National Workshop of Bangladesh
Rethinking MSME Finance: A Post-Crisis Policy Agenda

Hybrid meeting
06 June 2022

Workshop summary

Background
Micro, small, and medium-sized enterprises (MSMEs) represent over 90% of all Asia-Pacific businesses. The development of this sector has contributed significantly to the economic growth in the region. Strengthening the capacities of MSMEs further promotes inclusive growth at the national and regional levels. Nevertheless, despite their significance, MSMEs still face several challenges, especially regarding access to finance. This challenge was only exacerbated by the Covid-19 pandemic and countries’ successive health and quarantine measures.

Poor access to financial services is far from a new challenge and is among the most common and critical constraints among MSMEs. The financing gap for MSMEs in developing economies amounted to US$ 5.2 trillion in 2017, or 19 per cent of global GDP. Approximately 70 per cent of over 800 million MSMEs in developing economies do not have access to institutional finance. As a region, Asia and the Pacific makes up the highest proportion of the financing gap in the world, accounting for 57 per cent of the total global financing gap, or US$ 2.7 trillion, underlining the region’s potential for advances in this space.

Many MSMEs lack the elements traditional banks and financial service providers require for credit lending and extension, such as financial statements and proven ‘track records’ to assess their creditworthiness, or physical collateral to secure against repayment. Other institutional barriers include strict lending policies, complicated borrowing procedures, and high transaction costs, among others.

In this context, financial digitalization holds enormous potential to facilitate MSMEs’ daily operations and access to finance in the Asia-Pacific region, especially since the Covid-19 crisis. Financial digitalization offers solutions to increase efficiencies, lower transaction costs, enhance security, and expand financial services to the under-served MSME sector. New financial service providers, such as fintech companies, challenger banks, and e-commerce players, have provided digital financial solutions to MSMEs, in some cases using artificial intelligence (AI) and machine learning to assess credit scores.

Objectives
As part of ESCAP’s ongoing capacity building support in the Asia-Pacific region and Bangladesh, under the United Nations’ project ‘Global initiative towards a post-Covid-19 resurgence of the MSME sector’, the workshop aimed to: i) enhance the knowledge and capacity of the stakeholders on MSME development to foster a favourable ecosystem for financial inclusion and sustainability in Bangladesh, mainly through strengthening MSME clustering and digital financial solutions for MSMEs; and ii) bolster the resilience of MSMEs in Bangladesh to mitigate the economic and social impact of the Covid-19 pandemic, and
thereby facilitate MSMEs’ contributions to implementing the Sustainable Development Goals (SDGs). The workshop also aimed to establish a network of experts for follow-on interventions.

**Organization**

The workshop was jointly organized by ESCAP and the Bangladesh Small and Medium Enterprise Foundation (SME Foundation), Ministry of Industries of Bangladesh, and held in a hybrid format. Mr. Alberto Isgut, Acting Chief of Financing for Development Section, Macroeconomic Policy and Financing for Development Division, ESCAP; H.E. Ms. Zakia Sultana, Secretary, Ministry of Industries of Bangladesh; Mr. Md. Mafizur Rahman, Managing Director and CEO, SME Foundation; Mr. Md. Masudur Rahman, Chairperson, SME Foundation; Mr. Farid Aziz, Additional Secretary, Economic Relation Division, Ministry of Finance of Bangladesh; and Mr. Jaker Hossain, Executive Director, Bangladesh Bank, made remarks at the opening of the workshop.

Presentations were made by representatives of: i) the Bangladesh Institute of Bank Management; ii) the University of Tulsa; and iii) an independent development consultant. Bangladesh’s government officials from ministries of finance and industries, members of agencies, commercial banks and financial institutions, as well as entrepreneurs and academics, were among the workshop’s 130 participants.

**Key take-aways**

In Bangladesh, MSMEs are the bedrock of economic growth, and contribute significantly to the nation’s socio-economic development. MSMEs constitute more than 90 per cent of total businesses in the country. They also account for more than 64 per cent of non-agricultural employment in rural areas, over 80 per cent of industrial employment, and about 25 per cent of the country’s total labour force. The sector caters to over 30 per cent of total domestic demand and contributes around 25 per cent to Bangladesh’s GDP.

Due to its importance, the Government of Bangladesh has given special emphasis to the development of this sector in different policies, including the 8th Five Year Plan, the National Industrial Policy 2022, SME financing and credit policy of Bangladesh Bank, and SME Policy 2019. These policies recognize MSME development as a vehicle for employment generation, equitable distribution, poverty alleviation, and economic growth.

Despite these efforts, the sector was significantly impacted by the Covid-19 pandemic, and is facing additional challenges. The Government of Bangladesh implemented stimulus packages for MSMEs since the outbreak, but implementation was slow, and more than 50 per cent of MSMEs (especially rural and female-led MSMEs) still do not have access to it. Consequently, by the end of 2020, 94 per cent of MSMEs reported a decline in their sales, 21 per cent shut down their businesses, 33 per cent said that they could not pay back their loan instalments, and 37 per cent of workers from SMEs had lost their jobs.

Besides the challenges brought by Covid-19, MSMEs already had several constraints prior to the pandemic. Historically, Bangladesh’s MSMEs have faced inadequate access to finance, as they struggle to: i) provide the documentation required to be bankable according to the conventional banking system, and ii) access the necessary information to receive additional financing. Moreover, monitoring expenses are high for the financial institutions for MSMEs located in remote areas of the country; hence, many business initiatives remain beyond the formal banking system. As a result, the country’s MSMEs get access to only one-third of the funds they need for running their businesses, while rural entrepreneurs receive only 19 per cent of the total funds disbursed.
Limited access to finance is caused by both supply-side and demand-side barriers, but with greater emphasis often placed on the former (banks and other financial service providers). Therefore, policy interventions need to focus on addressing or mitigating these barriers, such as reducing information asymmetry and managing transaction and operational costs. The menu of interventions is well-established: guarantee mechanisms, credit scoring, quota systems and conditionalities, targeted funding/liquidity facilities, catalyzing more MSME-friendly instruments, side-stepping collateral constraints and the creation of ‘policy banks.’

However, these interventions are essentially attempts to plug the financing gap rather than trying to fix it. Moreover, these activities have had mixed success: developing countries face challenges to afford the cost of some of these interventions in the long term. Consequently, alternative interventions are necessary. In this context, Fintech has the potential to markedly transform the conventional market for MSME finance, and in so doing, address some of its major constraints.

With Fintech, the protective moat that used to exist between an MSME and its financier is being bridged by a wide range of service providers that are in a better position to overcome some of those constraints to MSME finance. The digital-induced revolution is breaking down previous sectoral silos and opening up new opportunities to dovetail MSME finance with other cross-cutting, sustainable development and inclusive economic growth issues (eg. green finance and climate change, gender and inclusion of marginalized communities, and other environmental, social, and governance (ESG) issues).

Fintech is helping to increase financial inclusion by boosting mobile banking (e.g., Bkash, Nagad, Rocket etc.), and to reduce information asymmetry by providing different ways to perform credit scoring using AI and big data, leveraging unconventional datasets to assess creditworthiness. For example, in Southeast Asia, CredoLab uses the cell phone data of entrepreneurs in conjunction with other sources of information (like social media activity) to generate credit scoring for MSMEs, thereby streamlining loan applications and increasing the number and amount of loans granted. Fintech also plays an essential role in increasing credit information bureau’s digitalization of records, which gives them a significant advantage in terms of efficiency and speed in opening more loans for the MSME sector. The Credit Information Bureau (CIB) of Bangladesh Bank, for instance, provides online solutions and a collateral information system that acts in this direction. Moreover, increased competition with traditional banking will lower transaction costs for MSMEs.

It is also important to highlight that advances in Fintech entail changes in mindset: i) away from thinking about MSME finance in terms of ‘money flows’ per se, and more towards MSME finance in terms of ‘data flows’; ii) towards ‘embedded finance’, and MSMEs selecting and accessing financing they need from a far wider range of providers, and accessing a wider range of services, at lower costs; and iii) financial products that are more tailored to an individual MSME’s needs.

Nevertheless, the arrival of Fintech should not diminish the requirement for robust regulation and effective enforcement. The main challenge for regulators is keeping up with the pace of change and innovation, making effective enforcement more onerous. Prohibiting all new innovations until proven safe can stifle advances that have the potential to radically improve MSMEs’ access to finance. Therefore, sandboxes have been used to test new innovations in a more controlled setting. Bangladesh can also work with other countries and development partners seeking to leverage Fintech to support MSME finance. Adaptations can then be made to suit the specificities of Bangladesh’s MSME sector and the country’s sustainable growth priorities.
Besides Fintech, other practices that can broaden access to finance are: i) registering and formalizing MSMEs; ii) embracing ESG; iii) reforming laws and customs that limit the ability of women to own assets; iv) improving dialogue among all stakeholders; v) enhancing access to equity markets (BSEC Small Cap is a good example, but Bangladesh can further improve venture capitals and angel investors networks, and provide capital market literacy programs and tax incentives to MSMEs); vi) building capacity for MSMEs; and vii) clustering MSMEs. Regarding the latter, cluster development and financing may create new avenues for lenders as well as for overall economic progress. Clustering can help, among others, to achieve economies of scale in production, advertising and sales and enhance collaboration between MSMEs from the same industrial sector. MSME development through the clustering approach can simplify the industrialization process, generate employment, reduce poverty, increase export earnings, and reduce the regional disparity in Bangladesh.

Policy recommendations

• **Leverage Fintech and shift to the digital economy.** Fintech has the potential to address some of the major constraints of MSME access to finance, such as information asymmetry and transaction and operational costs. Digitalization also unlocks further MSME financing by increasing transparency (thereby decreasing risk) and minimizing tax avoidance and corruption. Nevertheless, the government should not diminish the requirement for robust regulation and effective enforcement.

• **Promote sandbox policies with other countries and development partners.** Providing a regulatory environment where FinTech operators may test their innovation for a specified period of time within the financial services sector is a way to ensure regulatory certainty and promote knowledge sharing in a changing digital environment. MSME clusters could be used as sandboxes, in order to test pilot programs.

• **Foster cluster policy for MSMEs.** As most of the MSMEs are heterogeneous and scattered across the country, identifying and developing a comprehensive cluster policy - with tailored digital financial services for clusters - can ensure better growth and business success for MSMEs.

• **Promote capacity building for MSMEs.** Campaigns, workshops, marketing assistance, and digital and financial literacy programs can help MSMEs enhance their skills and make them aware of the recent developments in fintech and digitalization. This can also support the sector’s access to finance.

• **Support female-led MSMEs.** Policymakers can reform regulations that limit the ability of women to own assets and consider gender budgeting on national and local budgets to increase financial inclusion of female entrepreneurs. For example, a portion of the budget of an MSME development agency might be allocated specifically to female-owned MSMEs.

• **Embrace ESG.** ESG can be a source of competitive advantage for MSMEs regarding access to finance, as i) firms practising ESG tend to be more resilient; ii) investors and financial institutions prefer ESG firms; iii) trade finance and global supply chains find ESG forms more attractive; and iv) governments require new ESG financing and disclosure. Policymakers need to prepare MSMEs via education, facilitation and communication.

• **Improve dialogue among all stakeholders.** The private sector needs to be aware of what the government is doing and what society is demanding. Likewise, policymakers need to be aware of what is going on in the private sector, as well as the evolving needs of the community as a whole.