Innovative finance for small business

Research Study on

Diagnostics of Micro-enterprise (ME) Lending by MFIs in Bangladesh: Opportunities and Challenges

Business Finance for the Poor in Bangladesh (BFP–B) Project

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In conducting the study, we gathered information from primary and secondary sources. We had in-depth discussions with a select group of MFI-CEOs and bankers separately to identify the constraints and challenges towards expanding financing of micro-enterprises in Bangladesh. We deeply appreciate the participants at the discussion meetings for their time and wisdom. The MFIs extended their hands of cooperation in preparing the list of ME enterprises in the sample areas. Without their support and cooperation, it would have been extremely difficult to complete the study effectively and on time. Thanks are due to the MFI branch managers and their colleagues in our study areas.

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We hope, the findings of the study will receive due attention of the policymakers particularly from MRA, BB and MoF.

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Abbreviations

ASA	Association for Social Advancement
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BFP-B	The Business Finance for the Poor in Bangladesh
BKB	Bangladesh Krishi Bank
BRAC	Bangladesh Rural Advancement Committee
CDF	Credit and Development Forum
CGAP	Consultative Group to Assist the Poor
CIB	Credit Information Bureau
CME	Cottage and Micro-enterprise
EC	European Commission
GB	Grameen Bank
GDP	Gross Domestic Product
GoB	Government of Bangladesh
ICG	Independent Consultants Group
INAFI	International Network of Alternative Financial Institutions
InM	Institute for Inclusive Finance & Development
JUP	Joutha Unnayan Prochesta
MCSE	Micro Cottage Small Enterprise
ME	Microenterprise
MF	Microfinance
MFI	Microfinance Institution
MRA	Microfinance Regulatory Authority
MSE	Micro & Small-Scale Enterprise
MSME	Micro Small and Medium Enterprise
NBFI	Non-Bank Financial Institution
NGO	Non-Government Organisation
PKSF	Palli Karma-Sahayak Foundation
PMUK	Proshika Manobik Unnayan Kendra
PO	Partner Organisation
R&D	Research & Development

RAKUB	Rajshahi Krishi Unnayon Bank
RFM	Rural Financial Market
ROA	Return on Asset
SCE	Social Capital Exchange
SCM	Social Capital Market
SEC	Securities and Exchange Commission
SEF	Social Equity Fund
SME	Small Medium Enterprise
SMESPD	Small Medium Enterprise and Special Programmes Department
SUS	Sthaniya Unnayan Sangstha
ToR	Terms of Reference
UDDIPAN	United Development Initiative for Programmed Actions
WBES	World Business Environment Survey

Executive Summary

The report identifies key opportunities, challenges and way forward for microfinance institutions (MFIs) to expand micro-enterprise (ME) lending and deposit services in Bangladesh. The analysis is based on secondary data collected from Bangladesh Bank (BB), Microcredit Regulatory Authority (MRA) and MFIs; and primary data collected from 600 MEs and information through discussions with BB, MRA, banks and MFIs.

Several issues guide the analysis of the study. First, why development of MEs is so important in Bangladesh? Second, what constraints do MEs face in their development? Third, to what extent is finance a critical factor? Fourth, what is the existing demand-supply gap of ME credit? Fifth, what policies/strategies should be taken to promote and develop MEs through MFIs?

I. MEs in Bangladesh

MEs play a critical role in, and create opportunities for, the Bangladesh economy from both economic and social perspectives. From the economic perspectives, it contributes to employment and asset creation, mobilisation of local resources and technological adaptations. The social perspectives cover social dimensions of poverty reduction, balanced development, and redistribution of income in order to improve household and community welfare.

In Bangladesh, 7.82 million economic establishments operate employing 24.5 million persons (BBS 2013). Of these establishments, roughly 89 percent are cottage and micro (CME) in nature. These enterprises employ 56 percent of total employment. The average employment per CME is 1.98 persons. Considering the average size of economic establishments and the size of CMEs, the definition of CMEs as specified by the Ministry of Industries and Bangladesh Bank should be redefined. In terms of employment, any enterprise with employment of maximum of five employees should be termed as CMEs. From the lenders' perspective, any enterprise with employment size of maximum five and maximum loan size of Taka one million can be defined as CME. Even with this revised criterion, the enterprises that we surveyed are CMEs.

Until 2010, financing CMEs was not part of industrial credit policy. In 2010, BB formulated a comprehensive SME Credit Policy and programmes for creating opportunities for financing SMEs. In December 2015, the policy was amended. It enables banks to lend to CMEs directly through its branches, and indirectly through using the services of NGO-MFIs and any other agency under the 'Agent Banking' system. More importantly, as a part of monitoring, BB publishes specific statistics on credit to CMEs. All these have created opportunities for the CMEs to get financial services from banks. On the other hand, CMEs can also access the microfinance market. Until recently, MFIs used to provide financial services to its members. Since 2006, MFIs have been providing credit to the CMEs with lateral entry. All these together have created opportunities for expanding CMEs. But do these measures solve the problems of CMEs? Is finance adequate? Are there any other factors that hinder growth and development of such enterprises?

II. Constraints to ME Growth and Development

Available information on MEs shows that MEs are faced with multi-dimensional finance and non-finance constraints. But inadequate access to finance remains the major constraint not only in Bangladesh but also in other developing countries. In Bangladesh, finance is identified as the dominating constraint for micro and SMEs. This is also evident from the share of CME credit. In 2015, banks disbursed only 11 percent of SME credit for cottage and micro-enterprises. In 2014, the share of CME credit was 28 percent of both total loans disbursement and outstanding, corresponding to 8 percent of the total borrowers. The financial constraint is further exemplified by the financial structure of MEs.

In Bangladesh, the majority of enterprises are self-financed. This is true for micro and cottage industries as well. Sometimes enterprises require external financial support for scaling up the business. Bank financing has always been a constraint to the development of micro and SMEs. Although the MFIs provide support to MEs, they suffer from funding constraints. The CMEs start their business essentially with own equity and some informal credit. Only a very small share of capital investment is borrowed funds. More than 90 percent of the initial capital investment is self-financed. The situation has improved very little over time for CMEs.

The InM Micro-enterprise (ME) Survey (2016) shows similar results. The share of own fund in total capital investment is around 85 percent. The share of bank credit is 4 percent while MFIs contribute about 12 percent of capital structure of the surveyed MEs. Does it reflect financial constraint? More than 90 percent of the MEs recognise finance as the dominant constraint. This is followed by other major constraints: (i) product marketing, (ii) scarcity/high price of raw materials, (iii) competition with others, and (iv) low demand for the product in the market. Since MEs mostly operate in the local economy, product marketing or low demand for outputs is a lesser constraint. However, higher intensity of competition reflects some degree of risk. MFIs and banks do recognise such vulnerability of MEs which can be addressed if ME borrowers have access to information and training on product selection and market competition. The survey clearly shows that MEs are subject to severe financial constraint.

But the issue is: why do MEs have so negligible access to bank and microfinance markets? Why do they face severe financial constraint? When MEs identify finance as the major constraint, this should be equally reflected in the projected demand for ME credit.

III. Unmet Demand for Micro-enterprise Credit

The demand for ME credit is projected using 2016 InM ME Survey data from 600 MEs (borrowers and non-borrowers) and total number of cottage and micro-enterprises. The *projected demand for ME credit comes* to *Tk.737 billion.* The supply of ME credit from banking and microfinance sectors using information of 2012-14 is projected at Tk. 299 billion for 2015. This gives an unmet demand for ME credit of Tk. 438 billion. It is a static projection as this assumes constant annual growth rates of MEs and ME credit. Considering the assumptions and other factors, the above estimate of unmet demand could be treated as a lower bound. We find that demand for ME loan is interest elastic. A one-percent decrease in interest rate will increase demand for ME credit by 5.6 percent. With targeted economic growth rate over the next five-year plan period and interest elasticity of loan demand, the intensity of ME investment and demand for CME loan are likely to grow at higher rates. Why does excess demand for credit exist? Why are not banks and MFIs not able to meet higher demand?

IV. Why Do MEs Have Little Access to Bank and Microfinance Market?

The issue is explored through conducting separate focus group discussions with MFIs and bank officials along with information collected from secondary sources.

Bank officials identify several factors: (i) branch network is limited; (ii) existing collateral based lending practice is not suitable; (iii) ME lending is costly and risky; and (iv) large and medium-sized loans are profitable. However, they recognise that services of NGO-MFIs can be used to channel loans to MEs if MRA publishes the ranking of MFIs and a CIB is available for MEs.

MFIs disburse ME loans, and they are willing to expand loan intensity. Their critical argument is financial constraint. However, they also consider MRA rules as restrictive. They argue that relaxation of the regulatory restriction would not be sufficient to meet additional demand for credit. MFIs require more funds.

Considering the characteristics of the MEs, MFIs are probably the right vehicles for financing MEs. Banks have larger portfolio for maximising profit through reducing transaction and default costs. As such, we may presume that banks and non-bank financial institutions have limited role in financing cottage and MEs. Within such caveat, future policy implications are drawn.

MFIs identify three sets of constraints in financing MEs–operational constraint, financial constraint, and regulatory constraint. More than 72 percent of participants and MFIs identify operational and financial constraints as major ones.

The operational constraints relate to:

- Lack of skilled staff

- Lack of systematic training
- High drop-out of trained staff
- Lack of skills for evaluating ME loan proposals
- Lack of training on risk management

The identified financial constraints are:

- Inadequate access to borrowed funds
- High cost of funds
- Rigid terms and conditions of loan contracts
- Ceiling on ME loans

Financial constraints are also created by regulatory constraint. Around 45 percent of the MFI-participants hold that financial constraints are at least partly created by regulatory restriction on ME loan volume. The regulatory constraint arises from three provisions of MRA Rules 2010:

(i) Rule 34 requires that MFIs maintain 15 percent of member deposits as liquidity reserve requirement;
(ii) Rule 20 requires that MFIs should maintain 10 percent of Reserve Fund as deposits;
(iii) Rule 24(3) requires that ME loans should not exceed 50 percent of total loans outstanding.

Although MFIs argue that relaxation of regulatory restrictions will contribute to increasing supply of fund for ME financing, we consider that Rule 20 and Rule 34 will be required for liquidity requirements and financial stability. There is an opportunity to relax rule 24(3). But this may not be adequate. MFIs require access to additional fund. Additional funds can be mobilised through mobilising member or public deposits. MFIs consider that Rule 27(2), Rule 28(e) and Rule 29(e) restrict mobilisation of savings. The MRA rules are as follows:

(i) Rule 27 (2) requires that total deposit balance of any Microcredit Organisation will not exceed 80% of the principal loan outstanding at any given time.
(ii) Rule 28 (e) requires that the total voluntary deposit will not be more than 25% of the total capital of the organisation.
(iii) Rule 29 (e) requires that total term deposit will not be more than 25% of total capital of the organisation.

MFIs are unable to mobilise funds through offering different savings products because of the above regulatory restrictions in MRA Rules 2010. They also argue that skill development training for ME loan related staff will strengthen implementation of ME lending programmes. What ought to be done to remove the constraints of the lenders?

V. Policy Strategies for ME Financing

The analysis shows that banks have limited scope for financing MEs mainly because of their loan product approach. They are more inclined towards financing large and medium enterprises and, when they do, it is largely for working capital financing. Even when banks are financing MEs they are basically servicing the upper strata of MEs that are more close to graduation to small enterprises. Moreover, their operations are limited mostly to urban areas. In such a situation, it becomes quite difficult for the banks to finance rural MEs. Specialised agricultural development banks with their specific portfolio are more engaged in financing the agriculture sector.

Policy options are proposed under different scenarios. Moreover, not all suggested policy options are mutually exclusive. The options also need deeper critical examination and proposed changes need a comprehensive approach to implementation, as these will have different implications for various stakeholders having their own perspectives. In the case of financial market related policies, these should be evaluated both from micro and macro perspectives; from both firm and market perspectives.

STRATEGY ONE: Increased flow through the banking system

Banks have higher ability to mobilise financial resources and act as intermediaries to invest in the portfolio of firms and individuals. The analysis shows that banks have not been able to finance cottage and small enterprises directly; only around 11 percent of MSME loans outstanding are CME credit. Despite such limited role at present, given the advantages of banks, increasing funds flow to CMEs is important. The suggested policies are as follows:

- ***Bring changes in BB credit and refinancing policies***. Bangladesh Bank needs to bring some changes in its credit and refinancing policies to make it more CME friendly. Following measures can be taken:

    (i) *Set a credit floor for financing CMEs each year;*

    (ii) *Although 100 percent refinancing of SME loans are available, such refinancing facilities should be made a priority for CME loans in rural areas, in particular. A minimum of forty percent of the SME refinancing shall be set for CMEs.*

    (iii) *Preferential lending interest rate for CME loans in rural areas should be introduced as most rural employment is created in the CME sector and more than 90 percent of the economic establishments are CMEs in nature. It will be socially justified as net social benefits are expected to be positive.*

- ***Ensure investment of rural deposits in rural areas****:* Bank deposits are the source of funds for investment. The rural advance-deposit ratio shows a declining trend. In June

2015, the ratio of advances and deposits in RFM is 0.39. Such trend is counter-productive. This needs to be reversed in order to increase investment in rural areas. Bangladesh Bank can suggest following policy measures to ensure increase in rural investment of rural deposits:

(i) *set a clear policy of linking incentive-related policies like refinancing to rural advances out of rural deposits;*

(ii) *rural bank branches should be directly encouraged to use MFI branches for expanding credit facilities to both MEs and other economic activities in the areas where banks can not provide financial services directly.*

- ***Strengthen 'agent banking' system.*** The December 2015 amendments to Circular 4 of SMESPD require promotion of agent banking to provide financial services to CMEs. Though the policy is in effect, it is not as effective as it should have been. In the case of enterprise financing, NGO-MFIs are identified as agents. In recent years, the share of 'loans to NGO-MFIs' by banks has increased. In 2014, banks disbursed Tk.27 billion to NGO-MFIs, an increase by almost 30 percent from Tk.21 billion in 2013. However, bank loans constitute only 10.7 percent of total capital and liabilities in 2014. This contribution has been a part of normal lender-borrower transaction. *The principal-agent banking system should be specifically promoted and strengthened for financing cottage and micro-enterprises.* In the process of doing it, following steps may be taken:

  (i) *recognise licensed MFIs as a formal organ of the financial markets, particularly in rural financial markets.* Although there is a separate regulatory agency, Bangladesh Bank is the regulatory agency for the overall financial and monetary system. As such, it is imperative that better collaboration between banks and NGO-MFIs should exist. NGO-MFIs should not be treated as a 'client group' only. Such collaboration should start with recognition of licensed NGO-MFIs as a formal organ of the financial market. With such recognition and positive environment of collaboration, banks shall be able to use the services of NGO-MFIs more effectively.

  (ii) *rural bank branches should be encouraged to provide financial services to CMEs through efficient and sound MFIs;*

  (iii) *all commercial banks should be strongly encouraged to select some MFIs in rural financial markets as their agents. Bangladesh Bank should have specific policy guidelines for selecting MFIs under the principal-agent model of lending.*

  (iv) *Financial innovation and technology like mobile banking may be used to strengthen Agency Banking.*

Establishment of CIB for the microfinance sector will facilitate banks to lend with higher level of confidence. At present the process is underway for establishing such CIB.

STRATEGY TWO: Increase Flow of Fund for Financing CMEs through PKSF

PKSF is a major player in promoting and developing microfinance market in Bangladesh. Over time, it has diversified its activities from pure finance to development finance. In recent years, PKSF has brought major change in policy to promote micro-enterprises in Bangladesh through its partner organisations. In addition to banks, PKSF can be a major vehicle for increasing flow of fund for financing CMEs as it has higher abilities to monitor CMEs and financing MFIs and has established set of rules.

Considering the critical role that PKSF plays and the need for broad-basing ME financing, PKSF may open a special window for financing MEs with financial support from government and international agencies. This window may be a subsidiary organisation of PKSF or may be specialised ME Fund within PKSF. All licensed MFIs should have access to such specialised ME fund or to funds of its subsidiary, if established.

STRATEGY THREE: Support MFIs in mobilising financial resources

The NGO-MFIs finance their lending activities through mobilising resources from different sources. There is a relationship between sources of finance and four broad stages of development of NGO-MFIs: (i) start-up; (ii) operational self-sufficiency; (iii) financial self-sufficiency, and (iv) commercial level return. Bangladeshi NGO-MFIs have gone through such phases and most of them are now in the third phase. In this phase, NGO-MFIs are licensed and these licensed NGO-MFIs should have access to different sources of funds. The potential sources are: voluntary savings, debt capital and equity capital. In 2010, borrowed funds and member deposits constitute 78 percent of the total; the share declined to 60 percent in 2014 implying increasing share of equity and reserve funds.

NGO-MFIs need to raise funds from all potential sources. Higher amount of funds is needed for expansion and scaling up financing of CMEs. The current state may be termed as a 'state of capital deficit'. In such a state, MFIs are confronted with two inter-related problems: (i) slower growth rate, less than the desired level, and (ii) operational deficit which may limit MFIs to access the capital market. In such a situation, based on cost of funds associated with each source of finance, NGO-MFIs may adopt a number of capital-raising or fund-raising approaches.

- ***The NGO-MFIs should finance lending activities more by savings.*** *Currently, MFIs are allowed only to mobilise member savings and term deposits subject to restriction under rule 28(e) and 29(e). NGO-MFIs should mobilise more member savings and term deposits at a higher level. Several arguments are advanced to justify such strategy. First, MFIs cannot sustain long run financing of MEs with borrowed fund. Second, MFIs shall be able to reduce lending interest rate when cost of fund will be lower due to savings mobilisation. Third, it will enable MRA to design appropriate governance* *structure for better monitoring of the licensed MFIs. Fourth, it will facilitate MFIs to contribute to economic growth through up-streaming of their lending activities. Considering these arguments, we recommend the following measures:*

(i) *MRA should amend rule 28(e) and 29(e) to fasten the process of savings mobilisation and ME financing. The present restriction of limiting voluntary deposits or term deposits to 25 percent of equity capital should be amended as "voluntary deposits or terms deposits will not be more than 25 percent of loans outstanding". Our estimates show that such amendment will contribute to increasing ME financing by six times.*

(ii) *BB and MRA should examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions. This should be done in order to ensure financial stability and better monitoring of monetary policy.*

(iii) *Rule 24(3) may be amended to relax limit on ME financing as a ratio of loans outstanding. The existing limit on 50 percent may be relaxed to 60 percent without affecting financing of income generating activities for poverty alleviation.*

- ***Access to innovative financial instruments:*** Globally some innovative financial instruments are available for raising capital. The well-known instruments are: (a) Credit Guarantee Scheme; (b) Securitisation, and (c) Debt instruments.

(i) *NGO-MFIs can raise funds from financial institutions through a specially designed Credit Guarantee Scheme for financing CMEs. Bangladesh Bank with assistance from the government may design such a specialised scheme. However, it is not the product that has to be designed, but also the mechanism as well as terms and conditions that have to be properly defined so that they do not distort the behaviour of both lenders and borrowers.*

(ii) *Securitisation is a well-discussed issue in the microcredit market. BRAC was successful in raising funds through securitisation, which ultimately contributed to expansion of its activities. Such an approach may emerge as an effective instrument in linking the portfolios of NGO-MFIs or micro-enterprises to the capital market. The issue of securitisation needs to be examined in the context of the relationship between microcredit market and formal bank credit market.*

(iii) There are other debt instruments like certificates of deposit or bonds/debentures that are issued to raise funds from the capital or money markets. These instruments can be used for raising capital for MFIs. The issue needs careful examination in the context of the state of capital and money markets in Bangladesh.

STRATEGY FOUR: Raise social equity fund (SEF)

NGO-MFIs in Bangladesh are 'not-for-profit' social entities. There is no privately held equity, although the institutions are established and operated by social sponsors. On principle, there are two capital markets that the firms can access. Commercially motivated firms can raise funds from capital markets by offering private equity. Shareholders are entitled to participate in management and dividends. But NGO-MFIs in Bangladesh are social organisations. In such a situation, they can raise social equity capital. There are several ways of raising social equity capital: (i) participation of donor agencies (firms or individuals) in social equity; (ii) participation of institutions like banks and PKSF in social equity; and (iii) access to the social capital market (which does not exist at present in Bangladesh).

Raising social equity funds is an important policy issue. The policy should be examined from the perspective of (i) establishing a 'Social Capital Market (SCM) or Social Capital Exchange (SCE); and (ii) allowing individuals as well as national and international agencies to contribute to the Social Equity Fund. All relevant players e.g. BB, SEC, MRA, and PKSF along with relevant experts should examine the issue of establishing this specialised exchange for social institutions like NGO-MFIs. Implementing the second perspective of accepting contributions of individuals and organisations to SEF will be easy once a working policy is adopted by MRA in collaboration with BB. There is, however, another system called *kiva*micro-lending, quite well practised in some of the European countries. It is quite prominent in China as well. It is an on-line credit market where a platform is created for both potential lenders and borrowers. Both individuals and firms can participate. But unregulated *kiva* micro lending may create financial instability as well.

STRATEGY FIVE: Establish separate institutions for financing CMEs

Financing cottage, micro and small enterprises (CMSEs) requires 'up-streaming' of lending activities for NGO-MFIs and 'down-streaming' of lending activities of banks. In the context of Bangladesh, MEs are the missing entities in the formal bank credit market. Thus there exists a 'market failure' in the formal credit market. The microcredit market needs to up-scale its lending activities, which may affect their on-going financing of income generating activities and implementing development activities for poverty alleviation and rural economic growth. From such perspectives, one may argue for establishing separate specialised financial institutions in rural financial markets (RFMs). Establishing such specialised financial institutions in RFMs requires a serious policy review in the context of the expected role of NGO-MFIs, and the failure of specialised banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). Such banks may be termed as 'community banks' or 'rural banks'. In the Philippines, rural banks have been quite successful. They also exist in Indonesia. However, given the experiences with BASIC Bank, BKB and RAKUB, one may be apprehensive of another specialised bank for MEs. However, the targeted objective may be achieved through an alternative if PKSF is allowed to open a separate window for financing CMEs with capital contribution from the government, BB and low-cost funds from international agencies. BB and MRA may examine the proposal carefully to improve the performance of RFMs.

STRATEGY SIX: Transform MFIs into microfinance banks

About a decade ago, microfinance banks were unknown entities. At present, many microfinance banks operate in different countries. They operate even in several South Asian countries such as India, Nepal and Pakistan. In Africa, these are well spread. In Latin American countries like Bolivia, microfinance banks exist and have operated for over two decades. But not all these microfinance banks are social organisations. Some are commercial financial institutions with two modes of ownership – private equity and institutional equity. Although these are microfinance banks, their activities are spread over financing micro-enterprises to small and medium enterprises.

In Bangladesh, establishing microfinance banks may be considered as a policy option for 'up-scaling' activities of NGO-MFIs; financing CMEs, capacity improvements of NGO-MFIs, and strengthening rural financial markets. There are pros and cons for transforming MFIs into microfinance banks. In addition to scaling-up activities, transforming MFIs into microfinance banks will enable the banks to operate effectively in RFMs with available information. However, some critical issues need detailed examination:

- Should all MFIs be transformed into banks? (Probably not)
- What should be the ownership and governance structure?
- Should these banks be regulated by MRA? If not, what will be the future role of MRA?
- Should microfinance banks operate only in RFMs?
- Should microfinance banks be limited in number?
- Will transformation of selected number of MFIs into microfinance banks affect the targeted objective of financing IGAs and reducing poverty?

A clear policy needs to be formulated by BB and MRA. For example, State Bank of Pakistan has issued a set of detailed outlines or guidance for establishing separate microfinance banks or transforming MFIs into microfinance banks. These guidelines are quite extensive and address critical issues from ownership to governance.

In brief, the policy options or strategies need to be examined in detail. However, the aim should be to remove the constraints to financing CMEs and increase the flow of capital. It can be increased using the existing institutional framework and/or establishing new small and rural banks. The policies concerning the establishment of new institutions should be examined from the perspective of improving efficiency and competition in financial markets.

STRATEGY SEVEN: Remove non-financial barriers to developing MEs

Expansion and development of MEs cannot be done in isolation through making provision for finance only. It requires a holistic approach so that problems in credit markets, factor markets and product markets are simultaneously addressed. Otherwise, a piecemeal approach may create distortion in other markets and may contribute to inefficiency. Moreover, MEs are constrained by skills, market knowledge, product selection and infrastructure. In view of this, resolving the financial constraint will require creating an appropriate environment for ME development, defining CMEs, identifying target groups, recognising heterogeneity of MEs, providing business support and other relevant services. Moreover, distortions in factor and product markets will undermine credit market liberalisation for the MEs.

Based on the study outcomes, the table below provides a summary of the major recommendations on increasing ME financing and suggesting possible implementation modalities and lead institution/organisations to carry forward the implementation process.

Key Policy Options for ME Financing

Policy options	Suggested action	Time frame	Lead institution (s)
1. Increase flow of fund for ME investment through banking system		Short term	Bangladesh Bank
Bring changes in BB credit and refinancing policies	Set a credit floor for financing cottage and micro-enterprises (CMEs) each year. 20 percent of SME credit may be earmarked as credit floor.		
	A minimum of 40 percent of the SME refinancing may be set for CMEs		
	Preferential lending interest rate for CME loans in rural areas may be introduced		
Ensure investment of rural deposits in rural areas	Set incentive-related policies, like refinancing, to encourage investments of rural deposit in rural areas		
	Rural bank branches could be directly encouraged to use MFI branches for expanding credit		

	facilities to both MEs and other smaller economic activities		
Strengthen the 'agent banking' system	Recognise licensed MFIs as a formal organ of the financial market		
	Rural bank branches could be encouraged to provide financial services to MEs		
	All commercial banks could be strongly encouraged to select some MFIs in rural financial markets as their agents		
	Financial innovation and technology like mobile banking may be used to strengthen agency banking		
	Establish CIB for the microfinance sector		
2. Increase flow of fund for financing CMEs through PKSF	PKSF may open a special window for financing MEs. This window may be a subsidiary organisation of PKSF or may be a specialised ME Fund within PKSF	Short term	PKSF, Ministry of Finance
	The government could allocate a certain amount in the budget for ME financing every financial year, which could be channelised to MFIs through PKSF.		
3. Support MFIs in mobilising financial resources			
NGO-MFIs could finance lending activities to MEs more using savings	MRA could amend rule 28(e) and 29(e) to facilitate the process of savings mobilisation and ME financing	Short term	MRA
	BB and MRA could examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions.		Bangladesh Bank and MRA
	Rule 24(3) may be amended to relax the limit on ME financing as a ratio of loans outstanding		MRA
Access to innovative financial	NGO-MFIs may raise funds from financial institutions through a		MRA, Bangladesh

instruments	specially designed Credit Guarantee Scheme for financing CMEs		Bank, Ministry of Finance
	The issue of securitisation may be reviewed in the context of the relationship between microcredit market and formal bank credit market.		
	Certificates of deposit or bonds/debentures may be used for raising capital for MFIs		
4. Raise social equity fund for NGO-MFIs	Examine the feasibility of establishing Social Capital Market (SCM) or Social Capital Exchange (SCE)	Medium term	Bangladesh Bank, Securities and Exchange Commission (SEC), MRA, PKSF
	Review the possibility for individuals as well as national and international agencies to contribute to the Social Equity Fund		
5. Establish separate institutions for financing CMEs in RFM	Examine the expected role of NGO-MFIs, specialised banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB) in financing CMEs	Medium term	Bangladesh Bank, MRA, Ministry of Finance, SEC
6. Transform MFIs into microfinance banks	Explore the feasibility and identify potential MFIs which can be transformed into microfinance banks	Medium term	Bangladesh Bank, MRA
	Review alternative options and identify desirable ownership and governance structures		
	Identify the regulatory authority		
	Explore the area of operation: rural or urban or both		
	Identify the number of banks		
	Examine the effects of such transformation on social objectives of NGO-MFIs		
7. Non-financial Measures of ME development	Capacity of MFIs and micro-enterprise borrowers need to be enhanced through training and provision for market-related information.	Short Term	Government of Bangladesh, InM, BIBM

	Identify required non-financial services such as strengthening backward and forward linkages for MEs and adopt measures for delivery of comprehensive services.		
1. Defining Microenterprise	ME may be defined based on (i) loan size and (ii) employment size	Short Term	MRA
	entities with full time employment size of 1 and 5 be defined as micro-enterprises		
	ME Loan size may be set at Tk.70,000		

VI. The Way Forward

The study suggests two sets of strategies – one for improving access to ME credit market, and other for creating an enabling environment for promoting and developing MEs.

Improving Access to ME Credit Market

For implementing the proposed multi-dimensional programmes, several approaches may be adopted.

First, both MRA and BB should examine all the options that we have suggested, in consultation with different stakeholders. Some of the policy suggestions that we have put forward will require further analysis.

Second, MRA, in consultation with BB, should prioritise the policy suggestions and decide on phases of implementation of the agreed policies.

Third, MRA should look at promoting and financing micro-enterprises, as one of the goals of the regulatory authority is to influence economic growth. Therefore, it should formulate policies to finance enterprises.

Fourth, it may be necessary to make equity investments in MFIs who are involved in ME lending.

Fifth, it may be useful to explore the feasibility of a credit guarantee mechanism to promote linkages between ME-lending MFIs and private/other financial intermediaries. The overall approach should combine the instruments in a strategic fashion so that they become mutually reinforcing.

Sixth, it may be useful to review different MRA and BB rules in order to improve accessibility of MEs to credit services. Some rules and regulations of MRA may need to be amended.

Seventh, BB and MRA should jointly start a process of examining the issue of establishing selected number of ‘rural microfinance banks’ and/or dialogue with PKSF on opening a separate window for financing CMEs.

Finally, an important issue for ME development in Bangladesh is to set a vision and adopt a pro-active MEs promotion policy that would facilitate a rapid transition from traditional to relatively modern product categories along with higher capitalisation and use of better production technologies. This will help upscale the existing low productivity informal MEs and deepen their links with mainstream growth-seeking activities. As such, the development of MEs calls for a re-thinking of the present nature of MFI interventions to address the second-generation issues of finance up-scaling and technology diffusion necessary to create a sustained impact on poverty reduction in the country.

Creating an Enabling Environment

The important concern relating to ME sector is to ensure speedy growth in all aspects, including output and employment. For this, the country’s industrial strategy, in addition to focusing on growth on MEs, needs also to be anchored in multi-layered subcontracting arrangements between the larger enterprises and MEs and among MEs themselves. In recent years, ME-centred activities in trade, services, agriculture and food processing sectors have expanded rapidly in response to higher demand, and there exists more potential for their future expansion. Innovation and searching for new markets are also important for sustaining the growth of existing MEs and flourishing of new MEs.

For accelerating future growth and viability of MEs, technological innovation and knowledge transfer, product diversification, and marketing services are the key areas where special attention are needed. The adoption of a comprehensive road map, jointly worked out for implementation through public-private collaboration, for technological and marketing services for the MEs, can go a long way in creating a competitive ME sector with required market linkages in the country.

Chapter 1
Introduction and Methodology

This report has been prepared as per the agreement signed between the Institute for Inclusive Finance and Development (InM) and the Business Finance for the Poor in Bangladesh (BFP-B) Project for conducting a study on 'Diagnostics of Micro-enterprise (ME) Lending by MFIs in Bangladesh: Opportunities, Challenges and Way Forward'. The detailed terms of reference (ToR) of the study is given at Appendix-I.

1. 1 Introduction

In Bangladesh, MEs which are the key drivers of economic growth and structural transformation do not seem to have received the required attention in the past policy agenda. In this context, the complexity of the issue starts from the fact that there is no universally acceptable and precise definition of MEs in the country.[1] The practice around the world is to define MEs differently depending on a country's stage of development, policy objectives, and administrative arrangements. For the purpose, one widely adopted practice is to identify micro or small enterprises as those having fixed capital and/or the number of workers under certain threshold levels (World Bank 1978).

Moreover, a common characteristic of smaller firms across different countries is that these enterprises usually do not have adequate access to funds from traditional financial institutions (Berger and Udell 1998). The underlying theoretical explanation for such deprivation lies in the traditional problem of asymmetric information in financial intermediation. In addition, problems of adverse selection and moral hazard worsen the situation in the case of smaller enterprises that also face many additional constraints and problems.

At the macro level, a fundamental challenge for Bangladesh at its present level of development is to generate more rapid economic growth and make the growth process more inclusive such that the poor people can fully participate in, and enjoy the benefits of, economic growth. In this context, the poor people, particularly poor women in the rural areas, often lack access to channels of savings and other financial services, which can serve their specific requirements. More importantly, many of them cannot obtain credit to start businesses or to grow their enterprises. The poor often do not have basic services like insurance to protect themselves against drought, floods and other natural and/or man-made

[1] A review of the existing definitions and the need for arriving at a common definition of MEs as well as the recommendations in this regard are given in Section 2.1 of this report.

disasters. Small and very small firms owned by the poor often have little help in getting access to new technologies or business networks that could improve opportunities to sell their products at fair prices and increase profitability of their enterprises.

As such, improving the quality and affordability of financial services and extending access to excluded populations, and supporting small business entrepreneurs in selling their products by linking them with buyers and suppliers of goods and services are important activities to help small entrepreneurs access new inputs, technology and services that can lead to improved products having larger markets and higher profitability.

It is well recognised that MEs play a crucial role in the Bangladesh economy especially as key sources of growth and employment. These enterprises show significant dynamism and flexibility, and they can adapt quickly to changing market demand and supply situations. They are important vehicles for diversifying economic activity and have the ability to make significant contribution to economic well-being of the people. These enterprises also contribute to enhancing competition and entrepreneurship and have benefits on economy-wide efficiency, innovation, and aggregate productivity growth.

The MEs also contribute significantly in promoting entrepreneurial talent, resilience, and flexibility, which are important elements for confronting uncertainties of the country's dynamic and rapidly changing economy. These enterprises also provide important vehicles for the low-income people to escape poverty through undertaking remunerative and productive activities, as livelihoods of a significant share of the poor families are directly tied to this key sector of the economy. It is widely recognised that the success of Bangladesh's rapid transition to the middle-income country status will significantly depend on promoting more inclusive growth and broadening the distribution of growth benefits more towards the low-income people. Promoting MEs will go a long way towards achieving these goals as well as improving the competitiveness of the Bangladesh economy.

In recent years, MEs are emerging as the key drivers of economic growth and structural change in Bangladesh. These enterprises are important in broadening access to microfinance, markets, and resources especially for the relatively poor households as access to financial services provides them with the tools they need to compete in the markets and improve their economic wellbeing. It is now increasingly being emphasised that promotion of MEs is probably the new and potentially most promising avenue for bringing about inclusive and sustainable development along with eradicating poverty in Bangladesh.

The experience gained from the ME sector so far brings out three important lessons for Bangladesh: (i) rural economic growth can be greatly fostered through promoting MEs which have significant production and consumption linkages; (ii) access to finance is a necessary condition for expanding and up-scaling these activities; and (iii) financial institutions especially the MFIs have the capability of working as effective intermediaries which can provide the links between savings and credit for financing MEs. Overall, it can safely be concluded that MEs can significantly help create jobs, stimulate incomes, raise purchasing power, lower costs, and contribute to poverty reduction and social development in Bangladesh.

The present report intends to capture and unravel Bangladesh's experience with ME lending by MFIs to explore the opportunities and challenges and suggest possible directions for moving forward taking into account the links between various economic and social aspects of ME development in the country.

1.2Importance and Role of MEs in Bangladesh

Since the 1970s, one of the key issues in agriculture and rural development in Bangladesh has been to raise agricultural production and productivity through adopting new technologies and expanding rural infrastructure, irrigation facilities, markets and other support services. The disbursement of agricultural credit also steadily increased especially through creating agricultural development banks under the government initiative. All these efforts led to rapid increase in agricultural production along with diversification in the rural economy. The structure of Bangladesh agriculture has also been changing rapidly over the last two decades. In addition to rising food grain (rice) production using new technologies, there has also been emerging rapidly increasing trend towards 'industrialisation and modernisation' of agriculture with emphasis on new and more value added crops, agricultural processing, off-farm activities and exports.

While these changes raise value additions and incomes of the farming households, a major challenge for the small farmer-dominant agriculture in Bangladesh is to promote broad-based and inclusive development of the poor farmers through promoting more equality-generating forms of agricultural production along with rapid growth of the rural nonfarm economy which would provide the low-income people and marginal/small farmers with viable and stable sources of additional income and livelihood. For moving forward along these lines, agricultural production needs to be supported by a thriving rural nonfarm sector (e.g. MEs) capable of providing a decent livelihood for the low-income population along with fair returns to their labour. It is now increasingly being emphasised that promoting MEs is probably the new and potentially most promising avenue for moving forward of the rural economy in Bangladesh.

In the literature, there exist many supporting as well as sceptical arguments on the importance of smaller enterprises for development. Conceptually, the supportive view is based on three core arguments (Ayyagari et.al. 2003). First, smaller enterprises enhance competition and entrepreneurship and therefore have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. This helps to exploit social benefits from greater competition and entrepreneurship. Second, proponents of smaller enterprises claim that generally these are more productive than the larger ones but financial market and other institutional failures impede their development. Thus, in the absence of required financial and institutional improvements, broadening access to financial services to smaller enterprises can boost economic growth and development. Finally, it is argued that smaller enterprises boost employment more than larger enterprises as smaller enterprises are more labour intensive.

Conversely, the sceptical views question the pro-small arguments on several grounds. Some argue that large enterprises have the capacity to exploit economies of scale and better ability to bear the fixed costs associated with R&D to have positive productivity effects while others maintain that smaller enterprises are neither more labour intensive nor better at job creation than their larger counterparts.

The business environment view, on the other hand, stresses the importance of proper business environment facing all enterprises, both smaller and larger ones. It maintains that low entry and exit barriers, well-defined property rights, effective contract enforcement, and access to finance characterise the main features of business environment that is conducive to competition and enterprise growth. Thus the focus needs to be on environment facing all enterprises, not on smaller enterprises in isolation.

Despite the above arguments, the role and importance of MEs for the Bangladesh economy can be seen from both economic and social perspectives. The economic considerations can be highlighted in terms of employment and asset creation, mobilisation of local resources and technological adaptations. The social perspectives, on the other hand, cover dimensions such as poverty reduction, balanced development, greater availability of goods and services appropriate to local needs, seed bed for new and innovative initiatives, wider sharing of income and opportunity in the local community and deeper harnessing of individual involvement and commitment to improving household and community welfare. For the micro-entrepreneurs, MEs provide useful channels to use their talent for productive purposes and open up livelihood opportunities for themselves and their communities. Being small in size, capital and inventory requirements of MEs are relatively low and there exist fewer entry barriers to business.

In Bangladesh, MEs are generally considered to be small businesses employing between 10 and 24, or smaller number of, workers.[2] While each ME may have little turnover, the combined volume of business of MEs is significant in Bangladesh. Within the rapid structural transformations in the Bangladesh economy and changing economic environment, all enterprises need constantly to evolve, innovate and reconfigure their organisations to survive and succeed. This is especially true for the MEs since, under the changing nature of enterprise modalities in Bangladesh, MEs form an important segment, which are very small units and have existed since the very early stages of enterprise evolution. It is argued that, in addition to the role of individual entrepreneurship, the dynamics of embeddedness, social conditioning and the environment are important elements for survival and growth of MEs (see, for example, Dana 2007).

The MEs provide an example of enterprises where entrepreneurship lies at its very core and which are normally built on practical, time-tested and often innovative approaches. As a result, these can survive and even flourish under toughest economic situations. Usually, the models adopted by the MEs are market-responsive, require minimum capital, and usually are profitable which have the capacity to emerge as 'silent transformers' of the Bangladesh economy mainly due to their large numbers and relatively simple forms of operation consistent with the country's labour force characteristics and resource endowments (see Table 1-1). From the table, it can be seen that micro (including cottage) enterprises constitute nearly 89 percent of total number of enterprises and account for 56 percent of total engaged persons. In these enterprises, average number of engaged persons per enterprise is less than 2 compared with nearly 8 in small enterprises and more than 654 in large enterprises. The disaggregated figures further show that enterprises with up to 9 workers have an average engaged persons of 1.92 while similar number is 5.37 in enterprises having between 10 to 24 workers (BBS, 2013 Economic Census).

Table 1-1: Number and Persons Engaged in Different Categories of Enterprises, 2013

Category	Enterprises		Total persons engaged		Average engaged person per enterprise
	Number (thousand)	%	Number (thousand)	%	
Micro (including cottage)	6,946.9	88.85	13,727.2	56.03	1.98
Small	859.3	10.99	6.600.7	26.94	7.68
Medium	7.1	0.09	706.1	2.88	99.45
Large	5.3	0.07	3,466.9	14.15	654.13
Total	7,818.6	100	24,500.9	100	3.13

[2] This is the definition adopted by the Bangladesh Bureau of Statistics (BBS). There exist other definitions as well used by different institutions. These will be discussed in details in the relevant sections of the report. Globally, most MEs in developed countries are family businesses employing one or two persons. These micro-entrepreneurs operate MEs by choice. Most ME owners are primarily interested in earning a living to support themselves and their families. They only grow the business when something in their lives changes and they need to generate a larger income. According to information of the Census, MEs make up 95 percent of the 28 million US companies tracked by the Census.

Note: Definitions adopted by BBS in the census follow the National Industrial Policy 2010. Cottage enterprises have either the value (replacement cost) of fixed assets excluding land and building of less than Tk. half a million, or with up to 9 workers, including household members while micro-enterprises have the fixed asset value between Tk. half a million and Tk. 5 million, or with between 10 and 24 workers.
Source: BBS, Economic Census 2013.

Thus it is seen that, despite their small size, MEs account for a large share of the country's employment and consequently output and incomes. The disaggregated 2013 Economic Census data show that more than 87 percent of total enterprises have 9 or fewer employees. The information further indicates that MEs vary widely in terms of major characteristics, which make them a truly heterogeneous group of economic activities.

Potentials of MEs

Within the existing structural characteristics of Bangladesh, MEs can make significant contribution to aggregate employment, production, GDP and other socioeconomic determinants creating a virtuous cycle of development. The MEs can also contribute significantly in promoting entrepreneurial talent, resilience, and flexibility, which are important elements for confronting uncertainties of the country's dynamic and rapidly changing economy.

In the global context, micro and small-scale businesses are typically taken as important catalysts of socioeconomic development in the developing countries. These institutions are important vehicles of employment creation, major sources of earning for rural and semi-urban areas, and critical movers of entrepreneurship training. The multifaceted developmental role of micro and small businesses is well recognised in many countries, such as Malaysia, Japan, Thailand, South Korea, China and India. In particular, micro and small-scale enterprises (MSEs) have been acknowledged in the literature as the springboard for sustainable development and effective resource utilisation (Tolentino 1996, Oboh 2004, Odeh 2005). Case studies of industrial clusters in Asia and other regions suggest that clusters of various industries in different countries follow similar development paths until they reach a certain phase (e.g. birth of MEs) when the path bifurcates depending on specific characteristics at the country level (Nadvi1999, Otsuka and Sonobe2006). Penget. al. (2008) find that exogenous shock and/or loosening of credit constraints have allowed households in urban China to switch from salaried state employment to self-employment in MEs.

Studies further indicate that access to finance promotes a firm's entry into the market and thus contributes to growth. Mukherjee and Zhang (2007) have explored the factors that affect changes in the share of rural nonfarm employment in total employment over time in China and India. They find that the rural nonfarm sector has followed different paths in the two countries over the last two decades mainly because of differential access to institutional finance. The World Business Environment Survey (WBES) conducted by the World Bank, which covers more than 10,000 firms in 80 countries, shows that SMEs worldwide identify financing constraint as the second most severe obstacle to their growth. In the case of large firms, similar ranking is fourth indicating less severity of finance as a constraint for them (see Ody and David 2007).

The strategic importance of MEs has also been recognised by the World Bank and other international development institutions. Their proposed framework for rapid development of the low-income countries gives priority to developing the SME sector (MEs are a component of this sector) for fostering growth, employment and poverty alleviation. The strategy also recognises that microfinance serves as a useful means to empower the poor and provides a valuable external finance to assist the development of MEs.

At present, the conditions that shaped the development of the country's ME sector in the past have changed significantly in Bangladesh. The economy has undergone rapid structural changes in all respects and the economy has achieved greater economic dynamism. The liberalisation of the financial sector and change in the investment climate and regulatory environment has also created new opportunities and challenges. Institutional changes in the banking sector and MFIs — the major agencies for financing ME programmes— have also contributed to revisions in their lending strategies and operational procedures.

Key Financing Issues for MEs

In Bangladesh, the non-government organisations (NGOs) started their microcredit operations after the 1970s, especially in the rural areas, through extending very small loans to impoverished borrowers who typically lack collateral, steady employment and a verifiable credit history. Microcredit operations were designed not only to support entrepreneurship and alleviate poverty, but also to empower women and uplift the entire communities by extension. Over the years, microcredit programmes have undergone significant transformations in terms of approaches, scale of operation, targeting and coverage.

At present, microfinance is widely considered as a source of financial services for entrepreneurs and small businesses that generally lack access to banking and related services. There are two major mechanisms through which MFIs deliver financial services to the clients: (i) relationship-based banking for individual entrepreneurs and small businesses; and (ii) group-based models, where several entrepreneurs come together to apply for loans and other services as a group. These interventions represent an approach under which poor and near-poor households can have access to an appropriate range of quality financial services, including not just credit but also savings, insurance, and fund transfers.

A major dilemma in this context, however, is the fact that MEs represent a broad and heterogeneous segment of different activities, which often remain un- or under-served by formal financial institutions. In most cases, MEs belong to informal and family businesses. The financial needs of these enterprises are typically overlooked by the recent trend of 'downscaling' of bank credit portfolios and introduction of special credit programmes for SMEs, under which larger and more formal SMEs are taken as the natural market for financial products and services. On the other hand, many MFIs are now moving upward in the financial market to serve MEs with higher volume of loans. Overall, these trends have created new opportunities for creating appropriate space for financing of MEs in the country.

At present, the conditions that shaped the development of the country's ME sector in the past have changed significantly. The liberalisation of the financial sector and changes in the regulatory environment has created new opportunities. Institutional changes in the banking sector and MFIs have also brought adjustments in their lending strategies and operational procedures. Considering the changes taking place in the ME sector and modalities of financing options, it is important to identify the rationale, objectives and main components of ME financing strategy based on an in-depth analysis of the problems that the financing procedure should seek to address and strategic directions that the financing institutions should follow in the ME sector.

1.3 State of Microenterprises in Bangladesh

There is a strong evidence that ME development and financing can unleash the entrepreneurial capacities of those who lack access to mainstream business capital and services, leading to enterprise start-ups and growth. Both poverty reduction and job creation including other multiplier effects of MEs are now considered important aspects that need to be nurtured for ensuring inclusive development in Bangladesh.

The BBS 2013 Economic Census data show that there are a total of 8.03 million economic establishments in Bangladesh of which around 65 percent are located in the rural areas, and these create around 25 million jobs in total. Of these enterprises, nearly 7 million are MEs and 3.4 million operate in the rural areas. Khandker, Samad and Ali(2013)estimate that 80 percent of the rural enterprises are micro in nature. Muneer and Khalily (2015) using the 'Access to Financial Services in Bangladesh' survey data conducted by the Institute of Microfinance (InM) estimate that average employment is 1.9 per ME and these enterprises have created about 12 million full time jobs which have contributed greatly to poverty reduction. Khandker et. al. (2013) show that the average per capita income and expenditure of households engaged in MEs is higher by 36 percent and 28 percent respectively relative to the households without any involvement in MEs. Consequently, the former households have lower poverty than households without access to ME activities.

In addition to household income, the positive contribution of MEs covers a range of other dimensions including increasing welfare, building self-confidence and empowerment, bringing social and political stability, and influencing positive changes in income distribution and demographic characteristics. In particular, MEs are transforming women's livelihoods in Bangladesh through engaging them in non-farming activities. Involvement of women in MEs increases consumption and improves the nutritional level especially of women and children, enhances aspirations for children's education and contributes to reduction in household poverty.

As mentioned earlier, there exist several definitions of MEs. Hence, there is a need for establishing a clear yet broadly acceptable definition to facilitate the identification and targeting of policies for MEs. The combined terms 'micro' and 'enterprise' suggest that MEs are fairly small business operations. The information collected during the present study brings out several characteristics of MEs in Bangladesh:

- **Owner-operated:** MEs are mostly owner-operated initiatives having few employees and with limited capital. In most cases, the micro-entrepreneurs find it difficult to find jobs through regular channels with their available human skills and hence prefer to create their own jobs by starting a ME. This may be a full-time or a part-time arrangement depending on specific situations. MEs are greatly participated by the poor and marginalised segments of the poor (including women and 'graduates' of microfinance programmes) especially in the rural areas.
- **Diverse organisational forms:** MEs have different organisational forms with various structures e.g. sole proprietorship, partnership or family enterprise depending on convenience. These are highly characterised by competency in entrepreneurship, marketing and innovation. The majority of MEs are involved in sales of products and services (including traders, retailers and street vendors) aiming to generate income and build assets.
- **High degree of flexibility:** Significant flexibility exists in operational and other aspects of MEs. For example, a large number of MEs are temporary establishments (e.g. established outside household but organised in a temporary structure) or parts of economic households (e.g. households having non-agricultural economic activities such as cottage industry, shop or workshop in or within its premise). MEs are operated across diverse sectors, and have low entry requirements in terms of capital and human skills. Further, being small in size, MEs have the ability to be flexible and can respond easily to changes in market and customer demand.
- **Capital constraint:** In most cases, MEs face capital, management skills, technology, marketing links and other constraints especially while expanding their scale of operation.

Thus MEs in Bangladesh are very small enterprises typically owner operated and sells products/services using significant entrepreneurial abilities and flexible operational models. In many cases, these are owned and operated by the poorer groups in society including women and MEs often adopt flexible methods to manage entry barriers and capital constraints in order to respond effectively to market dynamics and changes in demand patterns.

The degree of heterogeneity of MEs in terms of activity can be seen in Table 1-2. In the case of MEs, nearly 88 percent of existing establishments belong to different services activities while only 12 percent are industrial enterprises. In services, trading and related activities are dominant with 44 percent of all MEs. A comparison of the number of enterprises and persons employed in different activities of MEs show that, although service MEs account for 88 percent of all such enterprises, their share in total engaged persons is around 81 percent (Table 1-3).

Table 1-2: **Heterogeneity of Activities of MEs**

Activity	Micro (including cottage) (No. in 000)		Small (No. in 000)		Medium (No. in 000)		Large (No. in 000)		All enterprises (No. in 000)	
	No.	%	No.	%	No.	%	No.	%	No.	%
Manufacturing	831.24	12.0	30.89	3.6	2.99	42.1	3.12	59.4	868.24	11.1
Other industrial activities	26.06	0.4	7.78	0.9	0.33	4.6	0.17	3.2	34.34	0.4
Trading and related activities	3057.71	44.0	531.03	61.8	0.63	8.8	0.08	1.5	3589.44	45.9
Transportation and storage	1265.93	18.2	37.69	4.4	0.16	2.3	0.04	0.8	1303.81	16.7
Other services	1765.96	25.4	251.94	29.3	3.00	42.2	1.84	35.1	2022.73	25.9
Total	6946.90	100	859.33	100	7.11	100	5.25	100	7818.57	100

Note: Other industrial activities include: mining and quarrying, electricity, gas, steam and air conditioning supply, water supply, sewerage, waste management and remediation and construction. Trading & related activities include: wholesale and retail trade, repair of motor vehicles and motor cycles and other services consisting of accommodation and food service activities (hotel & restaurant), information and communication, professional, scientific and technical activities, administrative and support service activities, public administrative and support service activities, public administration and defence, compulsory social security, financial and insurance activities, real estate activities, education, human health and social work activities, art, entertainment and recreation and other service activities.
Source: BBS, Economic Census 2013.

Table 1-3: **Number of Enterprises and Employed Persons of MEs by Economic Activity**

Economic activity	Micro-enterprises (including cottage)			
	Number of enterprises (thousand)		Total persons engaged (thousand)	
	Number	%	Number	%
Manufacturing	831.24	12.0	2,631.18	19.3
Other industrial activities	26.06	0.4	1.38	0.01
Trading & related activities	3,057.71	44.0	5,528.37	40.5
Transportation & storage	1,265.93	18.2	1,733.88	12.7
Other services	1,765.96	25.4	3,768.65	27.5
Total	6,946.90	100	13,663.46	100

Source: BBS, Economic Census 2013

Lending to MEs is emerging as one of the major activities of MFIs over the years. According to one survey conducted in 2014, nearly 41 percent of the MFIs have implemented ME programmes while the rest are yet to embark on ME lending (Table 1-4).

Table 1-4: **Share of MFIs Involved in ME Activities**

Activity status	Microfinance institutions (MFIs)	
	Number	%
MFIs without MEs	303	59.3
MFIs with MEs	208	40.7
Total	511	100

Source: CDF, Bangladesh Microfinance Statistics 2014.

The above survey also brings out the varied nature of ME activities that have been supported by the MFIs (Table 1-5). The table shows that the highest share of 40 percent of MFIs provided lending to MEs in small trade and business sector followed by livestock, poultry and dairy firms (25 percent) and agriculture and fisheries (20 percent each).

Table 1-5: **Type of ME Activities Supported by MFI Lending**

Activity	MFIs providing lending to MEs	
	No. of MFIs	% of total number of MFIs
Small trade & business	204	39.92
Agriculture	102	19.96
Livestock, poultry & dairy firm	125	24.46
Fisheries	100	19.57
Cottage industries, handicrafts & pottery	71	13.89
Transportation	63	12.33
Food processing	46	9.00
Small industry and mills/factory	37	7.24
Garments & tailoring	42	8.22
Timber business/carpentry	28	5.48
Others (photocopy & phone/fax, water health & sanitation, housing etc.)	112	21.92
Total	208	40.70

Note: The total in column 2 does not represent the sum of individual entries as individual MFIs provide lending to multiple activities in different sectors.
Source: CDF, Bangladesh Microfinance Statistics 2014.

A study conducted in 2013 brings out several important features of MEs in Bangladesh (Khalily and Khaleque 2013). It is found that most MEs (83.5 percent) are run and operated by both family and hired labour. The MEs run by family and hired labour have an average employee size of 2.34 while similar size for small enterprises is 5.86 and, for medium and large enterprises, it is 75.27. It is observed that non-poor households own more than 70 percent of the MEs. The usual practice adopted by the owners is to finance micro and cottage industries using own funds especially for establishing and initial running of such an enterprise. One study shows that 77 percent of the women entrepreneurs started their smaller businesses with family or own funds (Rahman et.al. 2013). This is mainly because of lack of access to formal finance mainly resulting from high transaction costs, asymmetric information, lack of collateral and other constraints. The constraints are more severe for the poor entrepreneurs who have little access to formal finance. The dominant practice is to start a ME with own funds with a smaller scale of operation, gradually increase the size of the enterprise, and then try to access formal finance as the chances of getting finance increases with maturity and larger scale.

The above-mentioned study further highlights that around 15 percent of the loan applications are rejected on the ground of inadequate guarantee or collateral. It reports that 65 percent of the existing MEs operate in their own factory premises and more than 50 percent did not apply for any loans. Around 45 percent of the sample MEs borrowed from banks, and, for those whose demands were not fully met by the formal institutions, they borrowed mostly from informal sources to supplement required funds.

In terms of ME financing, several aspects of the performance of the MFIs are provided in Table 1-6. It is seen that, over the period of 2012 and 2014, total annual disbursement of ME loans by MFIs rose from Tk. 142 billion to Tk. 177 billion while total recovery also increased from Tk. 142 billion to Tk. 183 billion over the same period. The number of outstanding borrowers also rose to 2.69 million in 2014 from 2.06 million in 2012. In 2014, the number represents about 10 percent of the total borrowers of the total number of 511 MFIs for which statistics have been collected by the Credit and Development Forum (CDF).

Table 1-6: **Some Aspects of ME Financing by MFIs**

	ME loans by MFIs		
	2014	2013	2012
Annual disbursement (billion Tk.)	176.95	157.24	141.86
Annual recovery (billion Tk.)	182.97	161.60	142.29
Outstanding loan (billion Tk.)	111.72	99.22	87.73
Number of outstanding borrowers (million)	2.69	2.37	2.06

Source: CDF, Bangladesh Microfinance Statistics 2014.

In terms of type of activities, the overwhelming majority (76 percent) of the borrowers are involved in small trade and business who received nearly 69 percent of the total disbursed loan in 2014 (Table 1-7). This is followed by agriculture (slightly over 7 percent of total borrowers and 9 percent of total disbursed loan). It is seen that total ME loans disbursed by the MFIs constitute around 27 percent of all loans disbursed by these MFIs. The average recovery rate of ME loans is also high at around 85 percent.

Table 1-7: **Distribution of ME Borrowers and Loan by Type of Activities, 2014**

Type of MEs	ME borrowers			ME Loan disbursement			Recovery rate (%)
	No. (million)	% of total	% of total MFI borrowers	Amount (billion Tk.)	% of total	% of total MFI loan	
Small trade & business	2.05	76.0	7.5	121.43	68.6	18.8	94.6
Agriculture	0.20	7.4	0.7	16.46	9.3	2.5	88.3
Livestock, poultry & dairy firm	0.12	4.4	0.4	7.84	4.4	1.2	100.0
Fisheries	0.06	2.4	0.2	5.00	2.8	0.8	92.2
Cottage industries, handicrafts & pottery	0.05	1.8	0.2	2.94	1.7	0.5	82.2

Transportation	0.04	1.5	0.2	3.82	2.2	0.6	88.9
Food processing	0.03	1.0	0.1	2.00	1.1	0.3	84.2
Small industry & mills/factory	0.01	0.5	0.1	1.31	0.7	0.2	86.1
Garments & tailoring	0.01	0.5	...	1.01	0.6	0.2	88.8
Timber business/carpentry	0.06	2.1	0.2	9.72	5.5	1.5	50.4
Others (photocopy &phone/fax, water health & sanitation, housing etc.)	0.07	2.6	0.3	5.41	3.1	0.8	77.3
Total	2.69	100	9.9	176.95	100	27.3	84.8

Source: CDF, Bangladesh Microfinance Statistics 2014.

The review presented above shows that MEs are rapidly emerging as the most dominant and dynamic component of the enterprise sector in Bangladesh. The MEs also have certain unique characteristics in terms of their development potentials and growth possibilities. Moreover, these enterprises face constraints specific to their nature of business and other operational requirements including size of loan, terms and conditions, and nature of client relationships. It also emerges that the sector needs specific attention for providing efficient financial and other services for realising the country's socioeconomic goals.

1.4 Objectives of the Study

In order to fulfil the requirements of the ToR, the present study has been designed to achieve the following specific objectives:

- Identify the key opportunities of MFIs to expand micro-enterprise lending and deposit services,
- Understand key policies which are constraining the MFIs from operating micro-enterprise loan programmes,
- Identify demand for deposit services and micro-enterprise loans among micro-entrepreneurs and ascertain the unmet demand,
- Identify the demand-supply gap of micro-enterprise lending and suggest how to minimise the gap,
- Explore the current sources of funds of MFIs and identify low cost funding sources, and
- Provide policy recommendations for Microfinance Regulatory Authority (MRA) and other regulatory bodies.

Through closely examining the challenges and opportunities confronting the MEs in Bangladesh, the primary aim of the study is to stimulate fresh insights and perspectives on ME financing and draw lessons for the sector using both quantitative and qualitative methodologies. Within the scope of the study, the report covers the following five broad areas:

Supply side perspectives

From the supply side perspective, the study has collected and analysed information from MFIs about microfinance and micro-enterprise loan portfolios, sources of funds, savings products and different kinds of savings outstanding amounts, opportunities and policy challenges of MFIs to operate micro-enterprise lending programmes.

Demand side perspective

The demand side analysis of the study identifies the demand for ME loans among the clients, ascertains the extent of unmet demand, and identifies the demand-supply gap. For the purpose, emphasis has been given to analysing a few key market segments in depth (such as, farmers especially those growing cash crops with or without a clear value chain, small roadside traders, micro manufacturing businesses, small service providers such as transport operators, tailors or mobile money agents) to ascertain their current financial service needs, choices and constraints.

Other stakeholders' perspective

The methodology of the study has also included efforts to gather views of different stakeholders about opportunities and policy challenges of ME lending of MFIs. The other stakeholders include microfinance networks and other key institutions e.g. Credit and Development Forum (CDF), International Network of Alternative Financial Institutions (INAFI), and Palli Karma-Sahayak Foundation (PKSF).

Regulatory perspective

From the regulatory perspective, views of Bangladesh Bank (BB) and Microcredit Regulatory Authority (MRA), among others, have been considered regarding opportunities and policy challenges of ME lending of MFIs.

Microfinance regulations of other countries

The study further examines the microfinance regulations of other countries, especially those countries with similar structural characteristics as Bangladesh, to assess relevant experiences and identify lessons for Bangladesh.

1.5 Methodology of the Study

The methodology follows the broad outline given in the Terms of Reference (ToR) of the study and is based on comprehensive understanding of the issues surrounding the ME sector in the country along with special consideration of the lending and financing aspects.

Initial dialogue with stakeholders

The methodology and approach to the study was finalised through organising a consultation meeting with the stakeholders prior to actual undertaking of the study. As suggested in the ToR, a consultation meeting was organised with five major MFIs, networks like CDF and INAFI, PKSF and MRA. In the meeting, the framework of the study was presented for reaching a consensus on the methodology and approaches such that the study becomes more effective and participatory. Based on the feedbacks, the approach and methodology was finalised. Broadly speaking, the study involves a number of activities including literature review, stakeholder consultation, analysis of secondary data and fieldwork. The field data have been collected through a structured questionnaire and focus group discussions with the micro-enterprise clients.

Literature review

The existing state of supply of and demand for ME loans has been documented based on available literature and documents published by MRA, PKSF, InM, CDF, CGAP, and other organisations. Microfinance regulations of other countries have also been reviewed. Since InM is working for a long time in the areas of MF regulations, the InM Team was able to use its expertise in proper understanding of the regulatory framework for the MF sector. This enabled to identify the policy gaps in the context of regulatory framework in Bangladesh and other countries.

Secondary data analysis

Key secondary data from MRA, PKSF, InM, CDF, MixMarket, annual and audit reports of MFIs, and other sources were analysed to understand growth trends of microfinance and micro-enterprise lending, savings portfolios and other issues.

Consultation with stakeholders

The Research Team held consultations with20 MFIs (2 very large, 7 large, 6 medium, and 5 small MFIs) to understand their views on opportunities and policy challenges of ME lending and collect data about their MF, ME and savings programmes. The number of MFIs is considered quite reasonable in bringing out a representative picture of the sector and ME lending in particular. Consultations were also held with microfinance networks (CDF and INAFI), PKSF, MRA, and the Ministry of Finance. Since changes in rules and regulations may be proposed, the issues were discussed with available board members of MRA especially to comprehend the approaches to the constraints faced by both MFIs and micro entrepreneurs.

More specifically, consultation with the stakeholders was taken as a continuous activity but was structured in nature. These mostly took place in formal seminars and workshops, and often were also conducted as a part of an informal process such as individual discussion. Some small discussion meetings/workshops were also organised with the regulators, government agencies, MFIs, banks, NBFIs; banking and microfinance associations, apex foundations, donors, academics, research institutes and think tanks. A consultation meeting with the banks and non-banks financial institutions was also organised on the existing conditions and potential problem solving approaches as well as exploring different alternatives for providing financial services.

Finally, as the ME services are heterogeneous in nature and the MFIs are also heterogeneous in character, dialogues were organised with the MFIs separately keeping specific group characteristics in view. For example, small MFIs have a different approach, which they might hesitate to share in the presence of large and medium MFIs. For getting the right perspectives, the meetings were organised in relatively homogeneous groups.

Data collection techniques

As mentioned earlier, the study is based on two sets of data - secondary and primary. Secondary data have mostly been used to assess existing state of supply of ME loans as well the size of MF market. The relevant data on selected number of parameters and structured for analysis have been gathered from MFIs, banks and non-bank financial institutions, mix market and CGAP.

The primary data have been collected from the micro-entrepreneurs. As there was no list of micro-enterprises at a single source and also there was no information on regional distribution of micro-enterprises, sample size was determined on a scientific basis using some statistical techniques.

A total of 600 micro-enterprises have been surveyed for collecting the primary data. Based on the discussion in the initial consultation meeting with the MFIs and PKSF, the following strategies were adopted to select samples for the purpose of the study.

First, we selected the major providers (MFIs) of ME loans from the Bangladesh Microfinance Statistics, 2014. In the process, we also considered regional distribution of the MFIs.

Second, we prepared a list of the branches of the selected MFIs that provided ME loans. Based on the list, we selected branches representing different divisions and distribution of sectors/sub-sector lending activities.

Third, we finalised a list of MEs from the selected number of sample branches. Based on the number of MEs, we identified 600 samples including some non-borrower MEs.

During the survey, primary data were collected by directly interviewing the micro entrepreneurs through a short structured questionnaire. The questionnaire focused on initial state and current status of the micro-enterprises. Major information parameters were: start-up capital and its sources, present capital structure, revenue and expenditures and projection of up-scaling of activities. Based on the results of such small samples and aggregate information on micro-enterprises, we used appropriate methodologies to predict total demand for ME loans by major sub-sectors.

Sampling frame for demand side ME survey

As one of the possible outcomes is to find out unmet demand for ME credit (gaps between demand for and supply of ME credit), we need to generate some information on population of micro-enterprises based on the uniform definition, population of micro-enterprise borrowers, demand for and supply of ME credit.

Defining population of MEs

Assessing the population of MEs is a requirement for estimating demand for credit. Based on the definition, we have estimated total demand for ME credit. As there is no list of MEs at a single source, we used the BBS data from 2013 Economic Census. According tothe Census, there were 3 million economic households with employment of up to 9. This is quite consistent with our estimate using data of InM household survey. One-fifth of the households were involved in micro-enterprises. Considering this ratio and the number of total households in Bangladesh, we arrived at a micro-enterprise population of 3 million. This forms the population of micro-enterprises in Bangladesh.

Defining population of ME borrowers

The core objective of the study is to develop MEs through providing finance primarily through using MFIs. In this respect, banks have little contribution to micro-enterprise financing till now. Therefore, we assume that ME borrowers will basically be the borrowers of MFIs. The Bangladesh Microfinance Statistics 2014 shows that there are 2.6 million ME borrowers in the country. This forms the population of ME borrowers. As there is no information on regional distribution of MEs, sample size is determined on scientific basis using statistical techniques.

Selection of ME borrowers and non-borrowers

For selecting ME borrowers, the sampling was made at different levels. During sampling for the survey, the following criteria, among others, were considered.

1. The sample should cover diversified providers of ME loan e.g. large, medium and small ME loan providers.

2. The sample should cover regional differentiation. This includes covering sample from all divisions and having rural-urban coverage in each location.

3. The sample should cover diversified ME sector/subsector activities like agriculture, trade, manufacturing etc.

4. The sample should cover both ME borrowers and non-borrowers.

Considering the above and the total population of ME borrowers and related issues, stratified sampling techniques were used. In the first stratum, we selected one district from each of the six divisions (considered Rangpur under greater Rajshahi division). In the second stratum, we randomly selected two upazilas from each randomly selected district with the exception of Sylhet and Habiganj based on concentration of micro-enterprises. This makes the total number of upazilas at 22.

Once the upazilas were selected, the critical issue was selection of ME borrowers. This process involved some rigorous exercise. As MEs are financed by different sized MFIs, we classified the relevant MFIs into three groups–small, medium and large. We then randomly selected a number of MFIs from different stratum. Total number of MFIs selected for the study was 19.

In the third stratum, we selected MEs financed by different MFIs. Once the upazilas are selected, information on the branches of the selected MFIs operating in those upazilas was collected. From each branch, we collected information on the number of ME borrowers. Table 1-8 shows the distribution of the total samples and branches by selected MFIs and district.

Table 1-8: Sample Distribution by MFIs and District

MFI	District	Sample size	Number of Branch
ASA	Faridpur	27	1
ASPADA	Gazipur	14	1
BURO	Barisal	27	2
	Sylhet	27	
CDIP	Comilla	42	2
CODEC	Barisal	13	1
ESDO	Dinajpur	27	2
	Rajshahi	12	
GUK	Bogra	14	1
Ghashful	Chittagong	54	2
Grameen Bank	Rajshahi	15	1
JCF	Jessore	54	2

NDP	Bogra	14	1
NGF	Satkhira	27	1
Padhakkhep	Dinajpur	27	2
	Habiganj	27	
RRF	Satkhira	27	1
SKS	Bogra	14	1
SSS	Gazipur	42	2
Shataful	Rajshahi	13	1
TMSS	Bogra	14	3
	Faridpur	27	
	Rajshahi	14	
UDDIPAN	Barisal	14	2
	Comilla	14	
Total		600	29

Source: Study Survey 2016

Finally, based on the available information and in consultation with the branch managers, we collected some 27-28 micro entrepreneurs including five non-borrowers. Both micro-enterprise borrowers and non-borrowers were selected from the same areas under each upazila so that homogeneity in market characteristics and heterogeneity in enterprises by economic activities are maintained.

Table 1-9 shows the distribution of sample of ME borrowers and non-borrowers by upazila and district.

Table 1-9: Sample Distribution of Borrowers and Non-borrowers by District

District	Upazila	Number of ME Borrowers	Number of non-borrowers	Total sample
Barisal	Bakerganj	22	05	27
	Barisal CC	22	05	27
Bogra	Sherpur	23	05	28
	Shibganj	23	05	28
Chittagong	Chittagong CC	22	05	27
	Mirsharai	22	05	27
Comilla	Chauddagram	23	05	28
	Daudkandi	23	05	28
Dinajpur	Dinajpur Sadar	22	05	27
	Birampur	22	05	27
Faridpur	Faridpur Sadar	22	05	27
	Alfadanga	22	05	27
Gazipur	Gazipur Sadar	23	05	28
	Kaliganj	23	05	28
Jessore	Jessore Sadar	22	05	27
	Keshabpur	22	05	27
Rajshahi	Rajshahi CC	22	05	27

	Baghmara	22	05	27
Satkhira	Shyamnagar	22	05	27
	Tala	22	05	27
Sylhet	Sylhet CC	22	05	27
Habiganj	Madhabpur	22	05	27
	Total	490	110	600

Source: Study Survey 2016

Table 1-9 shows that the sample covers a total of 600 MEs including 490 ME borrowers and 110 non-borrowers. The field level data were collected during January-February 2016.

Data analysis

Collected data were analysed using both descriptive and econometric techniques. Descriptive analysis covered frequency distribution as well as descriptive statistics including significant test. Econometric techniques have been used to estimate financial and economic rates of return of MEs and their determinants. This enabled us to assess the marginal impact of access to capital, and in turn estimate the aggregate demand for ME credit. For the purpose, two major econometric techniques have been used – Endogenous Switching Regression and Logit analysis. These techniques were also used to assess marginal impact of increasing access to finance compared to the counter-factual group of enterprises with no access to credit.

Once we estimated aggregate demand, we were able to compare demand with aggregate supply of credit and identify the gap.

Case studies

Sample survey and analysis using econometric techniques provided information on average and marginal effects. However, some process insights are also needed. Therefore, we undertook some case studies to complement the findings from the quantitative analysis. For case studies, the sample covered all business segments in urban and rural areas. Four major segments of ME businesses are identified: agriculture, manufacturing, services and trading. Each segment has further been divided into sub-segments. Five types of microenterprises have been selected from each segment: large urban, small urban, large rural, small rural and firms from remote areas. Case studies were conducted to identify major constraints (financial and non-financial), external and within firm factor, expectation of the owner from MFIs and related issues.

Discussion meetings/workshops

InM adopted a participatory approach in conducting the study. As such, it organised a number of workshops in small groups. Such group workshops were organised at the initial stage and policy consultations were conducted at the intermediate stage. Further, it is planned that final dissemination seminar will be organised after submission of the draft report by BFP-B. The participants in the workshop will be regulators, government agencies, MFIs, banks, NBFIs, microfinance associations, apex foundations, donors, academics, research institutes and think tanks.

1.6 Limitations of the Study

The conceptual framework underlying the study intends to provide a diagnostic picture of ME financing by the MFIs within the overall financing strategies of the MFIs and the overall financial sector of the country. Therefore, the analysis requires a comprehensive assessment of the ME sector along with its opportunities and challenges and alternative financing options covering all types of financial institutions and specific role of MFIs in ME lending activities. Conducting such a comprehensive analysis, however, may suffer from various problems; and hence, a more practical and prudent approach of ensuring greater participation of all stakeholders in related aspects of analysis has been preferred for the present analysis.

One of the important elements of the adopted design of the diagnostic study is to ensure that the sample MEs would serve as the basis for a credible analysis, which will also address the issues of selection bias and contagion. In this context, one major limitation of the study relates to the fact that the MEs were established at different times and no baseline data are available relating to the relevant indicators. The present study has therefore collected information by adopting the recall method for which necessary measures have been taken to overcome the methodological shortcomings so that the results of the assessment are credible.

1.7 Organisation of the Report

The report is organised in five chapters. After this introductory chapter, the second chapter provides a brief overview of the present state of ME sector as well as a review of existing constraints and challenges that the MEs face in Bangladesh especially focusing on the financing issues. The chapter also examines the definitional controversies surrounding the MEs and provides recommendations on the definitional issues in the sector. Chapter three is specifically devoted to analysing the demand for and the supply of institutional fund for ME lending and explores the existence of any gaps between the two. The analysis involves both primary and secondary information specifically collected for the present study. Chapter four deals with the important issues of identifying prudent strategies and policies for meeting the excess demand for funds for ME lending by conducting an in-depth analysis of existing policies, loan portfolio analysis of banks and MFIs, and analysis of existing and potential financing sources of MFIs. The chapter also examines alternative strategies for fund generation, institutional lending options, and policy options especially relating to the regulatory agencies. Finally, chapter five provides the synthesis of the study findings and policy implications of the study.

Chapter 2

MEs in Bangladesh: Present State, Constraints and Challenges

2.1 Introduction

Over the past decades, the dominant transformation of shifting from farm to nonfarm activities in the Bangladesh economy has drawn much attention of policymakers because of its prospects in creating low cost employment for the expanding labour force through forward and backward linkages. In most cases, these nonfarm activities adopt labour intensive technologies, absorb additional labour from the agriculture sector and contribute to poverty reduction through higher productivity and higher profits.

According to BBS Economic Census 2013, there operate about 8.0 million economic units[3] compared with 3.7 million in 2003 and, out of these 8.0 million, more than 35 percent are economic households.[4] The majority of these economic households are microenterprises (including cottage enterprises). However, despite having a small share in economic units, small and medium enterprises (SMEs) occupy a major position in industrial development policy of Bangladesh. Although small enterprises have little share in total SME loans, microenterprises (MEs) are mostly left out of formal banking system because of high transaction cost and absence of proper monitoring system. In Bangladesh large and medium enterprises have more access in formal credit market and micro and small enterprises have more access to MFIs and informal credit market (Khalily et al. 2013).

It is argued that access to credit can affect ME growth in two ways e.g. starting up and scaling up of operation. With access to credit, a household can start an enterprise and also if it is already involved in enterprise activity it can expand its operation by using more credit. Research shows that only around 23 percent of the enterprises in Bangladesh have access to credit for starting up and only around one-third of the enterprises have access to credit for scaling up of enterprises (Khalily et al. 2013). Other studies (e.g. Mukherjee and Zhang 2007) show that access to credit induces enterprise entry into the nonfarm market and thus contributes to growth. A number of researches acknowledge the role of credit in boosting up enterprises' productivity and growth (Johnson et al. 2002, Levine et al. 2000, McMillan and Woodruff 2002, Cull and Xu 2005). Khalily and Khaleque (2013) show that access to credit

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[3]An Economic Unit is defined as a single establishment or economic household operating economic activities for profit, households gain or produce indirect benefit to the community.

[4] Many households have non-agricultural economic activities such as cottage activities, shop or workshop in or within their premises. These are classified as 'Economic Household'. However, economic activities operated in the household as well as economic activities operated outside the household such as hawking, operating own rickshaw/push cart/van/easy bike, street vendor etc. are also included within the purview of household based economic activities. See, BBS 2014

accounts for 2.8 percent increase in labour productivity relative to enterprises having no access to credit.

As one of the major objectives of this study is to investigate issues relating to ME lending, we begin with present state of enterprises in Bangladesh and status of capital of these enterprises. We also need to understand what we mean by MEs as these are defined differently in different contexts. In Chapter 2, we start with a discussion on definition of MEs by different organisations (e.g. BBS, Bangladesh Bank, PKSF) as well as in the relevant literature. This is followed by a discussion on the present state of MEs and their contribution to the national economy. Finally, the chapter discusses the capital structure of MEs in the light of survey data and available evidence to identify the nature and severity of financial constraints operating on the MEs and spell out the challenges.

2.2 The Concept of Microenterprise

In general, enterprises refer to actions that involve some initiatives for taking a risk by setting up, investing in and running a business. However, there is no universal definition regarding which specific investments can be called microenterprises or small, medium and large enterprises as different attributes are used by different institutions to define the size of enterprises. Some classify enterprise on the basis of size of asset of the business while others use the amount of loan used in business or on the basis of number of employees.

2.2.1 Definition of Enterprises: A Global Perspective

Defining SMEs using an international scale is extremely difficult because the size of enterprise is closely related to economic and political situation, business culture and the legal system in a specific country or a region. According to the European Commission (EC), the common criteria to classify SMEs are: (i) number of workers; and (ii) turnover or balance sheet total. The classification, which is adopted by EC, is given in Table 2-1.

Table 2-1: **Criteria for Defining SMEs by EC**

Enterprise category	No. of Employee	Turnover[5] in million Euro	Turnover in million Taka	Balance sheet total[6] in million Euro	Balance sheet Total in million Taka
Medium	< 250	≤ 50	≤ 4,260	≤ 43	≤ 3,670
Small	< 50	≤ 10	≤ 850	≤ 10	≤ 850
Micro	< 10	≤ 2	≤ 170	≤ 2	≤ 170

Source: European Commission, *User Guide to the SME Definition,* 2015.

Table 2-1 shows that enterprises having less than 10 employees with Euro 0.17 billion turnover or balance sheet total are considered as MEs as per EC definition. A comparison with definitions adopted in Bangladesh (discussed later in this section) shows that the criteria used for MEs by EC is considered appropriate for large enterprises in Bangladesh.

[5]The amount of money taken at a particular period.

[6] A statement of enterprise's asset and liability

On the other hand, a ME in the US is a firm with five or fewer employees, started with $50,000 or less in initial capital and which may not have access to traditional commercial loans.

Usually, MEs start small, but can grow quickly into large job-generating businesses. In fact, 85 percent of all businesses in the US are micro. These very small firms generate close to 25 percent of all jobs in the US economy. In UK, MEs are characterised by fewer than 10 employees and an annual turnover or balance sheet below €2 million. This shows that UK follows the definition of EC. In Australia, ME refers to a business with a single owner-operator having up to 20 employees. In China, ME is defined in a different manner. If an enterprise has an annual gross sale under $25,000 then that enterprise is considered as ME. In India, ME is defined by the size of investment. If the investment size is less than Rs. 2.5 million excluding land and building, then it is called a ME. On the other hand, it is defined by the size of employment in Sri Lanka. If the size of employment is up to 10 including family employees, then the enterprise is a ME in Sri Lanka.

2.2.2 Defining MEs: Bangladesh Perspective

Definition of MEs by Bangladesh Bank (as per Industrial Policy 2010)

It is important to mention that until the formation of the SME Policy within the framework of Industrial Policy 2005, there was no separate economic policy to promote different enterprises in Bangladesh. Even in the above-mentioned policy itself, ME was not clearly defined. In the Industrial Policy 2005, industries were classified into three categories; large, medium and small. The micro industries were incorporated under small enterprises as the policy considered enterprises having less than 25 employees as small enterprises for the non-manufacturing sector. Obviously, in the absence of such a crucial category like ME, Industrial Policy 2005 was not conducive towards micro entrepreneurs. In Bangladesh, cottage and micro industries were added in the industry classification for the first time under the Industrial Policy 2010. The definition is as follows:

1) Large enterprises: In manufacturing, large industry is deemed to comprise enterprises with either the value (replacement cost) of fixed assets excluding land and building in excess of Tk. 300 million or with more than 250 workers. For services, 'large industry' corresponds to enterprises with either the value (replacement cost) of fixed assets excluding land and building in excess of Tk. 150 million or with more than 100 workers.

2) Medium enterprises: In manufacturing, medium industry is deemed to comprise enterprises with either the value (replacement cost) of fixed assets excluding land and building between Tk. 100 million and Tk. 300 million, or with between 100 and 250 workers. For services, 'medium industry' corresponds to enterprises with either the value (replacement cost) of fixed assets excluding land and building

between Tk. 10 million and Tk. 150 million, or with between 50 and 100 workers. If on one criterion, a firm fall into the 'medium' category, while it falls into 'large' category based on the other criterion, the firm is deemed as in the 'large' category.

3) Small enterprises: In manufacturing, small industry is deemed to comprise enterprises with either the value (replacement cost) of fixed assets excluding land and building between Tk. 5 million and Tk. 100 million, or with between 25 and 99 workers. For services, 'small industry' corresponds to enterprises with either the value (replacement cost) of fixed assets excluding land and building between Tk. half a million and Tk. 10 million, or with between 10 and 25 workers. If on one criterion, a firm fall into the 'small' category, while it falls into 'medium' category based on the other criterion, the firm is deemed as in the 'medium' category.

4) Microenterprises: In manufacturing, micro industry is deemed to comprise enterprises with either the value (replacement cost) of fixed assets excluding land and building between Tk. half a million and Tk. 5 million, or with between 10 and 24, or smaller number of, workers. If on one criterion, a firm fall into the 'micro' category, while it falls into 'small' category based on the other criterion, the firm is deemed as in the 'small' category.

5) Cottage enterprises: In manufacturing, cottage industry is deemed to comprise enterprises with either the value (replacement cost) of fixed assets excluding land and building of less than Tk. half a million, or with up to 9 workers, including household members. If on one criterion, a firm fall into the 'cottage' category, while it falls into 'micro' category based on the other criterion, the firm is deemed as in the 'micro' category.

Definition of BBS

The Bangladesh Bureau of Statistics (BBS) in the 2003 Economic Census classified enterprises by the number of full time employees engaged. The classifications are :(i) Microenterprises: enterprises having less than 9 employees; (ii) Small enterprises: enterprises having employees between 10-49; (iii) Medium enterprises: enterprises having employees between 50 and 99; (iv) Large enterprises: enterprises having employees above 100. However, in the 2013 Economic Census, BBS has followed the same classification as given in the Industrial Policy 2010.

Definition of PKSF

According to PKSF, an enterprise will be considered as a ME if it meets the following criteria:

- The business is legal, visible, environment friendly and a continuous economic activity.

- The owner's equity lies within the range of BDT 40,000 – BDT 1.5 million excluding land and building of the enterprise. If the entrepreneur has more than one ME, then the total equity of all MEs should not exceed BDT 2 million.
- The entrepreneur or the household members of the entrepreneur has to be involved at least 25 percent of their total working hours in a day.

Definition by MFIs

One of the major concern regarding ME development in Bangladesh is that there is no unique definition which can be followed in designing the policies. Being the largest financing source for MEs, MFIs also do not have any unique definition. Moreover, the supervisory and regulatory authority of MFIs, MRA (Microcredit Regulatory Authority) has regulation on ME loan ceiling for the MFIs; however, it does not have any policy on which enterprise is called a ME or which can be called small, medium or large enterprises. The present practice suggests that MRA defines MEs on the basis of loan size. Any micro loan of more than Tk. 50,000 is termed as micro-enterprise loans.

Similarly, CDF (Credit Development Forum) which is an organisation of national microfinance network in Bangladesh contributes to knowledge based capacity in the MFI sector including the ME borrowers' information and loan information also does not follow uniform classification of enterprises. This implies that both of these organisations follow the definitions that MFIs adopt for themselves.

In Bangladesh, MFIs define ME based on the loan size. If loan size of a business is above Tk. 30,000, then the business falls under ME according to MFIs' definition. Usually, ME loans are considered for those 'graduates' from microfinance programme who want higher amount of loan to run their own informal businesses for which traditional microfinance does not have provisions. Although there is no general consensus about the upper limit of the loan, however it can reach up to Tk. 1,000,000.

The Institute for Inclusive Finance and Development (InM) organised a consultation meeting with the MFIs to understand their views on opportunities and policy challenges of ME lending while initiating the present study. The representatives of 26 MFIs (3 very large, 9 large, 11 medium and 3 small) participated in the meeting. During the course of the discussion, it came out clearly that different MFIs had different practices for defining MEs. For example, Grameen Bank (GB) focuses on age and capacity of the entrepreneurs while giving a ME loan. GB does not stick to any particular loan size. Normally, the average loan size of GB financed ME is around Tk. 500,000.

On the other hand, the majority of MFIs consider size of loan while classifying enterprises though the size of loan for ME varies over the MFIs. Some MFIs consider Tk. 70,000 – Tk. 1,000,000 as ME loan. Some start from Tk. 50,000. It is important to note that the partner organisations (POs) of PKSF use the definition that PKSF has adopted. Initially, PKSF considered the loan size Tk.30,000- Tk. 200,000 as ME loan. However, in recent years

PKSF focuses more on size of investment of the enterprise rather than the loan size. At present, PKSF considers a business as ME that has a maximum asset worth of Tk. 2,000,000 without land and building.

The number of employees is also important. However, capital-intensive businesses might not depend on the number of employees. Hence, in the definition of PKSF the entrepreneur must be involved in the business full time and the enterprise must have the scope for scaling up. The loan range that PKSF now follows is Tk. 50,000 – Tk. 1,000,000. Moreover, PKSF has specified some policies regarding ME loan and, in these policies, PKSF provides a definition of MEs to be followed by its partner organisations (POs).

Definition of ME followed in the present study

From the above discussion, it is clear that no particular definition is followed in Bangladesh regarding classification of enterprises mainly due to the fact that the nature of these enterprises are too diverse to put these under a unique classification. For example, a grocery shop can be managed by 1 or 2 employees even with inventories as large as Tk. 500,000 or more. On the other hand, business like fisheries or handloom involves more labour with relatively small inventory or fixed asset. One alternative is to follow employment criteria or asset criteria for which classification of enterprise size might be different. In practice,, some studies have followed size of employment to define MEs. For example, Khalily and Khaleque (2013) consider a firm to be ME if it has less than 5 employees and large enterprise if it has over 50 employees. This is consistent with Nixon (2005), Green et al. (2006) where they define ME with full time employees no greater than 5 including family labour.

For the purpose of the present study, we categorise enterprises based on size of employment as it is observed that financial indicators such as return on asset or profit margin vary significantly with employment size. We have taken an enterprise as ME if the enterprise has less than 10 employees including family labour. We have further disaggregated the MEs into two groups; MEs that have less or equal to 4 employees, and MEs having 5-9 employees. All these categories include family labour. We term these categories as 'small' and 'large' MEs respectively. By following this definition, we find that almost 95 percent of sample enterprises fall under MEs, which is more or less consistent with Khalily and Khaleque (2013), Nixon (2005) and Green el al. (2006). The rest 5 percent of the sample falls under small enterprises. These enterprises are operated both by family labour and hired labour. However, almost 75percentof the sample enterprises have hired to family labour ratio of less than or equal 1. So it can be said that MEs are dominated by family labour.

2.3 Present State of MEs in Bangladesh

Not much information is available regarding the number of enterprises operating in Bangladesh. The BBS conducts an economic census where the number of economic households is surveyed every 10 years. From the survey, Table 2-2 is derived which gives the number of establishments covering cottage to large enterprises for two census years-- 2003 and 2013. As we have mentioned earlier, the classification of enterprises used in 2003 Economic Census 2003 is not the same as in 2013 Economic Census. As a result, the number of economic establishments in each category is not strictly comparable. However, we can compare the number of cottage enterprises in 2013 with the number of micro-enterprises in 2003 because, in both cases, the groups consist of enterprises that have equal to or less than 9 employees. As our focus is on MEs, comparing these two groups would give some insight on ME growth over the two periods.

Table 2-2: **Types of Enterprises in Bangladesh**

	2003		**2013**	
	No. of establishment	% of total	No. of establishment	% of total
Cottage	-	-	68,42,884	87.52
Micro	35,89,544	97.68	1,04,007	1.33
Small	74,629	2.03	8,59,318	10.99
Medium	5,125	0.14	7,106	0.09
Large	5,673	0.15	5,250	0.07
Total	36,74,971	100	78,18,565	100

Source: BBS, Economic Census 2013

Table 2-2 shows that the number of MEs has increased over the 10 years. However, if we observe the share of MEs in total establishment, it is seen that the share has declined over the period As mentioned before we are comparing the micro industry of 2003 with the cottage industry of 2013 as these groups consist only those enterprises having less than or equal to 9 employees. The result shows that in 2003 there were around 3.5 million MEs in Bangladesh and the number almost doubled in 2013 (around 6.8 million). However, the share of MEs in total establishment has declined by almost 10 percentage points. In 2003, more than 97 percent of total establishments were MEs whereas in 2013 the share came down to around 87 percent. The number of total establishments has increased over the period. The total number of establishment in 2003 was around 3.7 million, which rose to 7.8 million in 2013.

MEs by divisions and type of activities

Table 2-3 gives the number of MEs in six divisions (the number of divisions is now eight but we have followed the earlier number due to data limitation and convenience of comparing with 2003 data) of the country. The results show that for both the years the highest numbers of MEs are located in Dhaka division followed by Rajshahi division. The total number of MEs has almost doubled over the two periods. However, the percentage of MEs located in Dhaka division in total number of MEs across the country remains mostly unchanged although the share increased in the case of Rajshahi division.

Table 2-3: **Distribution of MEs by Division**

	2003		2013		Growth rate (%)
	No. of MEs	% of total	No. of MEs	% of total	
Barisal	1,99,248	5.55	3,35,605	4.90	6.84
Chittagong	6,46,610	18.01	11,42,924	16.70	7.68
Dhaka	11,18,272	31.15	21,25,067	31.06	9.00
Rajshahi	9,02,737	25.15	9,06,578	28.84	0.04
Sylhet	1,81,430	5.05	197,3,157	5.25	98.76
Khulna	5,41,247	15.08	3,59,553	13.25	-3.36
Total	35,89,544	100	68,42,884	100	9.06

Source: BBS, Economic Census 2013

On the other hand the lowest numbers of MEs are observed in Barisal and Sylhet divisions in both years. The growth of permanent MEs by rural and urban areas is shown in Table 2-4. For the BBS Economic Census, rural area refers to the area outside city corporations, paurosavas and upazila headquarters while the rest is treated as urban area. The table shows the rural share of MEs in total MEs has increased. Both areas have also shown positive growth of MEs.

Table 2-4: **Permanent MEs by Urban and Rural Areas**

	2003		2013		Growth rate (%)
	No. of MEs	% of total	No. of MEs	% of total	
Urban	10,74,192	36.90	11,06,539	30.31	0.30
Rural	18,37,167	63.10	25,44,714	69.69	3.85
Total	29,11,359	100	36,51,253	100	2.54

Source: BBS, Economic Census 2013

The sectoral composition of MEs is given in Table 2-5. It shows that the transportation sector had around 2 percent of total MEs in 2003 but the share has gone up to 18 percent in 2013. Although all sectors have shown positive growth, the share of MEs in total number of MEs has decreased in manufacturing, trade and services sector. Overall, trade activities cover the largest number of MEs in the country.

Table 2-5: **Sectoral Composition of MEs in Bangladesh**

	2003		2013		Growth rate (%)
	No. of MEs	% of total	No. of MEs	% of total	
Mining and Quarrying	2,480	0.07	19,007	0.28	66.64
Manufacturing	4,40,460	12.27	7,27,233	10.63	6.51
Transport	85,480	2.38	12,74,340	18.62	139.08
Trade	20,29,860	56.55	30,57,709	44.68	5.06
Services	9,30,500	25.92	17,64,595	25.79	8.96
Others	1,00,764	2.81	-	-	-
Total	35,89,544	100	68,42,884	100	9.06

Source: BBS, Economic Census 2013

Contribution of MEs to employment

We have already noted that MEs account for more than 87 percent of all enterprises in the country. It is therefore likely that MEs would also contribute significantly to employment and income generation. Table 2-6 shows the total employment generated by all enterprises in 2003 and 2013. It is seen that the number of employees has increased by one-and-a-half times in the ME sector in 2013 compared with 2003. In 2003, 68percent of total employment was generated by the MEs whereas the share has decreased to around 53 percent in 2013. Moreover, it appears that the average employment creation per ME has declined as well. In 2003, an average of 2.33 persons was employed per ME but this has reduced to 1.92 per ME in 2013. This declining trend of employment per enterprise seems to be true at the aggregate level also with the average persons employed per enterprise going down from 3.34 in 2003 to 3.13 in 2013. The total volume of employment created by all enterprises has however more than doubled between the two years.

Table 2-6: **Employment Generation by MEs**

	2003			2013		
	No. of person employed	% of total	Average person employed	No. of person employed	% of total	Average person employed
Cottage	...	...	...	1,31,68,327	53.75	1.92
Micro	83,75,542	68.21	2.33	5,58,870	2.28	5.37
Small	13,75,223	11.20	18.43	66,00,685	26.94	7.68
Medium	3,42,737	2.79	66.88	7,06,112	2.88	99.37
Large	21,91,842	17.85	386.36	34,66,856	14.15	660.35
Total	1,22,79,344	100	3.34	2,45,00,850	100	3.13

Source: BBS, Economic Census 2013

In terms of average number of persons employed per ME, urban area has higher value than the rural area (Table 2-7). The table shows that the relevant numbers in urban area are 2.72 and 2.34 respectively in the years 2003 and 2013 whereas these are 2.14 and 2.13 respectively in the rural area. It is important, however, to note that although urban area creates more employment on per ME basis, rural MEs generate more employment on an aggregate basis. In 2013, nearly 68percent of total employment has come from rural MEs. Overall the capacity of employment generation by enterprises has decreased over these 10 years as mentioned in Table 2-6. This is also true for permanent MEs. Table 2-6 shows that in 2003 a permanent establishment of ME could create 2.36 jobs on an average, whereas this figure decreased to 2.19 in 2013.

Table 2-7: **Employment Generation by Permanent MEs**

	2003			2013		
	No. of person employed	% of total	Average person employed	No. person employed	% of total	Average person employed
Urban	29,24,217	42.62	2.72	25,88,309	32.30	2.34
Rural	39,37,579	57.38	2.14	54,24,375	67.70	2.13
Total	68,61,796	100	2.36	80,12,684	100	2.19

Source: BBS, Economic Census 2013

Table 2-8 shows the employment pattern of MEs by sectoral activities. It is seen that the trade sector has the highest share of ME employment. In 2003, the share was 51percent of total ME employment, which declined to 42percent in 2013. The service sector contributes around 29 percent of total ME employment. In line with the rise in the number of transport related MEs, its employment share also rose from 2 percent in 2003 to more than 13 percent in 2013.

Table 2-8: **Employment of MEs by Sector**

	2003			2013		
	No. of person employed	% of total	Average person employed	No. of person employed	% of total	Average person employed
Mining and Quarrying	7,320	0.09	2.95	48,655	0.37	2.56
Manufacturing	15,06,460	18.55	3.42	20,72,309	15.74	2.85
Transport	1,73,700	2.14	2.03	17,52,790	13.31	1.38
Trade	41,21,840	50.77	2.03	55,28,371	41.98	1.81
Service	23,09,940	28.45	2.48	37,66,202	28.60	2.13
Others	2,56,282	...	...	...	...	...
Total	83,75,542	100	2.33	1,31,68,327	100	1.92

Source: BBS, Economic Census 2013

The number of persons employed per ME is highest in the manufacturing activity followed by mining and quarrying. The employment per ME has been declining for all activities over the two periods as we have noted earlier at the aggregate level. Overall, MEs created an average employment of 2.33 per enterprise in 2003, which decreased to 1.92 in 2013.

The overall comparison of the performance of MEs between the years 2003 and 2013 suggests that the share of MEs in the country's total economic activity has been showing somewhat declining trends indicating that the MEs have fallen behind the dynamism of other important sectors. The growth of total employment of the MEs has also failed to keep pace with other sectors. It is important therefore to examine the major factors that constrain the MEs to expand at the required rates so that MEs can play its potential role in future development of Bangladesh.

2.4 Constraints to ME Growth

2.4.1 Global Experience

Non-financial constraints

A large body of the literature on ME growth focuses on financial constraints to firm's growth. However, several recent works also focus on a wide range of growth obstacles to MEs. The obstacles identified other than finance are: security and protection of property rights, taxes, regulations, anti-competitive practices, quality and availability of roads, electricity, water, telephone, postal service etc., corruption of government officials, crime, and general macroeconomic stability.

Demirguc-Kunt and Maksimovic (1998) show that an efficient legal system smoothes firms' access to external finance, particularly long-term finance and thus expedites enterprise growth. Johnson et al. (2000) analyse firm growth in terms of employment and sales growth from 1994 to 1996 for five countries and find that unprotected property rights are more important for private sector growth than the lack of bank finance. Using Chinese data, Cull and Xu (2005) also show that protection of property rights as well as access to finance plays an essential role in smoothing firm's reinvestment rate.

Klapper et al. (2006) use firm level data from Western and Eastern Europe and focus on significance of infrastructure and regulation. They show that anti-competitive regulations such as entry barriers lead to slower growth in established firms. Dollar et al. (2004) also focus on infrastructure constraints. Using firm level data, they argue that cost of firms is highly correlated with different tailbacks such as days to clear goods through customs, days to get a telephone line, and sales lost due to power outages affect firm performance in China, India and Pakistan. Sleuwaegen and Goedhuys (2002) in their study in Ivory Coast find that inadequate physical and financial infrastructure hinders the efficiency of small firms.

Using a sample of Ugandan firms, Fisman and Svensson (2007) find that corruption; specifically bribe payments, halts firm growth. Latin American firms show that corruption reduces competitiveness among firms (Gaviria 2002). Macroeconomic stability also matters in expediting firm's growth. According to Desai et al. (2004) exchange rate depreciations increase the leverage of firms that have borrowed foreign currency denominated debt, constraining their ability to obtain new equity or to adjust their capital structure.

Beck et al. (2003) argue that small firms are most vulnerable to all kinds of constraints. They find that a poor infrastructural system with high level of corruption hampers small firms the most. Conversely, they find a marginal development in the financial and legal system and a reduction in corruption helps ease the constraints for the small and medium firms, which are the most constrained. However, all three constraints in their study – financial, legal, and corruption – hamper firm growth. They find that bank paperwork and administration also constraint firm growth. In addition, macroeconomic stability captured by high interest rates significantly reduces firm growth rates. Moreover, legal constraints and corruption, particularly the amount of bribes paid, the percentage of senior management's time spent with regulators, and corruption of bank officials also constrain firm growth significantly.

Financial constraints to enterprise growth

One of the major purposes of the present study is to identify the nature of financial constraints that MEs face. MEs suffer from various constraints such as product marketing, high cost of raw materials, competition and many more along with the financial constraints. Now the question is: why financial constraint stands out from other constraints faced by MEs?

A number of studies show that financial constraint hampers the enterprises to have an optimal growth, which in turn hinders the country's overall growth. According to Berger and Udell (1998) and Galindo and Schiantarelli (2003), small firms suffer more from financial deficiency which hampers the operation of the firms; and this is true for both developed and developing countries. The growth of small firms is important especially for poor countries because growth of these firms mean growth of private sector in the poor countries. Enterprises that depend on external financing grow faster in countries with better financial environment (Rajan and Zingale 1998). The effect of financial and legal development on the constraints-growth relationship is significantly stronger for small firms than for large firms. It is the small firms that stand to gain most from financial and institutional development. Financial and institutional development thus helps close the gap between small and large firms.

Beck et al. (2005) show that financial development applies an excessively large positive effect on the growth of industries that are technologically more dependent on small firms. Their results on 44 countries and 36 industries in the manufacturing sector suggest that the furniture industry in Italy (an industry with many small firms) would grow by 1.4 percent per annum faster than the spinning industry (an industry with relatively few small firms) in Canada (a country with a well-developed financial system) than in India (which has a low level of financial development). Using a sample of large listed firms across 44 countries, Beck et al. (2006) show that firms are larger in countries having higher level of private credit to GDP ratio, a standard measure of financial intermediary development. Sleuwaegen and Goedhuys (2002) analyse the firm-level data of Ivory Coast and find that inadequate financial infrastructure impairs the growth of small firms. Hence investigating the financial deficiency issue of enterprises, particularly for small sized enterprises, is important.

The issue of financial constraint, however, is not something, which is new. The firms around the world have been facing the problem for decades. The literatures highlights that impact of access to credit is higher for smaller firms than large firms. Yet smaller firms are more deprived of external finance compared with the large firms. The question is why? What does the theory say about it?

Generally, MEs suffer more due to financial constraints than small or large enterprises because of financial market imperfection. It has an adverse impact on small firms' borrowing. Financial market imperfection is mainly allied with asymmetric information. It is natural that an owner of a firm seeking investors to finance his/her enterprise has better knowledge about his/her firm than the investors. He/she knows about the performance of the enterprise than any other 'outside' investors. Singh (1997) points out that this is particularly true for smaller firms because for the large firms, information are composed by independent analysts and broadly disseminated to large group of potential and actual investors. Also, large firms publish annual reports where all the financial information is given for the investors. Such information is not readily available for small firms where there is little scope for external investment. Financial institutions need to take initiatives by themselves in terms of collecting information if they want to decide to invest in small firms. As a consequence, they face higher agency costs.

On the other hand, owner of a new firm is likely to have less knowledge about the prospects of his/her business than the loan officer of a financial institution. Jovanovic (1989) argues that for the new firms, loan officer will have better knowledge based on his/her experience from dealing with similar customers at the similar stage of business development. Nevertheless, with the growth of enterprise, entrepreneurs gather more knowledge about his/her firm because of experience of running his/her business on a daily basis. On the other hand, it is unlikely for a financial institution to improve its knowledge at the same rate because it is not possible to monitor the firms rigorously.

Along with ex-ante asymmetric information, financial institutions also face ex-post asymmetric information. Even after disbursing loan, it is difficult to monitor the action of small firms. Financial institutions have to monitor the firms to check whether they are acting in a compatible manner as per the loan contract. To make an accurate decision about the feasibility of the enterprise becomes very costly for financial institution for the small firms because of high monitoring and assessment cost. This high cost may discourage the financial institutions to finance the small firms. As it is difficult for the financial institutions to attain full information on entrepreneurs and enterprises, their decision on lending may lead to adverse project selection. To be on the safe side, investors therefore ask for high interest rate as a compensation for high agency cost, which can also lead to moral hazard. As the entrepreneur has to pay high interest, he/she may opt for riskier high return business. If the business is successful, he/she has to pay a pre-fixed interest and if the business fails, the financial institution becomes the loser rather than the firms.

Therefore, the lender's best interest is to ration credit rather than to increase the interest rate. The consequence of such rationing is that some borrowers will be excluded from having access to credit, especially the small borrowers even though they are prepared to pay higher interest rate. Moreover, collateral and owners' equity are most commonly used tools to overcome the moral hazard problem. For small firms, it is difficult to reach the required level of collateral and, even if they have that collateral, according to Hutchinson(1995), this will limit the firm's ability to raise additional debt capital and contract the personal equity base.

Schiffer and Weder (2001) use data from World Business Environment Survey, conducted in 80 countries, and show that the probability that a small firm reporting financing as a major hindrance (as opposed to moderate, minor or no obstacle) is 39 percent compared with 36 percent for medium sized enterprise and 32 percent for large enterprise.

Beck et al. (2006) validate the above hypothesis as they find that small firms finance, on an average, 13 percent less of investment with bank finance compared with large firms. They also find that smaller firms finance a considerable share by taking help from friends, relatives and informal money lenders. In developing countries, finance from friends and family play a much more significant role than in industrialised countries. Biggs and Shah (2006) argue that smaller firms in many developing countries suffer from lack of formal institutions and as a result they create a private governance system in the form of long-term business relationships and tight, ethnically based, business networks.

Using firm-level survey data for 52 countries, Demirguc-Kunt et al. (2006) show that enterprises face lower obstacles to their growth in countries with better-developed financial sectors and efficient legal systems, strong shareholder and creditor rights, low regulatory burdens and corporate taxes and efficient bankruptcy processes. Corporations report fewer financing, legal and regulatory obstacles than independent firms and this advantage is greater in countries with more developed institutions and favourable business environments. Further, they find some evidence of higher growth of independent businesses in countries with good financial and legal institutions.

According to Cull and Xu (2005), Chinese entrepreneurs are more likely to reinvest their profits if they are more confident in the system of property rights protection and have easier access to credit, and the effect is stronger for small firms. Using business environment data for 80 countries Ayyagari et al. (2006) investigate the impact of access to finance, property right protection, provision of infrastructure, inefficient regulation and taxation, and broader governance features such as corruption, macroeconomic and political stability on firm growth. They show that finance, crime and political instability are the only obstacles that have a direct impact on enterprise growth and finance is the most robust one among these.

2.4.2 Bangladesh Experience

Non-Financial Constraints

Not many studies are available on non-financial constraints to Bangladesh ME growth. Some of the literature focuses on constraints to SME growth in Bangladesh. Ahmed, Rahman and Haque (2011) identify several constraints to developing manufacture based SMEs in Bangladesh. The results of the study show that lack of infrastructural support, political unrest, shortage as well as price hike of raw materials, high financing cost and inadequate utility facility are some of the key factors for the slow development of manufacture based SMEs. Bhattacharya et. al. (2006) highlight the problems and prospects of SME sector in Bangladesh, and report that complex documentation processes, time consuming releasing and clearing of goods from ports, corruption in the customs department, and lack of computerised customs procedures act as major problems obstructing the growth of any business in Bangladesh and SMEs are not an exception.

Ahmed (2002) also highlights similar problems while analysing the constraints to firm growth in Bangladesh. On the other hand, Lester and Terry (2008) argue that as SMEs start becoming involved in export activities, these constraints become less important, and the business environment and internal capacities appear as stronger barriers. Reducing these constraints emerge as the key factor for the growth of SME sector in Bangladesh. Another study (Khan et al., 2012) also reports that lack of training for workers, harassment of government officials and poor supplementary utility facilities as significant barriers that require integrated steps.

Besides the above, enterprises in Bangladesh suffer from some regulatory constraints. The MFIs, which are one of the major funding sources for MEs, face severe regulatory constraints, which in turn affect the MEs. The Microcredit Regulatory Authority Act of 2006 limits two important potential MFI funding sources: equity investments and deposits. Foreign currency financing is also effectively prohibited. First, due to the absence of specific regulatory guideline, quite a significant number of MFIs are unable to provide appropriate financial services to the MEs for lack of sufficient funds. In addition, 2010 Rules and Regulations restrict the share of MEs to 50 percent (maximum limit) of the total loans outstanding. Second, MFIs are not allowed to transform into banks or NBFIs; although, they can establish sister banks, following the BRAC Bank as an example. The restrictions on transformation impede the provision of diversified savings products and remittance services to the existing MFI clients, which according to MRA regulations cannot be provided by MFIs. As a result, MFIs are not able to make any financial planning for MEs.

Financial constraints to ME growth

In Bangladesh, the majority of enterprises are self-financed. This is true for micro and cottage industries as well. Sometimes enterprises require external financial support for scaling up the business. Bank financing has always been a constraint to the development of micro and SMEs. Although the MFIs provide support to MEs, they suffer from funding constraints.

In a study on the SME sector of Bangladesh, Miah (2006) states that the major constraints for SMEs are lack of adequate investment, lack of modern technology, high rate of interest on bank loans, irregular/inadequate supply of power, poor physical infrastructure and high transportation cost, poor information about market opportunities and requirements, inadequate availability of raw materials, lack of skilled technicians and workers, lack of research and development facilities, fierce competition, absence of effective and transparent legal system, difficulties in accessing technology, credit constraints, low access to business services, constraint of quality of human resources, low awareness, low lobbying capacity, and rapid changes in policy environment.

According to Zaman et al. (2011), women contribute 26 percent of the bank deposit but they get only 2 percent as credit out of total outstanding loans. Access to finance is one of the most critical constraints faced by women entrepreneurs. Very few women apply for the SME loan from the banks, as they need to submit a number of statements such as bank statement of the enterprise and reference of the guarantor for collateral free loan. Chowdhury et al. (2008) show that about 79 percent of the women entrepreneurs in this sector have no access to formal financial institutions; they depend only on their own savings and family for capital to start a business. Despite several arrangements for financing small and medium enterprises, the actual amount of institutional credit to the sector has been grossly inadequate. One of the main factors that have hampered flow of institutional finance into small and medium enterprises is banks' preoccupation with collateral based lending (Bakht et al. 2015).

Ahmed (2006) shows that lack of funds is a major constraint to formation and growth of SMEs in Bangladesh. Banks are reluctant to expand their SME credit portfolio because they do not consider SME lending an attractive and profitable undertaking. This is because SMEs are regarded as high-risk borrowers because of their low capitalisation, insufficient assets and their inability to comply with collateral requirements of the banks. A study by Micro Industries Development Assistance and Services (MIDAS 2004) reveals that sources of finance are mostly friends and family members rather than formal sector in the case of SMEs. Chowdhury et al. (2013), while surveying 100 SME consumers to identify the bottlenecks of SME growth, report that lengthy waiting period for getting initial finance from banks because of tiresome paper works, lack of collateral to get loans, inexperience in preparing sound financial systems for getting loans lead to severe financial constraints for the small sized firms. As remedies, the respondents advised financial incentives for sound business plan and public-private partnership in providing effective training. This finding is also supported by some recent studies such as Khandker et al. (2013) and Khalily et al. (2014).

Khandker et al. (2013), using three rounds of national survey data, show the distribution of sources of start-up capital for rural micro-entrepreneurs (Table 2-9). It shows that own resources constitute the start-up capital for nearly 80 percent of the MEs. Regarding other financing sources of MEs, it is found that MFIs are the major external financial source for rural entrepreneurs and this share has been rising over time. In 2010, the share of MFI financing in the capital structure of MEs is 8 percent, which is the highest of all external sources. On the other hand, the share of MFI financing was only 3 percent in 2000. Banks do not play any significant role in financing MEs, which is only 1 percent in 2010. It is also seen that the share of contribution of the moneylenders in the capital structure has been declining over the years. The financing support from friends and relatives has remained at around 5 percent during the years. These results show that the share of equity is around four-fifths of the total in the capital structure of the country's rural MEs and the share of bank financing is

Table 2-9: **Start up Capital Structure of Rural MEs**

Source of finance	Share in %		
	2000	2005	2010
Own source	78.2	78.5	79.6
Loan from MFIs	3.4	5.9	8.2
Loan from bank	0.8	0.6	1.0
Loan from moneylender	2.4	0.6	1.2
Loan from relatives/friends	5.5	4.0	5.6
Other sources	9.7	10.4	4.4
Total	100	100	100

Source: Khandker et al. 2013

negligible. This further indicates the severity of the credit constraint problem of the MEs especially in the rural areas.

The study by Khalily et al. (2015) provides similar results for financing sources of capital structure of MEs. For MEs, financial constraints are observed particularly during two phases in their life cycle. First, during the initial stage when the business has just started or about to start; and second, during the development stage when the entrepreneur plans to expand the business. Several studies in Bangladesh discuss the financial constraint during initial period of business. Khalily et al. (2015) classify the enterprising households into three categories: 'small' MEs having full time employment of less than or equal to 2, 'large' ME having full time employment of 3-4 employees, and 'small' enterprises having full time employment of more than 5 employees.

Table 2-10: **Capital Structure of MEs in Bangladesh**

Source of fund	MEs (n=1,806)			Small enterprises (n=37)	Total (n=1,843)
	Having 1-2 full-time employees	Having 3-4 full-time employees	Total	Enterprises having full-time employees >=5	
Own resource	88.31	89.10	88.49	81.09	87.71
Partner's resource	0.69	4.68	1.61	1.16	1.56
Loans from commercial banks	2.77	3.45	2.92	14.28	4.13
Loans from MFIs	5.62	2.23	4.84	2.36	4.58
Informal loans	2.61	0.54	2.14	1.11	2.03

Source: Khalily et al. 2015

Table 2-10 shows the capital structure of enterprises having average operating years of 10 years. Hence, these are not operating at the initial stage. The results show that own finance is the major source of capital and, with increases in employment and enterprise sizes, the relative contribution of own finance decreases as revealed in the figures for MEs and small enterprises. Access to bank credit increases with rise in firm size. On the other hand, relative contribution of MFI financing decline slightly with the size if the figures are compared for MEs and small enterprises. However, 87percent of the enterprises are self-financed. It is important to note that MEs have significantly limited access to the formal credit market compared with the small enterprises. Small enterprises also receive MFI financing although the figure is low relative to that for MEs. If the own financing share in capital structure is compared, it is found that almost 90 percent of financing comes from entrepreneurs' own fund whereas the figure is 81 percent for the small enterprises. This can be taken to indicate that MEs are more credit constrained than small enterprises.

2.5 Constraints for MFIs: Supply Side Perspectives

During focus group discussions with relevant stakeholders organised by InM for the present study, several constraints are identified that the MFIs face while lending to MEs.

In general, it is observed that the default rate is higher in ME lending than in lending to other activities of the MFIs. Also, as the ME loan size is higher even a small percentage of default causes a bigger constraint for MFIs. On the other hand, profit is also higher in financing MEs and there exists demand for ME loans from the clients. Thus the MFIs face a dilemma: if they want to go for high profit responding to the demand for ME loan, they might face high default rate as well. The need for MFIs is to strike a right balance between the two by adopting relevant measures and pursuing prudent strategies. In this pursuit, some MFIs monitor debt-equity ratio of the MEs while others analyse cash inflows and outflows to minimise the risks of loan default. It has been suggested that forming of Credit Information Bureau (CIB) can be effective in informing the borrowing status and repayment history of the entrepreneurs and thus minimising the default rate of the MFIs. Scheme insurance and credit insurance may also be introduced.

Another constraint to ME funding relates to identifying the right and prospective MEs for lending. Many MFIs identify selecting of potential MEs as a big challenge. The MFI staff lack the capacity to identify the potential MEs and the entrepreneurs / borrowers do not possess the accounting and related knowledge to provide sufficient information about the cash inflow/outflow of their proposed businesses. Both borrowers and MFI staff need capacity building in these respects. Extensive training is needed to create a professional group among the MFI staff so that they can identify the right kind of MEs for lending. At the same time, entrepreneurs and potential borrowers need training on keeping financial records, cash inflows and outflows and financial transactions so that the financial health of the MEs can be properly assessed and right amounts of loan can be sanctioned.

In recent years, MFIs are also facing competition with banks in lending to MEs as banks have a lot of unutilised funds and they are moving to the ME market as well. On the other hand, MFIs are facing acute fund constraints and do not have adequate funds to meet the demand of the micro-entrepreneurs. One policy option could be to raise funds from the deposit market available with the banks and channel these funds to the MEs through the MFI network. Proper arrangements to create such links will be beneficial to both the banks and MFIs as well as play a major role in meeting the demand for loans of the micro-entrepreneurs.

The above review identifies the financing deficiency especially of MEs and the constraints that MFIs face in financing MEs. Both the theory and empirical evidence suggest that small sized enterprises are more credit constrained compared with the large sized enterprises. The evidence from the survey conducted under the present study is discussed in the next section along with the capital structure of enterprises using the survey data.

2.6 Analysis of Survey Data

As mentioned earlier, the survey data comprise of 600 enterprises from 12 districts of the country. Following the BBS definition, 95 percent of the enterprises in the sample are cottage enterprises included in the category of MEs for our purpose where all enterprises having less than or equal to 9 employees has been termed as MEs. Within the MEs, we distinguish two subgroups: small MEs having total employees up to 4; and large MEs with a total employee of 5 to 9. The main reason behind having these two classifications is that the former group constitutes around 83 percent of our sample enterprises. As this is the largest group, the group needs separate analysis. Moreover, significant variations in financial and non-financial characteristics along with their capital structure are observed between these two groups. A separate classification of enterprises having total employees in the range of 10 – 51 has also been conducted. This group has been termed as small enterprises. This is the smallest group in our sample with only around 4 percent of the total enterprises. .

2.6.1 Some Features of Sample Enterprises

Non-Financial Characteristics

The analysis in Table 2-11 shows that female ownership is higher for the small MEs having up to 4 employees. Relatively large enterprises have fewer female owners. There does not exist any significant variation in female ownership between large MEs with 5-9 employees and small enterprises with 10 and above employees. It seems that with the increase in size, the share of male ownership increases. This is expected because small MEs are normally home based and hence it is easier for women to operate these businesses from home.

Table 2-11: **Non-financial Characteristics of Enterprises by Employment Size**

	MEs		Small enterprises	Total (n=600)
	Small: having up to 4 employees (n=502)	Large: having between 5-9 employees (n=68)	Having 10-51 employees (n=30)	
Experience of the entrepreneur, years	10.85	11.71	13.71	11.10
Share of female ownership, %	8.98	4.35	3.33	8.17
Age of the entrepreneur, years	39.38	39.06	38.30	39.29
Educational qualification, tears of schooling	9.27	9.77	9.73	9.35
Registered under municipality, % yes	53.29	59.42	66.67	54.67
Hired to family labour ratio	0.59	3.92	11.48	1.52
Average employment creation, no.	2.00	6.22	16.93	3.23

Source: InM, Microenterprise Survey 2016

The experience of the entrepreneurs varies with size of enterprises. This is expected, as experience is required to operate larger enterprises. Our data show that the average experience of micro-entrepreneurs is around 11 years whereas a small entrepreneur has experience on an average of around 14 years. The results do not show any significant variation in educational qualification of the entrepreneurs. All the groups have around 9 years of education. It is observed that small MEs are less likely to be registered under the municipality. It is observed that around 53 percent of small MEs are registered under the municipality whereas this figure is 59 percent and 66 percent respectively for large MEs and small enterprises.

One of the distinct characteristics of MEs is that these mostly depend on family labour. The small MEsare mostly based on entrepreneurial labour. Even if some additional labour is needed, family members may be employed to operate the small businesses. Hence, the hired to family labour ratio significantly increases with the size of the firm. The data show that only 0.59 person is hired from outside against one family labour in small MEs. On the other hand, for large MEs around 4hired labour is employed per family labour and the number rises to 11 for small enterprises. It is important to note that all groups of enterprises have multiplier effect on employment; meaning that one firm can create on an average more than one employment. Such employment generating ability of small enterprises is higher compared to MEs. On an average it can create employment for around 17 people relative to 6 for large MEs and 2 for small MEs.

Financial Characteristics

It is generally argued that households with enterprise participation have higher income with higher consumption and these households are more likely to be non-poor relative to households without enterprises. It therefore suggests that these enterprises have positive profits and rates of return to result in households' income and consumption gains. In this section, the financial performance of enterprises is evaluated.

The rate of return is usually interpreted as the annual net income from a business expressed as a proportion of total asset or equity or sales of that business. In this study, we have calculated return on asset (ROA) and profit margin, which is also known as return on sales. The most common measure of assessing return is, the rate of return on enterprise assets (ROA), which is the enterprise profit as a percentage of enterprise assets. It measures how well the enterprise utilises assets to generate profits (Khandkeret al. 2013).

Different studies have measured asset of rural enterprises differently. It is because these businesses are mostly informal and therefore it is hard to keep track of every single input. For example, Grosh and Glewwe (2000) include fixed asset (land, building, equipment and other durable goods) along with raw material and inventory while calculating total asset. However, they do not include cash in hand. Woodruff et al. (2009) consider both fixed asset and working capital in the computation of total asset. Khandker et al. (2013) calculate total asset in a different manner. They estimate capital assets by combining working capital and imputed value of the enterprise. For our purpose, we include fixed asset, inventory of finished goods and liquid asset in total asset calculation.

While calculating fixed asset we consider the book value of land, building, equipment and other durable goods. Lastly, we divide the net business profit by total asset to get return on asset. The net annual profit is calculated by deducting the annual expenditure of the firm from annual revenue.

Profit margin is defined by profit as a percentage of revenue. It indicates how well it can cover its costs with its revenue. Hence, it measures the cost-effectiveness of a firm. A high profit margin indicates that the firm is secure. To calculate profit margin, we divide the firm's annual net profit by its annual revenue.

Table 2-12 shows that the average value of asset of small enterprises is more than three times larger than small MEs and 1.7 times larger than large MEs. Similar trend is observed while analysing the difference in working capital. Moreover working capital of small MEs is around 1.8 times lower than that of large MEs. If we observe the revenue of the enterprises it shows that small enterprises have the highest average revenue of around BDT. 10 million, which is nearly two times higher than small MEs and 1.7 times larger than large MEs. The trend is also similar for expenditure of firms. The annual profit of small enterprises is BDT 1.2 million which is nearly three times higher than small MEs.

Table 2-12: **Financial Characteristics of Enterprises by Employment Size**

	MEs		Small enterprises	Total
	Small: having up to 4 employees	Large: having 5-9 employees	Having 10-51 employees	
Total asset	858,370	1,714,164	2,913,618	1,036,659
Working capital	691,214	1,239,037	2,026,833	820,081
Total revenue	5,020,677	7,632,701	13,500,000	5,654,547
Total expenditure	4,608,812	6,902,045	12,300,000	5,174,658
Total profit	411,865	730,656	1,200,000	479,889
Return on asset	48%	43%	41%	46%
Profit margin	8.2%	9.6%	8.5%	8.5%
Debt-equity ratio	0.29	0.30	0.03	0.17

Source: InM, Microenterprise Survey 2016

Moreover, the difference in profit between small and large MEs is higher than the difference in revenue and expenditure. It is evident from the analysis that small MEs have the lowest profit compared with the other two groups. However, in the case of using the asset efficiently in generating profit, impressive performance may be noted. In the analysis we have found that return on asset has an inverse relationship with the size of enterprise. Small enterprises have the least return on asset, which is around 41 percent. Although small MEs have low profit but in terms of return on asset, it has the highest return even higher than large MEs. The results show that return on asset for small MEs is 48 percent, which is 43 percent for large MEs. There does not seem to exist any significant difference regarding profit margin among the enterprises. However, large MEs having employment range of 5-9 employees shows the highest profit margin which is 9.6 percent. The average profit margin for all enterprises is 8.5 percent. There is also no significant difference between the debt equity ratios of small and large MEs. On the other hand, for small enterprises the ratio is very low.

So far, we have observed the financial performance of enterprises. From the policy perspective, it might be useful to analyse the sectoral variation in performance across the enterprises. Table 2-13 shows that enterprises of the industry sector has the highest asset value which is BDT 1.5 million followed by the trade sector. The working capital of these sectors is also higher compared with the other two groups. However, in terms of return these two groups show lower rate than the other two. The return on asset for industry sector and trade sector is 41 percent and 53 percent respectively. On the other hand, service sector shows the highest rate of return on asset. Around 94 percent of asset is utilised to generate profit in service sector. Therefore, we can say that it is highly productive in generating profit with its asset. The return on asset for agriculture sector is around 77 percent which is significantly higher than those of trade and industry sectors. Similar trend is also observed in the case of profit margin.

Table 2-13: **Financial Characteristics of Enterprises by Sector**

	Agriculture & fisheries	Trade	Service	Industry
Total asset	600,332	1,167,298	478,315	1,538,431
Working capital	450,895	938,695	332,297	810,081
Total revenue	2,223,326	6,860,069	1,932,946	5,442,697
Total expenditure	1,760,810	6,245,682	1,481,581	4,816,057
Total profit	462,516	614,387	451,365	626,640
Return on asset	0.77	0.53	0.94	0.41
Profit margin	0.21	0.09	0.23	0.12
Debt-equity ratio	0.24	0.26	0.38	0.06

Source: InM, Microenterprise Survey 2016

The result shows that service sector has the highest profit margin among all the sectors, which is 23 percent. On the other hand, trade sector has the lowest profit margin of 9 percent, which, for industry sector, is 12 percent. The analysis shows that the industry sector is highly dependent on self-financing with only 6 percent of external debt financing. On the other hand service sector, which earns the highest profit, also has the highest debt equity ratio.

2.6.2 Capital Structure of Enterprises

In this section, we focus on the financial portfolio of the enterprises. This will help us to analyse how capital is formed in different enterprises. For example, we shall have evidence on the share of capital coming from equity and loan, share of banks and MFIs in total lending, share of informal loans and similar issues. Financial constraints in MEs are mostly observed during two phases: formative stage when the business has just started or about to start; and during the development stage when the entrepreneur is thinking of scaling up the business. To capture this, we analyse the capital structure in two points of time. First, during the beginning when the business has just started and second, at present (that is in 2016 during the survey). It is important to note that the average operating year of the enterprises is 11 years. This would mean that we will compare the present capital structure of enterprises with the capital structure 11 years back. We will also analyse if there is any variation in capital structure by employment size, size of fixed asset and type of enterprise.

Capital structure by employment size

Table 2-14 shows the capital structure of enterprises by employment size during initial and present periods. The results show that MEs are less dependent on self-financing in the present period compared with the initial period. It is not surprising since, about a decade back, it was more difficult to get loans from institutions like banks and MFIs. The dependence on own source has declined for both small and large MEs. This shows that MEs face less severe credit constraint now relative to the initial period when the business started. Another question is: which type of external source is dominant in the capital structure of MEs? The result reveals that in the initial period loan from informal sources played the dominant role. However, informal loan has lost its dominance significantly at present. As mentioned earlier, it is rather difficult to get loan from formal institutions like banks and MFIs for starting up a business. For the purpose, the major source of loan is relatives, friends or informal moneylenders. The result shows that loan from informal source is the largest source of external financing in the initial stage of small MEs.

The results show that the share of loan from MFIs has increased significantly for both small and large MEs at present. The share of MFI loan has increased by 9 and 6 percentage points for small and large MEs respectively. On the other hand, bank loan has always been difficult for small MEs. The share of bank loan in capital structure is negligible for small MEs. However, for large MEs the share of bank loan has increased by 3.5 percentage points.

Table 2-14: **Startup and Present Capital Structure of Enterprises by Employment Size**

Initial capital structure				
	MEs		Small enterprises	Total
	Small: having up to 4 employees	Large: having 5-9 employees	Having 10-51 employees	
Own resource	84.13	85.13	71.77	82.67
Partner’s resource	0.35	0.00	11.50	1.76
Loans from commercial banks	0.99	2.56	0.00	1.12
Loans from MFIs	3.59	3.14	1.55	3.25
Loan from cooperatives	0.00	0.00	0.00	0.00
Informal loans	7.03	3.88	2.26	5.88
Loan from other sources	3.90	5.29	12.92	5.32
Total	100	100	100	100
Present capital structure				
Own resource	77.17	71.93	95.41	84.02
Partner’s resource	0.26	4.78	1.23	1.26
Loans from commercial banks	0.93	6.10	0.22	1.33
Loans from MFIs	12.87	9.76	2.05	7.98
Loan from cooperatives	0.10	0.05	0.00	0.05
Informal loans	3.11	1.66	0.41	1.80
Loan from other sources	5.56	5.72	0.68	3.56
Total	100	100	100	100

Source: InM, Microenterprise Survey 2016

Regarding the capital structure of small enterprises, the data show that dependency on own source of fund has increased significantly by about 24 percentage points. Another important point to note is that, at the initial stage, small enterprises were more into partnership business. Around 11 percent of capital came from partner’s source. However, this constitutes only 1 percent of the capital at present. Neither MFIs nor commercial banks have a significant share in the capital structure of small enterprises although the share of MFI loan has slightly increased at present. In short, small enterprises are mostly dependent on own financing.

Capital structure by size of fixed asset

The BBS Economic Census 2013 and Industrial Policy 2010, in addition to the size of employment, also use the size of fixed asset for classifying enterprises. Enterprises are considered as MEs (cottage enterprises) which have fixed assets worth less than BDT 0.5 million excluding land and building. In the present sample, 97percent of the enterprises fall under MEs when the above classification is applied. We have used two cut off points; one with fixed asset less than BDT 0.5 million and the other with fixed asset more than BDT 0.5 million.

The results in Table 2-15 show similar patterns observed earlier. For MEs, the share of informal loan has decreased by 5 percentage points at present while the share of MFI loan has increased by 4.5 percentage points compared with the initial period. However, the share of own source has remained mostly unchanged. It is important to note that the share of MFI loan has increased significantly by 10 percentage points for the small enterprises.

Table 2-15: **Capital Structure of Enterprises by Fixed Asset Size**

Initial Capital Structure			
	MEs	Small enterprises	
	Having fixed asset of less than 0.5 million	Having fixed asset of 0.5–5.0 million	Total
Own resource	82.95	81.10	82.67
Partner’s resource	2.08	0.00	1.76
Loans from Commercial Banks	1.32	0.00	1.12
Loans from MFIs	3.55	1.54	3.25
Loan from Cooperative	0.00	0.00	0.00
Informal loans	6.28	3.63	5.88
Loan from other source	3.82	13.72	5.32
Total	100	100	100
Present Capital Structure			
Own resource	83.92	85.82	84.02
Partner’s resource	1.33	0.00	1.26
Loans from Commercial Banks	1.40	0.00	1.33
Loans from MFIs	7.80	11.08	7.98
Loan from Cooperative	0.06	0.02	0.05
Informal loans	1.81	1.57	1.80
Loan from other source	3.68	1.51	3.56
Total	100	100	100

Source: InM, Microenterprise Survey 2016

Our analysis shows that small enterprises are mostly self-financed. Around 95 percent of the capital comes from the own source of the entrepreneurs. The analysis of capital structure also shows the same trend although the magnitude is somewhat different. It shows that at present small enterprises depend more on self-financing. Does this mean these are more credit constrained than MEs? We analyse the issue with reference to optimal capital structure and average operating years of enterprises. In our sample, the average operating years of small enterprises is 14 years whereas for MEs, it is 10 years. It is usually observed that as an enterprise grows, it increases its ability to reinvest more profit in expanding its capital base.

At the initial stage of business, an enterprise is likely to grow at an increasing rate. After a certain stage when it reaches maturity, it would most likely to grow at a decreasing rate. Then it is not likely to borrow any more to expand the business. We also observe such a trend from the survey data. Figure 1 relates the operating years of business against the share of equity in the capital structure in the present period. It shows that up to 10 years of operation, the share of equity in capital decreases over time. During these years, it expands with the help of external financing. However, when an enterprise operates for longer years (e.g. more than a decade), it reaches a stage when it can reinvest its profit and expand it. Then it will depend more on own equity. As such, the figure shows a sharp increase in the share of equity in total capital.

Over the years, firms will gain more profits along with experience. This may also reduce its dependence on loan as it has higher capacity to reinvest profit to expand its business. The results shown in Table 2-14 and 2-15 support such contentions. The results show that 77 percent of capital of the small MEs is from equity whereas this is 71 percent for large MEs. On the other hand, 95percent of capital is self-financed in the case of small enterprises. Starting from the stage of being small to large MEs, entrepreneurs expand business by taking loan as they may not have sufficient profit to reinvest despite having the capacity to expand. These enterprises are yet to reach the maturity stage. However, for the small enterprises, the share of equity increases sharply to 95 percent of capital. These trends, along with the profit margins of the three groups of enterprises, lend support to our hypothesis. The debt equity ratio of the three groups also tells a similar story: debt equity ratio of small enterprises is only 0.03 whereas this figure is 0.30 for large MEs.

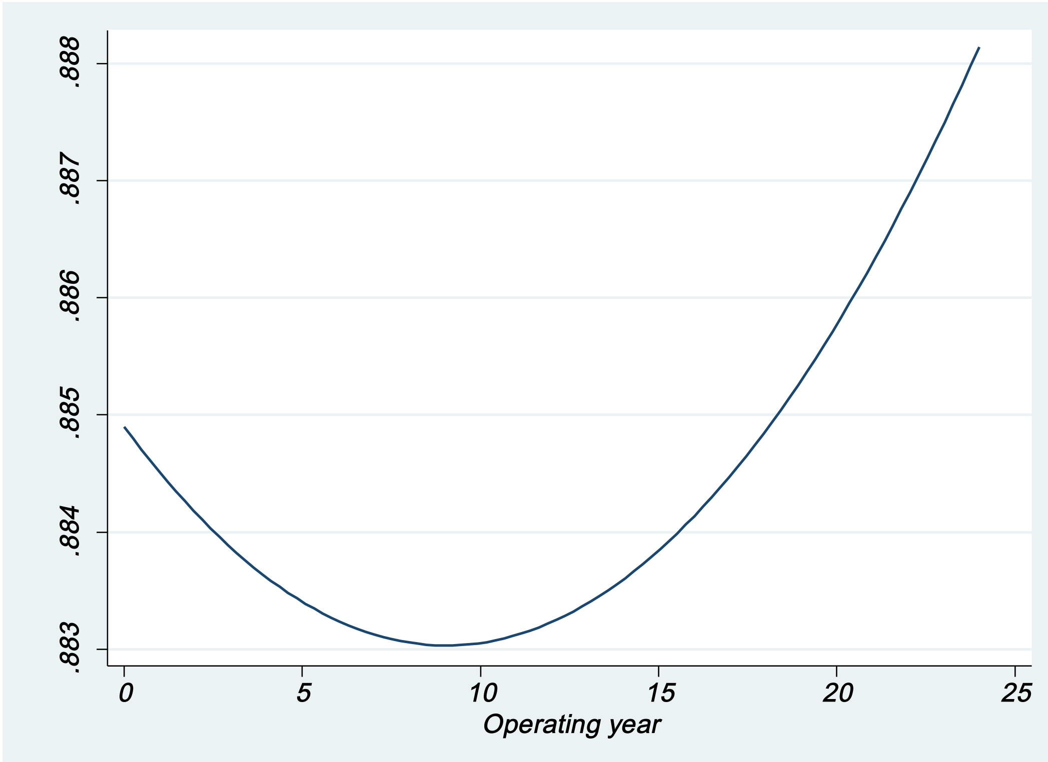


Figure 0-1: Relationship of Equity and Operating Years

Capital structure of enterprises by sector

For the purpose of the present study, it is important to analyse the capital structure of the enterprises from a policy perspective. Table 2-16 shows that during startup time, agriculture and fisheries sector suffers the least credit constraint. They receive loan from commercial banks which include the specialised banks as well. The dependency on informal loan has decreased at present. On the other hand, dependency on MFIs for external financing has increased significantly. This is true for all sectors. The share of MFI loan in the present capital structure has increased by 7 percentage points for the agriculture sector. For trade, the increase is by more than five-fold. Also, the highest profit margin earning sector which is the service sector has 20 percent of MFI loan in the capital structure which was around 9.5 percent at the initial stage.

Table 2-16: **Capital Structure of Enterprises by Sector**

Initial Capital Structure				
	Agriculture	Trade	Service	Industry
Own resource	67.32	85.35	71.83	87.31
Partner's resource	13.94	0.36	0.00	0.00
Loans from commercial banks	1.26	0.56	0.00	0.00
Loans from MFIs	6.52	2.25	9.53	3.65
Loan from cooperatives	0.00	0.00	0.00	0.00
Informal loans	7.93	5.24	11.07	4.14
Loan from other sources	3.02	6.25	7.56	4.90

Total	100	100	100	100
Present Capital Structure				
Own resource	74.82	77.89	72.68	93.93
Partner's resource	5.76	1.62	0.00	0.30
Loans from commercial banks	1.35	1.20	0.00	0.27
Loans from MFIs	13.25	11.31	20.40	2.83
Loan from cooperatives	0.00	0.07	0.73	0.02
Informal loans	1.06	2.06	0.91	1.62
Loan from other sources	3.76	5.85	5.28	1.03
Total	100	100	100	100

Source: InM, Microenterprise Survey 2016

One important observation that comes out from this analysis is that commercial banks have little contribution to the capital structure of the enterprises during both initial and later stages of their growth and development. Although enterprises of the agriculture sector have a small share of bank loan in their capital structure, it mostly comes from specialised banks like the Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). Moreover, the shares have not changed much over time. In all other sectors, the role of banks in capital structure is marginal and has not changed to any significant extent over time. Another important observation of the study is that in all sectors self-financing is the dominant mode of capital with as high as 93 percent of total capital for the industry sector.

2.7 Conclusions

This chapter has provided a brief review of the overall state of MEs in Bangladesh along with analysis of the constraints facing the MEs especially with respect to ME financing. Around 87 percent of all enterprises in Bangladesh belong to MEs and these contribute to 53 percent of total employment generated by all enterprises of the country. Despite playing such important roles in the national economy, MEs face significant constraints in both financial and non-financial aspects of their growth. The study shows that MEs are constrained of funds especially during the initial stages of their business. In the initial stage, around 85 percent of their capital is self-financed. Hence, it is extremely difficult to start up a ME if the potential entrepreneur does not have a strong base of own resources.

Although MFI support has been rising especially for scaling up MEs, there is very little contribution of banks in this respect. For small sized MEs, the contribution of banks in the capital structure is less than 1 percent. On the other hand, as MFIs do not have sufficient funds, they are constrained in meeting the demand of existing and potential micro-entrepreneurs. In practice, ME lending by MFIs is considered highly risky as such loans are larger in volume than traditional MFI loans and hence even a small share of loan default can put the MFIs in significant financial insolvency. On the other hand, despite the availability of funds, banks have not as yet come forward in a significant way to invest in MEs. The data collected from the survey shows that, despite generating high rate of return on asset (94 percent) and profit margin (23 percent), the contribution of bank loan in the capital structure of service sector MEs is nil. In other sectors, it is at best negligible. One proximate factor for the near-absence of banks in the ME sector is that it is difficult for them to reach out to micro-entrepreneurs especially in the rural areas since banks do not have wide network at the grassroots level as the MFIs have. This calls for development of appropriate mechanisms such that MFIs can procure funds from the deposit market and other sources for mitigating the financial constraints of the MEs.

Chapter 3

Financing of MEs: Estimating Supply-Demand Gap

3.1 Introduction

According to a World Bank (2007) study, financial penetration in Bangladesh is adequate for its current level of development. This refers to the formal financial sector and the use of formal financial sector services. On the other hand, Bangladesh has the highest microfinance penetration rate in the world: more the 15 percent of Bangladeshis have a microfinance loan. However, little information is available on the SME (micro-enterprise) finance market. Only recently has Bangladesh Bank begun to require separate reporting on the SME portfolios of the banks.

Due to lack of institutional arrangement, it is difficult to estimate how many MEs in the country are creditworthy. However, at any point in time, not all creditworthy MEs need a loan, nor will all micro-entrepreneurs who need a loan have a loan outstanding. Therefore, it requires widely varying estimates of how many creditworthy micro entrepreneurs actually demand loans. Even though Bangladesh, with its exceptionally high market penetration rates of microfinance loan, has significant advantages in these respects, but there remain significant anomalies, thus making it difficult to apply comparative evidence to the ME market.

In recent years, many banks have begun to recognise the market potential of the sector and started downscaling their operations to serve the MEs. At the same time, MFIs are up-scaling their loan operations to serve the MEs. It is important, however, to recognise that down-scaling or up-scaling of loan size alone is not adequate. What is needed is to adopt a fundamentally different approach since ME lending differs from medium and large businesses and requires its own approach to service and promotion, credit analysis, collateral, risk management and operations.

Given the lack of data on SMEs in Bangladesh, it is not possible to accurately and quantitatively assess the gap between the demand for and supply of SME finance. Studies conducted by ICG and the World Bank, although somewhat outdated, clearly indicate that access to finance is the number one financial constraint of SMEs in Bangladesh.

On the supply side, little data are available even though Bangladesh Bank has only recently required the banks to report separately on their SME portfolios. According to the most recent data on SME lending from Bangladesh Bank, 7,598 SMEs have been financed through the government-sponsored SME finance programme. This is a miniscule number compared with the roughly 6 million MSMEs and estimated 80,000 SMEs in the country. The vast majority of this is small and falls in between the target clientele of MFIs and banks: loan sizes demanded by 'graduating' micro clients or small businesses are generally too large for MFIs and MSMEs are deemed too risky by the banks. Bangladesh Bank has recently initiated policies to encourage banks to lend to this segment, but these policies are yet to bear fruits. Together, these factors indicate significant unmet demand for SME finance in Bangladesh. This chapter will analyse the demand for and the supply of institutional fund for ME lending and will explores the existence of any gaps between the two.

3.2 Demand for Fund by MEs

In practice, banks disburse more enterprise loan than MFIs do. However, MFIs mostly cover micro/cottage enterprises which banks usually exclude in their portfolio. Micro/cottage enterprises consist of almost 89 percent of total enterprises in 2013. So MFIs actually target the larger part of the enterprises. But the question is: are they able to meet the demand for loan of these cottage/micro-enterprises? We need to estimate the demand for loan of micro-entrepreneurs to answer the question. For the purpose, we conducted an enterprise survey to estimate the demand for loan by MEs.

Description of sample survey

The enterprise survey has been conducted in 12 districts of the country's seven divisions during 2016. To identify the ME borrowers, we have selected one or two MFI branches in each upazila/thana. From the list of ME borrowers of each branch, we selected the MEs for our study. Other than the ME borrowers, we have also selected some entrepreneurs from the locality who are non-borrowers. A total of 600 enterprises have been surveyed –among them 81 percent are selected from the list of ME borrower (Table 3-1).

Table 3-1: **Sample Enterprises by Borrowing Status**

	Frequency	Percentage
ME borrower	488	(81)
Graduated members	*184*	*[38]*
Lateral entry[7]	*304*	*[62]*
ME non-borrower	112	(19)
Non-borrower	*109*	*[97]*
Regular microcredit borrower	*3*	*[3]*
Total	600	(100)

Note: Figures in the first bracket indicate percent of total enterprise. Figures in the third bracket are the percent of groups.
Source: InM, Microenterprise Survey 2016

It is sometimes argued that the MFIs are drifting away from their social objective of targeting poor people and, in recent times, are more inclined to serve the MEs. This is true that enterprise lending of MFIs has recently increased, but this is no indication that they are drifting away from their social obligations. Some households, who were receiving smaller amount of loan from MFIs earlier, have now developed capacity to handle larger amount of loan. A segment of current ME borrowers are actually those graduated microfinance borrowers. The remaining borrowers are lateral entrants. In our sample survey, it is found that 38 percent of ME borrowers are graduated microfinance members and the rest (62 percent) are lateral entrants (see Table 3-1).

The entrepreneurs who are selected from outside the borrower list in the survey are actually non-borrowers –not borrowing from any bank or MFI. Only very few of them (a total of three entrepreneurs) had some borrowing history with MFIs but not with ME borrowing.

[7]Lateral entrant micro-enterprises are the enterprise-borrowers who are not members of MFIs. Like in banks, they are pure borrowers. Examples may include a restaurant or a small retail shop at a market place.

Most of the analysis in this study will be carried out through comparing between these two groups: (i) ME borrowers and (ii) ME non-borrowers. In Table 3-2, we report some basic characteristics of borrower and non-borrower entrepreneurs from the sample. Almost 8 percent of the sample enterprises are operated by female entrepreneurs. The share of female entrepreneurs is higher among the borrowers. This shows that MFIs have some positive role in women empowerment through involving women more in economic activities. There is no difference among borrower and non-borrower entrepreneurs in terms of age and education. The share of unmarried entrepreneurs is higher among the non-borrowers.

Table 3-2: **Characteristics of Entrepreneurs by Borrowing Status**

	ME non-borrower	ME borrower	Total
Characteristics of entrepreneurs			
Female (%)	3.57	9.22	8.17
Age (years)	38.4	39.5	39.3
Education (years of schooling)	7.9	8.1	8.1
Unmarried (%)	16.1	5.94	7.8
Previous occupation			
Wage labour (%)	8.33	8.19	8.22
Self-employed in agriculture (%)	17.59	15.09	15.56
Self-employed in non-agriculture (%)	25.00	30.82	29.72
Job/professional service (%)	21.30	19.83	20.10
Non-income generating (%)	27.78	26.08	26.40
Monthly earning from previous occupation	8,566	9,395	9,240
Location of enterprise			
At home (%)	20.54	25.41	24.5
At market (%)	62.5	63.9	63.7
Distance from nearest paved road, km	0.05	0.08	0.08
Distance from nearest small market place, km	0.61	0.46	0.49
Distance from nearest large business centre, km	1.14	1.21	1.20
Distance from nearest *union* council, km	1.75	2.10	2.03
Distance from nearest *upazila* council, km	5.97	5.02	5.20

Source: InM, Microenterprise Survey 2016

Prior to starting the present enterprises, 8 percent of the entrepreneurs used to work as wage labour, and almost 26percent were not involved in any income generating activities. One distinguishing feature among the borrower and non-borrower entrepreneurs is that borrower entrepreneurs are more engaged in off-farm self-employment activities. This indicates that they are more likely to have better experience in enterprise related activities than the non-borrower entrepreneurs.

The incidence of home based enterprises is higher among the borrower entrepreneurs than non-borrowers. In general, the majority of the enterprises are located at the market place. There were not much difference between these two groups in terms of distance of enterprises from the nearest physical facilities like paved road, market places, *union* council and *upazila* council.

In the previous chapter we found that enterprises, particularly the small ones, are constrained by various financial and non-financial constraints. All constraints are not valued equally. We were interested to know what constraints entrepreneurs perceived as most constraining to their enterprise development. We will explore the major constraints reported by the sample enterprises in the next subsection.

3.3 Constraints to Enterprise Development

The survey questionnaire includes several major constraints which are potentially obstructing to enterprise development. The constraints are:(i) product marketing, (ii) scarcity/high price of raw materials, (iii)scarcity of fund, (iv)competition with others, and (v) low demand for the product in the market. The respondent entrepreneurs ranked each of these constraints based on its severity. The severity of the each constraint to the enterprise may depend on the location of the enterprise or type of the enterprise or the characteristics of entrepreneurs (such as age/gender/education of entrepreneurs). In a remote/inaccessible area, for example, scarcity of raw materials and low demand for the product might be the major constraints in enterprise development. On the other hand, enterprises located in the growth centres might be constrained by heavy competition with others.

Table 3-3: **Major Constraints Reported by Sample Enterprises**

	% of respondents				
	Very high constraint	High constraint	Moderate constraint	Low constraint	No constraint
Product marketing	1.98	6.67	17.30	21.08	52.97
Scarcity/high price of raw materials	5.34	19.27	29.77	24.81	20.80
Scarcity of fund	26.86	16.08	29.68	19.08	8.30
Competition with others	18.41	14.23	16.89	27.89	22.58
Low demand for the product in market	3.08	3.46	17.31	28.08	48.08

Source: InM, Microenterprise Survey 2016

Table 3-3 shows that fund inadequacy is the major constraint identified by the sample entrepreneurs. Only 8 percent of the enterprises report that fund scarcity is not obstructing at all. However, 27 percent enterprises report fund scarcity as very much obstructing enterprise development. Market competition may be identified as the second major constraint in enterprise development. Product marketing is identified as the least obstructing in enterprise development.

The above findings show the importance of financing in enterprise development. Putting much weight on this indicator by the entrepreneurs indicates that their demand for fund is not fulfilled. The projection of loan demand by the entrepreneurs is thus important to analyse the funding implications for the MEs. But, first we need to understand how the enterprise capital is actually financed at present.

3.4 Financial Structure of Enterprise Capital

Start-up financial structure

The start-up of enterprise activities usually requires a large amount of fund. Own savings could be the major source of this fund but enterprises also look for other sources of fund like borrowing from different sources. Those who have access to formal financing usually borrow from these sources. If the demand is not met from formal financial source or if the enterprises do not have access to formal financing, the enterprises usually borrow from different informal sources. If we consider the cost of fund, borrowing from informal sources is usually high so the enterprises would rationally choose to borrow from different financial sources. Finally, if all these external sources cannot meet the demand then the enterprise may be compelled to start with a smaller scale.

Table 3-4: **Sources of Financing Capital (%) at the Beginning of MEs**

	ME non-borrower	ME borrower	Total
Own savings/equity	77.55	79.83	79.54
Family loan	9.64	1.14	2.20
Loan from relative/friend	1.66	2.94	2.78
Loan from local lender	0.22	0.74	0.67
Bank loan	0.00	1.28	1.12
Buy equipment on credit	6.12	5.21	5.32
Loan from co-operative	0.00	0.00	0.00
Selling own property	1.39	3.37	3.13
Regular micro-credit from MFIs	0.00	0.61	0.53
Micro-enterprise loan from MFIs	0.00	3.10	2.71
Capital collected from partners	1.77	1.76	1.76
Others	1.66	0.02	0.23
Total	100	100	100
Total Capital (Tk.)	166,211	268,325	249,234

Source: InM, Microenterprise Survey 2016

If we look at the sources of financing of ME borrower and non-borrower at the beginning of the enterprise, we see that the share of fund coming from own savings of these two groups is not much different (see Table 3-4). Non-borrower enterprises collect a large share of the fund (nearly 18 percent) from various informal sources. The borrower enterprises collect about 10 percent from informal sources. Rest of the amount is collected through borrowing from MFIs and banks (for borrowing entrepreneurs) and by selling own assets and from other sources. It may be noted that not all of those who are ME borrowers at present were MFI members during the beginning of the enterprises. In our sample, only 25 percent of the borrower enterprises had membership with MFIs prior to or during the start-up of the enterprises. So during the start-up, we see very small contribution of MFI credit in the capital structure of current ME borrowers.

Financial structure at present

When the MEs start their operation, enterprise profit becomes one of the major sources of financing current capital. However, the scale of production is not likely to be expanded significantly through depending on profits alone. For expanding the scale, the enterprises have to invest additional amounts. In this expansion process, borrowing is likely to play a vital role. Those who have access to finance can increase the scale of production at higher rates than those who do not have any such access. Moreover, enterprises that have access to formal financial sources will depend less on informal borrowing.

Table 3-5: **Present Sources of Financing Capital**

	ME non-borrower	ME borrower	Total
Own savings/capital	83.70	83.07	83.11
Family loan	0.40	0.30	0.30
Loan from relative/friend	0.09	0.38	0.37
Loan from local lender	2.46	1.03	1.12
Bank loan	0.00	1.41	1.33
Buy equipment on credit	5.14	3.03	3.16
Loan from co-operative	0.00	0.06	0.05
Selling own property	7.07	0.48	0.88
Regular micro-credit from MFIs	0.09	0.18	0.17
Micro-enterprise loan from MFIs	0.00	8.33	7.83
Capital collected from partners	1.05	1.28	1.26
Others	0.00	0.46	0.43
Total	100	100	100
Total Capital (Tk.)	425,535	1,469,270	1,279,661

Source: InM, Microenterprise Survey 2016

Currently average capital amount is almost 1.3 million. Fixed asset consists of 44% of total capital and rest of the amount is working capital. Among the fixed assets, land and house value consist the major share. Land value consists of 43% of total fixed asset. Share of house and machineries and furniture consist of 23% and 12% of total fixed asset respectively. Inventory stock consist the major share of working capital (about 58%). If we look at the source of finance of capital at the current time, we find that the share of own savings/income is still the major source of fund (see Table 3-5). The share of own savings as the source of capital is actually higher than what it has been in the beginning. There is no difference between the borrowers and non-borrowers in this regard. But ME borrowers now fund a large share from MFI borrowing, particularly from ME loan. Non-borrowers still collect a larger amount of fund from informal borrowing. Another distinguishing feature is that the ME borrowers are not anymore selling asset to collect the fund for capital whereas the non-borrower enterprises collect almost 7 percent of their fund by selling their own property. This suggests that access to formal financing helps enterprises in preserving their other assets.

Even though, enterprises are using their own equity to finance their capital, still external fund is important for the expansion of enterprise activities. So this is important to understand characteristics of MEs who do not /cannot use external fund and rely more on financing from own equity.

Which MEs are more likely to use own equity?

From Table 3-5, it can be seen that own savings/income of the enterprise is the major source of funding for all enterprises, but the enterprises need to look for other sources of fund as well. . Whether an enterprise has access to finance, and particularly to formal finance, does matter in the expansion of scale of production. Those who do not have access to formal financing usually go for informal borrowing, which is usually costly, and some time at the cost of their other assets/property. It is important therefore to understand the determinants of use of own equity as the source of funding current capital. For the purpose, we regress the percentage of own equity in current capital on a number of possible determinants (Table 3-6).

Table 3-6: **Regression Results on Use of Own Equity**

	(1)	(2)
VARIABLES	Own equity (%)	Own equity (%)
Enterprise borrower	-0.216***	
	(0.0275)	
Lateral entrant		[Base]
2. Graduated members		-0.0678***
		(0.0237)
3. Non-borrower		0.188***
		(0.0290)
Female entrepreneur	-0.0406	-0.0259
	(0.0404)	(0.0404)
Age of entrepreneur	-0.00195*	-0.00201*
	(0.00117)	(0.00116)
Education of entrepreneur	0.00826***	0.00661**
	(0.00273)	(0.00277)
1. Unmarried	[Base]	[Base]
2. Married	0.0577	0.0542
	(0.0409)	(0.0406)
3. Widow	0.0692	0.0245
	(0.125)	(0.125)
Current asset value	8.24e-10	5.94e-10
	(1.28e-09)	(1.27e-09)
Experience in the enterprise	0.000474	0.000600
	(0.00128)	(0.00127)
Monthly profit	-1.98e-07	-1.97e-07
	(2.27e-07)	(2.25e-07)
Number of full time employee	0.00719**	0.00730**
	(0.00287)	(0.00284)
Constant	0.835***	0.662***
	(0.0585)	(0.0604)
Observations	476	476
R-squared	0.159	0.174

Standard errors in parentheses
*** $p<0.01$, ** $p<0.05$, * $p<0.1$
Source: InM, Microenterprise Survey 2016

From the results, it can be seen that borrower enterprises are less likely to use own equity as the source of capital compared with non-borrower enterprises (Regression 1). On the other hand, if we compare the non-borrowers with the lateral entrant borrowers, we see that non-borrowers fund more from own equity. However, graduate borrowers are less likely to use own equity to finance capital than lateral entrant borrowers (Regression 2).

Other than the borrowing status of the entrepreneurs, we find a significant positive relation of using own equity with the education of entrepreneurs and number of full time employees of the enterprises. The number of full time employee is a proxy of the scale of production. Higher the scale of production, more the number of employees would be. The regression results suggest that as the enterprises raise their scale of production, they are more likely to use their own equity. This is probably because at the higher production level, the enterprises can depend less on borrowing or the borrowing amount becomes a less significant share of total financial structure of capital. Similarly, education of entrepreneurs positively affects the scale of production showing a positive relationship between education and use of own equity.

Age of the entrepreneurs is negatively associated with own equity; entrepreneurs at young age are more likely to finance from own equity. At a younger age, entrepreneurs are likely to be more credit constrained, so they have to rely more on their own equity.

Why financial structure of capital is important? Those who have access to finance are less likely to use their own equity and this may have some relation in increasing their scale of production and productivity –which is ultimate goal of all enterprises. So next we will explore the role of access to finance on the scale and productivity of MEs.

Does access to finance matter in the scale and productivity of MEs?

From the earlier discussion, it is found that those who do not have access to finance have to rely more on their own equity. Also, they have to rely on borrowing from informal sources and sell their other assets to finance enterprise capital. In this subsection, we examine the issue whether access to finance matters for production and productivity of enterprises (Table 3-7).

Table 3-7: **Scale of Production of MEs by Borrowing Status**

	ME non-borrower	ME borrower	Total
Experience in present enterprise (years)	11.19	12.71	12.46
Asset value (Tk.)	143,938	789,855	668,604
Employment (No.)	2.05	3.50	3.23
Monthly profit (Tk.)	31,556	45,002	42,462
Monthly sales revenue (Tk.)	250,721	535,160	482,137

Source: InM, Microenterprise Survey 2016

In the sample, the average experience (years of operation) of borrower and non-borrower entrepreneurs does not differ much. On an average, the borrowing enterprises have 1.5 years of higher experience than non-borrowing enterprises. But the physical asset of borrowing enterprises is almost 5.5 times higher than non-borrowing enterprises. Total number of employment and monthly sales revenue of borrowing enterprises are almost double those of non-borrower enterprises. The profit amount is also high.

From the descriptive analysis we find that having access to credit does make some difference in profit of enterprises. Does that mean it also leads to higher productivity of labour and/or capital? For the purpose, we analyse the elasticity of capital and labour productivity with respect to access to credit from banks or MFIs. We measure labour productivity by dividing the annual profit by number of hired labour.

The regression estimation[8] will give us an estimate of the additional profit that is generated by increasing one unit of labour. The capital productivity is measured following the same approach. The capital productivity indicates how much profit is generated by increasing one Taka of capital[9].

The regression results are given in Table 3-8.

Table 3-8: **Effect of Access to Credit on Productivity of Labour and Capital in MEs**

Log of Labour Productivity		
Variables	Coefficient	Std. error
If the enterprise has access to credit	.3357902**	.1871215
If any training received by entrepreneur	.1613745	.1541181
Entrepreneur's age	-.0055678	.0065067
Entrepreneur's education	.0200268	.0171471
Operating years of the enterprise	-0.0187	0.0162
Log of Capital Productivity		
If the enterprise has access to credit	.3542233***	.1591865
If the enterprise is registered with municipality	.3227702	.0072939
Operating years of the enterprise	.0010639	.1548314

*** p<0.01, ** p<0.05, * p<0.1
Source: InM, Microenterprise Survey 2016

The analysis shows that access to credit has a significant positive impact on productivity of labour. It has also significant impact on capital productivity. It is observed that MEs with access to credit have 34 percent higher labour productivity than MEs with no access to credit. The result is significant at 5 percent level. It is also observed that having access to credit increases capital productivity of MEs by 35 percent and the result is significant at 1 percent level.

It may be noted here that we have not taken the small enterprises into consideration in this productivity analysis. One of the reasons for this is that our focus is on MEs. Also MEs have wider scope of scaling up through increasing productivity with the help of credit whereas small enterprises are likely to have slower growth compared with MEs. As noted earlier, around 95 percent of the capital is self-financed for small enterprises. This, however, should not be taken to mean that they are not credit constrained and credit will not help them to grow. Obviously, optimum size of capital does matter. Hence the impact of credit on capital and labour productivity is more evident for MEs. Besides access to credit, training and education also have a positive impact on labour productivity although not found statistically significant.

All these discussions clearly indicates that access to finance is very important for the expansion of MEs and the small entrepreneurs found not meeting their loan demand is the

[8] $Ln(Y/L) = \alpha_0 + \alpha_1$access to credit + α_2 training + α_3 age + α_4 education + α_5 firm's operating years + μ

[9] $Ln(Y/K) = \beta_0 + \beta_1$access to credit + $\beta_3$registration with municipality + $\beta_2$firm's operating years + Ω

major constraint to their enterprise development. Next we thus need to quantify the loan demand of MEs and how much of them were unmet.

3.5 Unmet Loan Demand: Evidence from the Survey

For deriving some information on the demand for loan, we collected information from the entrepreneurs regarding the volume of investment that they had planned to make over the last one year. Then we asked them how much of the planned investment they had intended to meet from institutional loan, informal loan and own equity. The amount they had planned to meet from the institutional source gives one measure of the demand for institutional loan.

We also asked the entrepreneurs how much they actually invested during the last one year and how much of it came from institutional loan, informal loan and own equity. The difference between the planned demand for loan and actual loan received gives one measure of the amount of unmet demand for institutional loan (Table 3-9).

Table 3-9: **Planned and Actual Investment and Borrowing of MEs**

	ME non-borrower	ME borrower	Total
Planned investment during last one year			
Investment amount planned (Tk.)	275,240	466,376	436,462
Planned share to come from institutional loan, %	4.81	58.59	50.17
Planned share to come from informal loan, %	2.62	2.80	2.77
Planned share to come from equity, %	90.60	35.90	44.46
Actual investment during last one year			
Investment actually realised (Tk.)	222,144	373,148	349,515
Actual share met by institutional loan, %	2.86	57.38	48.84
Percentage met by informal loan (actual) (%)	3.65	3.08	3.17
Percentage met from own equity (actual) (%)	81.34	34.73	42.02
Gap between planned and actual (%)			
Investment	19.29	19.99	19.92
Institutional loan	52.01	20.96	21.43
Informal loan	-12.44	11.22	7.64
Own equity	27.54	21.92	23.72

Source: InM, Microenterprise Survey 2016

The tables shows that ME borrowers planned to invest Tk. 466,376 on an average in their enterprises. Of the amount, planned borrowing from formal financial institutions was 59 percent. This gives us the demand for institutional loan of Tk. 161,263 on an average by ME borrowers. If we add the demand for informal loan, total demand for loan comes to Tk. 168,970 by the borrower MEs.

The non-borrower MEs also had some demand for loan from formal financial institution to finance their investment. The average investment amount planned for the last year by the non-borrowing MEs was Tk. 275,240. Out of this, their plan was to borrow Tk. 13,239 from formal financial institutions. The planned total demand for loan was Tk. 20,446 if we add the demand for informal loan.

Now, we estimate the amount actually invested in the MEs. The ME borrowers could invest Tk. 373 thousand over the last one year, almost 20 percent lower than their planned investment. Of the amount, Tk. 127 thousand came from borrowing from formal institutions. The loan from informal sources was Tk. 7 thousand. In aggregate, total borrowing for investment was Tk. 134 thousand. These figures give the total unmet demand for loan from formal financial institutions at Tk. 33,797 for the borrower MEs. The unmet loan demand is almost 21 percent of the loan demanded from the formal financial institutions. In total (including informal loans), the unmet loan demand is almost Tk. 35 thousand which is 21percent of the loan demand of ME borrowers. If this loan demand were met, the percentage difference between planned and actual investment would have been reduced to 7 percent.

Unmet loan demand of non-borrowing MEs is Tk. 6,879 which is about 52 percent of loan demanded from formal sources. Total unmet loan demand of non-borrower is Tk. 5,993 which is about 29 percent of loan demand of non-borrower enterprises. Unmet loan demand of non-borrower enterprises is higher than borrower enterprises. Having no access to formal financing is probably one major reason for such high unmet loan demand.

Table 3-10: **Determinants of Number of Employment in MEs**

VARIABLES	(1) Total number of employment
Investment amount (in million Tk.)	1.079***
	(0.295)
Dummy for microenterprise borrower	1.178**
	(0.493)
Female entrepreneur	-0.765
	(0.684)
Age of entrepreneur	0.00188
	(0.0193)
Education of entrepreneur	0.0150
	(0.0468)
Unmarried	[base]
Married	0.791
	(0.731)
Widow	0.211
	(2.136)
Constant	1.104
	(1.072)
Observations	559
R-squared	0.044

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1
Source: InM, Microenterprise Survey 2016

One important question is: why should we be concerned about unmet loan demand? One important reason is that the MEs would then be forced to invest less and operate at a lower scale of production. Operating at a lower scale implies both less production and employment.

For getting some insight on the above issue, we have regressed total employment in MEs on possible determinants. Particularly our interest is to see how much investment is required to generate a given amount of employment. The regression results show that, investment of Tk. 1 million in MEs generates 1.08 number of employment (Table 3-10). Later on, we shall estimate how much employment opportunity would have been generated in Bangladesh if the unmet demand of all MEs is met. This finding suggests that meeting the demand for ME loan is very important for the economy. If the demand for ME loan were met then the ME would have generated more employment.

Next we explore two issues: first, determinants of higher demand for loan, and second, entrepreneur whose demand is mostly unmet. Table 3-8 shows that ME borrowers have higher demand for loan and probably this is because they operate at higher scale of production. But we need to know whether rural or urban MEs demand more loans; whether graduate or lateral entrants demand higher loans; and which sectors have higher demand for loans. For analysing these issues, were gress the demand for institutional loan with all possible determinants of loan demand.

Table 3-11: **Determinants of Demand for Institutional Loan by MEs**

VARIABLES	Demand for institutional loan
Lateral entrant	[Base]
Graduate member	-2,879
	(18,659)
Non-borrower	-144,196***
	(22,513)
Enterprise located at rural area	-6,956
	(17,861)
Agriculture	[Base]
Trade	-1,452
	(25,365)
Service	-24,851
	(40,908)
Manufacturing	-27,830
	(33,796)
Female entrepreneur	-52,998*
	(31,235)
Age of entrepreneur	799.8
	(802.4)
Education of entrepreneur	9,494***
	(2,182)
Number of employment in enterprise	12,135***
	(1,991)
Constant	34,916
	(50,782)

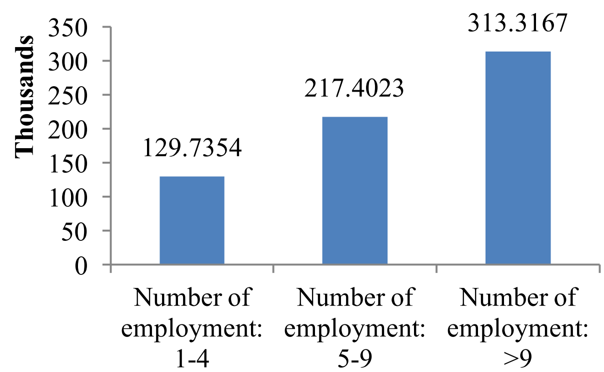
Observations	537
R-squared	0.202

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1
Source: InM, Microenterprise Survey 2016

Regression analysis shows that the (institutional) loan demand of non-borrower MEs is significantly lower than the lateral entrant borrowers. However, the demand for loan of lateral entrants and graduate members does not differ much. The demand for loan is smaller in rural area than in urban area but the difference is not statistically significant. Loan demand does not vary much over different sectors.

Female entrepreneurs demand less loan than male operated MEs. The demand for loan increases with education of the entrepreneurs. At the higher scale of production (indicated by higher number of employment), the demand loan will also be high. For one additional employment, the enterprise demands additional Tk. 12 thousand from formal financial institutions. Figure 3.1 shows how demand for loan increases as the number of employment increases in the enterprises.

Figure 3-1: Demand for Loan by Number of Employment



Next important issue is whose demand for loan is mostly unmet. From the previous discussion, we know that the proportion of unmet demand is larger for the non-borrowing MEs even though their demand for loan is small. We need to further investigate whether there is any sectoral or regional discrepancy in unmet loan demand. For this, we regress the unmet loan demand amount on possible indicators (Table 3-12).

Table 3-12: **Determinants of Unmet Loan Demand of MEs**

VARIABLES	Unmet amount of demanded loan
Lateral entrant	
Graduated member	-7,197
	(14,624)
Non-borrower	-35,093*
	(18,042)
Enterprise located at rural area	-7,053
	(14,074)
Agriculture	
Trade	-34,183*
	(19,931)

Service	-18,811
	(32,596)
Manufacturing	-34,530
	(26,490)
Female entrepreneur	-22,915
	(24,425)
Age of entrepreneur	642.3
	(636.0)
Education of entrepreneur	6,130***
	(1,720)
Number of employment in enterprise	5,259***
	(1,558)
Constant	-2,950
	(39,999)
Observations	529
R-squared	0.073

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1
Source: InM, Microenterprise Survey 2016

The analysis shows that the unmet loan amount of non-borrower MEs is less than that of lateral entrants. This is not surprising since the non-borrowers demand small amount so their unmet demand will also be small. There is no difference between lateral entrants and graduate members in terms of unmet loan demand. The geographical dispersion has no effect on unmet loan amount. Compared to agricultural sector, unmet loan demand of trade sector is low. This implies that agriculture sector might have been neglected by the supplier of institutional loan. In general those who have higher loan demand are more likely to have larger unmet loan amount.

Reasons for gap between planned and actual borrowing

We need to understand the gap between planned and actual borrowing from two perspectives. First, some enterprises cannot fulfil the loan demand because they do not have access to formal financing. For this group of MEs, the more relevant question is why they do not have any access to formal financing. Second, some enterprises have access to formal financing and they get loan from formal financial sources but not the amount they actually require. For this group of MEs, we need to explore whether there are any institutional limitations which create the gap between actual and planned borrowing. Probably these borrowers apply for lower amount of loan because of some institutional limitations; even though they have higher demand for loan. Or maybe they apply for what they need but the financial institutions reject his/her loan demand or approve smaller amount of loan.

In practice, both demand and supply side issues determine the access to credit. The argument is that, other things remaining constant, transaction cost of borrowing contributes to borrower's choice of a credit market. If firms or individuals have access to different credit markets, they will compare average cost of borrowing for each credit before making any decision to access the market. Essentially every borrowing decision reflects price behaviour. Even though some of the potential borrowers may not have applied for loan for risk reason, such risk factor becomes less important when interest rate and/or borrowing cost is reduced. Therefore, transaction cost of borrowing becomes one of the key determinants of access to credit. Transaction cost of borrowing includes both interest and non-interest cost.

The non-interest cost includes bribing, application fee, processing fee, conveyance expenses and time cost. Given average revenue from the project financed, a borrower will choose a lender based on accessibility and average borrowing cost. The borrower is confronted with several choices of markets – between banks, microfinance institutions and informal sources. Ladman's (1985) two lender case may be used to explain the choice of borrowing. For example, in case of choice between banks and microfinance institutions, given the unique characteristics of MFIs, should lender choose to borrow from MFIs, s/he will face high interest rate and low non-interest transaction cost. In contrast, if s/he chooses to borrow from banks, then there will be lower interest rate but higher non-interest transaction cost. Given these situations, decision to borrow from either of the lending institutions depends on two critical factors – loan size and average transaction cost. The simple two-lender case can be extended for any pair of lenders or any group of lenders.

Each credit market has unique characteristics and production technology. Banks require more paper work, documentation and collateral, thus, non-interest cost of borrowing is often high compared with other markets, given the loan size. Bank branches are not located in all places, so not all households can reach the formal credit market. In that case, ceteris paribus, non-interest cost will be high for the potential borrowers located far off from the nearby branch. On the contrary, presence of informal market is prevalent everywhere. Non-interest cost is expected to be quite low in informal credit market and every potential borrower can access this market.

The strong presence of informal credit market is due to the poorly developed formal credit market, and it still continues to exist despite wide expansions of MFIs. It is possible to access microcredit market from one's village or near-by home, and this should keep non-interest cost low. However, due to high operating cost, MFIs offer loans at reasonably high interest rate. Therefore, interest rate is lowest in formal credit market, it is higher in microcredit market and highest in the informal credit market. Given the lending interest rate and expected average borrowing cost, transaction cost of borrowing (interest cost plus non-interest cost) is expected to be high in informal credit market than in other two markets. If products are homogenous both in terms of characteristics and size, borrowers are more likely to borrow from microcredit. But this is not the case, products across markets are not homogenous; they vary in terms of nature and loan size. As such, firms or individuals will try to optimise transaction cost of borrowing.

To answer the question why enterprises receive a loan less than their demanded amount, we need to understand how they perceive the institutional arrangements of MFIs and banks. In our sample, we ask the microenterprise borrowers what they perceive to be the advantage and disadvantage of taking ME loan from MFIs. We ask them to identify three major advantage/disadvantages. We also ask them the disadvantage of taking ME loan from banks. Their perception reveals some important issues regarding the institutional arrangement of MFIs and banks.

Table 3-13: **Advantages of ME Loans from MFIs**

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
Easy to get loan	62.48%	15.47	12.38	90.33
Easy to repay instalment	25.15	52.22	12.96	90.33
Require less time to get loan	10.83	25.53	46.42	82.79
Interest rate is comparatively low	0.39	3.09	9.67	13.15
Limited loan-amount of microcredit	0.19	0.77	3.87	4.84
Others	0.97	0.19	0.00	1.16

Source: InM, Microenterprise Survey 2016

The majority of the borrower report that getting ME loan from MFIs is very easy and convenient and rank it as the number one advantage (Table 3-13). Second major advantage is easy repayment method. The borrowers do not have to travel to branch office to give the instalment. Third major advantage is that it requires less time to get the loan. It has to be noted that all these advantages of MFIs actually indicate low transaction cost associated with MFI loan. All these conveniences reduce travel cost and time of the borrowers.

Table 3-14: **Disadvantages of ME Loans from MFIs**

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
Not meeting the quantity demanded	23.65	7.50	6.92	38.08
Interest rate is high	57.88	23.27	4.81	85.96
Have to mortgage asset	3.08	7.50	8.27	18.85
Requires more time to get loan	2.50	2.88	2.50	7.88
Do not have long term loan	9.81	32.12	20.77	62.69
Cannot fulfil the demand for upper ceiling of loan	2.31	2.88	6.54	11.73
Others	0.77	0.38	0.77	1.92

Source: InM, Microenterprise Survey 2016

The borrowing entrepreneurs identified two major disadvantages of ME loan from MFIs (Table 3-14). First major disadvantage, as reported by MEs, is high rate of interest. Almost 58 percent enterprises identified it as the major disadvantage. This is probably the major reason why enterprises do not apply for higher loan even if they have demand for it. Another 24 percent enterprises identify inadequate amount of loan as the first major disadvantage of ME loan by MFIs. Second major disadvantage of ME loan, as identified by the enterprises, is not having loan for longer term. These disadvantages suggest that the MFIs should come out with some changes in their ME loan products and terms and conditions.

Table 3-15: **Disadvantages of ME Loans from Banks**

	% of respondents			
	Reason 1	Reason 2	Reason 3	Total
No bank in the nearest	16.79	3.69	2.95	23.43
Need many paper works	75.46	16.24	4.24	95.94
Banks do not want to provide ME loan	3.69	35.06	16.42	55.17
Loan conditions are not business friendly	2.77	27.86	23.62	54.24
Do not have the ability to provide mortgage	0.55	8.86	18.45	27.86
Others	0.55	0.18	0.92	1.66

Source: InM, Microenterprise Survey 2016

The major disadvantage of ME loan from banks is that it requires a lot of paper works and thus becomes infeasible for many micro-entrepreneurs (Table 3-15). The second major disadvantage is that, even if someone is willing to go through all these hassles of paper works, banks are somewhat reluctant to provide ME loans. And even if the banks agree to provide the loan, the loan conditions are not that much business friendly.

The disadvantages of MFIs and banks reported by entrepreneurs demand some institutional changes for these two groups of institutions. The MFIs need to change their ME loan product by adjusting interest rate, introducing longer term loan and increasing the loan size. The banks, first of all, should have willingness to lend to the micro-entrepreneurs. Secondly, banks should introduce easier way to apply for the ME loan by cutting paper works to the minimal.

In brief, there are some institutional and operational arrangement of banks and MFIs, which constrained the borrowers in availing more loans from these formal financial institutions. If some of these institutional arrangements could be relaxed or changed then this will affect the demand for loan as well. Understanding the sensitivity of demand for loan to these institutional tools like interest rate/loan ceiling is thus important which we will discussed next.

Sensitivity of ME loans to interest rate

In the previous subsection, we have identified high interest rate as the major disadvantage of ME loan of MFIs. In this context, it is important to examine the sensitivity of the demand for loan to changes in interest rate. For the sensitivity test, we have asked the entrepreneurs how much they would have demanded if the interest rate decreases by 10 percent. Alternatively, we have asked them how much they would have demanded if the interest rate increases by 10 percent. Table 3-16 summarises the demand for loan if interest rate increases or decreases by 10 percent. Actual loan amount borrowed during the last one year is almost Tk. 214 thousand. Clearly, the average demand increases substantially when the interest rate decreases by 10 percent. It also declines sharply if the interest rate rises by 10 percent. We calculate the elasticity of loan demand to interest rate from the information.

Table 3-16: **Sensitivity of Loan Demand to Interest Rate for MEs**

	Amount in Tk.
Loan demanded if existing interest rate reduces by 10 percent (L_1)	334,467
Loan demanded if existing interest rate increases by 10 percent (L_2)	98,614
Actual borrowing amount during last one year (L_0)	119,580

Source: InM, Microenterprise Survey 2016

The elasticity of demand shows how much a product is sensitive to change in its price. If, for example, price changes by 10 percent and the quantity demanded changes by less than 10 percent, then the demand is inelastic and if the quantity demanded changes by more than 10 percent then the demand is elastic[10].

We calculate the value of price change and change in loan amount as follows:

$$(P_1 - P_0)/_{P_0} = -10\%$$
$$(L_1 - L_0)/_{L_0} = \frac{334467 - 119580}{119580} = 180\%$$

From the above calculations, we find that demand elasticity is 18. This implies that, the loan demand will increase by 18 percent if interest rate falls by 1 percent.

We can also check what happen to the elasticity if interest rate falls.

$$(P_0 - P_2)/_{P_0} = 10\%$$
$$(L_0 - L_2)/_{L_0} = \frac{98614 - 119580}{119580} = -18\%$$

From the above calculation, we find that demand elasticity is 1.8. This implies that, the loan demand will decrease by 1.8percent if interest rate increases by 1 percent.

This analysis shows that the demand for loan is highly elastic to the interest rate. This information is useful for adjusting the interest rate and projecting the changesindemand for institutional loan due to interest rate adjustments.

Does loan ceiling of MFIs affect loan demand?

[10]Following equation gives the formula of estimating the elasticity of demand:

$$Demand\ elasticity = \frac{(L_1 - L_0)/_{L_0}}{(P_2 - P_0)/_{P_0}}$$

In the above equation, L_0 is the loan amount borrowed in the existing interest rate and L_1 is the demand for loan if the interest rate decreases by certain amount. Numerator of this equation thus gives the percentage change in loan demand if the interest rate decreases. The denominator is, as per our questionnaire, -10 percent.

At present, Tk. 1 million is the ceiling of ME loan by the MFIs. However, only a few entrepreneurs are provided loans at the ceiling amount. At the branch level, loan ceiling of MFIs is even lower. We have enquired from the entrepreneurs what would have been their loan demand if there were no ceiling of MFI loans from the MFIs. Not necessarily every entrepreneur would like to have loan amounts exceeding the ceiling. The amount of loan demand depends more on the current scale of production. Therefore, all MEs may not have demand for high volume of loan. However, a relaxation in the upper limit of loan may increase the demand for loan of certain borrowers. From the survey, it appears that the average loan demand would have been Tk. 406 thousand if there were no upper limit on loan (Table 3-17). However, they actually borrowed Tk. 214 thousand during the last one year. The results show that the loan demand would have been 90 percent higher if there were no ceiling on ME loan.

Table 3-17: **Loan Demand in Absence of Loan Ceiling**

Average loan demand per ME in absence of loan ceiling (Tk.)	406,397
Actual borrowing per ME over last one year with ceiling (Tk.)	214,112

Source: InM, Microenterprise Survey 2016

Future plan of surveyed MEs

During the survey, the MEs were asked about the intended volume of investment over the next one year. They were also asked about the intended amount of borrowing from formal institutions during the coming year. On average, the ME borrowers' intended investment is Tk. 439 thousand out of which they want to borrow Tk. 236 thousand which is about 54 percent of the planned investment (Table 3-18). The non-borrower MEs, on the other hand, though plans to invest smaller amount, still they would like to have 18 percent of their investment financed through borrowing from financial institutions.

Table 3-18: **Future Planned Investment and Loan Demand by MEs**

	ME non-borrower	ME borrower	Total
Planned investment per ME over next one year, Tk.	179,350	439,455	405,613
Planned demand for ME loan during next year, Tk.	33,071	236,236	209,802

Source: InM, Microenterprise Survey 2016

If the planned demand for the next year is compared with the loan amount of the last year, it is seen that the demand for loan as a share of total planned investment has not changed much for the ME borrowers. On the other hand, for the non-borrower MEs, this has increased from 5 percent of investment in the last year to 18 percent for the next year. The implication is that the current non-borrowers are more likely to participate in the formal financial market in future. Therefore, it would be important to consider the demand for loan of those currently non-borrower MEs as well while projecting the total demand for ME loan in future.

3.6 Aggregate Demand for ME Loan

In this section, aggregate demand and supply of ME loan will be calculated using different perspectives. The main objective will be to estimate the possible gap between supply of and demand for ME loan. The suppliers may be constrained by the availability of fund. Because of the fund constraint, they might not be able to supply additional ME loan. So we need to estimate the likely aggregate demand for ME loan. Our purpose here is to estimate the total demand for loan by MEs using information from the sample survey.

Demand for additional fund by MFIs

During discussion with MFIs regarding the problems and prospects of micro lending by MFIs, we have collected information from the MFIs which, among others, cover information on total ME loan disbursement and their demand for additional fund for ME loan. The MFIs represented three size groups: large, medium and small. A total of 18 MFIs provided the information.

We find that these 18 MFIs have disbursed a total of Tk. 35.47 billion as ME loan over the last one year. In response to the question of how much additional demand they had for ME loan, the additional demand of the MFIs comes to a total of Tk. 21.36 billion. The ratio of total demand to actual disbursement thus comes out to be 0.60. We would like to use this ratio to calculate total additional demand for fund by the MFIs.

The total disbursement of ME loan by MFIs in 2014 was almost Tk. 177 billion. Using the trend of ME loan disbursement from year 2011 to 2014, the projected total loan disbursement in 2015 is Tk. 196.24 billion. Based on the collected information, the ratio of fund demand over actual disbursement is 0.60. So, the total demand for additional fund by MFIs would be Tk. 117.74 billion. If MFIs get this fund, total disbursement of ME loan by MFIs would be around Tk. 314 billion.

Estimating total demand for ME loan by enterprises

For the projection of ME loan demand by enterprises, firstly, we need to identify the total number of MEs who would demand loan, and secondly, we need to estimate the average volume per ME loan which is robust enough to make the projection. Table 3-19 gives the total number of enterprises in Bangladesh as per the BBS Economic Census 2013.

Table 3-19: **Total Number of Enterprises, 2013**

	Employment size	Urban	Rural	Total no. of enterprises	% of total
Cottage	1-9	1,730,150	5,112,734	68,42,884	87.52
Micro	10-24	41,112	62,895	1,04,007	1.33
Small	25-99	450,601	408,717	8,59,318	10.99
Medium	100-250	4,141	2,965	7,106	0.09
Large	>250	3,542	1,708	5,250	0.07
Total		2,229,546	5,589,019	78,18,565	100

Source: BBS, Economic Census 2013

Table 3-20 gives the employment structure of the ME survey conducted by InM under the present study. It is evident from the table that any robust *estimate of total loan demand can only be made for cottage and micro-enterprises only in view of the sample coverage.* The number of enterprises in the small enterprise group is very few (only 1 percent of total sample). Also, the objective of the present study is to estimate the total demand foe ME loan alone. From Table 3-19, we thus have a total population of 6,946,891 enterprises, for which we can estimate the loan demand from our sample survey.

Table 3-20: **Number of Enterprises by Employment Size and Average Loan Demand**

	Employment size	Urban	Rural	Total
Cottage	1-9	383	187	570
Micro	10-24	20	6	26
Small	25-99	1	3	4
Medium	100-250	404	196	600

Source: InM Microenterprise Survey 2016

The next important issue is, whether our sample is sufficient enough to predict the population. In Table 3-21, we show the required sample size for the given population at different confidence intervals. Smaller confidence interval means higher level of precision. Table 3-21 suggests that our sample size is good enough to predict the actual population at the margin of plus-minus 4% error. Usually, most of the surveys allow confidence interval of 5%.

Table 3-21: **Required Sample Size for Given Population**

Population	Confidence level (%)	Confidence interval (%)	Required sample size
6,946,891	95	6	267
6,946,891	95	5	384
6,946,891	95	4	600
6,946,891	95	3	1,067

Source: InM Microenterprise Survey 2016

During the survey, we have collected information on how much loan they actually received and how much loan was actually needed for the MEs. The total of the actual need for loan gives the total demand for ME loan in the year for the sample MEs. In the earlier subsections, we have already reported the loan demand at the borrower level. Table 3-22 reports the loan demand of different sized enterprises (cottage and micro) at different locations (urban and rural). Enterprises with higher employment have higher demand for loan. Also enterprises located in urban area have higher demand for loan than those located in rural area.

Table 3-22: **Average Demand for ME Loan (Tk.)**

	Employment size	Urban	Rural
Cottage	1-9	107,710	104,283
Micro	10-24	228,750	133,333

Source: InM Microenterprise Survey 2016

We therefore calculate the total demand for ME loan using following formula:

$Total\ loan\ demand = \sum_{i=1}^{4} Totalnumberofestablishmenti \times Averageloandemand\ i$

In the above equation, *i* refers to different sizes of enterprises in different areas. We get total number of establishment from BBS survey (Table3-19) and average loan demand from the sample survey (Table 3-22). It is important to note that we assume the total number of establishments is fixed. From the above formula we get the total demand for loan for MEs which is summarised in Table 3-23.

Table 3-23: **Aggregate Demand for ME Loan**

	Total number of enterprises		Average loan demand (Tk.)		Total loan demand (Tk. in billion)		
	Urban	Rural	Urban	Rural	Urban	Rural	Total
Cottage (total number of employment:1-9)	1,730,150	5,112,734	107,710	104,283	186.35	533.17	719.52
Micro (total number of employment:10-24)	41,112	62,895	228,750	133,333	9.40	8.39	17.79
						Total	**737.31**

Source: BBS, Economic Census 2013 &InM Microenterprise Survey 2016

The amount we get from this projection is much higher than the actual supply of ME loan by banks and MFIs. Total ME loan outstanding of MFIs in 2015 (projected) was Tk. 123.27 billion. Total ME loan outstanding by banks in 2015 were Tk. 176.65 billion. So total loan supply to MEs was Tk.299.92 billion and demand-supply gap was Tk. 437.39 billion in 2015.[11]

Table 3-23 also shows that total demand for ME loan is higher in rural area particularly because cottage/MEs are concentrated in rural area. The implication of this observation is that the policymakers need to identify efficient mechanisms of loan disbursement in the rural area. Banks have thin presence in the rural area. Because of their operational mechanisms, banks do not have adequate incentives to operate in the rural area. The MFIs, on the other hand, have successfully brought the rural people under the financial system. Meeting the unmet loan demand of MEs will thus critically depend on how best the MFIs can be involved in these operations.

Obviously, like any other projection, our estimations also have some limitations. We have already observed that the non-borrowers have lower demand for ME loan. While predicting the loan demand, we have not considered the borrowing status of the MEs. Since there is no information on the borrowing status of enterprises in the BBS Census data, we are unable to determine the share of MEs who has access to formal finance. If the non-borrowing MEs have a large share, then there will be over-estimation in the total demand for ME loan.

[11]For consistency check, we also calculated the loan demand in different ways. It may be argued that the respondents may overestimate while reporting the demand/requirement for ME loan. We therefore calculated what would have been the minimum loan demand of the MEs. To calculate the minimum loan demand, we took the total of actual loan amount received from formal and informal financial sources. Informal borrowing is much costlier than formal borrowing. So we assumed that the enterprise would borrow from informal sources only when the demand for loan was unmet from formal sources and he/she was forced to borrow for the ME. So this total may be taken as the minimum loan demand of enterprises. From this alternative definition of loan demand, we found that total demand for loan by the MEs was Tk. 690.62 billion. So the conservative estimation of total demand for ME loan is quite close to our estimate.

3.7 Conclusions

Over the years, both banks and MFIs are increasing their ME loan portfolio. In 2015, total outstanding loan of banks and MFIs together is Tk. 299.92 billion. Is this amount sufficient for the MEs? How much of their loan demand is unmet? This chapter explores the gap between demand and supply of ME loan.

To measure the loan demand of MEs, a ME survey has been conducted. Total number of enterprises in the sample is 600, comprising both borrowing and non-borrowing enterprises. Borrowing enterprises consist of graduate members and lateral entrants in MFIs.

First we examine whether there is any difference among borrowing and non-borrowing enterprises in terms of financial structure of capital. We find that own equity is the major source of fund of capital at the beginning of the MEs. If the enterprises do not have access to formal credit, then rest of the amount is funded by borrowing from informal market.Non-borrowers are more likely to use own equity to finance the capital in the current time. Graduated borrowers use own equity less than the lateral entrant borrowers. At higher production level, the firm is more likely to fund the capital from own equity. We also analyse whether access to finance has any impact on production and productivity of enterprises. We find that access to finance matters in increasing scale of production and productivity of labour and capital.

Some Key Findings

2. Inadequate availability of fund for investment is identified as the major constraintin enterprise development.
3. Own equity is the major source of fund of capital at the beginning of enterprise activities. Those who do not have access to finance are more likely to depend on own equity at the current time.
4. Access to finance increases labour and capital productivity of enterprises.
5. Entrepreneurs are not likely to fully realise their planned investment because of unmet loan demand.
6. Various institutional and operational arrangements of banks and MFIs contribute to unmet loan demand of ME borrowers. High interest rate, insufficient loan amount and short term loan are the major problems of MFIs relating to ME loan. Too many paper work, low willingness to disburse ME loans and the complex loan conditions are major disadvantages of ME loans of banks
7. Demand for loan is highly elastic to changes in the interest rate.
8. Demand for loan by CMEs is estimated at Tk. 737 billion in 2015 which is almost 2.5 times higher than the total supply of ME loan by banks and MFIs during the same year. Considering the declining trends of interest rate, it is likely that the demand for ME loan will increase further.

When we look at the investment planning of the enterprises, we find that the enterprises cannot fully realise the investment amount they had planned for. Unmet loan demand results in lower investment than planned which adversely affects output and employment growth. Demand for loan of lateral entrant and graduate member does not vary much but their demand is significantly higher than non-borrowers. The demand does not vary significantly over rural-urban or over different sectors like trade, manufacturing, service and agriculture. Higher the demand for loan higher the unmet loan demand is. Compared to the agriculture sector, unmet loan demand of trade sector is low. This indicates that agricultural sector might have been overlooked by the supplier of institutional loan.

We then look at how borrowing enterprises perceived about the advantage and disadvantage of ME loan from MFIs and banks. To them, easy loan access, convenient repayment system and quick processing of loan are the major advantages of ME loan from MFIs. High interest rate and not having longer term loan is identified as the major disadvantage of ME loan of MFIs. Insufficient amount is also an issue for a number of entrepreneurs. Too many paper works, not willing to give ME loan at all and the complex loan conditions are the major disadvantages of ME loan of banks.

We also calculate the demand elasticity of loan to interest rate change. We found that, demand for loan is highly elastic to interest rate. For 1 percent decrease in interest rate, the loan demand will increase by 18 percent. The loan demand would have been 90 percent higher if there were no upper ceiling of ME loan.

Finally, we estimate the aggregate demand for loan at two levels. Firstly, we estimate what is the demand for additional fund by the MFIs for ME loan. We find that the demand for additional fund is Tk. 117.74 billion by MFIs which is about 60 percent of their current disbursement. Next, we estimate the aggregate demand for loan by the enterprises. Given the size of the enterprises in the sample survey, we can only estimate the loan demand of cottage and micro-enterprises. Based on the average loan demand from the sample survey, total demand for ME loan in 2015 was Tk.737.3 billion. The demand comes more from rural areas. Even if we measure the loan demand in a conservative manner, the minimum aggregate demand for ME loan would be Tk. 690.6 billion. Our interest sensitivity analysis of demand for micro credit shows that a one-percent decreases in interest rate will increase demand for credit by 5.6 percent. With such elasticity, and considering the decreasing trend of interest rate, demand for micro-enterprise credit will increase further. In this context, our estimates of projected demand for credit should be viewed.

Chapter 4
Meeting the Demand for ME Loan: Searching for Strategies

4.1 Introduction

From the previous chapter, it can be seen that the demand for ME loan is quite high, especially relative to the present availability of funding. The estimates are based on two critical assumptions: (i) current growth of MEs will be sustained; and (ii) the demand for ME loan will also grow accordingly. Such assumptions have been made based on the understanding that demand is constrained by supply side constraints. We have estimated the demand using different approaches. Moreover, the estimates may be considered as conservative since no major structural change in the composition of enterprises has been taken into account. Even with conservative estimates, it is seen that there is a huge demand-supply gap.

Within the above framework, the present chapter is structured into four sections covering institutional sources and credit deepening for financing MEs. In section one, we provide an analysis of ME financing policies and credit deepening of formal bank credit market. In this section, we show that banks have limited ability to finance MEs because of their primary objective of profit maximisation through reducing transaction cost of lending and operational policy constraints. In section two, we focus our analysis on policies of MFIs and credit deepening in micro credit market. We also show that MFIs are better equipped to finance MEs but they are unable to meet the demand for ME credit because of their liquidity and policy constraints. In the remaining sections**,** we discuss policy options to remove the constraints that restrict developing and financing of MEs in Bangladesh.

The formal credit market comprises bank credit market and micro credit market. Institutions operating in these two credit markets operate with different policy objectives. Profit maximisation is the basic objective of banks and non-bank financial institutions through minimising transaction cost and default cost given lending interest rate. On the other hand, MFIs get prominence because of their ability to provide financial services to poor households, who are subject to failures of the bank credit market in providing access to them. Formal banks attain its objective of profit maximisation following strategies of providing large and medium sized loans to firms and individuals at the branch level. On the other hand, MFIs provide microcredit at the doorsteps of the borrowers at a relatively high interest rate in order to cover high operating cost. As these MFIs are social-equity held institutions, they operate perhaps at a ‘satisfying’ profit level. Given these behavioural differences, we discuss the policies for financing MEs and ME credit deepening in Bangladesh. This will enable us to understand the credit market that can be feasible for financing MEs. Therefore, we discuss bank credit market and micro credit market separately.

4.2 Bank Credit Market: Institutional Policies and ME Credit Deepening

The banking sector in Bangladesh has been liberalised over the years. The allocation of resources among different loan portfolios, and fixation of lending interest rates are set by individual bank. The Bangladesh Bank offers policy guidelines and often pursues 'moral persuasion' to direct credit services in growth-oriented socially desirable economic activities. Bangladesh Bank formulates credit policies and programmes for different targeted sectors with assigned credit floor for different participating financial institutions with the ultimate objective of accelerating growth. Among others, credit policies for agricultural sector and industrial sector are noteworthy.

SME credit policies and ME financing

Bangladesh Bank formulates industrial credit policy particularly focusing on small and medium enterprise (SME) development. Such policy complements the implementation of industrial policy of the Government of Bangladesh (GoB). The latest industrial policy that is still in effect is that of 2010 known as "Industrial Policy 2010". In order to understand clearly the position of MEs in industrial credit, we need to have a brief discussion of the SME credit policies, followed by the modifications or amendments made in 2015.

The SME credit policies

Bangladesh Bank (BB) for the first time formulated the SME Credit Policy 2010 with specifications of the approaches to SME development, cluster development and targeted credit programme. The basic features of the policies are as follows:

(i) A targeted amount of Tk.239.9 billion as SME credit was earmarked for the development of SMEs in Bangladesh;

(ii) SME loans should be disbursed to small, medium and women entrepreneurs with priority focus on small and women entrepreneurs;

(iii) The policy requires banks to dedicate at least 40 percent of total disbursement target for SME credit;

(iv) Women entrepreneurs are given priority in the policy. As a part of the policy, banks and financial institutions are required to establish a separate 'Women Entrepreneurs' Dedicated Desk" at the bank and branch level;

(v) Preferential interest rate of not more than 10 percent for the women entrepreneurs (five percentage points in excess of bank rate);

(vi) The policy enables SME lending institutions to refinance 100 percent of the SME loans for manufacturing and service sector, and at least 15 percent of total BB refinance fund for SMEs for women SME lending; and

(vii) Finally, loan ceiling of Tk.5 million with credit floor of Tk.50,000 was imposed for the small entrepreneurs.

The above SME credit policies and programmes have significantly focused on small and women enterprises with targeted industrial development along with diversity and regional growth. How far could the policy achieve financing for small and women enterprises? This question has always been raised on the ground that banks would tilt towards providing more loans to medium enterprises than small and women enterprises due to low transaction cost and collateral driven presumably more secured 'medium enterprise' loans.

Table 4-1: **Cumulative Disbursement of SME Loans, 2011-2014**

(Taka in billion)

Description	2011	2012	2013	2014	2015 (Sept,)
SME loans disbursed	537.2	697.5	853.2	1009.1	819.5
Loans for small enterprises	258.5 (48.1)	378.8 (54.3)	443.1 (51.9)	525.8 (52.1)	421.4 (51.4)
Loans for women enterprises	20.5 (3.8)	22.2 (3.2)	33.5 (3.9)	39.4 (3.9)	25.2 (3.1)
Rural enterprises	143.9 (26.8)	166.2 (23.8)	198.2 (23.2)	254.1 (25.2)	179.8 (21.9)

Note: Figures in parentheses percentage of SME loans disbursed
Source: Schedule Bank Statistics, Bangladesh Bank, 2013-15.

Table 4-1 provides information on the trend in SME loan disbursement by banks and non-bank financial institutions. Several well-known findings are derived. First, a little over 50 percent of the loans were disbursed to small enterprises. Second, SME loans of the banks are overwhelmingly urban biased. Almost three-fourths of the SME loans at the end of 2014 were disbursed in urban areas. The argument for small and ME development emanates from the need for developing rural economic activities and creating employment opportunities and the perspective of financial inclusion.

From this perspective, the 2010 SME Credit Policies perhaps could not capture critical goals of SME development, and in particular for small and women enterprises. Despite policy incentives for the banks and financial institutions, women enterprises have very limited access to bank credit. However, average loan size over the period 2011-14 has steadily increased; it increased from Tk.1.68 million in 2011 to Tk.1.86 million in 2014. All these results suggest that banks are more oriented to provide SME loans to urban borrowers and more inclined toward providing higher loan. Such behaviour is consistent with profit maximising objective of the lenders.

MEs in SME credit policies: Amendments in 2015

The missing element from the policy was ‘micro-enterprises’. ME development has always been considered as a vehicle for economic growth with large-scale employment opportunities and potential forward and backward linkages. It is reported in Chapter 2 that more than 90 percent of economic establishments in Bangladesh are MEs. In order to promote micro and small enterprises in the country, Bangladesh Bank amended the SME credit policies of 2010. The SME and Special Programmes Department (SMESPD) issued circular 4 on 14 July 2015, regarding financing of SMEs. The amendments of the circular 4 in December 2015 were to incorporate core definition of medium, small and micro-enterprises as identified in the Industrial Policy 2010 and also to identify the process of financing micro and women enterprises. Even though we have discussed the criteria of defining these enterprises in the previous chapters, we reiterate those here in order to understand the issues in a cohesive manner.

The 2010 SME credit policy was focused on medium and small enterprises with priority treatment for women entrepreneurs. The amendments of the SMESPD circular 4 incorporated cottage and micro-enterprises as defined in the Industrial Policy 2010. The criteria for classifying enterprises are number of employees, investment size and loan size. It is shown in Table 4-2.

Table 4-2: Criteria for Enterprise Financing by Bangladesh Bank

Type	Attribute	No. of employees	Total Assets (Tk. In Million)*	Minimum Loan Size (Tk.)
Micro	Service	< 10	Less than 0.50	20,000
	Trading	≤ 5	Less than 0.50	
	Manufacturing	10 to 24	0.50 –5.0	
Cottage		≤ 10**	Less than .0.50	10,000
Small	Service	10-49	0.50-10.00	50,000
	Business/Trading	6-10	0.50 – 10.00	
	Manufacturing	25-99	5.00-100.00	
Medium	Service	50-100	10.00-150.00	No credit floor is defined
	Trading	11-50	10.00-150.00	
	Manufacturing	100-250	>100.00	

*Excluding land and building including replacement cost
**Including family members
Source: Amendments to Circular 4, Department of SME and Special Programmes, December 2015.

The criteria are diverse. They are not mutually exclusive. In the case of any conflict of enterprise type for the same enterprise using different criteria, the enterprise will be considered as enterprise of higher type. For example, if an enterprise is identified as micro-enterprise based on one criterion, and is identified as 'small' enterprise based on other criteria, in such a situation, enterprise will be classified as 'small'.

Financing of SMEs under the policy

Under the policy, BB requires that all banks and non-bank financial institutions should have at least 20 percent of total loan portfolio, and the share shall be increased to 30 percent in the following five years. It will not be effective until lenders are able to reduce transaction cost. Recognising potential high transaction cost, the policy strongly encourages all banks and non-bank financial institutions to use the services of NGO-MFIs and 'agent banking' in financing micro, cottage and small enterprises. Such policy recommendation would appear to be effective for expanding financial services particularly to rural areas. Interest rates should be preferential. The amended policy strongly encourages lenders to lend to women entrepreneurs.

The policy encourages lending institutions to finance micro, cottage and small enterprises through refinancing of loans at the bank rate. Full refinancing of agriculture-related MSMEs (Micro, Small and Medium Enterprises) will be available. Similarly, a maximum of 100 percent refinancing for other MCSEs (Micro, Cottage, and Small Enterprises) will be available subject to availability of fund. Preference for refinancing of rural MSME loans is set in the policy. However, refinancing for individual small enterprise loan will have a ceiling of Tk.5 million. The ceiling stands at Tk.0.5 million in case of cottage enterprise loan, and Tk.2 million for micro-enterprise loans. Micro and cottage loans are collateral free with a ceiling on loan of Tk. one million. Personal and/or third party guarantee will be required for loans with maximum of Tk.2.5 million.

In brief, the revised policies for MSME financing have some positive features with significant emphasis on rural micro and cottage enterprise development as well as requirement for increasingly higher share of MSME loans in total loans. The critical issue is the behaviour of banks and non-bank financial institutions.

Loan portfolio analysis of banks and non-bank financial institutions

The ultimate behaviour of banks and non-bank financial institutions can be better explained if we examine the portfolio behaviour of these lenders. Several questions are addressed in the portfolio analysis. As MSMEs are under the 'industry' sector, our first issue is to find out the share of industrial credit in total loans. The second issue is the composition of different segment of MSME credit in total industrial credit.

Banks and non-bank financial institutions offer loans to finance different sectors and sub-sectors. Not all institutions provide all types of loans; and even if they do, the proportion of each loan varies because of the intended objective of the lending institution. Table 4-3 provides portfolio mix of the loans for the period 2013-2015.

Table 4-3: **Loan Portfolio of Banks and Non-bank Financial Institutions, 2013-15**

(Taka in billion)

Sector	Dec'2013	Dec'2014	Sep'2015
Agriculture, fishing and forestry	248.17	258.01	304.19
	(5.59)	(5.08)	(5.57)
Industry	1493.22	1742.73	2038.58
	(33.64)	(34.33)	(37.36)
Construction	396.57	442.09	478.26
	(8.94)	(8.71)	(8.76)
Transport	51.01	54.21	42.47
	(1.15)	(1.07)	(0.78)
Trade & commerce	1742.01	1981.50	1989.38
	(39.25)	(39.03)	(36.46)
Other industrial loan	75.12	93.39	99.11
	(1.690	(1.84)	(1.82)
Consumer finance	295.95	451.17	465.35
	(6.67)	(8.89)	(8.53)
Miscellaneous	136.37	53.15	39.72
	(3.07)	(1.05)	(0.73)
Total	4438.44	5076.27	5457.08
	(100)	(100)	(100)

Note: Figures in the parentheses represent percentage of column total.
Source: Schedule Bank Statistics, Bangladesh Bank, 2013-15.

Two key sectors (industry and trade & commerce) constitute over 75 percent of the total loans. But the share of cottage and small enterprises is very insignificant (less than one percent in both 2013 and 2015) (Table 4-4). But the question is, what is the composition of

Table 4-4: **Loan Disbursements by Loan Type, 2013-15**
(Taka in Billion)

Type of loan	Industry	Dec'2013	Dec'2014	Sep'2015
Term loan	Total	764.3	804.3	967.9
	Large	431.0	498.8	530.9
	Small & medium	262.4	197.5	270.4
	Cottage/micro	0.7	28.3	4.6
	Service	70.1	79.7	162.0
Working capital loan	Total	728.9	938.4	1070.6
	Large	415.2	513.5	603.7
	Small & medium	190.4	286.5	286.9
	Cottage/micro	4.1	5.3	9.6
	Service	119.1	133.1	170.3
Aggregate	Total	1493.2	1742.7	2038.6
	Large	846.3 (56.67)	1012.3 (58.09)	1134.7 (55.66)
	Small & medium	452.8 (30.33)	483.9 (27.77)	557.4 (27.34)
	Cottage & micro	4.9 (0.33)	33.6 (1.93)	14.2 (0.70)
	Service	189.2 (12.67)	212.8 (12.22)	332.3 (16.30)

Note: Figures in the parentheses indicate percentages of column aggregate total.
Source: Scheduled Bank Statistics, Bangladesh Bank, 2013-15.

MSME loan portfolio? Which institution provides relatively more micro and cottage enterprise loans? Bank statistics show that only around 11 percent of the MSME loan outstanding by the end of September 2015 was micro and cottage enterprise loans (Table 4-5).

Table 4-5: **Distribution of SME Credit Outstanding by Type in Financial Sector, 2015**
(Percent)

	State owned banks	Specialised banks	Foreign banks	Islamic banks	Private com banks	All banks	NBFIs	Total of the financial sector
Medium enterprise	52.25	11.53	52.98	52.70	43.10	48.08	44.40	47.94
Small enterprise	45.50	55.90	16.17	28.11	50.67	41.23	45.83	41.40
Cottage enterprise	0.06	5.63	0.11	10.53	0.10	3.86	0.11	3.72

Micro-enterprise	2.19	26.93	30.74	8.66	6.12	6.83	9.66	6.94
Total SME loans outstanding (Tk in billion)	242.95	10.68	19.12	474.88	583..93	1331.58	51.72	1383.30

Source: Scheduled Bank Statistics, Bangladesh Bank, September 2015.

These results do suggest that banks have been financing mostly large enterprises. Both medium and large and medium enterprise loans constitute almost three-fourths of the loans disbursed and outstanding. The contribution of banks and non-bank financial institutions in financing cottage and micro-enterprises is very negligible. Of the total loan disbursement of Tk.2,038 billion in 2015, only around 45 percent was MSME loans. As noted above, of the MSME loans, only around 11 percent was cottage and micro-enterprise loans in 2015. This raises serious question of financing cottage and micro-enterprises through banks and non-bank financial institutions. But why banks cannot finance cottage and micro-enterprises? We had a discussion with the banks and the Bangladesh Bank on the issue of constraints to financing through banks.

Constraint to financing MEs: Banker's perspectives[12]

During the discussion, it emerges that the perception of the banks are quite consistent with the perceived notion. Several factors are identified as constraints to financing MEs.

First, demand for large, medium and small enterprise credit is sufficiently high. Financing these sectors contributes to both economic growth at a faster rate and higher return on lending.

Second, borrowers in most cases are not able to provide collateral and documents as well as financial information. This makes the ME loans risky for the banks.

Third, banks have limited ability to monitor activities and repayment behaviour of ME borrowers beyond the level of convenience of the branch management, for lack of sufficient branch level staff.

Fourth, with the existing branch network, banks are not able to reach out to the cottage and micro-enterprises. In the event it is done, transaction cost of lending and probability of default cost will increase which ultimately will be costly for the banking sector.

Fifth, cottage and micro-enterprise borrowers are less financially literate to comply with the terms and conditions of loans.

Despite such realistic assessment of their constraints, the participants in the dialogue thought that banks should be able to serve some segments of MEs that operate within the operating areas of a branch. Although this is part of SME credit policy, banks can continue

[12] The InM Research Team held a discussion meeting on 29 March 2016 with the officials of SMESP Department of Bangladesh Bank, selected banks and non-bank financial institutions on the issue of role of banks in financing MEs in Bangladesh. The team expresses its deep gratitude to Mr.Nirmal Chandra Bhakta, Executive Director, Bangladesh Bank, for his active interest in organising the meeting and providing required support (see Appendix-II) .

to support cottage and MEs through MFIs under the 'principal-agent' lending model. It will be facilitated if (i) the MRA publishes ranking of NGO-MFIs, and (ii) the MRA or any other competent authority establishes MFI-client based Credit Information Bureau (CIB)

4.3 Micro Credit Market: Institutional Policies and ME Credit Deepening

Micro credit market started its journey through the MFIs following successful experimentation in the 1970s on the hypotheses that (i) financial inclusion of the poor households leads to income and wealth enhancement and in turn graduation from poverty; and (ii) poor borrowers can repay loans. These experiments also had implications for rural financial system. From the very beginning, MFIs had provided financial services at higher interest rates to cover their high operating costs. As such, financial sustainability was the driving force for the development of the MFIs. The greatest challenge that the MFIs in the initial years faced was mobilisation of financial resources. Cheap funds from donors and international agencies contributed to building foundation of the MFIs and the micro finance sector.

Over the past decades, following the establishment of the Grameen Bank, a large number of MFIs have emerged, and have been operating with a wide network. These institutions initially started as voluntary social organisations, registered under the Societies Act. Unlike the experience of other countries, MFIs in Bangladesh had remained outside the purview of any regulatory authority until 2006. Prior to 2006, these institutions were self-regulated; self-regulated by a Board comprising of handpicked members. At present, the micro finance sector is regulated, and MFIs are licensed and regulated by the Microcredit Regulatory Authority (MRA) established in 2006 under the Microcredit Regulatory Authority Act 2006. The MFIs are now member-based formal financial institutions. We call the MFIs as 'financial institutions' because they perform the business of rendering financial services – mobilise member savings and borrowed funds to lend to the member-borrowers.

Some 692 MFIs are licensed with a network of about 17,000 branches by the end of 2015. Some 400 applications are under review of the MRA. The Credit and Development Forum (CDF) publishes Bangladesh Microfinance Statistics on a regular basis. The sector is quite large; it has created employment opportunities of some 200,000 employees. The MFIs in Bangladesh are not purely financial institutions as in some Latin American and African countries. MFIs in Bangladesh are social organisations; they provide both financial and non-financial services with poverty alleviation as the broad objective. In addition, these institutions have developed over time both as financial and development institutions. Products are quite diversified ranging from pure microcredit to savings, education, health, training, micro-enterprise, micro insurance, migration and remittance services.

Table 4-6 provides some basic information about institutional and membership outreach of the MFIs including the Grameen Bank. Over the period 2005-2014, the sector has increased enormously in size. Active members have increased by almost two times; net savings have increased by over four times; annual loans disbursement has increased by over five times; loans outstanding have increased by five times. With all such expansion and development, average loan size and member savings have also increased. Average savings and borrowing have increased by more than two times. The outreach related information provides evidence of the fact that (i) financial inclusion through MFIs has increased tremendously; some 34 million members have been brought under the network of the MFIs; (ii) poor members can save, and they have saved about Tk. 225 billion. The reason of providing such information is to show that the microfinance network has expanded enormously, and created an environment for wider financial inclusion, which can be an advantage for financing cottage and micro-enterprises.

The MFIs are now transformed as well. Under the regulation, governance structure has been changed; more transparency has been ensured, and interest of the members and borrowers has been protected. The MRA Rules 2010 guide the licensed MFIs. In one of the studies, Latif et.al. (2014) show that licensing of the MFIs has increased confidence of its clients. Khalily et.al. (2014) show that better regulation contributes to cost efficiency.

Table 4-6: **Trend in Outreach of Bangladesh Micro Finance Sector, 2005-2014**

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Active members	18.79	20.51	23.96	35.91	35.71	34.62	33.06	32.25	32.01	34.04
Net savings[a]	52	69	75	104	131	161	186	158	193	227
Loans outstanding[a]	83	106	133	127	189.267	221.667	279.825	311.044	348.053	409.965
saving-outstanding ratio	0.365	0.336	0.318	0.609	0.693	0.727	0.665	0.508	0.554	0.554
Annual disbursement[a]	131.78	174.32	226.88	370.80	370.80	371.82	440.29	498.10	566.84	647.22
Number of loanees	11.84985	13.6816	16.53165	25.32745	22.99505	23.12085	23.944	23.57	25.495	27
Active borrowers	13.941	16.096	19.449	29.797	27.053	27.201	27.172	25.952	25.672	27.241
Average loan size (disb)	11120.73	12741.05	13723.68	14640.08	16125.04	16081.42	18388.24	21132.84	22233.42	24242.99
Average savings	2767.00	3359.71	3110.94	2902.63	3677.25	4655.84	5630.33	4896.39	6023.63	6672.65
Average savings (Borr)	3730.22	4281.44	3831.82	3497.67	4853.69	5925.81	6850.88	6083.85	7510.52	8337.80

Source: Bangladesh Microfinance Statistics 2005-14

ME financing policies

While regulation has changed the behaviour of the institutions, it has created opportunities for the MFIs in expanding its services. *The MRA allows MFIs to scale up its lending activities through providing large ME loans, not exceeding 50 percent of the total loans outstanding.* This has created higher demand for fund, and at the same time, it has changed the behaviour of lending institution.[13] In this section, we discuss the issues confronting the financing of MEs. The issues are being discussed within the framework that banks, because of their different loan portfolio, will not be able to resolve the problem of financing MEs.

The MRA is yet to provide any detailed guideline on ME lending, more specifically on the terms and conditions. PKSF, wholesale lending agency with development motivation, has significantly contributed to the development of micro finance sector in Bangladesh. It has contributed to diversification of financial products including ME loan products.

PKSF policies for ME financing

In 2006, PKSF formulated the policy for financing MEs. The 2006 policy underscored the need for providing ME loans with some restrictions. It allowed only those partner MFIs that had a minimum equity of Tk.5 million with debt-equity not exceeding 9:1. With the objective of supporting graduating members, PKSF introduced ME loan programme. As such, the policy did not allow any lateral entrant to the ME programme. Under the policy, both credit floor and ceiling were imposed. ME loans were limited between Tk.30,000 and Tk.300,000 with duration of maximum two years. The debt-equity ratio for the borrowers was set at 80:20.

In 2010, PKSF reviewed the earlier policy and revised it. The scope was expanded. It defined ME using assets and employment. Total assets excluding land and building should be at least Tk.40,000 and maximum of Tk.1.5 million. A minimum 25 percent of total labour should come from the family. Loan ceiling has been increased to Tk. 1 million. However, first ME loan should not exceed Tk.100,000. Unlike the previous one, the restriction on lateral entry was withdrawn. The requirement of membership in a group was not enforced. In brief, the revised 2010 policy has enabled PKSF partners to expand ME loans to enterprises regardless of membership. The policy reflects the MRA rule.

Trend in ME loans

Before we discuss the issues pertaining to financing MEs, let us review the trend in ME loans. As reported in Table 4-6, annual disbursement of loans has been increasing at anannual average rate of 14 percent. In 2014, a total of Tk.647 billion was disbursed; increased from Tk. 498.1 billion in 2012 (Table 4-7**).** During the past three years,

[13] During a field trip, it is found that a branch of one MFI has disbursed almost 100 percent of the loans as ME loans because of higher demand.

Table 4-7: **ME Financing in Micro Credit Market by Sector, 2012-14**

(Taka in billion)

	2014		2013		2012	
	ME loan disburseme nt	ME loans outstanding	ME loan disbursement	ME loan outstanding	ME loan disbursement	ME loan outstanding
Manufacturing	7.26 (4.11)	4.52 (4.05)	7.86 (5.0)	5.11 (5.14)	2.12 (1.49)	1.30 (1.49)
Trade	133.08 (75.21)	84.61 (75.74)	114.03 (72.53)	71.23 (71.79)	127.63 (89.98)	78.88 (89.92)
Transport	3.82 (2.16)	2.62 (2.35)	1.72 (1.10)	1.14 (1.15)	0.82 (0.58)	0.48 (0.55)
Services and others	3.47 (1.97)	2.12 (1.91)	10.24 (6.52)	7.50 (7.56)	3.69 (2.61)	2.37 (2.71)
Agriculture	29.30 (16.56)	17.83 (15.96)	23.35 (14.85)	14.24 (14.36)	7.57 (5.34)	5.34 (4.67)
TOTAL ME loan	176.95 (100)	111.72 (100)	157.23 (100)	99.22 (100)	141.85 (100)	87.72 (100)
Total ME loan as % of aggregate loan	27.34	27.25	27.74	28.51	28.48	28.20
Percent of active ME borrowers		7.9		8.9		7.9

Note: Figures in the parentheses represent percentages of column total.
Source: Bangladesh Microfinance Statistics, CDF, 2012-14.

ME loans have increased steadily with almost constant share in total loans and number of borrowers. Average ME loan size was around Tk.68,000 during the period 2012-14. The percentage of ME borrowers was constant at 7.9 percent. The share of ME loans disbursement has remained more or less around 28 percent. Such share did not change when it was estimated based on loans outstanding. But such share is higher for top 10 MFIs. MFIs like BRAC, ASA, Buro, Padakkhep, Jagaoroni Chakra and TMSS have a share of MEs loans in total at around 46 percent with little room for extending new ME loans in future under the present MRA rules.

Borrowers have sought ME loans for different purposes. The purposes are classified into five sectors. By sector, 75 percent of the ME loans was directed for trading, as expected, followed by 16 percent in agriculture in 2014(Table 4-7).Although similar pattern is found for PKSF partner MFIs, the share of trading and agriculture together in ME loans was around 73 percent. *Regardless of the variation in number, this is quite common that trading occupies a major share in ME loans. This means, lateral entrant borrowers are mostly engaged in trading.*

During the field visit, it is also found that most of the lateral entrant ME borrowers are traders in local markets. This group may also be termed as the ‘missing group’ in formal banking sector.

Although the share of ME loans is well below the required policy of maximum 50 percent of loans outstanding, as set by MRA, the issue is, with the available funding structure, will the MFIs be able to reach the ceiling? This needs to be discussed in the context of potential demand for ME loans in future as well.

4.4 Estimation of Demand-Supply Gap for ME Loans

Demand for ME loan

It is estimated in Chapter 3 that despite wide expansion of financial services for the poor households and MEs through MFIs in Bangladesh, there is a huge demand for ME loans. The **excess demand for ME loans amounts to Tk.437 billion.** It may be noted that the above estimate may be treated as excess demand for all micro and cottage enterprises. With existing supply of funds for MEs, total demand for ME loans is projected to be Tk.737.31 billion in 2016. With higher interest elasticity of loan demand, such demand for ME credit will increase. With one-percent decrease in interest rate demand for ME loans will increase by 5.6 percent.

Supply of fund

As discussed in this chapter, supply of loans from cottage and MEs comes essentially from MFIs with little contribution of banks. Total supply of fund (based on loans outstanding of 2011-14) has been projected to be Tk.299.92 billion (Tk.123.27 billion from MFIs and Tk.176.65 billion from banks).

Demand-supply gap

Considering static estimates of demand and supply of fund, our conservative estimate of the gap is Tk.335 billion. There is one caveat in the interpretation of the estimate that it is a static projection.

Who can finance the excess demand for ME loans?

Considering the characteristics of the MEs, MFIs are probably the right vehicles for financing MEs. Banks have larger portfolio for maximising profit through reducing transaction cost and default cost. As such, we may presume that banks and non-bank financial institutions have limited role in financing cottage and MEs. With this limitation and caveat, we discuss the role of MFIs and draw future policy implications.

4.5 Financing MEs and the Role of MFIs

In this section, we examine the role of MFIs in scaling up financing of MEs. We address several issues in this section. First, what is the present capital structure of MFIs in Bangladesh? We address this question in order to find out financial ability of the MFIs to meet the extra demand for ME credit. Second, who has higher capability? Will all MFIs require additional fund for meeting higher demand for ME credit? Third, what can be done to raise funds for the MFIs for meeting additional demand for ME credit? Addressing these issues will enable us to move towards different policy options.

Sources of financing

The MFIs are social institutions with welfare objective of poverty alleviation. Over the past decade, as argued earlier, MFIs have been moving towards commercial objective of profit maximisation and sustainability of the institutions. But funds probably remain as a major constraint. Table 4-8 shows the financial structure of MFIs in Bangladesh.

Table 4-8: **Financial Structure of MFIs in Bangladesh, 2012-14**
(Taka in billion)

Sources of loan fund	2014		2013		2012	
	Taka	Percent	Taka	Percent	Taka	Percent
Members' net savings	226.587	43.6	192.21	44.0	157.18	45.7
Surplus income	50.35	9.7	39.22	8.9	28.70	8.4
Own fund	69.69	13.4	60.73	13.9	53.38	15.5
Reserve fund	13.12	2.5	13.29	3.0	8.95	2.6
Loan revolving fund	41.54	8.1	31.32	7.2	18.74	5.4
Emergency fund	3.25	0.6	2.61	0.6	0.59	0.2
Insurance fund	10.48	2.2	9.23	2.1	5.10	1.5
Bank loan	55.71	10.7	40.93	9.4	34.26	9.97
Grant from donor organisations	4.38	0.8	4.79	1.1	3.48	1.0
Loans from international NGOs	1.91	0.4	3.15	0.7	1.22	0.4
Loans from PKSF	34.45	6.6	32.69	7.5	28.10	8.2
Loans from local NGOs	0.55	0.1	1.08	0.3	0.64	0.2
Others	6.74	1.3	5.51	1.3	3.18	0.9
Total	518.76	100.0	436.77	100.0	343.53	100.0

Source: Bangladesh Microfinance Statistics, CDF, 2012-14

Table 4-9: **Sources of Loan Funds (%)**

Source	2010	2011	2012	2013	2014	All
Members' savings	54.33	54.38	45.75	44.01	43.68	48.43
Loans	24.01	17.28	18.69	17.83	17.68	19.13
Internal funds	12.23	17.36	25.25	26.83	26.62	21.66
Surplus income	6.29	6.99	8.35	8.98	9.71	8.06
Donors' grant	1.81	1.75	1.01	1.1	0.84	1.3
Others	1.32	2.24	0.93	1.26	1.3	1.41
Total	100	100	100	100	100	100

Source: Bangladesh Microfinance Statistics, CDF, 2012-14

The MFIs are not private equity held. Nevertheless, they have accumulated social equity in the form of reserves, created out of profit. It is directly correlated with the size of lending activities. Large MFIs shall be able to accumulate more reserves and mobilise more member savings than small and medium MFIs. Therefore, financing of assets including loans is dependent on borrowed funds. We find that member savings constitute roughly 44 percent of the total fund in 2014. Borrowing constitutes roughly one-fifth of the fund. But not all these funds can be used for financing lending activities. As per the rule, not all member savings can be used for financing investment of lending activities. The MRA requires that some 15 percent of the member savings should be retained as liquidity reserve. Given the present level of lending activities, banks are dependent on borrowed for financing loans and other investments. But the question is: does financial structure vary by MFI size?

We can examine the issue further by looking at some of the cases representing different MFI size. All MFIs are dependent on borrowed fund for financing its activities; however the intensity of dependency on borrowed funds varies (Bangladesh Microfinance Statistics 2014). Even very large MFIs like ASA and BRAC are dependent on borrowed funds. Borrowed fund constitutes almost 32 percent of total fund for BRAC. Uddipan, a large MFI, had dependency of 30 percent of funds from borrowing. On the other hand, a large MFI like PMUK had 60 percent of total fund from borrowing from PKSF and local banks. The ratio was equally higher for the Wave Foundation. The large and medium MFIs could grow with access to borrowed funds from PKSF and local commercial banks. Small MFIs have remained small for lack of access to external fund. For example, JUP in Jamalpur has a total fund of Tk.41.39 million with no borrowed fund. This is also the case with SUS in Tangail. This should be noted here that most MFIs are small in nature. Regardless of the size, it can perhaps be inferred that access to external fund is required for expansion and growth of MFIs.

The critical issue is: how would access to external finance affect sustainability of the MFIs as access to borrowed funds would increase financial cost? It will depend on the portfolio yield, interest margin and intensity of operating self-sufficiency. The Microcredit Regulatory Authority (MRA) publishes statistics of NGO-MFIs in Bangladesh every year. The fact is not every institution is able to operate profitably. This is well documented that performance of a firm is determined by debt-equity ratio. The relationship between debt-equity ratio and performance is inverted-U. Several studies on Bangladesh MFIs show that higher leverage will have negative effect on performance (e.g. Khalily and Hoque 2015, Khalily and Sayla 2015). The findings suggest that neither higher dependency on long term debt or equity will have positive impact on performance. In this study, we evaluated financial statements and performance of eight MFIs representing different size, as defined by MRA. In attempting to establish the causality between performance and capital structure, we define performance as operating self-sufficiency (OSS)[14] and debt-asset ratio as net savings/loans outstanding ratio (used as a proxy variable). We postulate that an MFI with higher dependency on member savings or long term borrowed fund in financing loans will have relatively poor performance compared to those MFIs with optimum capital structure. We present the relation between the two variables of eight MFIs in Figure 4.1.

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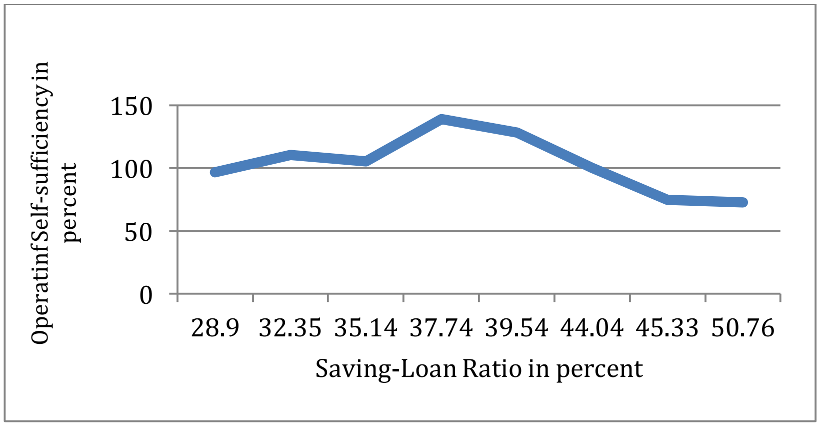
[14] OSS is defined as the ratio of operating revenue and total expenses including operating expenses and interest expenses.

Figure 4-1: Relationship between OSS and S-L Ratio



The figure shows that an inverted U-shaped relationship exists. It suggests that the MFIs shall be able to increase performance through use of some mix of debt or savings and equity to finance lending activities. As most MFIs are small in size, access to external fund will help them expand their lending activities. Savings as a source of finance will be more effective because of its lower cost. The review of MRA statistics (MRA 2013) shows that average cost of savings is around 2.5 percent per Tk.100 of loan. In contrast, cost of borrowed fund is as high as 8 percent.

Constraints to Financing MEs: Perspective of MFIs

During our meeting with the selected number of MFI[15], the issue of constraints or challenges in financing MEs was discussed. Three sets of constraints are identified–operational constraint; financial constraint, and regulatory constraint. More than 72percent of the participants and MFIs identified operational and financial constraints as major constraints.

The operational constraints as identified by the MFIs are:

- Lack of skilled staff
- Lack of systematic training
- High drop-out of trained staff
- Lack of skills for evaluating ME loan proposals
- Lack of training on risk management

The participants identified the financial constraints as:

- Inadequate access to borrowed fund
- High cost of fund

[15] The list of participants and MFIs is given at Appendix-III.

- Rigid terms and conditions of loan contracts
- Ceiling on ME loan

However, financial constraint is also created by regulatory constraint. Around 45 percent of the participants thought that financial constraint has been partially created by regulatory restriction on ME loan volume. The regulation constraint arises from two provisions of MRA Rules 2010:

(i) Rule 34 requires that MFIs maintain 15 percent of member deposits as liquidity reserve requirement;
(ii) Rule 20 requires that MFIs should maintain 10 percent of Reserve Fund as deposits;
(iii) Rule 24(3) requires that ME loans should not exceed 50 percent of total loans outstanding.

The participants argue that relaxation of regulatory restrictions will contribute to increasing supply of fund for ME financing. But this will not be sufficient; they will require access to additional fund. Additional funds can be mobilised through mobilising public deposits. In this context, some serious consideration is required for amending the following three provisions of the MRA rules:

(i) Rule 27 (2) requires that total deposit balance of any Microcredit Organisation will not exceed 80% (eighty percent) of the principal loan outstanding at any given time.
(ii) Rule 28 (e) requires that the total voluntary deposit will not be more than 25% of the total capital of the organisation.

MFIs are unable to mobilise funds through offering different savings products because of the above regulatory restrictions in MRA Rules 2010.

However, as they argue, skill development training for ME loan related staff will strengthen implementation of ME lending programme.

4.6 Strategies for Addressing Excess Demand for ME Loans

Our analysis shows that banks have limited scope for financing MEs because of their profit maximisation objective and loan product approach. They are more inclined towards financing large and medium enterprises, and when they do it, it is largely for working capital financing. Even when banks are financing MEs they are basically servicing the upper strata of MEs that are more close to graduation to small enterprises. Moreover, their operations are limited to urban areas. In such a situation, it becomes reasonably difficult for the banks to finance rural MEs. Specialised agricultural development banks with their specific portfolio are more engaged in financing the agriculture sector.

We discuss different policy options under different scenarios for a better comprehension of probable solutions. Moreover, not all suggested policy options are mutually exclusive. However, our suggested policy options need to be critically examined and policy change, if needed, should be comprehensively looked upon as the policies will have implications for different stakeholders having different perspectives. A policy improvement, therefore, should be optimum in nature. In the case of financial market related policies, these should be evaluated both from micro and macro perspectives; from both firm and market perspectives.

STRATEGY ONE: Increase flow of fund for ME investment through banking system

We assume that banks have higher ability to mobilise financial resources and act as intermediaries to invest in the portfolio of firms and individuals. Our analysis shows that banks have not been able to finance cottage and small enterprises directly; only around 10 percent of loans outstanding are cottage and micro-enterprise credit. Despite such limited role, given the advantages of banks, we delve into the issue of increasing fund flow to cottage and micro-enterprises. Our suggested policies are as follows:

Bring changes in BB credit and refinancing policies. Bangladesh Bank needs to bring some changes in its credit and refinancing policies to make it more CME friendly. Following measures can be taken:

(i) *Set a credit floor for financing cottage and micro-enterprises (CMEs) for each year. Bangladesh Bank through a circular should set such credit floor at 20 percent of targeted SME credit.*

(ii) *Although 100 percent refinancing of SME loans are available, such refinancing facilities should be made a priority for CME loans in rural areas, in particular. A minimum of forty percent of the SME refinancing shall be set for CMEs.*

(iii) *Preferential lending interest rate for CME loans in rural areas should be introduced as most rural employment is created in the CME sector and more than 90 percent of the economic establishments are CMEs in nature. It will be socially justified as net social benefits are expected to be positive.*

Ensure investment of rural deposits in rural areas: Bank deposits are the source of funds for investment. The rural advance-deposit ratio shows a declining trend. In June 2015, the ratio of advances and deposits in RFM is 0.39. Such trend is counter-productive. This needs to be reversed in order to increase investment in rural areas. Bangladesh Bank can suggest following policy measures to ensure increase in rural investment of rural deposits:

(i) *set a clear policy of linking incentive-related policies like refinancing to rural advances out of rural deposits;*

(ii) *rural bank branches should be directly encouraged use MFI branches for expanding credit facilities to both MEs and other economic activities in the areas where banks can not provide financial services directly.*

Strengthen 'agent banking' system. The December 2015 amendments to Circular 4 of SMESPD require promotion of agent banking to provide financial services to cottage and micro-enterprises. Though the policy is in effect, it is not as effective as it should have been. In the case of enterprise financing, NGO-MFIs are identified as agents. In recent years, the share of 'loans to NGO-MFIs' by banks has increased. In 2014, banks disbursed Tk.27 billion to NGO-MFIs, an increase by almost 30 percent from Tk.21 billion in 2013. However, bank loans constitute only 10.7 percent of total capital and liabilities in 2014. This contribution has been a part of normal lender-borrower transaction. *The principal-agent banking system should be specifically promoted and strengthened for financing cottage and micro-enterprises.* In the process of doing it, following steps may be taken:

(i) *recognise licensed MFIs as a formal organ of the financial markets, particularly in rural financial markets.* Although there is a separate regulatory agency, Bangladesh Bank is the regulatory agency for the overall financial and monetary system. As such, it is imperative that better collaboration between banks and NGO-MFIs should exist. NGO-MFIs should not be treated as a 'client group' only. Such collaboration should start with recognition of licensed NGO-MFIs as a formal organ of the financial market. With such recognition and positive environment of collaboration, banks shall be able to use the services of NGO-MFIs more effectively.

(ii) *rural bank branches should be encouraged to provide financial services to CMEs through efficient and sound MFIs;*

(iii) *all commercial banks should be strongly encouraged to select some MFIs in rural financial markets as its agents. Bangladesh Bank should have specific policy guideline for selecting MFIs under the principal-agent model of lending.*

(iv) *Financial innovation and technology like mobile banking may be used to strengthen Agency Banking.*

Establishment of CIB for the microfinance sector will facilitate banks to lend with higher level of confidence. At present the process is underway for establishing such CIB.

STRATEGY TWO: Increase Flow of Fund for Financing CMEs through PKSF

PKSF is a major player in promoting and developing micro credit market in Bangladesh. Over time, it has diversified its activities from pure finance to development finance. In recent years, PKSF has brought major change in policy to promote micro-enterprises in Bangladesh through its partner organisations. In addition to banks, PKSF can be a major vehicle for increasing flow of fund for financing CMEs as it has higher abilities to monitor CMEs and financing MFIs and has established set of rules.

Considering the critical role that PKSF plays and the need for broad-basing ME financing, *PKSF may open a special window for financing MEs with financial support from government and international agencies. This window may be a subsidiary organisation of PKSF or may be specialised ME Fund within PKSF.* All licensed MFIs should have access to such specialised ME fund or to funds of its subsidiary, if established.

The Finance Minister in the budget for FY 2016-17 proposed to allocate Tk. 1,000 million to form a 'Challenge Fund' to ensure easy access to loans for rural women and under-privileged entrepreneurs. Such Fund can be extended to finance CMEs through budgetary allocation. Considering the ground realities, the fund can be channelled to the MFIs through PKSF.

STRATEGY THREE: Support MFIs in mobilising financial resources

The NGO-MFIs finance their lending activities through mobilising resources from different sources. Access to different sources of finance is related to the development of MFIs. Fehr and Hishigsuren (2004) show the relationship between sources of finance and size of development. They identify four stages of development of NGO-MFIs: (i) Start-up; (ii) Operational self-sufficiency; (iii) Financial self-sufficiency, and (iv) Commercial level return. Bangladeshi NGO-MFIs have gone through such phases of development. They are now in phase three of development. In this phase, NGO-MFIs are licensed now. In stage three, licensed NGO-MFIs should have access to different sources of fund. They are voluntary savings, debt capital and equity capital. In 2010, borrowed funds and member deposits constitute 78 percent of the total; the share declined to 60 percent in 2014 implying increasing share of equity and reserve funds.

Table 4-10: **Sources of Finance and Stages of NGO-MFI Development**

	Stage-1: Start up	Stage-II: Operational Self-sufficiency	Stage-III: Financial Self-sufficiency		Stage IV: Commercial Level Return	
	NGO	NGO	NGO	Licensed MFIs	NGO	Licensed commercial MFIs
Donor						
Grant and soft loans	x	x	x	x	x	x
Internal						
Forced Savings	x	x	x		x	
Voluntary Savings				x		x
Private						
Debt						
Commercial loans		x	x	x	x	x
Guarantee Funds						
Bonds			x	x	x	x
Securitisation			x	x	x	x
Inter-bank borrowing				x		x
Equity						
Quasi-equity			x	x	x	x
Retained earnings			x	x	x	x
Socially responsible equity				x	x	
Commercial equity					x	x

Source: Fehr and Hishigsuren (2004)

NGO-MFIs need to raise funds from the sources as noted above. Higher demand for fund is needed for expansion and scaling up financing of CMEs. The current state can be termed as 'state of capital deficit'. In such a state, MFIs are confronted with two inter-related problems: (i) slower growth rate, less than the desired level, and (ii) operational deficit may limit MFIs to access credit market. In such a situation, based on cost of fund associated with each source of finance, NGO-MFIs should adopt the following capital-raising or fund raising approach.

The NGO-MFIs should finance lending activities more by savings. *Currently, MFIs are allowed only to mobilise member savings and term deposits subject to restriction under rule 28(e) and 29 (e). NGO-MFIs should mobilise more member savings and term deposits at a higher level. Several arguments are advanced to justify such strategy. First, MFIs cannot sustain in long run for financing MEs by borrowed fund. Second, MFIs shall be able to reduce lending interest when cost of fund will be lower due to savings mobilisation. Third, it will enable MRA to design appropriate governance structure for better monitoring of the licensed MFIs. Fourth, it will facilitate MFIs to contribute to economic growth through up-streaming of their lending activities. Considering the arguments, we recommend following measures:*

(i) *MRA should amend rule 28(e) and 29(e) to fasten the process of savings mobilisation and ME financing. The present restriction of limiting voluntary deposits or term deposits to 25 percent of equity capital should be amended as "voluntary deposits or terms deposits will not be more than 25 percent of loans outstanding". Our estimates*[16] *show that such amendment will contribute to increasing both member voluntary savings and term deposits by six times. Its implications will be found also in lending, weighted cost of fund and sustainability. Weighted cost of funds will reduce by nine percent; loans will increase by 25 percent; revenue from loans will increase by 26 percent, other things remaining same. Consequently, profitability will increase by 35 percent.*

(ii) *BB and MRA should examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions. This should be done in order to ensure financial stability and better monitoring of monetary policy.*

(iii) *Rule 24(3) may be amended to relax limit on ME financing as a ratio of loans outstanding. The existing limit on 50 percent may be relaxed to 60 percent without affecting financing of income generating activities for poverty alleviation.*

[16]Details of the estimates and the analysis are reported in Appendix IV.

Access to innovative financial instruments: Globally some innovative financial instruments are available for raising capital. The well-known instruments are: (a) Credit Guarantee Scheme; (b) Securitisation, and (c) Debt instruments.

(i) *NGO-MFIs can raise funds from financial institutions through a specially designed Credit Guarantee Scheme for financing CMEs. Bangladesh Bank with assistance from the government may design such a specialised scheme. However, it is not the product that has to be designed, but also the mechanism as well as terms and conditions that have to be properly defined so that they do not distort the behaviour of both lenders and borrowers.*

(ii) *Securitisation is a well-discussed issue in the microcredit market. BRAC was successful in raising funds through securitisation, which ultimately contributed to expansion of its activities. Such an approach may emerge as an effective instrument in linking the portfolios of NGO-MFIs or micro-enterprises to the capital market. The issue of securitisation needs to be examined in the context of the relationship between microcredit market and formal bank credit market.*

(iii) There are other debt instruments like certificates of deposit or bonds/debentures that are issued to raise funds from the capital or money markets. These instruments can be used for raising capital for MFIs. The issue needs careful examination in the context of the state of capital and money markets in Bangladesh.

STRATEGY FOUR: Raise social equity fund (SEF)

NGO-MFIs in Bangladesh are 'not-for-profit' social entities. There is no private held equity, although the institutions have been established, and are being operated by social sponsors. There are two capital markets that the firms can access. Commercially motivated firms can raise funds from capital markets by offering private equities. Shareholders are entitled to participation in management and dividends. But the NGO-MFIs in Bangladesh are social organisations. In such a situation, they can raise social equity capital. There are several ways of raising social equity capital: (i) participation of donor agencies (firms or individuals) in social equity; (ii) participation of institutions like banks and PKSF in social equity; and (iii) access to social capital market (which does not exist at present in Bangladesh).

Raising social equity fund is a serious policy issue. The policy should be examined from the perspective of (i) establishing 'Social Capital Market (SCM) or Social Capital Exchange (SCE); and (ii) allowing individuals as well as national and international agencies to contribute to the Social Equity Fund. The Bangladesh Bank, Securities and Exchange Commission (SEC), Microcredit Regulatory Authority (MRA), Palli Karma-Sahayak Foundation (PKSF) along with participation of experts should examine the issue of establishing this specialised exchange for social institutions like NGO-MFIs. Implementing the second perspective of accepting contribution of individuals and organisations to SQF will be easy once a working policy document is prepared by the MRA in collaboration with Bangladesh Bank.

There is, however, another system called *kiva* micro-lending, quite well practised in some of the European countries. It is quite prominent in China. It is on-line credit market where a platform is created for both potential lenders and borrowers. Both individuals and firms can participate. But unregulated *kiva micro lending* may create financial instability.

STRATEGY FIVE: Establish separate institutions for financing CMEs in RFM

Financing cottage, micro and small enterprises (CMSEs) requires 'up-streaming' of lending activities for the NGO-MFIs and 'down-streaming' of lending activities of banks. In the context of Bangladesh, MEs are the missing entities in formal bank credit market. There exists a market failure on the part of the formal credit market. Microcredit market needs to up-scale its lending activities, which may affect their on-going financing of massive income generating activating and implementing development activities for poverty alleviation and rural economic growth. From this perspective, one may argue for establishing separate specialised financial institutions in rural financial markets (RFMs). Establishing such specialised financial institutions in RFMs requires serious policy examination in the context of the expected role of NGO-MFIs, specialized banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB). Such banks can be termed as 'community banks' or 'rural banks'. In the Philippines, rural banks have been quite successful. It also exists in Indonesia.

Bangladesh Bank and MRA need to carefully examine with a positive frame of mind to improve performance of RFMs. However, given the experiences with BASIC bank, BKB and RAKUB, one may be apprehensive of another specialised bank for MEs. The targeted objective can be achieved if PKSF is allowed to open a separate window for financing CMEs with capital contribution from GoB, BB and cheap funds from international agencies.

STRATEGY SIX: Transform MFIs into microfinance banks

About a decade ago, microfinance banks would have been unknown entities. At present, many microfinance banks operate in many countries in the world. They operate even in South Asian countries like Nepal, Pakistan and India. In Africa, these are quite spread. It Latin American countries like Bolivia, microfinance banks exist and operate for over two decades. But not all these microfinance banks are social organisations. All these are commercial financial institutions with two modes of ownerships – private equity held and institutional equity held. Although these are microfinance banks, their activities are spread over financing micro-enterprises to small and medium enterprises. Why microfinance bank is required?

In Bangladesh, establishing microfinance banks may be considered as a policy option for 'up-scaling' activities of the NGO-MFIs; financing CMEs, capacity improvements of NGO-MFIs, and strengthening rural financial markets. There are pros and cons of transforming MFIs into microfinance banks. In addition to scaling-up activities, transforming MFIs into microfinance banks will enable the banks to operate effectively in RFMs with available existing information. However, some critical issues need detailed examination:

- Should all MFIs be transformed into banks? (Probably not)

- What should be ownership and governance structure?
- Should these banks be regulated by MRA? If not, what will be role of MRA in future in the long run?
- Should microfinance banks operate only in RFM?
- Should microfinance banks be limited in number?
- Will transformation of selected number of MFIs into microfinance banks affect the targeted objective of financing IGAs and reducing poverty?

A clear policy needs to be formulated by Bangladesh Bank and MRA. The State Bank of Pakistan has issued a set of detailed outlines or guidance for establishing separate microfinance banks or transforming some MFIs into microfinance banks. These guidelines are quite extensive and address critical issues from ownership to governance. The 'Guidelines' are attached in Appendix V.

In brief, the policy options or strategies need to be examined in details. However, the aim should be to remove the constraints to financing cottage and micro-enterprises and increase the flow of capital. It can be increased using the existing institutional framework and/or establishing new small and rural banks. The policies concerning the establishment of new institutions have to be examined from the perspective of improving efficiency and competition in financial markets. To quote a Managing Director of a bank in India: 'The new small banks will have to be niche to be successful. But the niche will have to be in terms of customers or products. If niche is merely 'geographical or in terms of market, the bank will fail'. In this context, policy options for increasing flow of fund have to be examined and reviewed.

STRATEGY SEVEN: Non-financial Measures of ME development

In our analysis as well as during the meeting with the MFIs, it became quite clear that MFIs have limited capacity to finance CMEs because of lack of sufficient fund and inadequate trained staff to process ME loans. On the other hand, in Chapter Three, the micro entrepreneurs considered asymmetric information as a major constraint that has contributed to increased competition at the local level. These non-financial constraints need to be corrected. *We recommend that capacity of MFIs and micro-enterprise borrowers need to be enhanced through training and provision for market-related information. Institutions like InM and BIBM can impart training to the ME-related staff of MFIs. In turn, it is expected that the trained staff of MFIs will be able to provide training to the micro entrepreneurs. MRA as a regulatory agency may facilitate the process through formulating a policy for ME development incorporating the need for both financial and non-financial services.*

ME development as a strategy is emphasized because of its potential backward and forward linkages. In this context, the Government of Bangladesh can integrate ME development as a part of overall enterprise development from the perspective of employment creation, local economic growth and fiscal incentives.

DEFINING MICRO-ENTERPRISE – A Pre-requisite for Sound Development of MEs

Defining ME based on common parameter is a pre-requisite for a sustainable and sound development of micro-enterprises in Bangladesh. As discussed in Chapter Two, different MFIs and banks use different definitions of MEs. Consequently, we lack a complete information on ME financing. MRA could play a direct role in CME development through redefining ME-that will be mandatory for all MFIs to follow.

ME may be defined based on (i) loan size and (ii) employment size. *Based on the distribution of economic entities of BBS, we recommend that entities with full time employment size of 1 and 5 be defined as micro-enterprises. Loan size may be set at Tk.70,000. This we recommend based on the average loan size and distribution of ME loans given by MFIs.* However, it may need to be re-visited from time to time. This will also allow the MFIs to comply the rule 24(3) with larger disbursement to microenterprises. Moreover, MRA could fix certain target amount of ME loan to be achieved by MFIs. This will increase the overall finance for MEs as some of the MFIs are yet to provide ME loan to prospective micro-entrepreneurs.

Summary of the Policy Options as Recommended

Based on the above discussion, we have summarised in the following table the major policies to increase ME financing, how those policies could be implemented and the institution/organizations that are primarily responsible for the implementations of those policies.

Key Policy Options for ME Financing

Policy options	Suggested action	Time frame	Lead institution (s)
1. Increase flow of fund for ME investment through banking system		Short term	Bangladesh Bank
Bring changes in BB credit and refinancing policies	Set a credit floor for financing cottage and micro-enterprises (CMEs) each year. 20 percent of SME credit may be earmarked as credit floor.		
	A minimum of 40 percent of the SME refinancing may be set for CMEs		

	Preferential lending interest rate for CME loans in rural areas may be introduced		
Ensure investment of rural deposits in rural areas	Set incentive-related policies, like refinancing, to encourage investments of rural deposit in rural areas		
	Rural bank branches could be directly encouraged to use MFI branches for expanding credit facilities to both MEs and other smaller economic activities		
Strengthen the 'agent banking' system	Recognise licensed MFIs as a formal organ of the financial market		
	Rural bank branches could be encouraged to provide financial services to MEs		
	All commercial banks could be strongly encouraged to select some MFIs in rural financial markets as their agents		
	Financial innovation and technology like mobile banking may be used to strengthen agency banking		
	Establish CIB for the microfinance sector		
2. Increase flow of fund for financing CMEs through PKSF	PKSF may open a special window for financing MEs. This window may be a subsidiary organisation of PKSF or may be a specialised ME Fund within PKSF	Short term	PKSF, Ministry of Finance
	The government could allocate a certain amount in the budget for ME financing every financial year, which could be channelised to MFIs through PKSF.		
3. Support MFIs in mobilising financial resources		Short term	
NGO-MFIs could finance lending activities to MEs	MRA could amend rule 28(e) and 29(e) to facilitate the process of savings mobilisation and ME		MRA

more using savings	financing		
	BB and MRA could examine the possibility of allowing MFIs to mobilise public deposits and treat MFIs as licensed financial institutions.		Bangladesh Bank and MRA
	Rule 24(3) may be amended to relax the limit on ME financing as a ratio of loans outstanding		MRA
Access to innovative financial instruments	NGO-MFIs may raise funds from financial institutions through a specially designed Credit Guarantee Scheme for financing CMEs		MRA, Bangladesh Bank, Ministry of Finance
	The issue of securitisation may be reviewed in the context of the relationship between microcredit market and formal bank credit market.		
	Certificates of deposit or bonds/debentures may be used for raising capital for MFIs		
4. Raise social equity fund for NGO-MFIs	Examine the feasibility of establishing Social Capital Market (SCM) or Social Capital Exchange (SCE)	Medium term	Bangladesh Bank, Securities and Exchange Commission (SEC), MRA, PKSF
	Review the possibility for individuals as well as national and international agencies to contribute to the Social Equity Fund		
5. Establish separate institutions for financing CMEs in RFM	Examine the expected role of NGO-MFIs, specialised banks like Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB) in financing CMEs	Medium term	Bangladesh Bank, MRA, Ministry of Finance, SEC
6. Transform MFIs into microfinance banks	Explore the feasibility and identify potential MFIs which can be transformed into microfinance banks	Medium term	Bangladesh Bank, MRA
	Review alternative options and identify desirable ownership and governance structures		
	Identify the regulatory authority		

	Explore the area of operation: rural or urban or both		
	Identify the number of banks		
	Examine the effects of such transformation on social objectives of NGO-MFIs		
7. Non-financial Measures of ME development	Capacity of MFIs and micro-enterprise borrowers need to be enhanced through training and provision for market-related information.	Short Term	Government of Bangladesh, InM, BIBM
	Identify required non-financial services such as strengthening backward and forward linkages for MEs and adopt measures for delivery of comprehensive services.		
9. Defining Microenterprise	ME may be defined based on (i) loan size and (ii) employment size	Short Term	MRA
	entities with full time employment size of 1 and 5 be defined as micro-enterprises		
	ME Loan size may be set at Tk.70,000		

Chapter 5
Summary of Findings and Policy Implications

The present study shows that MEs are rapidly emerging as the dominant and dynamic component of the enterprise sector in Bangladesh. The MEs also have certain unique characteristics in terms of their development potentials and growth possibilities. Moreover, these enterprises face constraints specific to their nature of business and operational requirements including availability and size of loan, terms and conditions of credit, and nature of client relationships. It also emerges that the sector needs specific attention for providing efficient financial and other services for realising the country's economic potentials.

5.1 Key Lessons from the Study

This study on diagnostics of ME lending by MFIs in Bangladesh brings out several important lessons based on which future courses of action could be designed. Some of these lessons are:

- The ME sector in Bangladesh is an extremely heterogeneous continuum of different types of enterprises, requiring different types of support for their development.
- Regulatory policies, which largely provide the operational framework for MEs in the country, often represent significant obstacles to the development of the ME sector; so that appropriate policies are a key factor in the success of lending to MEs by the MFIs.
- It is essential to assess and understand the overall conditions that exist at a given time to adopt well-focused ME financing strategies for the MEs.
- Inadequate access to institutional financial services is a major obstacle facing MEs; but non-financial services, such as technical and marketing assistance, are also critical to ME development.
- Building sustainable institutional capacity to serve the MEs is important for guaranteeing productive ME lending by the MFIs rather than just disbursing loans or giving onetime training to micro-entrepreneurs.
- The economic viability of MFIs serving MEs is a key to their long-term sustainability. Subsidised credit programmes are not necessarily ideal for the purpose as these programmes damage economic performance of MFIs and the subsidies are usually captured by larger MEs.
- With financial sector reforms and liberalisation, the opportunity to reach new market niches like MEs for both formal financial institutions and the MFIs in a profitable manner may be used as the strongest incentive for expanding services to this underserved sector.
- The adoption of appropriate credit technologies and the development of appropriate financial products on the part of the MFIs can significantly reduce transactions costs and improve the capacity of MFIs to serve the ME sector and help them to emerge as effective intermediary institutions for ME development in the country.

5.2 Creating Environments for ME Development and Lending

MEs are constrained by both demand and supply side factors. The InM Enterprise Survey 2016 carried out for the present study shows that MEs are faced with different constraints including finance, product selection and competition. The present study shows that finance is one of the critical elements in ME development. Therefore, the problem of financial constraint should be addressed as an integrated part of developing MEs. Otherwise, solving the problem in the credit market alone may create distortions in other factor and product markets especially related to the MEs. As such, our primary recommendation is to create appropriate environment for developing MEs and solving the problems of credit market failures for the MEs in an integrated manner.

5.2.1 Creating Supportive Environment for ME Development

Policy environment and reform

The MEs mostly operate at the margin of the formal economy which is largely outside the reach of formal laws and regulations, and their largely 'informal' status may appear as major constraints to their prospects for growth and integration into the mainstream economic activities. At present, economic reforms and new development frontiers have opened up new opportunities for growth of ME sector in the country, and for developing sustainable financing options to serve the sector. The important issue, however, is to adopt required policy changes to create a level playing field for the country's smallest enterprises. Improved business regulations, tax regimes and licensing requirements, and the adaptation of financial sector norms and supervision are some of the areas that must be addressed to permit the expansion and sustainability of MFI-ME services and improve the conditions for ME financing.

Identifying the target group

The target group of the MFI-ME lending is made up of enterprises that lack adequate access to financial and business services in all fields of economic activity (including trade/business, agriculture, manufacturing, and services). This report shows that, despite the small size, MEs account for a large share of the country's employment, output and incomes. Although little reliable data exist, estimates show that MEs employ a significant share (about 25 percent) of the labour force of the country. Moreover, the share of employment in MEs has been steadily growing since the 1990s along with their contribution to GDP.

Although the report identifies size parameters (e.g. employment and value of assets) to define the MEs for MFI lending, one should be cautious regarding strict adherence of these definitions in practice. As is well known, quantitative definitions may provide an incomplete picture on the type of enterprises to be targeted by the MFIs as quantitative information may tell only a part of the story. The qualitative aspects of MEs, particularly their lack of access to services, their existence at the margin of legal and regulatory frameworks, overlap of consumption and production activities within the MEs, and similar other characteristics are perhaps important factors that should be considered as well for shaping MFI-ME lending in Bangladesh. Therefore, the MFI-ME group has to be properly targeted and defined in order to make ME loan programme more focused and better adopted to reality.

Heterogeneity of ME sector

As the study shows, the ME sector in Bangladesh is extremely heterogeneous and varies dramatically in relative size and composition. At the lower end of the spectrum, there exist subsistence-oriented enterprises that depend exclusively on family labour, sometimes having no distinct separation between household and enterprise finances. On the other hand, there are MEs with up to 24 employees at the upper end, adopting relatively modern production technologies and often having linkages with larger firms in the formal sector through diverse supplier-client relationships.

In view of the disadvantaged situation of the smallest MEs, special efforts would be needed for providing finance and other support to these enterprises since their lack of access to finance and support services is particularly acute and context-specific. At the same time, such support mechanism should be a part of the continuum of MFI-ME financing and business development strategies adopted for the ME sector as a whole. The important issue should be to ensure that the special programmes do not lead to any segmentation and isolation of smallest MEs, rather support them to grow and work more closely with the rest of the MEs.

ME business development services

Micro-entrepreneurs lack access to essential nonfinancial services including marketing, training in basic business skills such as book keeping, and technology transfer. Moreover, this area of support to MEs appears to be relatively less developed as compared with microfinance operation in general. The provision of these services is extremely limited and mostly dependent on grant resources which intrinsically are not likely to be sustainable over time. The quality of available training and other business development services being offered to the micro-entrepreneurs is generally low and the lack of organisation in the ME sector makes it more difficult and costly to provide these services to the MEs.

Other institutional support activities

The framework for ME lending of the MFIs needs also to take into consideration mechanisms to support the creation, expansion and strengthening of organisations specialised in providing market-oriented, sustainable business services to MEs. The focus should be on improvement in the quality of training and technical assistance programmes, development of marketing networks that would expand the access of micro-entrepreneurs to more profitable segments of the market, assistance to comply with legal and regulatory procedures, promoting subcontracting arrangements with larger firms, and transfer of appropriate technologies to improve productivity, especially those that are financially sustainable and environmentally sound.

The Way forward

The important concern relating to the ME sector is to ensure its speedy growth in all aspects including output and employment. For this, the country's industrial strategy, in addition to focusing on growth on MEs, needs also to be anchored in multi-layered subcontracting arrangements between the larger enterprises and the MEs and among the MEs themselves. In recent years, ME-centred activities in trade, services, agriculture and food processing sectors have expanded rapidly in response to higher demands and there exists more potential for their future expansion. Innovation and searching for new markets are also important for sustaining the growth of existing MEs and flourishing of new MEs.

For accelerating future growth and viability of the MEs, technological innovation and knowledge transfer, product diversification, and marketing services are the key areas where special attention are needed. The adoption of a comprehensive road map, jointly worked out for implementation through public-private collaboration, for technological and marketing services for the MEs can go a long way in creating a competitive ME sector in the country with required market linkages.

5.2.2 Creating Supportive Framework for ME Financing through MFIs

The present study suggests that, despite years of support programmes and institutional efforts, a very small share of the country's micro-entrepreneurs have access to formal financial services including those from MFIs. It appears that supplier credit and informal money lending are important sources of finance of MEs and this is likely to continue to play a key role in future as well unless visible changes are made to remove the constraints facing the formal financial institutions and MFIs including information constraints to ME lending. Formal financial institutions, using their traditional credit technologies, still do not reach most MEs because of the relatively high cost of making small loans and the lack of required forms of collateral. Evidence collected in this study shows that the MFIs provide access to finance to a limited number of MEs, but most are not sustainable without access to adequate funding sources in the face of relatively high cost of operation.

The MEs face constraints on the deposit side as well. Most MEs are financed through the owners' and family members' savings. But their access to and use of formal savings mechanisms are constrained by several factors such as minimum deposit requirements, limited liquidity, high transaction costs, inconvenient banking locations and hours, and unfamiliarity of micro-entrepreneurs with banking regulations and customs.

The study identifies financial constraint as the major problem of MEs. Our estimates of demand for ME loan (based on demand side survey) and supply of ME funds (based on existing supply of credit by MFIs and banks) show that an excess demand of Tk. 437 billion (which is about one and half times higher than the current disbursement). This is based on a constant rate of growth as projected from the past. Considering the targeted economic growth rates during the Seventh Five Year Plan (2016-2020), much higher levels of investment in MEs would be required. .

With the varied experience of successful financing of microfinance activities, the MFIs can be made to emerge as a major source of ME lending in Bangladesh through right action in the following four key areas: (i) creating a favourable policy and regulatory environment; (ii) building strong, sustainable institutions providing financial and nonfinancial services to meet the demands of MEs; (iii) creating improved access of low-income and disadvantaged (including women) micro-entrepreneurs to financial and business development services; and (iv) ensuring continuous and permanent flows of required financial resources to the MFIs for meeting the needs of the MEs.

An important element of the recommendations of this study is to focus, along with ensuring adequate flow of ME financing from the MFIs, on two fundamental pillars: policy reform and institutional development. This is essential to expand access to financial services for low-income and disadvantaged micro-entrepreneurs. The ME lending framework needs to be supported by several key components as follows:

Institutional development

One central feature of the strategic component for ME development should be to support the strengthening of formal institutions as well as the MFIs, along with enhancing their capabilities to become sustainable providers of financial and other services to micro-entrepreneurs. Institutional strengthening should focus on helping financial intermediaries and organisations involved in providing financial and business development services to adapt their services to meet the demands of micro-entrepreneurs and improve the efficiency and effectiveness of service delivery. Obviously, institutional strengthening must be accompanied by mechanisms to procure additional resources for ME lending by the MFIs on a larger scale.

Developing MFIs as financial intermediaries

There is a need to support the strengthening of the MFIs as financial intermediaries for extending ME loans through the transfer of improved and innovative financial technologies in order to reduce transactions costs and credit risks. It will also facilitate their graduation as efficient financial institutions and enable them to develop effective links with and access to capital markets, thus enhancing their ability to mobilise resources in a sustainable manner. Under the existing rules, MFIs are not allowed to mobilise public deposits and develop different savings products to attract savings.

There are two possible ways of developing MFIs as efficient financial intermediaries. First, the existing rule of restricting public deposit mobilisation by MFIs can be relaxed, and at least be reviewed for a positive outcome. Second, selected number of MFIs may be transformed into microfinance banks within a sound framework. Whatever be the policy decision, the decision should not create distortion or cutthroat competition in financial markets.

Developing innovative financial instruments

In order for the MEs to grow and build up their capital base, new financial products and instruments such as term loans, leasing and factoring would be required in the longer term. Keeping these longer term issues in view, the development of these innovative services for MEs needs to be considered. Savings accounts and deposit services are important vehicles for MFIs, and capturing local savings is essential to the long term financial sustainability of MFIs. Therefore, savings mobilisation from public and the creation of financial products tailored to the demands of the micro-clients for deposit services can form an important element within the ME lending framework of the MFIs.

Increasing supply of external finance

The study brings out the reality that resources available with the MFIs are not adequate to cater to the total demand for ME financing. The present level of funding by the MFIs meets only a small share of the total requirements leaving a huge gap between the demand for and supply of available funds. Given the enormous size of the ME sector and its economic potential, such a significant resource constraint needs to be urgently addressed.

In addition to traditional sources, promising new opportunities for expanded private sector investment in ME development should be explored. For the purpose, several steps may be taken.

First, MFIs may be allowed to raise social equity fund as social capital where the equity-holders will not be private owners. Such social capital fund can be mobilised from private investors and capital market. A policy option of establishing Social Capital Exchange may also considered for a sustainable financing of MEs and small businesses in Bangladesh.

Second, Bangladesh Bank along with MRA may introduce Credit Guarantee Scheme for MFIs to inject fund from banking sector or international agencies. This needs to be clearly examined based on past experiences.

Third, for enhancing the flow of resources for ME lending, a critical issue for the MFIs is to ensure the channelling of more funds from private sources. The importance of these resources is that they represent long-term sources of financing which are not currently available. Attracting funds to expand coverage of the ME sector from private sources needs consideration of several factors including transactions at market rates of interest and other issues of the financial sector. Moreover, the range and size of such ME lending will be dependent on the existence of adequate institutional capacity to effectively provide financial services to the MEs.

An investment fund may be created with resources from private investors, MFIs and other donors, to provide equity financing to the MFIs that are ready to provide financial intermediary services and/or undertake joint ventures with financial institutions seeking to enter or expand their financial services to the MEs.

Way Forward For Improving Access to the ME Credit Market

For implementing the proposed multi-dimensional programmes, several approaches may be adopted.

First, both MRA and BB should examine all options that we have suggested, in consultation with different stakeholders. Some of the policy suggestions that we have put forward will require further analysis.

Second, MRA, in consultation with BB, should prioritise the policy suggestions and decide on phases of implementation of the agreed policies.

Third, MRA should look at promoting and financing micro-enterprises, as one of the goals of the regulatory authority is to influence economic growth. Therefore, it should formulate policies to finance enterprises.

Fourth, it may be necessary to make equity investments in MFIs who are involved in ME lending.

Fifth, it may be useful to explore the feasibility of a credit guarantee mechanism to promote linkages between ME-lending MFIs and private/other financial intermediaries. The overall approach should combine the instruments in a strategic fashion so that they become mutually reinforcing.

Sixth, it may be useful to review different MRA and BB rules in order to improve accessibility of MEs to credit services. Some rules and regulations of MRA may need to be amended.

Seventh, BB and MRA should jointly start a process of examining the issue of establishing selected number of ‘rural microfinance banks’ and/or dialogue with PKSF on opening a separate window for financing CMEs.

Finally, an important issue for ME development in Bangladesh is to set a vision and adopt a pro-active MEs promotion policy that would facilitate a rapid transition from traditional to relatively modern product categories along with higher capitalisation and use of better production technologies. This will help upscale the existing low productivity informal MEs and deepen their links with mainstream growth seeking activities. As such, the development of MEs calls for a re-thinking of the present nature of MFI interventions to address the second generation issues of finance up scaling and technology diffusion necessary to create sustained impact on poverty reduction in Bangladesh.

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APPENDIX-I

Terms of Reference

Diagnostics of Micro-enterprise Lending by MFIs in Bangladesh: Opportunities and Challenges

1. Project Background

Business Finance for the Poor in Bangladesh (BFP-B) is a five-year programme funded by UKaid from the UK government. Bangladesh Bank is the implementing agency, and the Bank and Financial Institutions Division of the Ministry of Finance, Government of Bangladesh, the executing agency. Nathan Associates (London) Ltd, in consortium with its partner, Oxford Policy Management, has been appointed as the management agency for the programme. The programme seeks to promote **innovative finance for small business** and is designed to couple social and economic welfare objectives with a deliberate, commercially-sound approach to foster increased access to finance for Bangladesh's micro- and small enterprises (MSEs), especially those that are currently unserved/underserved by the formal financial sector. BFP-B seeks to contribute to inclusive economic growth in Bangladesh. BFP-B has three components, a Challenge Fund, a Credit Guarantee Fund, and a Policy Component. The Challenge Fund will catalyse and support innovative financing products and delivery channels to foster financial inclusion; the Credit Guarantee Fund will support bank finance to hitherto unbanked, but creditworthy, MSE borrowers; and the Policy Component will work as a support function for these two components, unblocking regulatory barriers. The Policy Component of the BFP-B programme is focusing on facilitating a collaborative approach to financial sector policy and regulatory reform to create an enabling regulatory environment for the MSE sector in Bangladesh and increasing financial inclusion for small business. . This scope of work is part of the policy component, which is overseen by a 'Policy Advisory Committee (PAC).

2. Background and Context of the Study

MRA defines micro-enterprise loan based on loan size. If the loan size is more than BDT 50,000, then MRA considers it as micro-enterprise loan and the loan size below BDT 50,000 is considered as microcredit[17]. The following table illustrates the growth of microcredit and micro-enterprise loans over the last three years[18]:

Particulars	June, 2011	June, 2012	June, 2013
Total micro-credit and micro-enterprise borrowers (million)	20.65	19.31	19.27
Micro-enterprise Loan Borrower (million)	0.62	0.82	0.94
Amount of micro-credit and micro-enterprise Loan Outstanding (BDT billion)	173.79	211.32	257.01
Micro-enterprise Loan Outstanding (BDT billion)	40.18	56.78	66.96

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[17] MRA (2012), *NGOs-MFIs in Bangladesh, volume-viii, June 2011*, Microcredit Regulatory Authority, November, 2012

[18] MRA (2014), *NGO-MFIs in Bangladesh, Volume-X, June 2013, and* MRA (2013), *NGO-MFIs in Bangladesh, Volume-IX, June 2012,*

The microfinance loan portfolio of MRA-licensed Microfinance Institutions (MFIs) increased by 32% in 2013 compared to 2011. The growth of micro-enterprise loan portfolio was 40% during the same period.

The main sources of fund of MRA licensed MFIs in Bangladesh are client's savings (33.62%), loan from PKSF (12.16%), loan from Commercial Banks(15.26%), Cumulative Surplus (29.77%), donor and other funds (9.19%)[19]. The MRA policy on deposit mobilisation allows MFIs to accept deposits up to 80% of loan principal outstanding. However, there is a restriction on mobilising voluntary[20] and term deposits. MFIs may mobilise a maximum of 25% of their capital as voluntary and an additional 25% as term deposits[21]. These restrictions prevent MFIs from serving the savings needs of the poor, mobilising low cost deposits, and increasing the micro-enterprise lending portfolio. Up to June 2013, the ratio of savings to loans of MRA-licensed MFIs was 37%[22]. This is in sharp contrast to Grameen Bank, which was set up under a special act and is not regulated by MRA. With its increasing offering of deposit products (especially pension), overall deposits mobilised have grown from BDT 5 billion in the year 1997 to BDT 154 billion during 2013 and the deposit outstanding to loan outstanding ratio has rapidly increased from 36% to 176% during the same period[23]. MFIs and microfinance networks have long-standing requests to the MRA to amend this policy.

Deposit mobilisation entails risks for small savers. However with the offsite and onsite supervision in place, the MRA can assess risks of different MFIs based on track record and supervision reports and distinguish between low risk and high risk MFIs as size and risk may differ. To further encourage better performance, governance and management practices of all MFIs, exceptionally well managed and low risk MFIs can get policy support with increased freedom to expand on deposit mobilisation or lending side as per customer demand and organisational capacity. Very different internal skills, systems and customer relationships are needed to rapidly grow deposits and micro-enterprise portfolio. Policy reform can also lead to specialisation as all MFIs may not be good at both deposit mobilisation and micro-enterprise lending. The reform of deposit mobilisation policy would assist strong MFIs to obtain lower-cost savings and/or expand their micro-enterprise lending.

As of June 2013, the total loan outstanding of MRA licensed MFIs was BDT 257.01 billion and micro-enterprise loan outstanding was BDT 66.96 billion, which is 26% of total loan portfolio[24]. Currently, MFIs in Bangladesh may not devote more than 50% of their lending portfolio for micro-enterprise clients[25]. Options need to be explored to remove or relax this restriction. The micro-enterprise portfolio of some of the large MFIs is now gradually reaching the 50% of overall microfinance loan portfolio. Large and medium-sized MFIs have reported that the current restriction on micro-enterprise loan portfolios is hampering the growth of MSE lending of MFIs. MRA is planning to be flexible on micro-enterprise lending portfolio restriction upon application of individual MFI lending. Despite supporting this policy issue, MRA has yet to amend 'MRA Rules 2010'. Such amendment requires the approval of the MRA Board and the Ministry of Finance (MoF). In addition, MRA Rules 2010 is primarily concerned with microfinance programmes with less attention on micro-enterprise programmes. Over the last three years the micro-enterprise loan portfolio of all MRA licensed MFIs has rapidly grown from BDT 40.18

[19] MRA (2014), *NGO-MFIs in Bangladesh, Volume-X, June 2013.*

[20] Voluntary deposits are not mandatory for clients. However, if clients are interested, they may deposit a certain amount in excess to the MFIs.

[21] Clause 27(2), 28(e) and 29(e) of MRA Rules 2010 restrict MFIs to mobilise savings

[22] MRA (2014), *NGO-MFIs in Bangladesh, Volume-X, June 2013.*

[23] **Analysis based on Grameen Bank Balance Sheet data of 1997 and 2013,** http://www.grameen.com/index.php?option=com_content&task=view&id=180&Itemid=425

[24] MRA (2014), *NGO-MFIs in Bangladesh, Volume-X, June 2013.*

[25] MRA considers all loans to micro borrowers in excess of BDT 50,000 to be micro-enterprise loan. Those below BDT 50,000are considered to be microfinance loans. According to the clause 24(3) of MRA Rules 2010, the size of micro-enterprise loans of any MFI will not be greater than half of the size of the total loan portfolio at any given time.

billion to BDT 66.96 billion (67% increase over three years) and reached approximately 27 percent of the total loan portfolio. The MFIs, especially large and medium sized MFIs[26], are expecting separate policies/rules for micro-enterprise lending because micro-enterprise programmes are different from traditional microfinance programmes in terms of nature of loan operations, repayment protocols, risk exposure, operational cost, etc. However, an assessment is required to understand whether the MFIs are shifting their focus on micro-enterprise lending because of loan demand among the clients or profitability.

Based on assessment, a separate micro-enterprise policies / rules could be developed that would help guide MFIs to better operate micro-enterprise programmes. This is critical as: a) most banks struggle to cost effectively serve borrowers needing loans between 50,000 and 500,000; and b) considering inflation since 2010 when the 50,000 limit was set, many of the microfinance borrowers are being categorised as micro-enterprise borrowers due to the 50,000 limit; and c), the micro-enterprise loan size of MFIs is increasing gradually and some MFIs are providing loans of up to BDT 1.5 million.

Based on the above context, the policy component of the Business Finance for the Poor in Bangladesh (BFP-B) programme has been asked by the PAC to commission a study on ***'Diagnostics of Micro-enterprise (ME) Lending by MFIs in Bangladesh: Opportunities and Challenges and way forward'***

3. Objective and Purpose of the Assignment

The overall objectives of this study are to-

- identify the key opportunities of MFIs to expand micro-enterprise lending and deposit services
- understand key policies which are constraining the MFIs from operating micro-enterprise loan programmes
- identify demand for deposit services and micro-enterprise loans among micro-entrepreneurs and ascertain the unmet demand
- identify the demand-supply gap of micro-enterprise lending and suggest how to minimise the gap
- explore the current sources of funds of MFIs and identify low cost funding sources
- provide policy recommendations for MRA and other regulatory bodies.

4. Scope of Work

The study is expected to cover five broad areas:

i) Supply side perspective: The supply side perspective will collect information from MFIs about microfinance and micro-enterprise loan portfolios, sources of funds, savings products and different kinds of savings outstanding amounts, opportunities and policy challenges of MFIs to operate micro-enterprise lending programmes.

***ii)Demand side perspective*:** The demand side analysis will identify the demand for micro-enterprises loan among the clients, ascertain the unmet demand, and identify the demand-supply gap. Rather than generic analysis, it would be helpful if the study team can analyse a few key

[26] Source: MRA (2014), *NGO-MFIs in Bangladesh, Volume-X, June 2013*. MRA categorises MFI size based on number of borrowers. MRA has categorised MFIs as very large (more than 1 million borrowers), large (between 100,001 to 1 million borrowers), medium (between 50,001 to 100,000 borrowers), small (10,001 to 50,000 borrowers), and very small (up to 10,000 borrowers).

market segments in depth (such as farmers esp. those growing cash crops, with or without a clear value chain; small roadside traders; micro manufacturing businesses; small service providers such as transport operators, tailors or mobile money agents) to analyse current financial service needs, choices and constraints for micro-entrepreneurs.

iii) Other stakeholders' perspective: The consultant (Consulting Firm)[27]will gather views of the different stakeholders about opportunities and policy challenges of micro-enterprise lending of MFIs. The other stakeholders include microfinance networks e.g. Credit and Development Forum (CDF) and International Network of Alternative Financial Institutions (INAFI), and Palli Karma-Sahayak Foundation (PKSF). The list of the stakeholders to be consulted will be finalised at the commencement of the assignment

iv)Regulatory perspective: The consultant will gather views of Bangladesh Bank and Microcredit Regulatory Authority (MRA) about opportunities and policy challenges of micro-enterprise lending of MFIs.

v) Microfinance Regulations of other countries: The study is expected to draw lessons from Microfinance Regulations of other countries.

5. Detailed tasks including suggested methodology

Prior to starting the study, the consultant is expected to prepare a draft research proposal and organise a consultation meeting with 5 MFIs, microfinance networks, MRA, and PKSF. Then the consultant will finalise the research proposal with a work plan and methodology to be reviewed by BFP-B Policy Working Committee to ensure clear understanding of the methodology, approach, main deliverables and timelines. The study will involve literature review, stakeholder consultation, analysis of secondary data and field work. The field data will be collected through a structured questionnaire and focus group discussions with the micro-enterprise clients. Consultant will be responsible for revising the approach as necessary in consultation with BFP-B.

Literature Review: Undertake literature review of different reports/documents of MRA, PKSF, Institute of Microfinance (InM), CDF, Consultative Group to Assist the Poor (CGAP), and other organisations. The consultant will also review the microfinance regulations of other countries. However, it is expected that the consultant will already have significant existing knowledge on these issues and can also access/review additional literature relevant to the study.

Secondary data analysis: Analyse key secondary data from MRA, PKSF, InM, CDF, Mix Market, annual and audit reports of MFIs, and other sources to understand growth trends of microfinance and micro-enterprise lending, savings portfolios etc.

Stakeholder consultation: The consultant will consult with at least 20 MFIs (2 very large, 7 large, 6 medium, and 5 small MFIs) to understand their views on opportunities and policy challenges of micro-enterprise lending and collect data about their microfinance, micro-enterprise and savings programmes. However, the number of MFIs to be consulted will be determined later through discussion with the consultant. The consultant will also consult with microfinance networks (CDF and INAFI), PKSF, MRA, and Ministry of Finance. It is also expected that the consultant will consult with some board members of MRA about their views on

[27]The consultant refers here Consulting Firms/ academic and/or research institution having policy research experience.

current policy challenges facing MFIs for micro-enterprise lending. The stakeholder consultations will include a series of phone calls, specially organised meetings, focus group discussions as well as consultation sessions at workshops and training programmes being organised by other stakeholders. Based on initial primary and secondary research, the consultant is expected to facilitate generation of alternative policy options for Bangladesh and explore amongst key stakeholders as to how these could accelerate or constrain deposit mobilisation and micro-enterprise lending e.g. innovative linkages amongst MFIs, NBFIs, Banks and mobile money operators. Analysis of existing constraints, opportunities, policy choices and recommendations should be linked to market segments as generic analysis may be of limited use. There is significant diversity amongst MFIs and other criteria for segmentation (apart from size) should also be explored e.g. not all large MFIs may be low risk.

Primary Data collection: The primary data will be collected from the micro-entrepreneurs. The sample size and primary data collection methodology will be proposed by the consultant in their technical response and finalised after consultation with key stakeholders (including BFP-B).

Discussion meetings/workshops: Organise some small discussion meetings/workshops with the regulators, government agencies, MFIs, banks, NBFIs; banking and microfinance associations, apex foundations, donors, academics, research institutes and think tanks. The number of discussion meetings/workshop will be proposed in the technical response and finalised later through discussion with the consultant and some key stakeholders.

Dissemination seminar: BFP-B will organise a dissemination seminar to share the draft findings of the study report. The participants of the workshop will be regulators, government agencies, MFIs, banks, NBFIs, microfinance associations, apex foundations, donors, academics, research institutes and think tanks. The Experts of the Consulting Firm involved in this research will make a presentation of their findings in the dissemination seminar.

6. Expected output

The consultancy will have five major outputs:

i) Detailed analysis of the findings of the discussions with the supply side and other stakeholders. Identify the opportunities and policy challenges for MFIs to accelerate deposit mobilisation and micro-enterprise lending programmes.

ii) Detailed analysis of the demand side data. Based on demand side data analysis, identify the demand for micro-enterprise loan and deposit services, and estimate the unmet demand.

iii) Identify the demand-supply gap of micro-enterprise lending and suggest policy choices to address this gap.

iv) Analysis of good microfinance regulatory practices of other countries

v) Identify impacts of existing policies and summarise key lessons learnt. Identify any unintended impacts that were not anticipated when the policies were formulated. Provide policy choices and recommendations as to how to increase micro-enterprise lending of MFIs and if required, provide necessary recommendations for amendment of ‘MRA Rules 2010’. The recommendations should be prioritised between short, medium and long term.

7. Qualifications, Competencies and Experiences of the Experts

The assignment requires at least a Local Team Leader having extensive experience in Microfinance and/or Micro-enterprise Policy and Access to Finance Research, one Local Microfinance/Micro-enterprise Expert, and one Research Associate. If the Consulting Firm deems necessary, they may involve more experts.

The specific requirements of the experts are as below:

Team Leader: *Microfinance and/or Micro-enterprise Policy and Access to Finance Expert*

- Minimum Post Graduate Degree in Finance/Economics/Business Administration/Public Policy/Any other relevant subject. MPhil or Phd degree would be preferable.
- At least 15 years of proven experience in Microfinance and/or Micro-enterprise Policy research and/or Access to Finance research.
- Experience in Microfinance or Access to Finance Policy formulation and review would be preferable
- Strong knowledge and experience in microfinance and micro-enterprise programmes of Bangladesh
- Knowledge about financial service providers in Bangladesh
- Track record of advising national policy makers in the area of microfinance and/or access to finance
- Strong knowledge and experience in preparing policy research reports and policy/research briefs
- Language skills: Fluency in English and Bangla

In addition to the overall assignment, the Team Leader will play be responsible to ensure successful delivery of the agreed outputs. The Team Leader will manage his/her team members in order to ensure the timely delivery of the output.

Microfinance/Micro-Enterprise Expert:

- Minimum Graduate Degree in Economics/ Finance/Business Administration/Development Studies/ Public Policy/Any other relevant subject
- At least 10 years of proven experience in Microfinance and/or micro-enterprise operations/research in Bangladesh
- Strong knowledge and experience about financial service providers in Bangladesh
- Demonstrated capacity to conduct policy research
- Knowledge and experience in preparing policy research reports and policy / research briefs would be preferred
- Language skills: Fluency in English and Bangla

Research Associate:

- Minimum Graduate Degree in Finance / Economics / Business Administration / Public Policy / Law / Any other relevant subject
- At least 5 years of proven experience in Microfinance and/or micro-enterprise research in Bangladesh
- Strong knowledge and experience about financial service providers in Bangladesh
- Demonstrated capacity to conduct policy research
- Strong Experience in Statistical Software and Data Analysis

▪ Knowledge and experience in preparing policy research reports and policy / research briefs would be preferred
▪ Language skills: Fluency in English and Bangla

8. Deliverables

Name	Type	Estimated Submission Date*
Inception Report	**Report**	
Draft Research Report (in English and Bangla)	**Report**	
Draft Policy Brief extracted from the research findings and policy recommendations (both in English and Bangla)	**Policy Brief**	
Final Research Report (in English and Bangla)	**Report**	
Final Policy Brief (both in English and Bangla)	**Policy Brief**	

***Notes:** The estimated submission date will be determined later upon signing of the contract with the consultant.

9. Schedule of assignment

Estimated start date: 15th December, 2015

Estimated end date: 15th March, 2016

The schedule of assignment will be finalised upon signing of the contract by BFP-B Project/Nathan Associates London Ltd.

10. Reporting

The consultant shall report to the BFP-B Team Leader and the BFP-B Policy Manager for overall strategic and technical guidance. The BFP-B Policy Manager will work closely with the consultant, provide task coordination, attend stakeholder consultations, review the research report, and disseminate the draft research findings. The BFP-B Team Leader and the Working Committee will approve the study report.

APPENDIX- II

The Institute for Inclusive Finance and Development (InM) organised a consultation meeting with Bangladesh Bank and some selected number of public and private banks and non-bank financial institution on March 29, 2016 to understand their views on the constraints, opportunities and policy challenges of microenterprise lending. The discussion meeting was chaired by Mr. Nirmal Chandra Bhakta, Executive Director, Bangladesh Bank. The representatives of SME divisions of two state owned banks, six private commercial banks and one non-bank financial institution and number of higher officials of Bangladesh Bank participated in the program (refer to annexure-1 for the participant list). In the course of discussion InM team has identified some major issues on microenterprise lending.

- Role of central bank in promoting ME
- Constraints to micro-enterprise lending by banks and Way Forward

Role of Central Bank in Promoting ME

Bangladesh Bank has been contributing to microenterprise development through formulating policies. Public and private commercial banks and non-bank financial institutions follow the rules set by Bangladesh Bank. Initially the enterprises were categorised as large, medium and small. Considering that smaller enterprises require specific attention and policies, for the first time in the industrial policy in 2010 Bangladesh Bank included cottage and micro industry in the industry classification. A separate division under Bangladesh Bank named SME and Special Program Department is completely dedicated to support micro entrepreneurs. Besides providing detailed definition Bangladesh Bank also formulated some policies to support these small sized industries. As the network of the bank is not so widespread like NGO-MFIs banks can go for agent banking with the MFIs so that banks can channel funds to entrepreneurs through MFIs. Not only the local banks also the foreign banks are making agreements with NGOs to promote agent banking. The mobile banking facilities are also being promoted to facilitate the entrepreneurs. Bangladesh Bank has made it mandatory for each branch having SME department to train up at least three entrepreneurs and choose one entrepreneur from that group to provide loan. It has formed Women Entrepreneurs Development Unit in the head office so that it can solely facilitate the women entrepreneurs.

Constraints faced by Banks in Lending the Micro Entrepreneur

Banks are willing to support the micro entrepreneurs however they are facing some constraint. As microenterprise loans are mostly known as supervisory credit meaning that these loans have to be monitored strictly hence providing more loan becomes costly as monitoring cost goes high. Moreover, most of the entrepreneurs are not able to provide collateral. As loan without any security is risky, providing more loans in microenterprise sector means incurring more risk by the banks. Even if the banks want to provide loan to the entrepreneurs, the entrepreneurs most of the time cannot provide necessary documents such as trading license, cash flow statement etc. on which basis the bankers can provide loan to them. So entrepreneurs also have to co-operate the bankers so that they can provide loan to the entrepreneur. They have to have some basic financial literacy so that they can prepare some basic form of cash flow statement. Many of the banks in the discussion meeting also mentioned about networking problem. Definitely agent banking is a solution for this problem. However, for the banks it is difficult to choose the MFIs for agent banking. Normally they choose the large MFIs for agent banking to be on the safe side. In this regard MRA can play a significant role. MRA can disclose the MFI rating to the banks so that they can choose MFI for this purpose. Furthermore, CIB can be formed so that they can be well informed about the borrowing status and repayment history of the borrowers of those MFIs.

Name	**Designation & Organisation**
Nirmal Chandra Bhakta	Executive Director, Bangladesh Bank
Swapan Kumar Roy	General Manager, Bangladesh Bank
Md. Belayet Hossain	D.G.M., Pubali Bank Ltd.
Mohd. Arifur Rahman	AGM, Pubali Bank Ltd.
Iftekhar Enam Awal	Head of SME, AB Bank Ltd.
Md. Maruf Hossain	AVP, Islami Bank Bd, Ltd.
Shahida Milki	Sonali Bank Ltd.
Nasima Akhter	Janata Bank Ltd.
Md. Abul Kashem	Janata Bank Ltd.
Chris August	Team Leader, BFP-B
Md. Mahmud Hasan	DGM & SME Focal Person , Basic Bank
S.M. Ferdous Hossain	DGM, Basic Bank
Nawshad Mustafa	JD-SME SPD, Bangladesh Bank
Md. Mubarak Hossain	JD-SME SPD, Bangladesh Bank
Rojina Akter Mustafi	JD-SME SPD, Bangladesh Bank
Mst. Kamrun Nahar	DGM-SME SPD, Bangladesh Bank
SM Mohsin Hossain	DD-SME SPD, Bangladesh Bank
SM Ishtiaque	Assistant Manager, IDLC Finance Ltd.
Ahmed Rashid Joy	H SME, IDLC Finance Ltd.
Md. Mahbub-Un-Nabi	JAVP, SME, Mutual Trust Bank Ltd.
Tarek Reaz Khan	SEVP, Head-SME, Mutual Trust Bank Ltd.
T.I.M Rawshan Zadeed	EVP and Head of SME, IFIC Bank Ltd.

APPENDIX- III

Participant List

Sl no.	**Name**	**Designation**	**Organisation**
1	Fazlul Haque Khan	Director	CDIP
2	K. Manishankar Howlader	DD	TMSS
3	Helal uddin Mazumder	LO	Prottyashi
4	Md. Sobur Mollah	Senior Manager	Shakti Foundation
5	Khalilur Rahman	Chief Executive	Endeavour
6	Maniruzzaman Chowdhury	Asst. head of MF	GBK
7	Iqbal Ahammed	ED	Padakhep
8	Bazlur Rashid	Program Manager	Srizony Bangladesh
9	Samsul Alom	Joint Director	DSK
10	Sanat Kumar Shaha	Deputy General Manager	Grameen Bank
11	Md. Tajul Islam	Director	PMK
12	Musifur Rahman	Deputy Director	SSS
13	Md. Kamal Hossain	Senior coordinator	ESDO
14	Md. Abdul Hamid	Deputy Asst. Director	RRF
15	Md. Hasan Ali	ED	PBK
16	Md. Fokor Uddin	Deputy coordinator	Wave Foundation
17	Atul Karmokar	Coordinator	Sajeda Foundation
18	Md. Foijar Rahman	EVP	ASA
19	Md. Didar Uddin	PC	DORP
20	Abdul Khalek	Senior Assistant Director	Uddipon
21	Mukhlesur Rahman	Director	GUK
22	Md. Moshihur Rahman	Director (EES)	POPI
23	Arif Sikder	Executive Director	EC Bangladesh
24	Mohammad Nue-E-Alam	Assistant Coordinator Finance	SAP - 3D
25	Sayed Ahmad Khan	AC (M & R)	Buro Bangladesgh
26	Mohammad Shafiqul Islam	DD (Accounts)	ASPADA Paribesh Unnayan Foundation

APPENDIX-IV

There are several ways MFIs can increase ME financing in Bangladesh. Let us consider the following amendments to certain provisions of the MRA Rules 2010:

(a) redefine loan size of ME loan: redefined from Tk.50,000 to Tk.75,000;
(b) modify voluntary savings and term deposits as 25 percent of loans outstanding, rather than of equity of MFIs.

We assume that borrowing interest rate from banks is 12 percent, and savings interest rate is 7 percent. We assume that MFI is forced to borrow from informal sources at an interest rate of 10 percent.

How would these changes affect balance sheet and the profitability of the MFI.

To start with, let us consider the initial sample Balance Sheet of an MFI.

Sample Balance Sheet of an MFI

(Amount in million BDT)

Assets	Taka	Liabilities and Owner's Equity	Taka
Current Assets:		**Current Liabilities:**	
Cash	2	**Savings:**	
Bank Deposit	8	General	25
Loan Outstanding:		Voluntary	5
Microfinance	50	Term Deposit	5
Microenterprise	50		
Total Current Assets	**110**	**Total Current Liabilities**	**35**
Long-term Assets:		**Long-term Liabilities:**	
Building	10	Loan from PKSF	35
Land	10	Loan from Banks	25
Total Long-term Assets	**20**	Other Loan	15
		Total Long-term Liabilities	**75**
		Equity (Surplus / Capital)	**20**
Total Assets	**130**	**Total**	**130**

Total loans outstanding amounts to Taka 100 million. Total equity is shown as Tk. 20 million. Considering the rule 28(e), voluntary savings and term deposits cannot exceed Tk. 5 million each. Borrowing from PKSF is cheaper than that of commercial bank loan. It carries an average interest rate of 10 percent.

Let us now consider implications of the suggested modifications, as stated above. The suggested modifications will have implications on loans outstanding, voluntary savings and term deposits as well as borrowing from banks.

As loan size has been modified, we have increased loans outstanding based on the assumption that additional increase in loans disbursement has not affected repayment behaviour of the MFI. As a result, loans outstanding increases to Tk. 126 million. How has it financed? Let us apply the suggested amendment that the MFI will be able to mobilise both voluntary savings and term deposits by 25 percent each of loans outstanding. This will lead an increase in voluntary savings and term deposits by a total of Tk.62 million. Such increase in voluntary savings and term deposits will reduce borrowing from banks and other informal sources. This is depicted in the following Table:

Revised Balance Sheet
(Taka in Million)

Assets		**Liabilities and Owner's Equity**	
	Taka		**Taka**
Current Assets:		**Current Liabilities:**	
Cash	2	**Savings:**	
Bank Deposit	8	General	25
Loan Outstanding[1]:		Voluntary [2]	31
Microfinance	63	Term Deposit[3]	31
Microenterprise	63		
Total Current Assets	**135**	**Total Current Liabilities**	**88**
Long-term Assets:		**Long-term Liabilities:**	
Building	10	Loan from PKSF	35
Land	10	Loan from Banks[4]	12
Total Long-term Assets	**20**	Other Loan[5]	0
		Total Long-term Liabilities	**47**
		Equity (Surplus / Capital)	**20**
Total Assets	**155**	**Total**	**155**

With an increase in savings and deposits, borrowing from banks has reduced to Tk. 12 million, reduced by 50 percent. Other informal borrowing reduces to zero because of access to institutional sources of finance – savings and bank borrowing. Given the loans outstanding, savings and deposits together finance 50 percent. Given the borrowing from PKSF, the MFI borrows from banks.

Let us now see the impacts:

First, voluntary savings increases by more than six times.

Second, term deposits also increases by more than six times.

Third, borrowing from banks reduces by 50 percent.

Fourth, other loans reduce to zero.

Fifth, cost of fund reduces by 9 percent.

Six, given lending interest rate, revenue from loans increase by 26 percent, as loans disbursement increase by 26 percent.

Taken all these outcomes together, in addition to increase in loans disbursement, the MFI financially gains by 35 percent. Therefore, it becomes more financially viable.

APPENDIX- V

Appendix to Chapter Four

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Licensing Requirements and Guidelines for Setting up Microfinance Banks in Pakistan

Introduction (State Bank of Pakistan)

Pakistan has a separate legal framework to govern the microfinance activities of the Microfinance Banks (MFBs). The MFBs are licensed and regulated by State Bank of Pakistan. Considering the separate needs and dynamics of microfinance, SBP has in place a separate regulatory and supervisory framework for MFBs. Since its creation, the policy framework has seen various improvements on the basis of feedback of key stakeholders and assessment of the evolving needs and conditions of the sector. To promote the mainstreaming of microfinance into overall financial system, SBP encourages creation of new MFBs and transformation of existing operationally sustainable MFIs into MFBs. The presence of a large potential market and availability of an enabling policy environment offer the opportunities for both social and commercial investors to explore this segment of the financial market. The growth and sustainability continue to be the two guiding objectives for the development of the sector. SBP is fully cognizant of the fact that pursuing these two objectives concurrently is a challenging task. This requires vision of sponsors / management, deep understanding of the target market, viable business model, appropriate organisational structure, and management capabilities to adopt innovation in products & delivery channels. All the prospective investors need to gain deep understanding of the local microfinance banking industry vis-à-vis its performance & potential, and challenges & incentives. Moreover, the promoters of prospective MFBs should also dedicate adequate time and energies to explore the learning and innovations that are occurring rapidly across the globe.

1. The Licensing, Regulatory & Supervisory Agency

The licensing, regulation and supervision of MFBs established under MFIs Ordinance 2001 has been entrusted to State Bank of Pakistan. No institution/person can commence operations as Microfinance Bank unless granted license by the State Bank under section 13 of the MFIs Ordinance 2001.

2. Structure of Licensing Policy

Licensing requirements for establishment of an MFB may be classified into two distinct categories: (a) new MFBs, and (b) Transformation of MFI into a MFB. The requirements for licensing of a new MFB have been given in Section-I. These requirements would apply equally to the MFI intending to transform into MFB. In addition, transforming MFI would also follow additional requirements as laid down in Section-II. The Section-III provides guidance on the process flow of the licensing / transformation relating to MFB.

I. Requirements for setting up a new MFB and transformation of MFI into a MFB
II. Additional requirements for transformation of MFI into MFB
III. Process Flow Chart for Grant of License

Section - Requirements for setting up new MFB and transformation of MFI into MFB1. Who Can Apply for a License for Establishing Microfinance Bank?

i. Institutions

a. Institutions which have demonstrated successful microfinance experience as an MFI locally or globally. Local microfinance institutions (MFIs) can transform their existing MF operations into a MFB (Details are given in section-II).

b. Institutions having large distribution network and / or technology resources.

ii. Person or group of persons

Any person or group of persons, Pakistani or foreign national, having requisite financial and managerial capacity and commitment to the financial sector, have to first establish an MFI for at least three years in order to become eligible for MFB License. However, in extremely exceptional circumstances, where individual sponsors have long exposure/experience of Micro/Agriculture/SME Finance and/or other related areas, SBP may consider them for issuance of an MF Banking License

In all the above cases, the business proposal of the proposed MFB should clearly indicate the commitment towards providing inclusive banking services to the target market and generating funds / deposits for financing portfolio growth. *Note*: No group shall be granted a license for establishing more than one MFB.

2. Ineligibility to Become Sponsors

Any person (s) having any of the following disqualification shall not be eligible to be a Sponsor of MFB:

a) has been convicted by a court of law in Pakistan or abroad for a criminal offence;

b) has been associated with any illegal activity especially contravention of banking and corporate laws.

c) has failed to meet his/her obligations to banks and other financial institutions. The Sponsors/Directors shall furnish names of the banks/DFIs and their branches with which they have had dealings along with the reports from such Banks/DFIs.

d) has defaulted in payment of taxes- each director and sponsor shall indicate his/her National Tax Numbers.

e) is or has been associated as Director/Chief Executive with the Corporate Bodies whose corporate and tax record including customs duties, central excise and sales tax has been unsatisfactory. They shall name the corporate bodies, their bankers and disclose their tax numbers and dividend record. Those not so associated with Corporate Bodies would be required to indicate their occupation/profession/trade and highlight their achievements.

f) is member/office bearer of any political party or member of Senate, National/Provincial assembly/assemblies

g) In the opinion of the sanctioning authority maintains adverse reputation regarding integrity and performance.

3. Minimum Capital Requirement:

No MFB shall commence business as a microfinance bank unless it has a minimum capital as given below:

i. Nation wide MFBs: minimum paid-up capital of Rs.1,000 million

ii. Province wide MFBs: minimum paid-up capital of Rs.500 million

iii. Region wide MFBs: minimum paid-up capital of Rs. 400 million

iv. District wide MFBs: minimum paid-up capital of Rs.300 million

The minimum paid up capital (free of losses) as prescribed above is required to be maintained at all times.

4. Capital Adequacy Ratio

The MFBs shall also maintain Capital Adequacy Ratio (CAR) equivalent to at least 15% of their risk-weighted assets. For the purpose of maintaining minimum CAR, MFBs are also allowed to raise sub-ordinated debt in local currency, subject to obtaining prior written approval from the SBP. Instructions on calculation of CAR based on risk weighted assets, and the terms and conditions for raising sub-ordinated debt are provided in the BSD Circular No. 7 of 2008 , as amended from time to time.

5. Minimum Contribution by Sponsors

The promoters or sponsor members shall subscribe at least 51% of the minimum capital and the shares subscribed to by the sponsors shall remain in the custody of CDC and shall not be transferable nor shall encumbrance of any kind be created thereon without prior permission in writing from SBP. The bank's sponsor shares (sponsor shares mean 5% or more paid up shares of an MFB) shall remain deposited in blocked account with Central Depository Company of Pakistan Limited (CDC) in terms of BPRD Circular No. 9 of 2009, as amended from time to time.

6. Net Worth of Sponsor Directors

The declared personal net worth of sponsor directors shall not be less than the amount to be subscribed by them personally. The net worth needs to be supported by a duly authenticated copy of the latest Wealth Statement filed with the Taxation Department. In case sponsor directors residing in countries where filing of Wealth Statement is not a requirement of law, a certificate of Personal Net Worth and General Reputation issued by an international bank of repute would be acceptable. This facility would also be available to applicants who had returned to Pakistan within six months before the submission of application for grant of license. The institutions interested in sponsoring an MFB either individually or in collaboration with other persons shall submit a resolution of their respective Boards/Governing Bodies covering followings:

i. Objectives of proposed investment
ii. Amount to be subscribed, and
iii. Nomination of Directors representing the institution on the MFB Board.

In addition to the Board's resolution, sponsoring institutions shall also submit latest audited financial statements along with the auditors' opinion on the financial repute and capacity of the institution to make the proposed investment in the MFB.

7. Public Floatation of Share Capital

In case the sponsors are interested in raising some capital through public floatation of the share capital, a firm commitment from 'A' rated underwriting firms to underwrite the public floatation shall be submitted along with the application for grant of license.

8. Foreign Investment

Foreign investors can establish Microfinance Banks either in whole and / or in partnership with local investors. The foreign investments shall be governed in accordance with the Foreign Investment Policy of Government of Pakistan.

9. Fit & Proper Criteria for Board of Directors / CEO

The MFB shall have to meet all necessary requirements for their directors and CEO, as laid down in the Fit & Proper Criteria, prescribed by SBP from time to time (BSD Circular No. 2 of 2005/Prudential Regulation No. 26). The MFB shall also meet all other provisions of aforesaid criteria.

10. Information/Documents to be submitted with the Application

The application shall be submitted on the format prescribed by SBP, and is given at Annexure-I. The sponsors shall submit following information/documents with the application:

i. Sponsors' commitment to subscribe the prescribed capital.
ii. ii. Detailed CVs and proforma information of the Chief Executive and proposed directors in light of Fit & Proper criteria issued by SBP as given under Prudential Regulation No. 26
iii. Organisational structure of the proposed MFB
iv. Commitment letters from the Sponsors/Directors, Chief Executive and Members of senior Management team to subscribe the committed capital and serve in their respective positions.
v. Job descriptions and detailed CVs of the senior management team
vi. Detailed Feasibility Study based on the actual survey of the target market. The findings of survey should highlight the viability of MF banking proposal, design of products, and service delivery channels.
vii. A detailed work plan for mobilising funds (especially core deposits) to support the loans growth. viii. Financial projections for 5 years based on assumptions which realistically reflect sponsors' capacity, sector's conditions, and future outlook.
viii. Short term and long term business plans to support financial projections. The plan should highlight the salient features of the proposed business model, growth strategy, use of technology options, MIS, and HR development.
ix. The draft Memorandum and Articles of Association of the MFB and the proposed name;

11. Application Processing Fee

The applicant shall deposit a sum of Rs. 1,000,000/= (Rupees one million) or equivalent in US dollars along with the application as processing fee. The fee so deposited shall be non-refundable. Incomplete applications shall neither be entertained nor returned. The processing fee in such cases shall also be non-refundable. The fee may be deposited through demand draft or pay order.

Section – II Additional requirements for transformation of MFI into MFB

The MFIs (NGOs, RSPs, etc.) have played an important role especially in the initial development of microfinance sector. These MFIs continue to be significant players in the sector today. The legal framework acknowledges their contribution to the sector and encourages the MFIs having requisite capacity to transform into Microfinance Banks (MFBs). The licensing criteria for establishing Microfinance Banks allows MFIs having potential and capacity to contribute up to 50% of the required capital in the form of credit and other assets portfolio subject to review by a Chartered Accountancy Firm from amongst the SBP panel. To facilitate the MFIs in their transformation process, this section highlights various aspects of the transformation and prescribes essential requirements to be completed for the transformation. However for complete details in this regard, transformation guidelines may be referred. The MFIs may apply additional processes to assess their capacity to transform and ensure a smooth transition from a non-profit oriented and unregulated to profit oriented and regulated financial institution for the poor.

1. Underlying Reasons for Transformation

Transformation from MFIs to MFB is a major shift from a non-profit, socially motivated and donor dependent institution to profit oriented, self-reliant and regulated financial institution, which involves cultural, organisational, operational and financial transformation. Normally one or all of the following objectives leads to the transformation decision: (a) Access to commercial capital, (b) Portfolio growth, and (c) Product diversification.

2. Transformation Cost & Transformation Continuum

The transformation involves substantial cost including pre-transformation cost, regulatory requirements, taxation cost, vulnerability to external shocks etc. Hence, the decision to transform should be carefully evaluated keeping in view all the associated cost and expected benefits. The global experiences show that the successful transformations take place in a gradual process which essentially includes following milestones:

i. Adequate experience as MFI and achieving reasonable operational size & scale in terms of credit portfolio and service delivery network, reliable accounting & information system, establishment of internal audit function, review of books of accounts by external auditors etc.
ii. Adoption of professional, business like approach to manage the MFI's operations and offering demand driven products/services at cost recovery basis;
iii. Achieved full operational sustainability and satisfactory progress towards achieving financial self-sufficiency
iv. Ability to access private risk capital and market based funds for sustainable growth
v. Prepare to operate as profit oriented financial institution subject to prudential regulations/supervision
vi. Have acquired /developed reliable software to support the existing operations.
vii. Preferably be rated by a reputed credit rating agency. The MFIs willing to transform into MFB should assess their respective positions in the transformation process and accordingly decide to proceed further.

3. Governance Structure

The auditors/consultants shall review the governance structure of the MFIs, the composition of its Board of Directors/Governing Body, the criteria & eligibility for election/selection as directors, the capacity and understanding of the Board about MF dynamics, the members' commitment with the mission and objectives of the MFIs and their willingness as well as capacity to contribute resources/funds to the new entity's capital. They shall also review the decision making process in MFIs and the role and effectiveness of the Board in developing professional and business like environment and culture in the MFI. Further, the auditors/consultants shall recommend changes, if any, required in the composition and skill mix of the Board keeping in view the objectives that an MFI would set in terms of its transformation into an MFB. The recommendations would also take into account the legal and regulatory requirements.

4. Recommendation for Transformation

In addition to the findings of institutional assessment, the auditors/consultants shall exercise an objective analysis of macroeconomic conditions, legal and regulatory environment for the MF sector, and future outlook of the sector. Based on this thorough analysis, auditors/consultants shall recommend that whether the MFIs should go for transformation. They shall also advise on the future course of action if they recommend in favour of transformation.

5. Transformation Decision

The MFIs' Board on receipt of the institutional assessment report by audit/consulting team, shall review the report and its recommendations and make a decision to go for transformation or otherwise. In case of decision in favour of transformation, the Board shall authorise preparation of proposal and application for submission to State Bank of Pakistan for grant of license to operate as Microfinance Bank under MFIs Ordinance 2001. The resolution of the Board shall also be submitted to SBP along with other documents. In preparing the proposal, the MFI must review the requirements as laid down in Section – I.

6. Information/Documents for Submission

The MFI shall submit the application as per the procedure given in the Section-I. The additional requirements in the application are given as follows:

(i) The application should be duly filled-in and signed by the person as authorised by the board of MFI
(ii) Institutional Assessment Report prepared and completed as per the guidelines given in above paragraphs
(iii) Board Resolution to go for transformation along with its objectives
(iv) Detail of assets & liabilities to be transferred to the MFB - the transfer shall be admissible at value assessed/determined by the audit/consulting team during institutional assessment phase

Section – III Process Flow Chart

1. NOC for Incorporation with SECP

The sponsors shall submit the application complete in all respect including the processing fee to the Director, Banking Policy & Regulations Department, State Bank of Pakistan, Karachi for grant of license to operate as MFB. The State Bank shall process the application and if satisfied with the quality of the proposal of the proposed MFB, shall issue NOC to the sponsors for incorporation of the proposed bank as a public limited company. In case of weaknesses in the proposal and / or incomplete information, the sponsors will be given an opportunity to improve the proposal and take steps to address the concerns raised by SBP. The NOC will be issued if proposal etc. is improved to the satisfaction of SBP; the application will be declined otherwise.

2. Grant of License

After receiving NOC, the sponsors shall apply to SECP for incorporation as public limited company. After incorporation of the company, the sponsors shall submit the incorporation certificate to SBP. The State Bank shall grant the license subject to receipt of clearance from security agencies and CBR etc.

3. Commencement of Business

The MFB shall commence operations within six months of the grant of license by SBP. After grant of license the sponsors shall subscribe the committed capital and obtain certificate of commencement of business from SECP. The licensed MFB shall then apply to SBP for grant of licenses for opening branches/places of business under branch licensing policy for MFBs.

4. Compliance with Legal Framework & Prudential Regulations for MFBs

The company granted license to operate, as MFB shall comply with the provisions of Microfinance Institution Ordinance 2001, Rules/Prudential Regulations framed and SBP directives issued/to be issued from time to time.

About BFP-B Project

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

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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

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