government agencies, development partners, NGOs and the private sector in relation to the SMEF strategy for value chain development or in relation to any strategy that is development by a development partner, a financial institution or a business membership organization or any other entity with the goal to benefit MSMEs in the whole value chain by facilitating higher value for their activity in the value chain. Value chain development strategy should be harmonized to the cluster development strategy for the relevant product or service such that one contributes to the development of the other.”*	Immediate	Small and Medium Enterprise Foundation (SMEF)

4.	**Amend the BB master circular on MSME financing and introduce the definition of cluster financing and value chain financing in context of Bangladesh**	Cluster financing and value chain financing is not defined by BB. The lack of definition of cluster and value chain financing means that there is no strategic effort for development of specific financing instruments that can facilitate growth of specific clusters and value chains. Currently cluster financing is seen by financial institutions as a strategy to increase coverage of SME financing to MSMEs in clusters. We propose that BB considers the following definitions of cluster and value chain financing and incorporates those as clause 1.9 under the master circular on MSME financing. Proposed Definition of Cluster Financing: *"Cluster financing refers to lending, deposit, insurance, payroll, fund transfer, mentoring services provided by Micro Finance Institutions, Banks (State owned Banks, Private Commercial Banks, Islamic Banks, Foreign Commercial Banks) and Non-Bank Financial Institutions with the goal to satisfy both collective and individual financing needs of the MSMEs in a cluster and within the purview of the cluster development strategy as defined by SMEF Five Year National Cluster Development and Financing Strategy Plan."* Proposed Definition of Value Chain Financing: *"Value chain financing refers to lending, deposit, insurance, payroll, fund transfer, mentoring services provided by Micro Finance Institutions, Banks (State owned Banks, Private Commercial Banks, Islamic Banks, Foreign Commercial Banks) and Non-Bank Financial Institutions with the goal to satisfy both collective and individual financing needs of the MSMEs in a cluster and within the purview of the cluster development strategy by SMEF Five Year National Value Chain Development and Financing Strategy Plan."*	Immediate	Bangladesh Bank
5.	**Mandate SMEF to develop 5 Year National Cluster and Value Chain Development and Financing Strategy Plan; amend BB master circular on MSME financing to attract banks and financial institutions to channel cluster financing based on the 5-year national cluster and value chain development financing strategy**	SMEF is currently working on developing cluster development strategy papers for individual clusters. While this is beneficial to understand the scope for development to individual enterprises it is not facilitating a strategic, coordinated and harmonized national effort for cluster and value chain development. We propose that the clause 5.4 under the industrial policy 2016 is amended as below: *"SMEF will develop a national 5-year strategy plan for cluster and value chain development plan and in consultation with BB define the cluster and value chain financing strategy to facilitate finance for the identified development initiatives. To achieve this SMEF will establish a definition of cluster and value chain. BB will amend its master circular on MSME financing to define cluster and value chain financing. SMEF will undertake a revision of its national cluster map to make it more comprehensive. SMEF will also undertake an assessment of financial needs and readiness of the clusters and categorize them with respect to their financial need and readiness. SMEF will develop a strategy paper for cluster and value chain financing for the major clusters and value chains identified through the national cluster mapping exercise. BB, SMEF, MRA, BSCIC will coordinate to ensure that the formal financial institutions (Bank and non-bank financial institutions, MFIs) provide financial services to the MEs in these clusters based on the strategy paper for cluster and value chain financing.*	Mid-term	SMEF and BB
6.	**Establishment of a cluster development working committee in light of section 16.8 under industrial policy 2016**	Cluster and value chain development would require national level supervision, direction and monitoring. The industrial policy does not have provision for a national working committee that could undertake these roles. However, section 16.8 provides the scope for creation of such working committee. We recommend to utilize this provision for the establishment of a national working committee for cluster and value chain development. The working committee could be chaired by the Secretary of the Ministry of Industries and will have representative members from Bangladesh Bank, SMEF and BSCIC. The working committee should be kept lean so as to facilitate fast planning and implementation process. The working committee would work under the National Committee for Industrial Development. This would ensure that the relevant ministries and departments of the government are engaged on the development, supervision and implementation of the interventions under the 5-year national strategic cluster and value chain development plan for MSME development in Bangladesh.	Mid-term	MoI

7.	**Revise the scope for BB refinancing schemes and Credit Wholesale Programme of SMEF to channel financial incentives to specific development needs underscored on the 5-year national cluster and value chain development financing strategy**	Under the SMEF Credit Wholesaling Programme only a small number of enterprises from each clusters receive single digit interest loan for a limited period of time. Afterwards, the programme is usually withdrawn from the cluster and the funds are re-allocated to another cluster. Within the limited timespan, the enterprises that receive single digit interest loan do not grow to the scale that could create further demand for financial products (payroll, savings, insurance and such). The BB refinancing scheme incentivizes the banks to increase their investment on SME refinancing. But it has a latent potential to incentivize SME financing towards development interventions (For instance common facilitation centre, warehouses, skills development centres) which remain dependent on non-market financial stimulus (such as donor grants). We recommend that a part of the SMEF Credit Wholesale Programme and the BB refinance scheme is directed towards the development need of the clusters and the value chains which could accelerate growth of larger number of enterprises in the clusters and thus lead to overall growth in demand for and use of financial products. In light of this, we propose to revise clause 5.2.1 under the industrial policy 2016 as below: *'The BB SME Refinancing scheme and the SMEF Credit Wholesaling Programme and such other schemes and interventions initiated with the purview to clusters and value chain development should be directed towards specific development needs which include but is not limited to establishment of common facility centres, establishment of skill development centres, creation of storage and warehouse facilities. As such at least 30% of the SME finance under BB refinancing scheme and 50% under the SMEF Credit Wholesale Programme should be made available for investment towards interventions that are underscored in the 5-year national cluster and value chain development and financing strategy.'* In conjunction to the above, we recommend that the BB SME Financing Master Circular section 2.3 is amended to incorporate the following: *'At least 40% of the SME financing portfolio of the banks should be reserved for enterprises in clusters identified by the SMEF.'*	Immediate	BB, SMEF
8.	**Create a position of Cluster Development Agent for each Upazila in Bangladesh**	There are no grass root level implementation mechanisms for cluster development in Bangladesh. Clause 5.13 under the industrial policy 2016 allows for establishment of SME service centre in each upazila. We recommend that the clause is amended to create a provision for a cluster development agent: 'To facilitate grassroot level implementation of the government's cluster development strategy; a cluster development agent will be recruited as full time staff under SMEF. The cluster development agent will work to identify and work on local opportunities and challenges for cluster development. The cluster development agent will also work to coordinate the efforts of BB, BSCIC and SMEF for cluster development. The cluster development agents will also work to improve financial literacy of the enterprises in the clusters and will work with the associations in the clusters to improve financial readiness of their members. If such associations are not available, the cluster development agent will work with the enterprises in the cluster to facilitate formation of such agents. In this regard, SMEF will create a position for a national cluster development coordinator to lead the upazila level works undertaken by the Cluster Development Agents (CDAs).'	Mid-term	MoI, BSCIC

9.	**Infrastructural investment for cluster development**	Section 5.9 under the industrial policy 2016 specifies that the SMEF and the Ministry of Investment will provide support for establishment of industrial parks, Common Facility Centre, Design centres etc. This clause does not specify the type of support to be provided by SMEF and the Ministry of Industries. Furthermore, BB is not provided any role on facilitating investment on these initiatives. If the clause under 5.2.1 is revised as per our recommendation (recommendation number 6), then it is essential that clause 5.9 is amended to incorporate the following: 'BB will create a special fund to attract private investment or public-private partnership for infrastructural development as identified by BSCIC and SMEF.' In relation to the above, clause 5.9 under page 33 should be changed to clause 5.8 and BB and BSCIC should be included as implementing organization under the clause. Also, clause 4.3.13 under BB Master Circular on SME financing should be amended to incorporate cluster and value chain financing as a priority area for refinancing.	Long Term	MoI, BB, SMEF, BSCIC, MRA
10.	**Make the eligibility to the credit wholesale programme conditional to the creation of cluster development service centres by the financial institutions**	Clause 2.8 under BB Master Circular calls for financial institutions to establish service centres for cluster based financing. We recommend to amend the clause such that the eligibility to SMEF credit wholesaling programme is gauged against the establishment of a service centre by the FIs in the clusters. As such we recommend to amend clause 2.8 as below: 'The banks and financial institutions should have dedicated service centres for clusters to be eligible for SMEF Credit Wholesale Programme.'	Immediate	SMEF, BB
11.	**Incentivize development of special financial instruments for cluster value chain financing**	Special Purpose Vehicles (SPVs) are being used in different countries to facilitate finance on cluster development. Such instruments are yet to be tested in Bangladesh. Given the emphasis on infrastructural development for clusters, such vehicles could prove to be vital in attracting finance for cluster development. To tackle the challenge of liquidity of the MSMEs, factoring, warehouse receipt and such other instruments need to be tested and promoted. As such we propose that clause 5.4 under industrial policy is amended to incorporate the following sub-clauses: - Cluster and Value Chain Financing will be adopted as a multi-partner development banking approach led by BB, MRA and SMEF - BB will undertake an assessment of the feasibility of introducing factoring, warehouse receipt and special purpose vehicles for promotion of cluster and value chain financing in Bangladesh - BB in consultation with SMEF and BSCIC will introduce a guideline for introducing such schemes - BB together with Bangladesh Institute of Bank Management (BIBM) will introduce training courses for the financial institutions to support capacity development of the financial institutions to introduce cluster and value chain financing instruments in their respective organizations - MRA will introduce a guideline for cluster and value chain financing as a harmonized strategy with the BB guideline to support MFIs implement and scale up cluster and value chain financing instruments for micro enterprises To support the above, we propose that 2.8 of the BB Master Circular on MSME financing is amended to incorporate the following: 'To support banks and other financial institutions develop their own financing strategy for clusters and value chains; BB will provide the following support in coordination with SMEF, BSCIC, BIBM and such other agencies as deemed appropriate. The supports provided include but is not limited to:	Long Term	MoI, BB, SMEF, BSCIC, MRA

		- Training on cluster and value chain financing strategy and instruments in context of Bangladesh by BIBM - Support to assess financing needs of the targeted clusters and value chains in Bangladesh and develop organizational strategy for cluster and value chain financing by the SME Credit Policy and Special Programmes Department - Support to liaise with the enterprises and clusters in the value chains through the national cluster development coordinator seated with SMEF and the upazila SME service centres and cluster development agents managed by SMEF		
12	**Adapting cluster and value chain financing for facilitating financial inclusion of women entrepreneurs**	Under the industrial policy 2016 clause 10.2 Bangladesh Bank is mandated to support women entrepreneurs in micro, small, cottage and medium enterprises through financial support and incentives. To strengthen the scope of this clause, we propose to amend it and incorporate the following sub-clauses such that the initiatives of BB are directed towards solving the challenges faced by the women entrepreneurs in Bangladesh - SMEF together with women chambers at the district level will set-up a one stop financial and trade support centre for women entrepreneurs (Trade and Financial Support Centre for Women Entrepreneurs) - The centre will provide all documentation support for business establishment and application of bank loans - The centre will undertake financial literacy programmes and provide fee based financial management and accounting services and credit application services - The centre will work with banks and other financial institutions to promote the financial services of these institutions to the women entrepreneurs	Long Term	MoI, BB, SMEF
		- The centre will facilitate women entrepreneurs to apply for and avail group based loan under the BB master circular on SME financing clause 3.5 and 3.6 - The centre will work together with women chambers to assess the challenges and opportunities for financial inclusion of women entrepreneurs and undertake national level policy advocacy to address the opportunities and challenges		
13.	**Develop detailed Microenterprise (ME) policy guideline. The guideline should contain:**	The MFIs, especially those under PKSF are already reaching clusters and value chains across the country. PKSF has special programmes for cluster and value chain development. According to PKSF the average micro enterprise loan is about BDT 1 lac. But on case by case basis, the partner NGOs of PKSF lend up to BDT 6 lacs. About 5% of the MEs loans are in the range of BDT 3.5 lacs. BRAC and Sajeda Foundation are disbursing loans that have upper ceiling of BDT 25 lacs. MRA has set up a committee to reassess the ceiling and increase it to BDT 40 lacs. The MFIs are thus expected to serve large percentage of the micro enterprises' financing needs. Also given the fact that they have the resources in the field and the technical knowledge for development interventions, they are more adaptive to cluster and value chain financing if compared to the banks and non-banks financial institutions. It is thus essential that MRA, BB and SMEF works together to define the scope of each of these agencies in facilitating cluster and value chain financing in Bangladesh.	Immediate	MRA, BB, SMEF

WE CREATE ECONOMIC OPPORTUNITIES FOR SMALL BUSINESSES IN BANGLADESH

About BFP-B Project

Business Finance for the Poor in Bangladesh (BFP-B) is a £25m facility to create economic opportunities for small businesses by changing the behaviour of market actors in the financial sector. BFP-B is improving the policy and regulatory environment for financial institutions, inducing private sector investment in expanding the frontiers of finance, and enhancing the credit worthiness of small businesses. BFP-B programme funded by UKaid from the British Government. The Bangladesh Bank and Microcredit Regulatory Authority (MRA) are the implementing agencies, and the Financial Institutions Division of the Ministry of Finance, Government of Bangladesh, the executing agency of this programme. Nathan Associates London Ltd, in consortium with Oxford Policy Management, is the management agency for the programme.

BFP-B Partners

Bangladesh Bank

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

www.bb.org.bd

Microcredit Regulatory Authority (MRA)

The Microcredit Regulatory Authority (MRA) has been established by the Government of the People's Republic of Bangladesh under the "Microcredit Regulatory Authority Act 2006" to promote and foster sustainable development of microfinance sector through creating an enabling environment for NGO-MFIs in Bangladesh. MRA is the central body to monitor and supervise microfinance operations of NGO-MFIs.

www.mra.gov.bd

UKaid

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

www.gov.uk

Management Agency

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Nathan Associates is a private international economic and analytics consulting firm established in 1946 that works with government and commercial clients around the globe to deliver practical solutions through building frameworks for economic growth or navigating regulatory hurdles, securing infrastructure financing or evaluating and assessing disputes. Nathan Associates London has been awarded the contract by DFID to deliver technical and financial assistance under the BFP-B Project.

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Contact: BFP-B
Level 3, House 11
Road 27, Gulshan 1,
Dhaka 1212, Bangladesh

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