SME Financing in Bangladesh: A Comparative Analysis of Conventional and Islamic Banks

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Abstract

SME financing is now constructing the economy building of the country with the major key role players of banking industry which will appear advanced in near future. Analyzing the performance of SME financing by the banking industry this study identifies the major SME investors among banking industry. It compared the performance of banks grouping them into two broad categories: conventional banks and Islamic banks. Disbursement of SME Loan by all selected conventional banks shows about 1.5 times growth from Year 2009-2011. BRAC bank is the leading SME loan providers among the conventional banks and it captured 5.87% market share within SME banking arena of Bangladesh. On the other hand, disbursement of SME Loan by all Islamic banks portrays about 1.35 times growth. Among the top five leading SME investors IBBL is the top. Although SME financing seems very promising, it has various problems such as risk profile, lack of collaterals, lack of uniform definition of SME, participation of women and complexity in distribution.

Keywords: SME, SME Financing, Banks, Islamic Banks, Bangladesh, Performance

JEL-classification: N25, N20, G21

1. Introduction

Bank is committed to provide high quality financial services/products to contribute to the growth of the country through stimulating trade and commerce, accelerating the pace of industrialization, boosting up export, creating employment opportunity for the youth, poverty alleviation, raising standards of living of limited income group and overall sustainable socio-economic development of the country.

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In achieving the aforesaid objectives of the Bank, Credit Operation of the Bank is of paramount importance as the greatest share of total revenue of the Bank is generated from it, maximum risk is centered in it and even the very existence of Bank depends on prudent management of its credit portfolios. The failure of a commercial Bank is usually associated with the problem in credit portfolio and it's less often the result of shrinkage in the value of other assets. As such, credit portfolio not only features dominant in the assets structure of the Bank, it is crucially importance to the success of the Bank also.

Banks loan portfolios include commercial loan, industrial loan, consumer loan and SME loan. All of these loans have significant impact on the banks profitability. So their treatment is different, require different procedure, documents and so on. Now-a-days SME financing is getting more important because it is the way of boosting our economy and also creating employment opportunities.

Small and Medium Enterprises (SMEs) all over the world have been playing a crucial role in promoting economic development as well as industrial production. In particular, SMEs provide the necessary foundations for sustained growth and rising income in the less developed and transitional economies. SME financing is a topic of significant research interest to academics and an issue of great importance to the policymakers of Bangladesh and around the world. However, this study attempts to analyze and compare the SME financing scenarios of the conventional banks and the Islamic banks of Bangladesh.

2. Objectives

2.1 Broad Objective

The broad objective of the report is to have an overview on the SME Banking in banking sector.

2.2 Specific Objectives

- To know SME position of Islamic banks and their performance in this sector.
- To know SME position of Conventional banks and their performance in this sector.
- To evaluate the contribution of SME financing towards profitability of the banks.
- To identify the problems associated with SME financing of the bank.

3. Methodology

3.1 Sources of Data

As it is implied above, data has been collected from both primary as personal observation and secondary sources as evaluation on different research papers and policies etc. as given below:

Primary Source:

Interview of experienced bankers of the different banks will be taken to get the insight of the SME financing.

Secondary Source

Almost all of the data required for this report will be from secondary source such as

- Company websites
- Annual reports
- Bangladesh Bank report
- ADB reports

3.2 Data Analysis

In this report, analysis is done through both qualitative and quantitative secondary data. Basically, this report carries out a rational judgment on the SME banking performance. Correlation, regression and other comparative tools had been used for analysis purpose.

3.3 Processing of Data

After collection of the raw data, the following computer packages have been used in editing and processing the entire report:

- MS-Excel
- MS-Word
- SPSS

4. Operational Definitions

Existing definition of SME is recommended by Better Business Forum and accepted as a uniform one by Ministry of Industry and Bangladesh Bank. Criteria of the definition of SME are given below:

4.1 Definition of Small Enterprise

Small Enterprise refers to the firm/business which is not a public limited company and complies the following criteria:

Table 1: Definition of Small Enterprise

Serial No.	Sector	Fixed Asset other than Land and Building (Tk.)	Employed Manpower (not above)
01.	Service	50,000-50,00,000	25
02.	Business	50,000-50,00,000	25
03.	Industrial	50,000-1,50,00,000	50

4.2 Definition of Medium Enterprise

Medium Enterprise refers to the establishment/firm which is not a public limited company and complies the following criteria:

Table 2: Definition of Medium Enterprise

Serial No.	Sector	Fixed Asset other than Land and Building (Tk.)	Employed Manpower (not above)
01.	Service	50,00,000-10,00,00,000	50
02.	Business	50,00,000-10,00,00,000	50
03.	Industrial	1,50,00,000-20,00,00,000	150

5. Analysis

5.1 Ratio Analysis

5.1.1 SME Loan/Investment to Total Loan/Investment Ratio

SME Loan/Investment to Total Loan/Investment Ratio

Conventional Banks vs. Islamic Banks			
Name	**009**	**010**	**011**
SME Loan to Total Loan Ratio of Conventional Banks	0.243	0.237	0.283
SME Investment to Total Investment Ratio of Islamic Banks	0.165	0.166	0.182

SME loan/investment to total loan/investment ratio means that how much SME loan/investment is financed by total loan/investment. In case of conventional banks we can see that in 2009, 24.3% SME loan was financed by the total loan. While in 2010 and 2011, 23.7% and 28.3% SME loan was financed by the total loan. In case of Islamic banks we can see that in 2009, 16.5% SME investment was financed by the total investment. While in 2010 and 2011, 16.5% and 18.2% SME investment was financed by the total investment.

5.1.2 SME Loan/Investment to Total Assets

SME Loan/Investment to Total Assets

Conventional Banks vs. Islamic Banks			
Name	2009	2010	2011
SME Loan to Total Assets Ratio	0.138	0.138	0.133
SME Investment to Total Assets Ratio	0.134	0.13	0.138

SME loan/investment to total assets ratio means that the portion of SME loan/investment in total assets. In case of conventional banks we can see that in 2009 among the total assets, SME loan was 13.8%. While in 2010 and 2011among the total assets, SME loan was respectively 13.8% and 13.3%. In case of Islamic banks we can see that in 2009 among the total investment, SME investmentwas 13.4%.

While in 2010 and 2011 among the total investment, SME investment was respectively 13% and 13.8%.

5.1.3. SME Loan/Investment to Total Deposit Ratio

SME Loan/Investment to Total Deposit Ratio

Conventional Banks vs. Islamic Banks			
Name	**2009**	**2010**	**2011**
SME Loan to Total Deposit Ratio	0.201	0.214	0.25
SME Investment to Total Deposit Ratio	0.027	0.153	0.164

SME loan/investment to total deposit ratio means that out of total deposit how much SME loan/investment is provided. In case of conventional banks we can see that in 2009 among the total deposit, 20.1% SME loan was provided. While in 2010 and 2011among the total deposit, respectively 21.4% and 25% SME loan was provided out of total deposit. In case of Islamic banks we can see that in 2009, 2.7% SME investment was made out of total investment. While in 2010 and 2011, respectively 15.3% and 16.4% SME investment was made out of total investment.

5.2 Statistical Analysis

5.2.1 Relationship between total profit and SME loan

Regression Equation	$\widehat{Y}$**=28030.52+0.037*(SME Loan)**
Multiple R	**94.6%**
R Square	**0.895 (89.5%)**
Adjusted R^2	**79%**
Standard Error	**2075.482**

In this table, the value of **R = 94.6%**expresses that there is a high degree of positive relationship between the dependent variable total profits and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation.

Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total profits that can be explained by the estimated regression equation. Here R^2 is equal to **0.895 (89.5% % expressed in percentage)** indicates **89.5** % of the variability in obtained total profits is explained by the independent variable total SME loan.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

Standard Error of Estimate shows how much error or variability stands between the estimated result and actual forecasted result. Here the value is **2075.482** that show the amount of variability of our estimated result and the actual result of the observation.

5.2.2 Relationship between total asset and SME loan

Regression Equation	$\widehat{Y}$=77334.76+8.811*(SME Loan)
Multiple R	98.8%
R Square	0.977 (97.7%)
Adjusted R^2	95.4%
Standard Error	221445.739

In this table, the value of **R = 98.8%** expresses that there is a high degree of positive relationship between the dependent variable total assets and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation. Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total assets that can be explained by the estimated regression equation. Here R^2 is equal to **0.977 (97.7% % expressed in percentage) indicates 97.7 %** of the variability in obtained total assets is explained by the independent variable total SME loan.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

5.2.3 Relationship between Total Loans and SME Loan

Regression Equation	$\hat{Y}$=652978.93+2.51*(SME Loan)
Multiple R	96.2%
R Square	0.926 (92.6%)
Adjusted R^2	85.2%
Standard Error	115913.797

In this table, the value of **R = 96.2%**expresses that there is a high degree of positive relationship between the dependent variable total loans and advances and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation. Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total loans and advances that can be explained by the estimated regression equation. Here **R^2** is equal to **0.926 indicates 92.6%** of the variability in obtained total loans and advances is explained by the independent variable total SME loan.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

Standard Error of Estimate shows how much error or variability stands between the estimated result and actual forecasted result. Here the value is **115913.797**that show the amount of variability of our estimated result and the actual result of the observation.

5.2.4 Relationship between Total Profit and SME Investment

Regression Equation	$\hat{Y}=919.47+0.071*$(SME Loan)
Multiple R	70.4%
R Square	0.496 (49.6%)
Adjusted R^2	(0.008)%
Standard Error	2737.451

In this table, the value of **R = 70.4%%**expresses that there is a high degree of positive relationship between the dependent variable total profits and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation. Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total profits that can be explained by the estimated regression equation. Here **R^2** is equal to **0.496 (49.6% % expressed in percentage) indicates 49.6%** of the variability in obtained total profits is explained by the independent variable total SME Investment.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

Standard Error of Estimate shows how much error or variability stands between the estimated result and actual forecasted result. Here the value is **2737.451**that show the amount of variability of our estimated result and the actual result of the observation.

5.2.5 Relationship between Total Assets and SME Investment

Regression Equation	$\hat{Y}=64034.512+6.026*$(SME Loan)
Multiple R	99.2%
R Square	0.985 (98.5%)
Adjusted R^2	96.9%
Standard Error	29173.950

In this table, the value of **R = 99.2%%**expresses that there is a high degree of positive relationship between the dependent variable total assets and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation. Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total assets that can be explained by the estimated regression equation. Here R^2 is equal to **0.985 (98.5% expressed in percentage) indicates 98.5%** of the variability in obtained total profits is explained by the independent variable total SME Investment.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

Standard Error of Estimate shows how much error or variability stands between the estimated result and actual forecasted result. Here the value is **29173.950**that show the amount of variability of our estimated result and the actual result of the observation.

5.2.6 Relationship between total Investment and SME Investment

Regression Equation	$\widehat{Y}$=117026.205+4.024*(SME Loan)
Multiple R	99.1%
R Square	0.982 (98.2%)
Adjusted R^2	96.5%
Standard Error	20874.621

In this table, the value of **R = 99.21%**expresses that there is a high degree of positive relationship between the dependent variable total investment and the independent variable SME loan. If the independent variables increase at that point this will result in the dependent variable increase accordingly.

The term **R Square** is the multiple coefficient of determination interpreted as the proportion of variability in the dependent variable that can be explained by the estimated multiple regression equation.

Hence, when multiplied by the 100, it can be interpreted as the percentage of the variability in total investment that can be explained by the estimated regression equation. Here R^2 is equal to **0.982 (98.2% expressed in percentage) indicates 98.2%** of the variability in obtained total investment is explained by the independent variable total SME Investment.

If a variable is added to the model, **R Square** becomes larger even if the added variable is not statistically significant. The **Adjusted R Square** compensates for the number of independent variables in this model.

Standard Error of Estimate shows how much error or variability stands between the estimated result and actual forecasted result. Here the value is **20874.621**that show the amount of variability of our estimated result and the actual result of the observation.

6. Findings

6.1 Conventional Banks

Based on the previous chapter analysis segments and the brief description of SME Banking, following findings are originated:

➢ Informational asymmetries & lack of collaterals are always present in enterprise financing transactions. Entrepreneurs typically possess privileged information on their businesses that cannot be easily accessed or cannot be accessed at allby prospective lenders or outside investors.
➢ SME face a more uncertain competitive environment than larger companies—they experience more variable rates of return and higher rates of failure.
➢ Banks database of SME transactions are not so strong. Banks are not careful about the income potentiality of SME finance.
➢ Conventional bank's performances are better than that of Islamic Banks. Conventional banks have different product ranges & tenor of loan considering the ability of the borrowers.

➢ Interest rate is higher in SME Banking as the handling of SME financing is an expensive business. The cost of appraising a loan application—or of conducting a due diligence exercise in view of a possible equity investment—is largely independent from the size of the financing under consideration.

➢ Regression analysis indicates commercial total income of the bank highly dependent on commercial lending

➢ Highest net interest margin generated from commercial lending because of its huge volume but in last two years net interest margin of SME financing increases tremendously.

➢ From the perspective of per unit risk taking bank needs to take highest risk for SME financing lowest risk for commercial lending.

6.2 Islamic Banks

➢ Information asymmetries & lack of collateral are also problems for Islamic banks to grant SME loan

➢ SME activities are not so emphasized in Islamic Banks but there are huge potentialities of SME Banking here.

➢ Islamic Banks have recently greater investments in SME Banking than those in the past.

➢ Regression analysis indicates commercial total income of the bank highly dependent on commercial lending

➢ Highest net interest margin generated from commercial lending because of its huge volume but in last two years net interest margin of SME financing increases tremendously.

➢ From the perspective of per unit risk taking bank needs to take highest risk for SME financing lowest risk for commercial lending.

➢ They should appoint more employees in SME department. As number of the employees against the loan application is very low. So it makes the loan processing system slower.

7. Conclusion

The SME sector in Bangladesh holds enormous opportunities to contribute to economic growth, generate employment, and reduce poverty. The sector, however, has a very limited access to finance through the institutional sources. For boosting the development of the SME sector, new generation of financial institutions are needed along with financing mechanisms to provide access to appropriate finance and meet up the diversified needs of financial services of this potential sector. Banks should come forward to lend the SME with fewer formalities.

Now, SME financing is explored as a potential sector of investment in banking industry. To keep pace with recent changes the bank needs to develop different products for SME financing and analyze the performance of SME financing on regular basis.

Conventional banks provided most of the SME loans to the entrepreneur. But in recent time Islamic banks are investing SME sectors to develop the economy in halal way. SME investment is mainly concentrated in Dhaka division, but out Dhaka there are many potential areas where raw materials for Small and Medium Enterprise are easily available to set up SME organization. Moreover, in recent time banking industry is focusing on SME financing as a profitable business segment. Thus Bangladesh is expected to flourish thorough these SME enterprises in the near future.

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