

# **Post-COVID-19 Financing Mechanism for CMSMEs: Challenges and Readiness**

**Dr. Md. Mosharref Hossain**

Associate Professor, BIBM

## **Introduction and Background**

Small and Medium Enterprises (SMEs) play an important role in both developing and developed countries toward balanced and sustainable economic growth, employment generation, development of entrepreneurial skills (Mamun et al, 2013). SMEs generally use local resources to produce products and services for local needs. In most of the developing countries, SMEs are labor intensive and cover the market segments that are left by the larger firms (Maksimov, Wang, & Luo, 2017). They are more efficient in resource allocation as compared to large scale industry from a social point of view. According to World Bank (2018) statistics, SME represent about 90% of businesses and more than 50% of employment all over the world. Formal sector SMEs usually contribute up to 40% of GDP in emerging economies and the total numbers are significantly higher when include informal SMEs (World Bank, 2018). Beyond the contribution towards the GDP and employment, SMEs are also significant for the society for building social network, ensuring life standard of poor people, export earnings, reducing social unrest, creating new entrepreneurs, satisfying consumers' needs with competitive price, fulfilling the requirements of many large firms and so on (Hossain & Ibrahim, 2020). SMEs that survive over the long time offer economic stability for owners, employees as well as their families by providing a steady source of income.

Realizing the significance of CMSMEs' contributions towards the economy, it is highly important to concentrate more on this sector. In Bangladesh, SME sector contribute 25 per cent to the GDP, about 40 per cent of gross manufacturing output, account for 90 per cent of the private sector enterprises and about 70 to 80 per cent of the non-agricultural workforce working in the sector which is around 25 per cent of the country's total labor force (Alo, 2014). Despite having huge potential, the contribution of SME sector to the GDP in Bangladesh is still lower than those of many other countries. For example, SMEs' contribution to GDP is 60 per cent in China (Pandey, 2015, June 9), 40 per cent in India (Weerakkody, 2015, October 30), 37 per cent in Thailand (Rojanasuvan, 2014, February 5), 30 per cent in Pakistan (Shahzad, 2014), more than 50 per cent in Sri Lanka (Weerakkody, 2015, October 30), and 33.7 per cent in Malaysia ("SMEs on track" 2014, March 27). Although SME sector in Bangladesh are facing multi-various problems, still the researchers believe that, this sector is one of the best options in Bangladesh for increasing the growth rate of GDP, reducing poverty level, and generating more employment with a minimum level of investment (Begum & Abdin, 2015; Mamun et al., 2013).

Irrespective of the size, all firms, whether large or small, require financial resources for fulfilling business start-up needs, funding investment and to facilitate operation, expansion, and growth potential. Unfortunately, small firms all over the world face severe financial constraints (Franco & Haase, 2010; Islam et al., 2014; Malo & Norus, 2009; Osei-Assibey, 2013; Rahaman, 2011; Raravi, Bagodi, & Mench, 2013). SMEs face such difficulties mainly for the market imperfections, asymmetry of information, institutional insufficiencies and high level of operational cost (Beck and Demirgüç-Kunt 2006; Beck et al. 2006; Cheng, 2015; Yazdanfar, 2012; Yoshino and Taghizadeh-Hesary 2015). Study by Beck, Demirgüç-Kunt, Laeven, and Levine (2008) shows that financial development of a country has an excessively positive effect on small firms. Due to the lack of such development, SME sector still experiences a huge finance gap for their development. According to the estimate of IFC, around 65 million firms or 40% of formal MSMEs in developing countries have \$5.2 trillion financing gap every year, which is equivalent to 1.4 times of the global MSME lending (World Bank, 2018). Ayyagari, Demirgüç-Kunt and Maksimovic (2010) find that bank finance is linked with faster SME growth, while informal finance is not. Beside, Beck, Lu and Yang (2015) also confirm that access to bank finance is positively associated with the decision to become an entrepreneur and initial investment

Like other developing countries, financing has been identified as a major issue for small firm growth in Bangladesh (Akterujjaman, 2010; Chowdhury, Azam, and Islam 2013) as this sector has much restricted access to finance in formal institutional sources (Islam, Yousuf, and Rahman 2014). In Bangladesh, financial system is mostly the bank based system. However, commercial banks perceive the SMEs as a very risky sector alone with the incurring high monitoring cost. Although this is true in many cases, nowadays, there is a new trend where a few of them are coming forward with a good number of initiatives for serving SMEs. However, it is expected that these are not adequate to fulfill the larger amount of demand from the SMEs. Moreover, it is most likely the banks are providing the financing on the behest of the central bank. Thus, the SMEs in Bangladesh are viewed as underserved in terms of getting finance from the commercial banks. This indicates the importance to examine the participation of commercial bank in providing loans to the SMEs in Bangladesh.

### **Impact of COVID-19 on SME Sector-Some Studies**

In the banking sector, BRAC Bank SME Division conducted an extensive and rapid survey of their 5105 SME clients (out of 1,30,637) across eight SME regions<sup>1</sup> in Bangladesh covering 15 segments<sup>2</sup> of the industries. The survey result showed that, on an average, 67% SMEs were out of operations,

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<sup>1</sup> Dhaka (907), Gazipur (571), Cumilla (675), Chattogram (550), Barishal (460), Jashor (687), Sylhet (577), Bogura (667).

<sup>2</sup> The covered segments are Agriculture (13.5%), Agro-processing (4.96%), Auto Parts (0.43%), Cloths (7.62%), Cosmetics (5.25%), Electric & Electronics (10.79%), Engineering Works (10.03%), Furniture (8.95%), Grocery (9.56%), Hardware (12.36%), Pharmacy (9.01%), Shoe (6.46%), ICT & E-commerce (0.10%), Steel & Sheets (0.33%) and Medium Textile Industries (0.88%).

63% employees were not in work place, 82% reduction in sales, 55% lost half of their annual revenue, 61% had 30 days' worth of stock, 78% of closed businesses had more than 1 to 3 months' worth of stock, 84% unable to collect any receivables, 82% can roughly afford their wages, rental and other expenses for 1 to 2 months, and 63% can afford to pay debts and EMIs for barely a month (BRAC Bank Ltd., 2020).

In another study, LightCastle Partners and Sheba.xyz conducted a primary survey of 230 SMEs<sup>3</sup> across all the eight divisions of Bangladesh during April 6 to 8, 2020 and found that 52% of the SMEs completely shut down their business operations, 28% lost their revenue ranging from 50% to 99%, 24% slashed their employee salaries, 42% had to curtail their marketing and distribution expense, 68% will not be able to survive the lockdown situation for more than 4 months, 32% will be less impacted if the lockdown continues for 4 to 12 months, 46% employers anticipated layoff of over 50% staff if the lockdown extends beyond 4 months, and 47% reported disruption in supply of raw materials for the manufacturing sector SMEs (LightCastle Partners, 2020).

BIBM surveyed among banks for the potential effects of COVID 19 on the CMSME sector of Bangladesh, based on the rapid response survey. The survey results showed that demand for different types of loans for CMSMEs decreased during the lock down situation, however, the bankers predicted that the demand for loans will be increasing gradually. They identified some sectors (Pharmaceuticals, Hospitals, clinics, diagnostic centers and other healthcare related industries; Hotel, restaurant & tourism sector; ICT sector; Motorcycle/Bicycle traders; Agro based industries etc.) those may demand more fresh loans as well as the sectors (Retailers of clothing/garments and Boutique businesses; Automobile and Luxury consumer items; Furniture Business; Transportation; Construction & Real Estate; Printing Press; Studio & Film Production Houses; Cosmetics and Beauty Parlors etc.) those may not demand for more fresh loans. In terms of recovery and quality of different types of CMSME loans, banking sector is experiencing low rate of recovery and high NPL due to COVID 19 situation. Regarding the Stimulus packages of Government and Bangladesh Bank, 68% bankers raised their concern about the implementation of these packages. All the respondents predicted an improved situation of the CMSME sector in 2021 compared to 2020.

All the stakeholders including Government, Bangladesh Bank, SME Foundation, CMSME businesses owners, Commercial Banks and others should take proactive approach for facing the challenges of COVID 19 pandemic in coming days. In this regard, the recommendations mentioned in the paper may be considered for future policy formulations.

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<sup>3</sup> The surveyed SMEs included the major industries such as agriculture, poultry, dairy, fisheries, jute diversified products, retail stores, food processing, and services (tailoring, electrical, laundry, mobile recharge & MFS shop).

## **Some Challenges of Financing and Possible Way Out**

### **Challenge One: Analyzing the whole supply chain and develop financing tools for the required segment**

Supply chain of CMSMEs has been disrupted during Covid-19. Many CMSMEs facing difficulties to recover the impact of stuck up receivables which has reduced capacity of operating their business due to shortage of working capital. In general CMSE business has interdependency for procuring raw material, selling goods etc. Therefore, disruption of any end will automatically affect the other businesses.

*In order to make the chain vibrant, financing products and mechanism should develop for all the business unit related to the whole supply chain.*

### **Challenge two: Developing non-financial services for making them ready to fight**

Most of the CMSEs are operated by a family or close group, owner of the firm is the day-to-day decision maker, lack proper knowledge for business operation, are not well educated and others. Therefore, they require different non-financial services for their survival. While CMSEs were competent in their core business activity, peripheral support structures like human resources, finance, taxation, marketing, and access to markets and networking opportunities are limited because of their scale of operation and manpower specializations.

*In this context, the stakeholders may introduce non-financial services like: business coaching and mentoring, consulting and advisory services, accountancy and financial planning advice, economic insight and business intelligence, training and development for CMSEs, peer and value chain networking etc. Also commercial bank may decide to partner with various organizations to develop and deliver non-financial initiatives to SMEs that would complement the bank's core financial products and services.*

### **Challenge three: Lack of strong database for CMSMEs**

In Bangladesh, one of the important challenges for the CMSME financing is the dearth of database. There is no proper list for all the CMSEs or even for the licensed businesses. We do not have any organization where small business owner can get any information about the market, industry, competition, demand for exportable items and so on. Even we do not know the exact financing gap in the CMSME sector.

*The address the overall financing need, it is an urgent to develop strong database for CMSMEs and to identify the demand supply gap of the sector. The CMSME directory can also help the lender to identify the quality loan customers. Government may take initiative to create a center for storing all the relevant information for CMSME from where even they can buy the information with minimum fees.*

### **Challenge four: Start financing for overdue clients**

Constant decline in sales revenue resulted in cash flow crisis for majority of the CMSMEs. In many cases, the cost of raw materials/Cost-of-goods-sold increased. Hence, the profit margin reduces by large extent compared to previous. The CMSMEs those involved with export/import business are in a challenge due to hike in freight cost. Similarly, sales of luxury items are most adversely affected, and

even after the high Covid situation, sales of luxury items are not increasing. In such case, many CMSMEs are still facing difficulties to serve their debt obligation and thus reported as overdue. Considering the overdue status, banks, considering the credit risk perspectives avoid financing to overdue clients.

*In this regard, Bangladesh Bank's stimulus loan may be allowed as term loan for 3 years to allow CMSMEs enjoying 3 years long term facility. i.e. CMSME can be allowed stimulus loan at subsidized interest for 3 consecutive years. Even, working capital support for the affected businesses and industries may be converted to term loans with a moratorium period to make it easy for the borrower to ensure regular repayment.*

#### **Challenge five: Reintegration of the lost business**

Due to major business fallouts during covid-19, sales of many CMSMEs went down drastically which is creating hindrances for banks to identify business track record and future growth projections. Many entrepreneurs lost their confidence of doing business in the modality as they were performing early. As a result, their demand for financial requirement dropped and banks have limited room for financing.

*In order to reintegrate the lost business, long-term capital backup plan would be implemented for CMSEs. It may be for 3 years where one year is for the grace period. Bangladesh Bank's stimulus loan may be allowed as term loan for 3 years. At the same time, stimulus facilities for trading concern may be increased.*

#### **Challenge six: Addressing Heterogeneous CMSE Customers**

Since CMSEs are very heterogeneous and scattered throughout the country, it is absolutely impossible for banks or FIs to reach the all qualified customers through the branch network. Most of the banks and FIs do not have their branches in the rural areas where many of the CMSEs are operating. Although many banks and FIs already have taken initiatives to reach the local market through agent point or unit office, still they are not financing through those channels. BIBM Survey result showed that around 70 percent of the banks opined that the current market structure is not sufficient for rural CMSE financing and 82 percent of banks did not finance with their alternative delivery channels.

*In this regard, banks and FIs may open sub-branch where possible, extensively introduce channel marketing; employ more agent outlet or unit office; create linkage credit through UDC or post offices; extend mobile financial services to tap more CMSE clients. FIs may start extensive financing through alternative delivery channels along with the deposit mobilization. FIs should carefully select the agent with enough net worth and should provide training related to the financing mechanism.*

#### **Challenge seven: Reaching in the rural areas**

From the BIBM study findings it is identified that 57.60 percent of banks were facing several problems in financing rural areas and 51.50 percent of banks claimed that they face many problems for setting agent point in the rural areas. Sometimes banks do not have proper control over the activities of agent and may incur with some fraudulent activities.

*In this connection banks and other FIs may establish CMSE booth in different locations of business area by which they can collect deposits, process loan files, open customer accounts, collect loan*

*installments, ensure fund transfer, etc. This approach will reduce the problems of setting agent point. Also, banks and FIs can establish their own control and can provide financing services with minimum cost. Banks may design some schemes and establish small outlet near to the specific cluster with two to three employees for banking services to those clusters. This will reduce the cost and can generate the business for banks*

#### **Challenge eight: Introducing software-based financing model**

High administrative and monitoring cost is the great challenge for banks and FIs to financing the CMSME sector. On the other hand, the CMSMEs those are located far from the lender premises face various problems like huge cost and time requirement, business operation disturbance, do not get instant service, fail to do transaction on time, communication interruption, etc. for visiting branch or sub-branch.

*To address such challenge, banks and FIs may start software-based financing. In this regard two to three officers from the local area will be employed in any particular business location without having any office premises. These officers will visit some businesses each day and will observe the business activities and build relationships with the CMSEs. Meanwhile, when the enterprises demand any loan they will collect documents and send the snapshot through tab or mobile devices to the near branch for assessment. After assessing the enterprise, the credit officer will take decision and can sanction credit to the quality customers within very short time. Subsequently, the local officers always monitor those businesses, collect installments and deposit to the banks or FIs.*

#### **Challenge Nine: Requirement of small ticket loan**

From the BIBM survey it is observed that around 79 percent of the banks claimed they have competitors other than banks in the rural areas for financing CMSEs and they are facing various threats from those competitors namely offering small ticket loan, loan without trade license, provide personal loan, etc. It is also evident that most of businesses in the rural areas are micro businesses (57.2%).

*Therefore, banks may consider small ticket loan even for the business that do not have trade license. Banks may also provide the personal loan to them those may include in CMSE portfolio. Because, many of the CMSEs take personal loan and use for the businesses. In this case banks must consider the business volume and its future prospect with cash flow movement.*

#### **Challenge Ten: Developing FinTech-based products**

The application of information technology (IT) may play an important role in financing CMSEs. It may be considered as a major enabler for new forms of working and collaborating within financial institutions as well as across organizational borders. Integrated IT solution may help to ensure faster decision and disbursement regarding the CMSE financing.

*Hence, a strong management information system (MIS) for CMSEs may be developed by the financial sector. Besides, banks and FIs may develop app-based solutions and AI-based interactive Chatbot banking by which customer can get financing information as well as can apply for loans. In addition to that banks and FIs may use Big data analytics for analyzing huge volume of data which may help to find various pattern of CMSE business for decision making. Moreover, banks and FIs may form consortium to launch blockchain-linked funding for CMSEs.*

#### **Challenge eleven: High documentation formalities**

Many enterprises comfort to get loan from the sources other than banks even with higher interest rate (average 16.58%) due to easy access of loan, easy processing of loan, low demand for documents, etc.

*Hence, banks should change their mind set and establish a minimal documentation requirement so that CMSEs feel encouraged to get access to the bank financing. Banks may emphasis on the relationship lending to reduce dependency on more documents. Similarly, to avoid misunderstanding, all documents related with CMSE loans (including charge documents) should be printed in Bangla, so that the clients can easily read and understand it. On the other hand, to address the problems of getting documents from different issuing authorities, government and other relevant authorities may ease the documents-obtaining process by establishing separate counter for the CMSE clients*

#### **Challenge twelve: Developing tailor-made products for heterogeneous CMSEs in the rural areas**

In the present study of BIBM it is evident that around 68 percent of the respondents claimed that they are not satisfied with the existing features of banks' loan products (EMI, grace period, maturity, inflexible installment and other terms and conditions). Hence, there is a great need for improving existing features of loan products and innovate new features to cater the need of customized products for the CMSEs in Bangladesh.

*As CMSEs are heterogeneous in nature and scattered all over the country, banks may design customized products based on area and cluster approach. In addition, Banks may add separate features for a single product targeting rural, semi-urban and urban CMSEs (including women entrepreneurs) so that banks can fulfill customers' requirement as per their needs. in this case some new products like seed money, leasing, factoring, invoice financing, venture capital, investment funding etc. Banks also have to develop products based on market data that may require a certain degree of market research.*

#### **Challenge thirteen: Enhancing customers' awareness**

It is evident that CMSEs are accustomed and habituated with the local borrowing sources due to absence of banking network, easy access to the sources other than banks and lack of availability of information of banking products and services. Hence, banks may popularize their products and offerings to the CMSEs to break the CMSEs' mindset about interacting with the banks. There are many financial products and services of banks available for the CMSEs in the rural areas, but they could not avail it due to lack of information. As a result, the CMSEs are borrowing from the local moneylenders and micro finance institutions which increase their cost of doing business. Moreover, many of the entrepreneurs do not know about the different sources of refinancing or pre-financing scheme available in our country.

*In this regard, to penetrate in the local market banks should disseminate information to CMSEs about their products and requirements through poster, banner, social networking and advertising in rural areas to attract the prospective CMSEs that may reduce the information gap between the borrowers and lenders.*

#### **Challenge fourteen: Minimizing collateral requirements and searching for alternative collateral security**

Now a days the banking sector offers the lowest interest rate compared to the other market players (NGO-MFIs, multipurpose cooperative, samiti, moneylenders, etc.) for the CMSEs. However, due to

the excessive collateral and third-party guarantee requirements, most of the CMSEs prefer to get loan from the market players other than banks with high interest rate. Although many banks have started to offer collateral free loans to CMSEs even in the rural areas, this may not be sufficient for the overall need of the CMSEs.

*Banks may take care for the collateral free loan where personal guarantee is strong and the CMSEs have good future prospects. Moreover, Banks can concentrate on finding collateral substitute such as cash flow-based lending, extensive monitoring, social security etc. Besides, Bank can introduce group guarantee for CMSE financing (some of the banks are practicing this approach). In case of cluster financing, guarantee can be taken from the association of cluster which will ultimately reduce the possibility of default. To minimize the risk, credit guarantee scheme may be helpful in this regard.*

#### **Challenge Fifteen: Proactive thinking and mindset of banks in financing CMSEs**

The survey results revealed 61.80 percent CMSEs feel that the banks are negligent in financing and dealing with the CMSE clients.

*Banks should change their mindset to better serve and consider the sector as the opportunities for enhancing better profitability. Banker should have good customer relationship, positive and caring attitude towards the CMSEs. The bankers have to nourish the CMSEs to become successful based on their proactive mindset.*