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International Trade Finance and SME: Bridging the Gap

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Foreword

As part of the ongoing dissemination of the BIBM research outputs, the present Research Monograph contains the findings of the research project titled "International Trade Finance and SME: Bridging the Gap". The keynote paper was presented in a seminar on 25 September, 2023.

Small and Medium-sized Businesses (SMEs) are vital to both national and international economies because they make major contributions to trade, employment, and production. However, SMEs frequently encounter significant obstacles when trying to obtain trade finance, which continues to be a significant obstacle to their involvement in global trade despite their economic significance. SMEs are disproportionately impacted by the ongoing trade finance gap, especially in developing nations like Bangladesh where sustainability and business growth depend on financial services accessibility.

This study explores the nuances of trade finance for SMEs, looking at the root causes of institutional, regulatory, and funding barriers that impede SME expansion in international trade. Along with practical suggestions to close the financing gap, it offers a thorough analysis of trade financing mechanisms, global trends, and policy frameworks.

It gives me immense pleasure to publish and distribute this research output to the practitioners of the banks as well as to the academics and common readers. I hope this monograph will be a useful guide, especially for the bank employees working in the concerned departments.

We do encourage feedback from our esteemed readers on this issue which certainly would help us to improve upon our research activities in the years to come.

Md. Akhtaruzzaman, Ph.D.
Director General, BIBM

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We have completed the Seminar with extensive support from many people, especially from the executives of different banks.

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We are happy to all the faculty colleagues for their comments and positive suggestions to carry out the research.

Our honest gratitude goes to the research assistants, who have facilitated us to collect very useful information related with the seminar paper.

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International Trade Finance and SME: Bridging the Gap

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Abbreviations

AML	Anti-Money Laundering
BCG	Boston Consulting Group
CDD	Conduct Customer Due Diligence
CFT	Counter Financing of Terrorism
CISG	Convention on the Sale of Goods
ECAs	Export Credit Agencies
ERF	Export Readiness Fund
FCBs	Foreign Commercial Banks
FGDs	Focus Group Discussions
KYC	Know-Your-Customers
PCBs	Private Commercial Banks
PCBs	Private Commercial Banks
SCB	State-owned Commercial Banks
SMEs	Small and Medium Enterprises
TFP	Traditional Trade Financing Products
UPICC	UNIDROIT Principles of International Commercial Contracts
WTO	World Trade Organization

Executive Summary

Small and Medium-sized Enterprises (SMEs) are major forces behind global employment and economic expansion. SMEs have a difficult time getting trade finance, which restricts their ability to enter foreign markets even though they make substantial contributions to trade and production. A significant problem that disproportionately impacts SMEs, especially in developing nations like Bangladesh, is the trade finance gap. In addition to analyzing the extent, reasons, and consequences of this disparity, this study suggests legislative actions to improve SMEs' access to trade finance.

This paper provides an overview of the global trade finance environment and emphasizes the structural obstacles that SMEs encounter when trying to obtain funding. SMEs are excluded from formal trade financing mechanisms due to a number of factors, including strict regulatory requirements, high collateral demands, and low financial literacy. Additionally, because of their short credit histories and inadequate documentation, SMEs are frequently viewed by financial institutions as high-risk borrowers.

SMEs in Bangladesh have been very important economic actors and closely related to the country's GDP and exports. It is noted that SMEs contribute one-quarter of the country's GDP and are heavily engaged in the market's export industry including RMG. Similar to most other developing countries, 'Access to finance' is the biggest obstacle to the growth of the country's SMEs. Governments have made some efforts to streamline small and medium enterprises' access to finance. These efforts vary from encouraging banks to lend more to SMEs, offering a chance for banks and financial institutions to refinance at cheaper rates, and policy support to banks to encourage financing of SMEs.

The general situation of financing for small and medium-sized enterprises in Bangladesh improved and the lack of financing decreased. However, trade finance to the SMEs did not receive adequate policy attention and the trade finance gap was a key concern for the SMEs of the country. Major factors which are responsible for the trade finance gap in Bangladesh, including regulatory compliance burdens (such as KYC and AML requirements), lack of awareness of trade finance solutions, and high transaction costs. Additionally, asymmetric information and inadequate financial records among SMEs further contribute to their financing challenges.

SMEs are not specially addressed in the trade finance operations and policy fronts in Bangladesh. The policy environment on SMEs or CMSMEs seems to touch upon their development only within the domestic sphere and trade finance issues do not receive any attention as a special topic to be addressed. 'Trade Finance to SMEs' needs to be addressed specially and separately on policy and operational fronts to address the SME access of issues and challenges concerning trade finance. A coordinated effort from policymakers, financial institutions, and international trade bodies is necessary to create a more supportive trade finance ecosystem for SMEs.

International Trade Finance and SME: Bridging the Gap

1. Introduction

Small and Medium Enterprise (SME) is a crucial segment of the production units in both developed and developing economies that have significant contribution within the country and also in cross-border trading activities. Though by definition SME indicates firms of relatively smaller sizes, however, perceiving the term ‘SME’ is more about their relative disadvantages in the market and inherent challenges in getting access to some essential services. According to the available published information, around 80 percent of cross-border trade transactions depend on some form of financing, and adequate financing for SME traders in particular is an important part of the resilience equation of the trading partners (ADB, 2022). The trade finance deficit, or the gap in trade finance, continues to be significantly large. This shortfall is particularly severe for Small and Medium-sized Businesses (SMEs), making up over 90% of all companies and employing the majority of the workforce in developing Asia. Therefore, enhancing their involvement in trade is essential for promoting inclusive trade and economic development (ADB, 2022).

Considering the prevalence of small and medium-sized enterprises in Asia, facilitating their involvement in global trade would encourage more inclusivity in economic expansion. Nevertheless, these businesses often have restricted entry to financial services and risk management plans that are crucial for their expansion. Small and medium-sized enterprises often do not have the money or assets needed to get trade finance loans, and they may not know how to navigate the complicated and spread out trade finance system. Additionally, financial institutions and other businesses involved in trade financing experience substantial expenses related to regulatory compliance. No matter the specific size of the difference now, there is no argument that it unfairly affects small and medium-sized enterprises. (Trade wind, 2020).

Published reports and surveys show that there is a lack of structure in trade finance, and obstacles are still stopping trade finance suppliers from closing the trade finance gap. Small and Medium-sized Enterprises (SMEs), which are important for creating jobs and promoting overall economic growth, still struggle with getting approved for trade finance. Asia and the Pacific region holds the largest portion of trade finance requests and turn-downs worldwide, indicating a missed chance for trade and growth. Due to Asia and the Pacific's dependence on bank-based finance, it is at risk of facing rejections. Other forms of finance, such as inter-company, non-bank, and digital trade finance, are still limited. Banks must depend a lot on their own resources to stay current, but this can be expensive and time-consuming. Therefore, the majority of lenders only provide these services to big businesses and well-established companies. Additionally, small businesses may also have limited understanding of trade finance solutions. Given the significance of small and medium-sized enterprises, it is crucial to comprehend the magnitude and direction of unfilled need for financing in trade—referred to as the trade finance gap. This understanding will enable policymakers to implement both policy and business initiatives to enhance financing capability in areas with the greatest need.

SMEs in Bangladesh have been very important economic agents and have great associations with the country's GDP and exports. One-fourth of the country's GDP is said to be contributed by SMEs, and these enterprises are heavily engaged in the export market of the market including RMG. Not different from many other developing countries, 'Access to finance' is a critical challenge to the progress of the SMEs of the country. Policymakers have taken various actions to make it easier for small and medium-sized enterprises to get financing. These actions include encouraging banks to increase their loans to SMEs, giving banks and financial institutions a way to refinance at lower rates, and giving policy support to banks to make financing SMEs more attractive. The general condition of small and medium-sized enterprise funding in Bangladesh got better and the funding shortage decreased. However, trade financing to the SMEs did not receive due policy attention and the trade finance gap remained a critical challenge for the SMEs of the country.

On the above background, the study is about examining relevant issues of trade financing to the SME sector and putting forward policy suggestions and operational measures. To attain the objective, the study aimed to analyze conceptual issues and global development on the trade financing gap for SMEs; to examine policy and regulatory initiatives associated with trade financing to the SME sectors; and to capture banks' and traders' perceptions to identify measures for minimizing trade finance gap in the SME sector of Bangladesh.

The study is based on both primary and secondary information. Secondary data have been gathered from both domestic and international publications, reports and articles related to international trade and SMEs. Publications and reports of BB and Bangladesh Bureau of Statistics are the major secondary data sources in Bangladesh context. To gather primary data, two questionnaires were prepared for the banks. One questionnaire was sent to the heads of international division, and other is for heads of CMSME of the banks. Both open-ended and close-ended questions were incorporated into the survey questionnaire. Two Focus Group Discussions (FGDs) have been conducted to collect more information, validate data of the primary survey, get more practical insights into the study and to identify challenges involved in the gap between international trade and CMSMEs financing. Two FGDs have been organized with the heads of international banking divisions and CMSME divisions. For more understanding of the study, some personal interviews with expert and knowledgeable bankers in international trade and CMSMEs are also executed. Sample banks included four State-owned Commercial Banks (SCB), twenty four Private Commercial Banks (PCBs) and two Foreign Commercial Banks (FCBs) of different generations. The list of sampled banks is given in appendix one. Appendix 2 & 3 contains the list of the bankers who are participated at FGDs. In the paper, the term SME and CMSME has been used interchangeably.

2. Trade Financing in the Global Context and Trade Finance Gap: Literature Review

Expansion of international trade activities is directly associated with trade financing. COVID-19 devastation severely hampered global trading activities that have notable implications for trade financing activities throughout the globe. Trade finance markets are vulnerable during economic and financial crises, and the drop in trade during these periods was attributable to trade finance shortages (IFC, 2020). Trading countries recovered remarkably in 2021, however, are still in the grip of global economic and political instability and developments. Despite these, there are positive forecasts regarding the expansion of trading activities[1]. The expansion of trade would automatically expand the trade finance market. However, it is evident that the trade finance gap especially of SMEs is becoming even more challenging.

2.1 Global Trade Finance Market and Available Products for SMEs

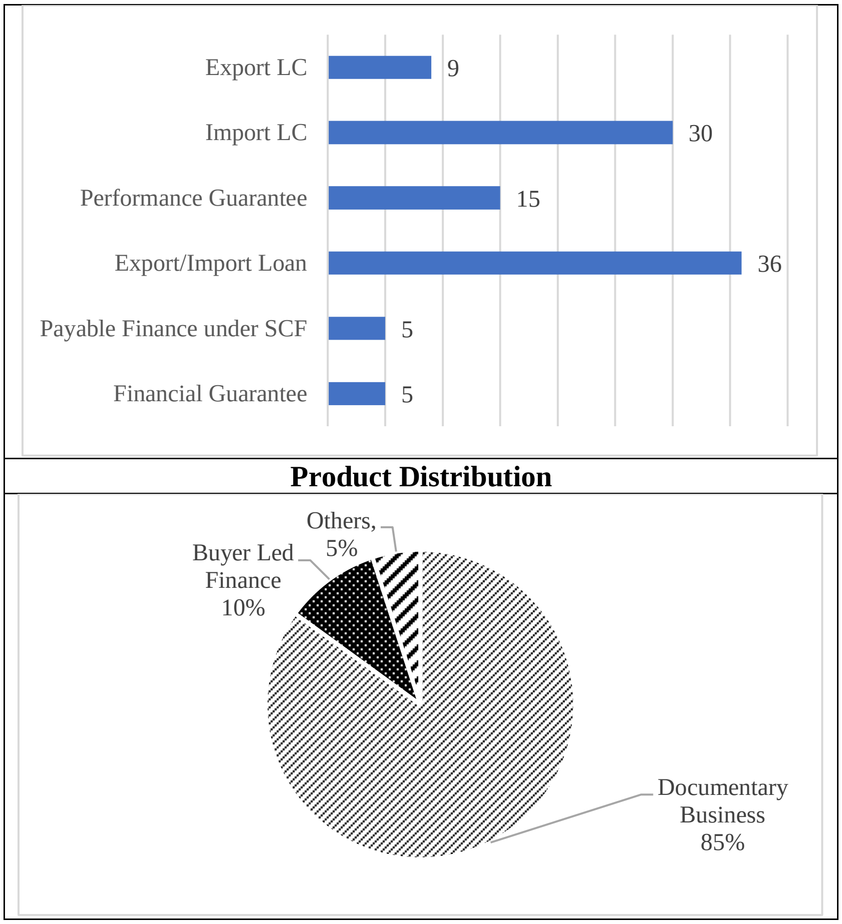
Trade finance relies on a network of connections between different institutions, all working together to reduce the risks involved in international trade. Numerous trade finance tools are accessible, and these tools represent connections between different participants in the trade finance network. One crucial difference between trade finance and other types of finance is that the connections that support them are international. The important participants in the ecosystem are companies that import goods; companies that export goods; banks in the importing countries; banks in the exporting countries; regulators; and multilateral development banks.

There is not precise data on the exact amount of trade financing products, but traditional Trade Financing Products (TFP) still have a strong hold in the market. Based on the ICC survey from 2021, receivables discounting is considered the most popular supply chain method among clients, followed by payables finance, loans/ advances against receivables, and factoring.

Despite the growing popularity of SCF, the projections indicate possible dominance of TFPs even in the near future. LC remained the most widely used trade financing product. The connection between banks is another important aspect of trade finance structure linked to TFPs. Enabling payment for international trade requires a bank in the seller's country to establish a correspondent relationship with the bank in the buyer's country. These banks can perform different functions, including issuing bank, confirming bank, advising bank, nominated bank, remitting bank, collecting bank, and more depending on the particular tool used. Bank-facilitated trade funding is pricier and less adaptable than open account trade funding, but it provides more security for suppliers and is favored for trade involving riskier clients or destinations.

Figure 2.1: Bank-Facilitated Finance (Trillion USD) in the Globe

[1] According to new forecasts in April, 2022, the World Trade Organization (WTO) (2022) expects global trade volume to grow 3.0% in 2022 and 3.4% in 2023 (Trade Finance Global, 2022). The 2022 forecast was lowered from 4.7% as prospects for the global economy dimmed with the Russian invasion of Ukraine in February 2022.



Source: ICC, 2021.

In 2020, the volume of trade finance transactions supported by major global banks was estimated to be around USD 9 trillion and trade loans, letters of credit, and guarantees account for 90% of trade finance transactions (Figure-2.1). From the AfDB survey data, it is noted that short-term revolving credit, pre-export finance/import loans, and letters of credit are the main instruments used by both SMEs and large corporates. However, SME exporters rely more on pre-export finance and supply chain finance than do large exporters (AfDB-Afreximbank, 2020).

Default rates are significant markers that demonstrate the risks of trade finance tools. From 2008 to 2023, the default rates for import and export letters of credit were 0.40% and 0.04% respectively, while the default rate for export/import loans was 0.72% during the same time frame. Despite defaults occurring, the recovery rates are quick and quite high: 83% for import letters of credit, 83% for export letters of credit, and 77% for export/import loans during the same period. (ICC, 2023).

Table 2.1: Default Scenario in Trade Finance

Financing Products	Default Rate	Recovery Rate
Import Letter of Credit	0.40	83%
Export Letter of Credit	0.04	83%
Loans for Import/Export	0.72	77%
Performance Guarantee	0.45	49%
Supply Chain Finance-Payable Finance	0.30	73%

Source: ICC Trade Registrar Dashboard (Accessed on September 19, 2023)

The government, through national Export Credit Agencies (ECAs) or export-import banks, provides trade credit insurance and guarantee programs. These programs help commercial banks share the risk and be more willing to finance trade transactions for client segments like SMEs who would otherwise be excluded. Sometimes, governments also act as a reinsurer for the national ECAs. Governments occasionally offer financial aid to local or national banks, along with insurance and assurances, to support trade loans. (Christian and Sreshtha, 2022).

Banks conduct Customer Due Diligence (CDD) on businesses that they provide financing to. During the CDD process, banks ask for details about Know-Your-Customers (KYC), Anti-Money Laundering (AML), and Counter Financing of Terrorism (CFT) measures to make sure they follow the rules in these areas. These usually comply with international regulatory standards or frameworks for CDD-related measures on KYC, AML, and CFT, as well as aspects related to banking safety, such as the Basel III regulation on capital need. Multinational development banks and global organizations have helped ensure enough trade funding for overlooked markets and participants. Global backing for trade funding has also increased during financial slumps. (Auboin and Behar, 2020).

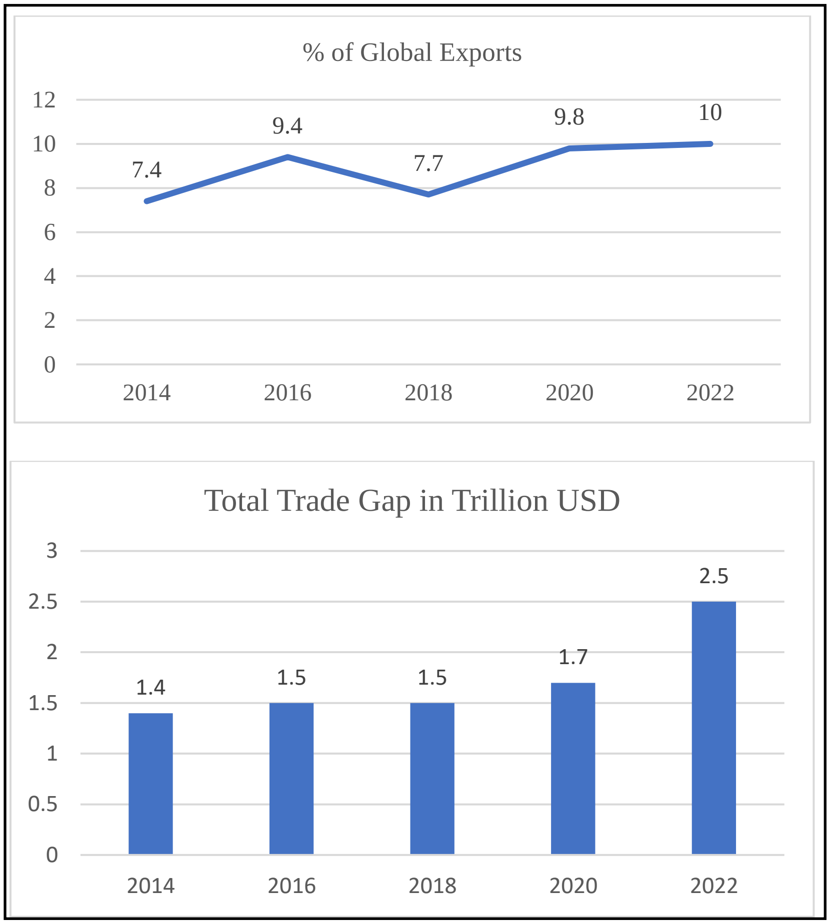
2.2 Visible Trade Finance Gap and High Rejection of SME Application

Global trade finance gap has been a critical challenge that has increased over time. The COVID-19 pandemic has caused a historically large trade finance deficit. According to the latest Trade Finance Survey, the trade finance gap increased to about $1.7 trillion in 2020, representing 10% of worldwide goods trade. (Kim et al. 2021). The uncertainty in the overall economy made banks think that borrowers would be less likely to repay; this was making it harder on the bank's requirements to keep enough cash on hand available for lending to customers, resulting in more loan application denials. According to the ADB (2023) survey[2], the trade finance gap for the year 2022 was as high as USD 2.5 trillion which is around 10 percent of the total trade transactions of the globe. However, other estimates from the UK All-Party Parliamentary Groups (APPG) on trade

[2]Findings and recommendations in the 2023 survey are based on responses from 137 banks across 54 countries and 185 firms from 43 countries. The survey responses reflect over 60% of the global market for bank-intermediated trade financing. The survey responses were collected online from May 2023 to July 2023.

finance put the current gap as high as USD3 trillion to USD5 trillion (Trade Finance Global, 2022). It means in terms of total global export transactions that may be even up to 20 percent. Greater risk aversion would increase already burdensome capital and regulatory requirements and can also lead to further increases in rejection rates in trade finance applications, as banks may potentially stop taking on new financing obligations. This would compound existing strains faced by regular trade finance borrowers and would make trade finance even more inaccessible for SMEs and women-owned enterprises. This will, in turn, have a larger trade finance gap. (ADB, 2022).

Figure 2.1: Global Trade Finance Gap

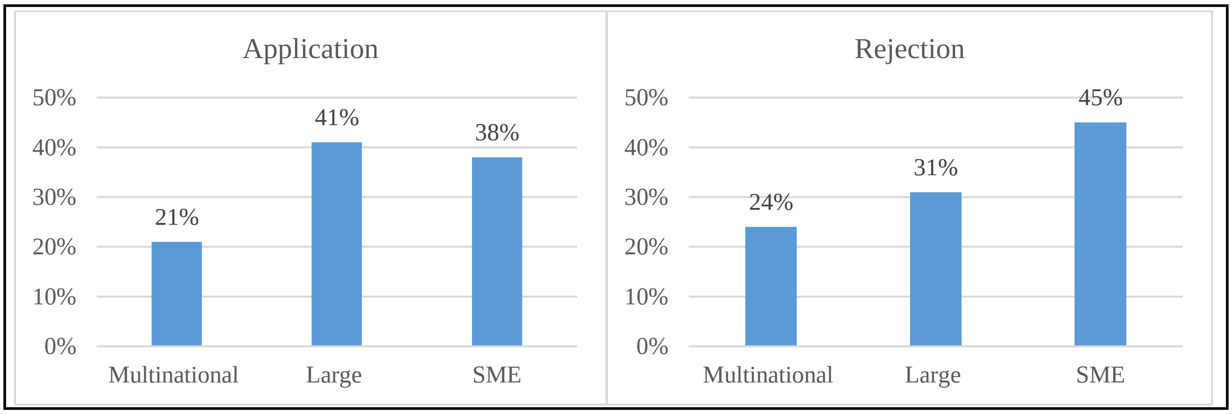


Source: ADB (2022).

High trade finance gap is relevant both for developed and developing countries and across the region. SMEs are more self-rationed in the trade finance market than are large firms. Close to 20 percent of SMEs did not apply for trade finance even though they needed it, compared with 4 percent of large firms; and higher proportions of trade finance applications are rejected. Over half of global trade finance requests by SMEs are rejected, compared with just 7 percent for multinational companies (WTO, 2016). Notable trade-finance gap is clearly visible in Asia-pacific region and other regions of the globe. However, the rejections fell more disproportionately on SMEs as opposed to their larger counterparts. For example, in 2022, although 38 percent of the applications received by banks emanated from SMEs, a larger proportion of the rejections-45 percent-was attributed to these same SMEs (Figure-2.2) Approximately 40% of the trade finance facility applications received from SMEs were rejected by banks in Africa in 2019 (AfDB-Afreximbank, 2020).

They would also, therefore, be more likely to have higher rejection rates and, hence, wider financing gaps compared with well-represented group-led businesses. Similarly, ADB's 2017 and 2019 trade finance surveys yield consistent results; specifically, woman-owned firms experienced a higher rejection rate than those owned by men. (Kim et al., 2019).

Figure 2.2: Comparative Scenario of Trade Finance Application and Rejection



Source: ADB, 2023 Survey.

2.3 Factors Responsible for Trade Finance Gap and Greater Rejection of SMEs

Understanding the reasons for growing trade-finance gap and such high rates of SME rejection is a crucial step on the path to closing the gap. According to the ADB survey (2022), the most commonly cited reason (72.4%) for SME rejection is the stringent AML and KYC requirements in place today. Another factor may be the impact of time-consuming and manual onboarding processes on the profit that banks are able to make from SME clients. APPG reports that banks now face onboarding costs as high as USD 80,000 for SME clients due to this cumbersome, redundant, and mostly manual bureaucracy (Trade Finance Global, 2023). 'Insufficient collateral' has been identified as the primary reason for the rejection of the SMEs' trade finance applications, as claimed by the SME entrepreneurs (AfDB-Afreximbank, 2020).

Of late, the slowdown in global economies, rising interest rates, and protectionist trade policy, together with rising inflationary pressure, have all contributed to SMEs' difficulties. Systemically, the cost of financing for SMEs is on the rise. SMEs generally have greater possibilities of getting trapped into trade and business-related frauds. Further, with the increasing ESG requirements and reporting standards, the barriers for SMEs went up (Trade Finance Global, 2023).

According to the ADB's 2021 survey, approximately 44% of loan applications were denied by banks due to being unsuitable, lacking sufficient collateral, and having inadequate information. Businesses find the collateral requirements to be burdensome, and approximately 36% of firms consider this requirement to be the deciding factor in loan applications being denied (Tables-2.2 and 2.3). Small businesses face challenges from the start because they are seen as having little collateral, which makes banks hesitant to lend, particularly in developing countries where legal systems supporting property registration and property rights enforcement are likely to be lacking. A lot of small businesses don't have enough information about the standard practice of sharing and keeping records of information. This affects the way they act when doing business with banks and other lenders. To SMEs, KYC or AML requirements are hardly a reason to reject their trade finance applications, less than 1 percent of firms cited KYC/AML as a potential reason behind trade finance rejections in the ADB Survey 2022. SMEs also find banks' application processes lengthy and bureaucratic. Alongside the unfriendly approach of banks, the lack of understanding of SMEs on banks' KYC/AML requirements seems important challenge.

Table 2.2: Reasons of Rejecting Trade Finance Applications (Banks Perspective)

Application was completely unsuitable for support	19%
Application lacked additional collateral	10%
Covid related concerns	11%
KYC/AML concerns	10%
Unprofitable Venture	10%
Insufficient Information	08%

Source: Based on ADB survey (2022)

Table 2.3: Reasons for Rejecting [not availing] Trade Finance Applications (Borrowers' Perspective)

Insufficient Collateral/Guarantee	36%
Very High fees/interest rates	18%
No previous transactions/relationship issue	17%
High risk rating	11%
Inability to fulfill Documentary Requirements	10%

Source: Based on ADB survey (2022)

Rejected SMEs commonly have very limited options but to move to their own fund (36%) or to the much more costly informal sector. According to the ADB (2022) survey, 18 percent of SMEs did not find an alternative that must have had notable implications on their business and trade operations. Informal financing sources were business partners (32%), family members (23%), money lenders (19%), and informal saving groups (18%), etc. (Table-2.4).

Table 2.4: Responses of SMEs to the Rejection of Trade Finance Loans [2021]

Use of own funds or retained earnings	39%
Unable to find an alternative	18%
Used informal financing	17%

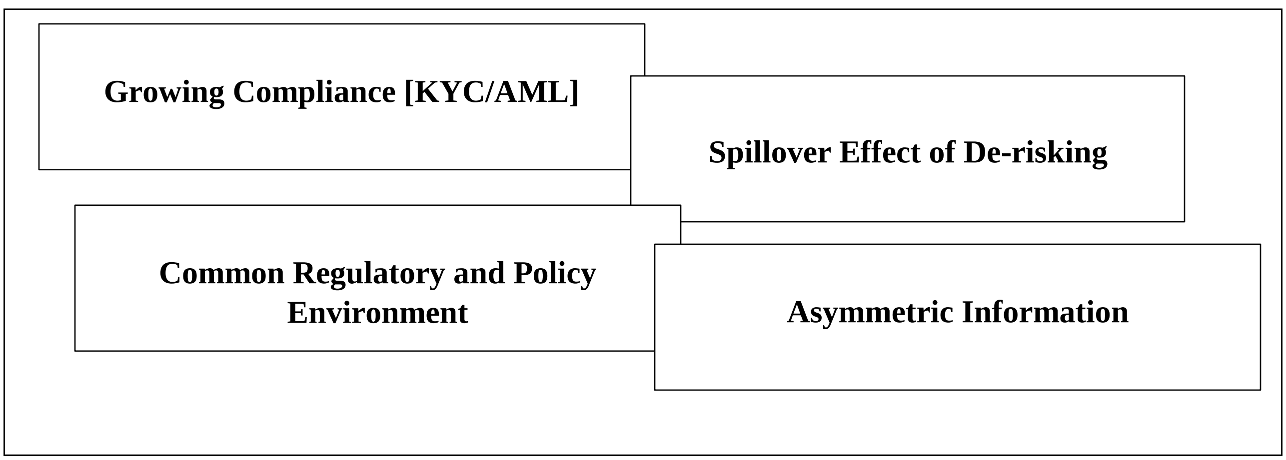
Source: Based on ADB surveys (2022)

In general, policy approaches focused on solving the trade finance gap need to be connected to the main difficulties faced by small and Medium-sized Enterprises (SMEs) when expanding internationally. These challenges typically include: A lack of connections with large multinational companies, A lack of high-quality, competitive products and insufficient investment in research and development Limited business knowledge and capacity 4. Poor regulatory compliance 5. Limited access to financial resources (ADB, 2021).

2.4 Key Delaying Policy Approaches and Addressing Trade Finance Gap for SMEs

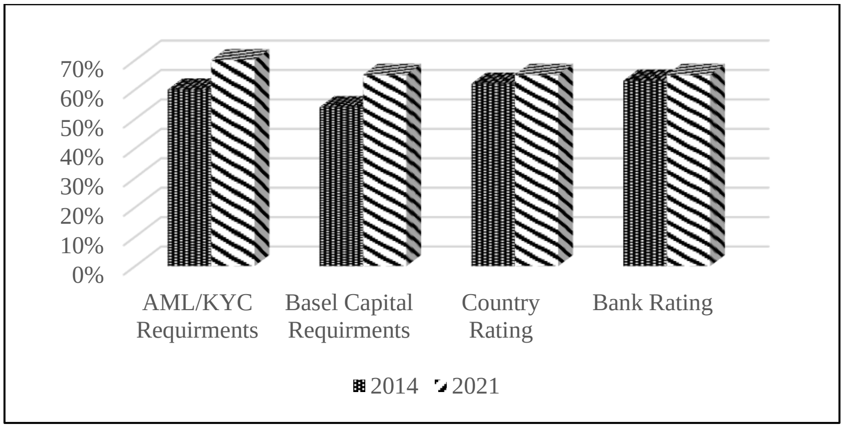
Certain policy approaches and existing and potential market interventions need to be discussed to reflect the challenges and possible measures association with trade finance gap. These may be categorized into the following:

Figure 2.3: Key Trade Finance Business Challenges for SMEs



New trade regulations, designed to fight illegal activities like money laundering, can accidentally hinder trade. Small and Medium-sized Enterprises (SMEs) are particularly impacted by this. (Beck and Estrada 2021). The increased expenses related to meeting KYC and AML regulations have consistently made it difficult for banks to meet the trade finance needs of the global market. Meeting regulatory requirements such as KYC and AML procedures can make the processing of loans more expensive, leading trade finance providers to be very choosy about which applications to approve. In reality, rules and increasing demands to follow the rules are becoming huge and limiting trade finance. (Figure-2.4).

Figure 2.4: Factors Restricting Trade Finance Transactions [2014-2021]



Around one-third of banks implemented De- risking strategies had a negative effect on importers and exporters, specifically those located in Asia and Africa. The Basel regulations require banks to have more money in reserve, which encourages them to be choosy about who they lend to and to only lend to the most creditworthy borrowers (Clark, 2017). This increases the chances of banks' lending to big companies instead of small and medium-sized enterprises, and it shows a very cautious attitude (Metzgen, McLean et al., 2018).

Asymmetrical information can also lead to the incorrect pricing of risk, because banks and financial institutions frequently do not fully grasp the risks associated with SME projects. Smaller companies' potential lenders are likely to have a more in-depth understanding of the business operations, risks, and potential returns compared to larger, well-known enterprises. In order to account for the lack of information balance, banks typically review a borrower's credit history and financial statements. Regrettably, a lot of small and medium-sized enterprises do not have financial documents to confirm their current earnings. As a result, Small and Medium-sized Enterprises (SMEs) often get rejected for trade-related and other loans by banks because they are unable to prove their financial stability using the banks' set standards. The demands are stricter in trade finance than in domestic credit activities.

Common policy and regulatory approaches for lending generally have greater implications for the smaller than the big borrowers. Despite special treatment, SMEs face difficulty in domestic credit services. Generally, SMEs are not always differently or specially treated while offering trade financing as KYC/AML compliance requirements are determined considering the associated risks. This is particularly true in the context of developing economies that confront country risks associated with illicit fund outflows and money laundering. SMEs confront greater challenges during crisis than those of bigger enterprises.

Several market interventions and policy initiatives might be helpful in minimizing the SME trade finance gap. Digitalizing the trade ecosystem is widely seen as a key enabler to help streamline efficiency in the industry and close the trade finance gap. Most banks said they are preparing to use technology to offer trade finance services to more small and medium-sized enterprises in the 2022 ADB survey. They plan to do this by processing KYC more efficiently, gaining a better understanding of this market segment through data mapping, and creating new products. According to The Boston Consulting Group (BCG), in 2025, approximately 10% to 15% of overall trade finance and 20% to 25% of small and medium enterprise trade finance will happen on digital platforms. Costs associated with implementing technology, lack of knowledge, and outdated legacy systems pose significant obstacles. These systems are not compatible with current technologies. As a result, majority of banks have implemented the 'wait and see' strategy. (Ramachandran, 2019). Moreover, a considerable knowledge gap persists about fintech and trade finance. Further, SMEs remained far behind the larger companies in terms of financial literacy and familiarity with trade finance products.

SME Export Cluster might be another helping tool. SMEs struggle in the international market conditions are challenging for these enterprises and also for banks. Many SMEs shy away from international markets (Sousa and Bradley, 2009). There are specific reasons that prevent small and medium-sized enterprises from entering international markets; such as challenges in locating international partners, complying with foreign regulations and standards, accomplishing economies of scale and specialization of work, and lastly; absence of international expertise and managerial experience, capability, and necessary financial knowledge. (UNIDO, 2003). Small and medium-sized businesses need to work together with other organizations or SMEs (export clusters) in order to successfully enter and thrive in international markets. These connections can come in different types, with each type having its own advantages and consequences. These connections can be established through export help, distributor backing, or group arrangement. (Sousa and Bradley, 2009). However, for success, members must trust one another; and there must be strong internal networks such as governmental, technical, educational, and financial service providers (Tambunan and Hendrawan, 2004). They should be able to capitalize on the various possibilities offered by the cluster form, and a strict structure eliminates the opportunities of exporting clusters. Group the Public Relations Department: There is a correctly structured Public Relations Department which should be tied in with one, not two personalities representing into markets and among them but as whole export group to present. (Scheer and von Zallinger, 2007).

3. Policy and Regulatory Provisions and Trade Financing Products Relevant for SMEs

3.1 SME Supportive National SME and Trade Policies

SMEs and international trade have been given priority in the national and sectoral policy documents that have implications for trade finance activities. The Eighth Five-Year Plan, formulated on creating employment, and inclusive development, has given emphasis to export policy to be consistent with the 8th Five-Year Plan and Perspective Plan 2021- 2041. Import Policy 2021-24 has generic policy approaches and supportive approaches to the importation of materials and capital machinery supportive trade finance products like back-to-back LC. Export Policy 2021-2024 has treated diversified Jute products, Agricultural products and processed agricultural products, and light Engineering products as priority sectors that are very much within SME sector. According to the policy, commercial Banks have to consider, on a priority basis, providing credit to the exporters of 90 percent of LC or confirmed contract value against irrevocable 'letter of credit' or confirmed contracts.

Export Policy 2021-24 recommended introducing special and priority-based policy for women to get loan without mortgage; and to reduce the cost of export-oriented businesses for female entrepreneurs; and to extend the support of Women Chamber of Commerce and Industries in coordinating women in businesses, achieving potential expertise, sharing experiences, providing necessary information, providing support to establish relationship with the export-oriented associations, getting credit facility from the banking sectors, etc. to facilitate women's participation in trade. The policy also recommended to increase the participation and involvement of women in the global platform named 'She Trade' by the International Trade Center; and to extend special assistance to women and small entrepreneurs to act as backward linkage and supply chain industries in export-oriented production. It targets to assist to small and women entrepreneur for participation in international fairs and exhibitions to promote markets.

The export policy added new priority sectors for promoting exports. It encouraged subcontracting-based exports to build strong supply chain and backward connectivity in export-oriented industries-very relevant to SMEs of the country. An Export Readiness Fund (ERF) has been declared to renovate (old, medium and small) export-oriented factories.

To promote exporters of the agriculture and light engineering sectors, government of Bangladesh decided offer special privileges. Government decided to offer Khas land to exporter for producing vegetables, flowers and fruits. According to the Export Policy document, exporters will be encouraged to create export village; assistance will be provided for modern equipment in the field level and for research to develop new export oriented agro product based on demand of foreign markets besides domestic demand. To take the initiative for the export of light engineering products in international market, Export Policy vowed to encourage the factory owners to convert green zone of light engineering sector. And loan facility to be given to convert higher technology with easy condition and lower rate of interest, to reduce low tariff and longtime tax rebate for import raw materials.

The Gov-ernment of the Bangladesh has taken a few initiatives to enhance small and medium-sized enterprises in Bangladesh. Out of the many, one such problem as stated in the policy documents is that it is difficult for businesses to get loans easily. In accord with its 'Vision 2021', through various channels, enhancing access to funding for small and medium-sized enterprises, and closing the financial gap has been in process for a while now by the Bangladesh government. While the Government of Bangladesh has strategized 'Expanding Access to Finance in SME sector' as strategic Goal-2 with tools and 'Developing and Expanding SME Cluster-based Enterprises Network' as strategic Goal-5 with tools in the SME Policy 2019, the 'SME Foundation' is highly active in support of small and medium-sized enterprises and has also taken major initiatives for the development of the SME sector.

3.2 SME Credit Policies and Programs by the Bangladesh Bank

Bangladesh Bank has been very active on the SME financing front and a separate department (SMESPD) has vigorously been involved in guiding, supporting, funding, and monitoring SME financing. It has also been part of SME entrepreneurship development and working with other government entities and donor agencies. In 2010, banks and financial institutions in Bangladesh set a goal for SME loan distribution for the first time, recognizing the importance of SME development as a key agenda for the country's development. As per the instructions of the BB to support small and medium-sized enterprise women business owners, banks created special 'Women Entrepreneurs' Dedicated Desks' with the appropriate staffing. Banks and financial institutions were encouraged to receive group security/social security in the SME financing by the central bank. BB also offered licenses to new branches specifically to finance the priority sectors like SME and agriculture. These SME supportive systems are directly relevant to all types of SMEs including clusters.

As per the current BB guidance, 25 percent of the total loan disbursement by the banks/NBFIs must be in the CMSME sector by 2024. Refinancing is an important source of funds for banks for CMSME financing by banks and NBFIs. In order to standardize industrial growth and provide financial assistance through banks, at least 15% of the entire BB refinance fund for Small and Medium-sized Enterprises (SMEs) has been set aside for women business owners.

To emphasize the importance of CMSME sector towards the advancement of the economy, BB introduced guidelines on cluster financing in CMSME sector. According to the new policy, BB told all banks and financial institutions to release minimum 50% of their CMSME loans to 19 'high-priority' and 'priority' clusters. An entrepreneur can also borrow from many banks without going over the highest credit limit stated in the circular.[3]

3.3 Policy and Regulatory Framework for Trade Financing in Bangladesh

The main law governing and directing trade finance operations by banks and other financial institutions for traders, including SMEs, is the Foreign Exchange Regulation Act of 1947 (FERA 1947). The trade policies issued by Bangladesh's Ministry of Commerce have a significant impact on banks' trade financing operations. When providing their services, banks must also abide by a number of international regulations. The most pertinent international guidelines for banks are those published by the International Chamber of Commerce (ICC).

FERA 1947 gave the BB the authority to issue foreign exchange circulars, which the Authorized Dealers are required to abide by. The BB organized all of the FE circulars into a guideline called GFET. Officials working at various desks of the trade services departments in AD branches must be well-versed in the BB Guidelines for Foreign Exchange Transactions from an operational banking perspective. Other than a few, most of the trade finance rules and trade financing supports have been generic in nature that targets all types of traders (exporters and importers) including SMEs. For example, several GFET provisions and some recent circulars (FE and BRPD) related to trade finance on 'safeguard of Export Trade transaction ensuring appropriate due diligence before involving any banks to avoid 'Shell Bank'[4]; 'policy guideline on Post Import Financing (PIF)'[5]; 'Open Account Transaction Supported by Undertakings'[6]; 'Promoting Export through Export Development Fund'; 'Credit Report on Foreign Suppliers in Imports'[7]; 'Provisions of Cash in Advance, open account and documentary collection in Import'[8]; 'Price Competitiveness and

[3] SMESPD Circular No. 05, Dated August 14, 2022.
[4] FE-25, dated July 13, 2021.
[5] BRPD-12, dated June 13, 2021.
[6] Exporters are allowed to export against payment undertaking/payment risk coverage from abroad (FE-25, dated June 30, 2020).
[7] Credit Report on Foreign Suppliers in Import (GFET Vol. I 2018 Chapter-7): The ADs should also obtain confidential report on the exporters from their branches or correspondents abroad or in their discretion, satisfy themselves as to the standing of the exporter by consulting standard books of reference issued by international credit rating agencies acceptable to the ADs in all cases where the amount of LC/contract exceeds USD 10,000 against proforma invoices issued directly by foreign suppliers and USD 20,000 against indents issued by local agents of the foreign suppliers (GFET Vol. I 2018 Chapter-7).
[8] Importers can avail outward remittance for import upto USD10000 in the form of cash in advance, otherwise obtaining repayment guarantee from bank abroad, if not possible, permission of BB is required. Commercial importers can make import payment upto USD500,000 under contract-based payment method (IPO 2021-2024). Industrial importers can import goods for any amount. In case of import of raw materials and capital machinery by the registered industrial importers for the use in their own factories, without opening LC irrespective of any price Limit(GFET Vol. I 2018 Chapter-7).

Vessel or Container Tracking in export and import etc.[9] have implications for traders of all sizes. Of the SME specific policy supports, in June 2023, BB relaxed margin in opening LCs by CMSME commercial importers[10].

Compliance requirements and circulars of the Bangladesh Financial Intelligence Units (BFIU) targets traders of all sizes (including SMEs) to handle money laundering and terrorist financing through trade services by banks. For example, in December 2019, BFIU issued specific guidelines for banks to prevent TBML, and due to COVID-19 situations, BFIU extended the timeline for full implementation from June 2021[11]. It is expected that with the full implementation of this guideline, TBML will be significantly reduced in the future in Bangladesh. For managing risk, the guideline prescribed four levels of risk assessment i.e. Infrastructure Level Risk Assessment, Customer Level Risk Assessment, Transaction Level Risk Assessment and Enterprise Level Risk Assessment. It also suggests required control mechanisms to mitigate the identified risk. All of these TBML rules and guidelines, and KYC norms are required to be followed by the trade finance providing bankers while facilitating trade finance to large or SMEs equally.

Purchase-sale contact, which is basically an agreed Proforma-Invoice or agreed Indent, is an essential document in trade facilitation however is hardly standardized and legally enforceable. Concerning uniform rules for the contract, the major trading partners of Bangladesh like United States, UK, members of the EU, China are among the signatory countries of 'UN Vienna Convention'. Most of the trading partners of the country are also amongst the signatories of 'Unidroit Principles' However, Bangladesh is yet to sign the treaty and the principles, and the country also does not have any national regulation to cover cross-border purchase/sale contracts.

3.4 Trade Financing in Use and Procedures in Bangladesh

Payment methods are agreed upon in the purchase/sale agreement, and at the operational level, there are two types of payment processing mechanisms in Bangladesh that are Branch Based and Centralized. AD branches conduct trade service operation not only for their customers but also for the customer of Non-AD branches under branch-based arrangement; whereas under centralized system, trade services are offered through a centrally managed department. Sometimes a hybrid arrangement is followed. In Bangladesh, use of Cash in Advance is very limited. Though Open Account is the most popular payment method in the globe, Open Account (excepting in EPZs) is

[9] ADs are to do screening of underlying export shipments through vessel/container tracking system recognized by competent authority has been made mandatory through (FE Circular No.07, dated April 20, 2022) and to conduct the tracking of shipments for relevant import transactions (FE Circular No. 09 dated May 17, 2022).

[10] ADs can set margin in opening LCs based on banker customer relationship instead of 75 % cash margin for import of machineries, spare parts, textile and chemical raw materials of plastic and packaging items and medical equipment (BRPD circular letter 19, Dated: June 19, 2023).

[11] BFIU Circular Letter, dated March 2021.

hardly used due to some explicit and implicit regulatory restrictions. A kind of conditional open account arrangement has been allowed in the context of COVID-19 situation.

Documentary Collection is one of the most widely used method in Bangladesh. The method is collectively regulated by Uniform Rules for Collection (URC 522) and the Purchase/sale contract. Documentary Credit or LC involves long steps and widely used in Bangladesh. Trade services departments of banks also offer services related to issuance and settlement of Local LC. These are mainly connected with commodity trade within the national boundary. Of the different types of LC, transferable LC is very common in Bangladesh where the country has a bit unusual practice of 100 per cent transfers to the second beneficiaries. This is an indigenous exercise generally not common in other economies. There are also use of confirmed LC that are in use in export transactions.

Exporters and importers need financing at different stages and financing pattern varies in different methods of payments. As a whole, the financing products for the exporters can be grouped under pre-shipment and post-shipment financing; and financing to the importers can be grouped into pre-import and post-import financing. Pre-shipment credit is obtained to meet expenses on purchasing raw materials, processing, transportation, insurance, etc.; and these cash credit facilities are commonly provided against hypothecation and pledge. The most popular form of pre-shipment credit i.e. Packing Credit is extended against transport documents evidencing transportation of goods. The country's exports have heavy reliance on back-to-back LC, which is a financing technique to import raw materials for preparing exportable in the country. In Bangladesh, back to-back may also be open against purchase/sale contracts.

EDF has been an important source of export financing to meet foreign currency needs mainly to import raw materials under back-to-back arrangements. EDF facility is now faster and bigger in terms of processing and fund availability as compared to any recent past. The facility has been expanded over the period. As part of economic stimulus, the EDF fund expanded in the context of Covid-19 situation. In a notable initiative, the EDF facilities were allowed to meet back-to-back obligations. The central bank offered extended time for realizing export proceeds, back-to-back letter of credits and payment of export development fund loans, and repatriation of export bills.

Post-shipment credit facilities are extended to the exporters by the banks after shipment against export documents. It is important for exporter as exporter cannot wait for a long time without making certain payments. Banks in Bangladesh extend post-shipment credit to the exports in the form of Negotiation of documents under LC, Purchase of DP & DA bills, and Advance against Export Bills submitted for collection. Introduction of supply chain products (conditional open account) is yet to get nod in the trade finance market.

For importation, banks offer credit facilities to the importers at the pre-import and post import stage. LC itself is a financing technique for importers. In Bangladesh the popular form of post-shipment import financing techniques includes PAD, LIM and LTR. Under PAD or Payment against Documents, an Issuing Bank makes payment against documents on behalf of importer. Bank extends credit facility against imported merchandise is known as Loan against Imported Merchandise (LIM). Advances against a Trust Receipt or LTR are for very good customers that allow customer to have control over the goods. Banks also offer shipping guarantee/ delivery order/airway releases to facilitate the release of goods when goods arrive before the documents. Another offshore-based financing product to offers post-shipment credit to the exporter or financing to the importer is popularly known as UPAS LC. It develops as part of LC transactions in response to the demands for immediate payment by the exporter and the applicant's request for deferred payment.

Several international organizations are active in supporting trade financing activities in the country. Some qualified banks have been drawing soft loans from international organizations like IFC, ADB, and offering trade financing to the traders including SMEs. For example, currently IFC is extending BRAC Bank Limited (BBL), a USD50 million loan to aid SMEs emerge from the lingering effects of the Covid-19 pandemic. This investment is expected to contribute to the preservation of jobs and bring foreign exchange liquidity into BBL to help support the working capital and trade finance requirements of the Bank's SME importer- and exporter- clients.[12]

4. Trade Finance-Gap in the context of Bangladesh with Special Reference to SMEs-Survey Outcome

The contributions of SMEs to the country's GDP and employment generations are well recognized though data regarding these are hardly available. In a study conducted by the International Cooperation Organization for Small and Medium Enterprises in Asia (ICOSA), Japan, the contribution of SMEs to the GDP was estimated at 20.25 percent in Bangladesh.[13] In 2022, it was claimed that SMEs constitute 25 percent to 27 percent of the GDP, and the sector holds 80 percent of total industrial jobs; and SME Foundation targets to raise the SME sector's contribution to the country's GDP to more than 35 percent by 2030, as part of the government's endeavour to achieve the global agenda of sustainable development goals (SDGs)[14]. SMEs have notable involvement in the country's exports. RMG contributes 85 percent of total export in the country, and of the total RMGs, 70 percent falls in the category of SMEs.[15] SMEs are the main participants in the other export sectors of the county that include jute and jute manufacturers; fish, shrimp and prawn; leather and leather manufacturing; home textile, handicraft, etc. There is consensus on the high

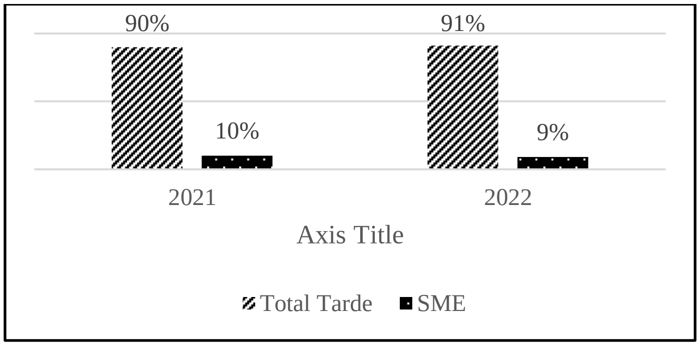
[12] https://pressroom.ifc.org/all/pages/PressDetail.aspx?ID=27626 (June, 2023).
[13] https://www.thedailystar.net/business/news/sme-contribution-still-negligible-study-1807207, The Daily Star Report, September, 2019.
[14] https://www.tbsnews.net/economy/smes-contribution-gdp-expected-hit-35-2030-447914 (The Business Standard June, 2022).
[15] https://www.textiletoday.com.bd/small-rmg-factories-find-difficult-survive

potential of SMEs in export promotion and diversification, and common agreement on the necessity of addressing their operational and business challenges.

'Limited access to finance' has been a recognized challenge for SMEs, and national policy documents, and Bangladesh Bank's financing policies and programs have been addressing the issue since long (as discussed in Section-3). It is visible that when SME or CMSME financing is the issue, it is mostly about the financing needs that fall within the national boundary. The gross approach does not distinctively point to the trade financing that is inherently different in terms of risks, regulations, and documentation. Despite consistent policy efforts, 'inadequate access to finance' remained a recognized challenge of the SMEs of the country, and the 'SME trade-finance gap' as a separate agenda appeared to be out of the expected attention and policy focus.

Though some banks do maintain data on all types of credit facilities to the SME or CMSMES by drawing information from different departments including Trade Services, Trade Finance/Trade Service departments of banks in the country generally do not consider SME as a distinctive group, and these vulnerable clients hardly get any special attention in the process of facilitating trade financing, as observed in the survey and in the FGDs. Banks generally have CMSME desks to address the special needs of SME clients in response to the BB's policy instructions, however, this is not generally the case with the trade financing.

Figure 4.1: Average CMSME Trade Finance out of Total Trade Financing

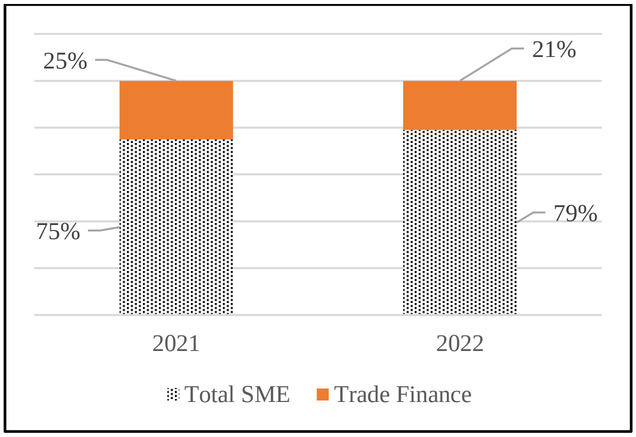


Source: Survey Data

According to the survey data, of the total trade finance of the banks, only 9 percent was offered to SMEs in the year 2022, which was around 10 percent in 2021 (Figure-4.1). This is relatively lower than the overall proportion of CMSME loan figures in the country. According to the BB published data, total CMSME loans for March 2023 was around 19 percent of the total outstanding loans.

With the expanding CMSME activities and graduation, their access to the global market is increasing, and over 20 percent of the total trade finance is going to the SME/CMSME enterprises (Figure-4.2). This indicates the extent of their international trade activities that are supported by the bank financing. Though there is no way to conclude the exact extent of their trade financing gap, however, the cases and FGDs (with trade finance and SME bakers, and traders) reflect their relatively less access and greater difficulties compared to the large enterprises.

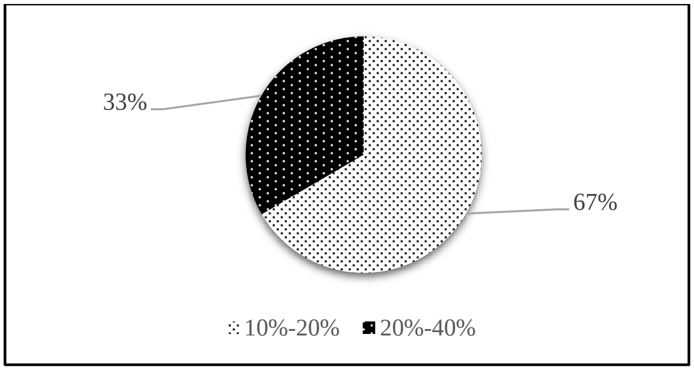
Figure 4.2: Average Trade Finance out of Total SME Finance by Banks



Source: Survey Data

Rejection of applications is a very big challenge, especially for the SMEs in all developing economies including Bangladesh, and this is particularly true in the case of trade finance. Data inaccuracy is obvious on this front. According to the perceptions survey outcome, of the banks, 67% claimed rejection of SME application of 10%-20%; whereas 33% claimed to reject 20%-40% of the SME/CMSME application of trade finance during 2022 (Figure 4.3). The challenges of women appear to be even higher.[16]

Figure 4.3: Overall Rejection Rates of SME Trade Finance Applications by Banks in Bangladesh



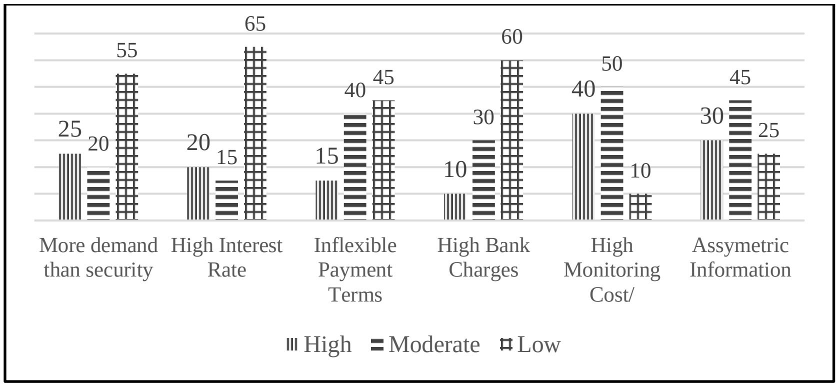
Source: Survey data

[16] According to the study titled "Assessing the current ecosystem of financial products for women in Bangladesh", 40% to 50% of loan applications by women entrepreneurs in the country get rejected owing to a lack of required documents. The financial sector has a target of raising the ratio of CMSME loans to women entrepreneurs against the total CMSME loans to 15% by 2024, he mentioned. Also, a separate desk has been set up for women in each branch of banks (https://www.tbsnews.net/economy/banking/40-50-loan-applications-women-get-rejected-lack-documents-study-502130)

The reasons for rejections as identified by the bank respondents may be associated with banks' lending approaches and the limitations of the SME clients. According to the survey data and FGD, high cost of funds for the given business, inflexible payment terms, high monitoring costs, asymmetric information etc. are considered key supply-side challenges from the bankers' perspective (Figure-4.4). These indicate banks' lower level of confidence on SMEs over their financial capabilities and greater uncertainty of repayment.

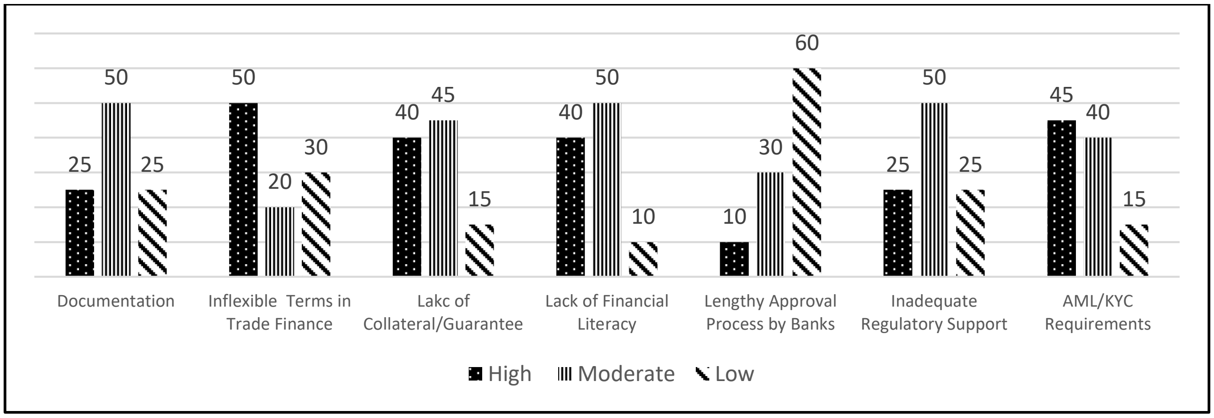
Regarding the demand-side challenges, bankers identified 'lengthy approval process', 'inflexible trade terms', 'documentation', and KYC/AML requirements as the most critical challenges that are causing them difficulty in getting trade finance access (Figure-4.5). These also indicate lack of adequate capacity of SMEs to place their demand for trade finance to the banks and financial institutions.

Figure 4.4: Limitations of Trade Financing Banks in Addressing Trade Finance Needs of SMEs [Banks' Perception]



Source: Questionnaire Survey and FGD

Figure 4.5: Limitations of SME Trade Finance Clients in Drawing Trade Finance Facilities from Banks [Banks' Perception]



Source: Questionnaire Survey and FGD

In several instances, the same or similar circumstances do not allow SMEs to get trade finance access whereas large exporters/importers do not face difficulty. It is not difficult for large exporters to draw pre-shipment financing under contract or documentary collection. This, however, may not be the case for the SME traders (Mini Case-4.1). Sometimes shifting from LC to collection requires even similar level of security as a measure to address uncertainty or reputation risks (Mini Case-4.2). In several instances, higher KYC/AML requirements have been identified as the reason for the rejection of the SME trade finance (Mini Case-4.3).

Mini Case 4.1: Difficulty in Obtaining Pre-shipment Export by Small Traders of Exports under Contract (Documentary Collection)

A small exporter approached a bank to obtain pre-shipment export finance under contract. The exporter previously executed export orders through advance TT and export LC. In several instances, the exporters could not manage export orders under advance T.T and LC. However, the exporter managed to have a sales purchase contract with the foreign buyer to export under documentary collection. In such a situation, Trader M wanted to avail of pre-shipment export finance under that contract, but the bank did not provide pre-shipment export finance. As per discussion with the trader, it was found that the bank's unwillingness was due to the risk of non-payment of the contract. As small-sized exporters receive very small export orders, banks commonly find these uncertain in terms of adjustment of overdue export bills, whereas medium or large sized exporters are regularly getting this sort of finance under contract.

Note: Based on FGD with SME Trader

Mini case 4.2: Stricter Security Requirements of Banks Discourage Small Traders Adversely

A commercial importer imports lime stones for local market. The importer has a good history of doing business with a private commercial bank in terms of payment and collateral. Every time the trader imports against LC. To avoid higher margins and other service charges, the importer wanted to shift from LC to documentary collection. However, the client could not import goods under the contract due to higher bank charges/margins or securities.

Note: Based on Consultation with the Trader

Mini Case 4.3: AML/KYC Requirement Restricts Issuance of LC for CMMSE Clients

M/s. M. S, a CMSME, wanted to import medical equipment to supply to different hospitals and clinics in a District. Y Bank PLC is the Banker of this CMSME client. In order to import the equipment, he approached Y bank PLC to open the LC in favor of a company in Taiwan. He has submitted all the required papers and documents to the Bank. Upon receiving the documents and papers, the LC opening official of the Bank checked and verified the fair price of the medical equipment as stated in the Proforma Invoice. The Bank has robust system-generated price justification tools in place. After justifying, it was found that the price of the quoted medical equipment was substantially high in compared with the present market situation and historical price database of the Bank. In this situation, the Bank has refused to open the LC as it is a clear indication of Trade Based Money Laundering as per the Guideline for Prevention of Trade Based Money Laundering issued by the Bangladesh Financial Intelligence Unit (BFIU). The importer however did not agree with the decision and considered his lack of credit history and the size of the operation as culprits. The client failed to open LC.

Note: Based on the Discussion with the Trader and FGD

During crises or business challenging situations, the suffering of SMEs increases further. This was quite visible following the COVID-19 crisis, and also apparent in the existing country's inflation and foreign exchange market-related challenges. Currency depreciation and 100% cash security and margin requirements became truly burdensome for relatively small traders (Mini Case-4.4 and 4.5). Lengthy approval processes are also particularly challenging for the small businesses (Mini Case-4.6).

Mini Case 4.4: Challenges Faced by Importers due to Potential Currency Depreciation and Provision for Opening LC with 100% Cash Security

ABC Traders, an importer of Polyester Fiber, has a credit limit Tk. 5.00 million with XYZ Bank and employs a staff of 15 individuals. Initially, they opened a LC for their imports with a 10% cash margin and an exchange rate of approximately 87 taka per USD. However, due to changing circumstances, they are now required to open LCs with a 100% cash margin and an exchange rate of approximately 109 taka per USD. As a result, ABC Traders needed around Tk. 1,090,000.00 to cover USD 10,000.00, and this amount remained in the bank from the LC's opening date until the payment date, which extended for approximately three months. In their previous arrangement, they only needed Tk. 87,000.00 as the initial margin during LC opening and around Tk. 870,000.00 during the payment stage. This adjustment necessitated an additional Tk. 220,000.00 for the same purchase. Furthermore, the client had to tie up the full amount for approximately three months. Consequently, they had to import fewer materials and supply them to their customers, resulting in the loss of their clients.

Note: Based on Consultation with the Trader

Mini Case 4.5: Higher and Heterogeneous Margin Requirement Causes Business Growth Negatively for Small Enterprises

ABC Traders imports steel house for local market. The importer has a good history of doing business with a private commercial bank in terms of payment and collateral. The yearly import of the client is around BDT 30 crore. For import business, the trader has given a sufficient mortgage to the bank, however, at the time of opening LC, the LC issuing bank keeps 100% margin, though previously the margin was 10%. Due to the lack of margin, the importer has reduced import at a significant level. The trader has also claimed that margin requirement is not same for all banks. Though BB circular has made relaxation for commercial imports for CMSME in some sectors. and facilities. Now it is 75% for steel houses.

Note: Based on Consultation with the Trader

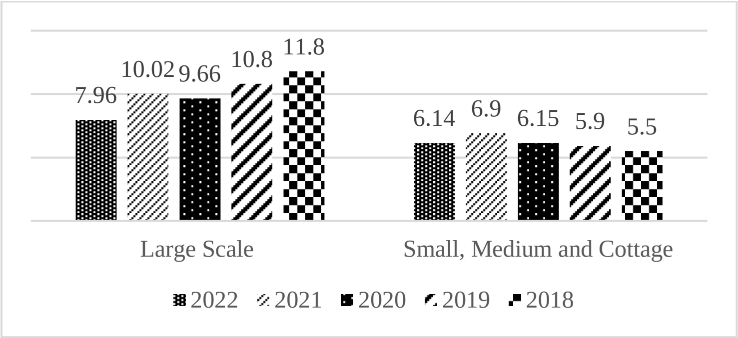
Mini Case 4.6: Lengthy Approval Process is Particularly Challenging for Small Businesses

M/S AR Brothers import heavy construction equipment and machines from abroad. After the importation of the machines, the importer rents to mega projects in development sectors. Previously the trader used to get LCs within shortest possible time and the business was running smoothly. A challenge has recently arisen that requires keeping higher margin (100% or 70%). Even if the customer keeps the margin, the bank takes more than 2 or 3 months to issue LC due to the approval process. The unusual time to open LC results into loss of business and maintain daily expenses to run the business. Medium and large-sized customers have sufficient collateral and they possess a limit from the bank. However, for small traders, the approval process is case to case, which results in more time to open LC than that of the Medium and large-sized customers.

Source: Based on Consultation with the Traders

Lack of capacity and uncertainty in SME financing with high credit risks are commonly cited. Practically, despite several capacity development challenges, comparative Non-performing Loan (NPL) data on CMSME and large enterprises do not reflect the greater risk of repayment and uncertainty. Rather manufacturing CMSMEs are better borrowers of banks in terms of repayment history (Figure-4.6). Separate data on NPL in trade finance and the CMSME trade finance are not captured separately. However, NPL in trade finance is believed to be at par with the national figure and thus is relatively much higher than the global trade finance figures.

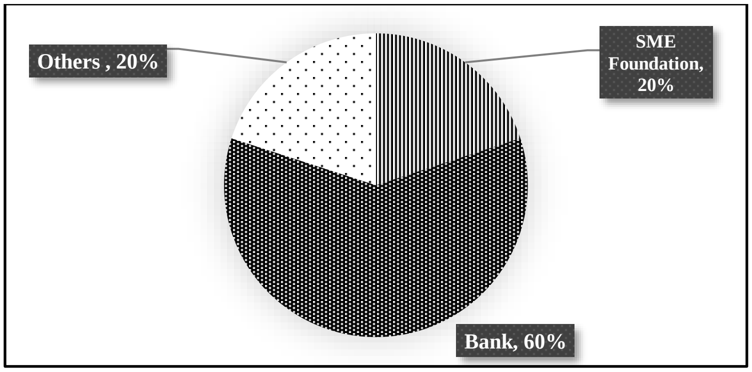
Figure 4.6: NPL in the Manufacturing Industry of Bangladesh during 2018-2022



Source: Financial Stability Report, 2023

The perceived changes of lack of capacity seemed to be valid for all types of financing. Rather in the case of trade finance, the challenge might be more acute and require higher regulatory and documentation requirements, and stringent KYC. Banks, BIBM, SME Foundation, etc. offer capacity development support to bank executives (Figure-4.7). However, according to the FGD outcome, capacity development training on CMSME financing for the bank executives hardly covers trade financing techniques and the associated issues like trade finance risk management, documentation, special requirements, etc. Several organizations also offer some capacity development programs to SME traders, and at a very limited scale (as came up in the FGDs with traders). And contents of these programs also do not cover trade finance issues.

Figure 4.7: Capacity Development Training to the Bankers



Source: Questionnaire Survey with Banks

It is recognized that opening LC or availing trade finance by SMEs rises which typically consist of small-scale, home-based, or local businesses, may have some common obstacles due to their size and limited financial resources. Several key challenges have been identified in the FGDs conducted for the SME traders that came up with some fundamental challenges of SMEs of the country associated with limited financial resources, lack of credit history, high transaction cost, and limited access to bank financing; and specific challenges of trade financing like complex documentation, and international exposures (Box-4.1).

Box 4.1: Obstacles Faced by the SMEs (Small and Micro Enterprises) to Get Access to LC and Other Trade Financing

Limited Financial Resources: Micro and Small enterprises often have limited financial resources, making it challenging to meet the financial requirements associated with opening an LC. Banks may require a certain level of collateral or a substantial cash deposit as security, which can be difficult for small businesses to provide.

Lack of Credit History: Micro and Small enterprises may not have an extensive credit history or a track record of large-scale international transactions. Banks may be hesitant to issue LCs or offer trade financing to businesses with limited credit history, as they may perceive them as higher-risk clients.

High Transaction Costs: The fees associated with opening and managing LCs and other services can be relatively high, especially for small businesses. These costs can be a significant burden for cottage industries with limited financial resources.

Complex Documentation Requirements: LC transactions and Trade financing often involve complex documentation, including detailed contracts, shipping documents, and compliance with international trade regulations. These enterprises may lack the expertise or resources to navigate these requirements effectively.

Size and Scale: Due to their small size and scale of operations, cottage industries may not have the bargaining power or leverage to negotiate favorable LC and Trade finance terms with banks and suppliers, leading to less favorable terms.

Lack of International Experience: Small and micro enterprises commonly lack experience in international trade, which can make it difficult for them to effectively manage the complexities of LC transactions, including foreign exchange risks and customs regulations.

Limited Supplier and Buyer Networks: Cottage industries may have limited access to international suppliers and buyers, which can restrict their ability to engage in international trade and, consequently, their need for trade financing.

Note: Based on FGDs with Bank Executives and Traders

5. Findings and Way Forward

One, SMEs are not distinctively treated in the trade finance policy and operational fronts in Bangladesh. The policy approach on SMEs or CMSMEs seems to target their progress only within the national boundary and trade finance issues receive very limited attention as a distinct area to address. At the operational level, banks' CMSME treatments also include mainly domestic credit facilitation. Special desks and products are designed to target SME traders which is not the case with trade finance. Practically, the perception of trade finance is comprehensively different in terms of definition, risks, compliance requirements, documentation, and costs that deserve special attention. The trade finance gap of SMEs can hardly be minimized by such generic treatment of issues. 'Trade Finance to SMEs' must be treated differently and distinctively both on policy and operational fronts to handle the SME access of trade finance-related challenges and struggles. It is also important to gather and disclose segregated data on the performance of banks in trade finance, and separately for SMEs. For policy and operational effectiveness, coordination among the policymakers (with in the regulatory setting) and operational bankers (within the bank) associated with CMSMEs and trade financing is a crucial need.

Two, SMEs generally have inadequate credit history to comfortably offer trade finance by the banks. Asymmetric information challenge is a key challenge associated with SMEs that causes greater rejection of their loan drives. These enterprises sometimes do not have the required financial statements and documents to support the verification of their financial capabilities to justify their loan claims. Trade finance departments are even more serious and rigorous regarding the financial viability and risk issues. Well-trained trade finance bank executives with supportive skills and mindsets in the trade finance/trade services departments of banks might be helpful in overcoming the challenges and doing justice to SMEs.

Three, KYC and AML challenges and the associated compliance requirements are extremely challenging to trade finance banks and traders. These may impede trade and SMEs are especially affected. The cost-push effect of complying with these requirements has consistently hindered banks' servicing of global trade finance needs. These are associated with country risks and their implications may vary from country to country. In an economy like Bangladesh, where country risk and TBML risk are relatively higher, there is no way to compromise with these requirements. However, over-compliance in the name of de-risking must be avoided. SMEs need awareness and preparation to handle these challenges to get access to the required trade financing schemes.

Four, Costs associated with trade finance products have notable implications for SMEs. In several global economies, supply chain products are gaining popularity among SMEs. Assessing the effectiveness of traditional products and exploring the potential of the relatively new supply of chain products are expected jobs by the stakeholders. However, trade finance products must be adopted and promoted considering the country's circumstances especially the country risk issues including TBML risk. From AML perspective, LC remained the most effective method, while 'documentary collection' comes second. Despite cost advantage, 'open account' might be risky from AML and country risk perspective. Moreover, the conditional open account (that has been permitted in Bangladesh) and the tagged supply chain products do not appear cost-effective to date. Considering the current overall circumstance, 'documentary collection might be the most suitable option for SME traders' at this moment. However, banks must have the right kind of approach to support SME exporters in this regard. There must also be the required policy initiative to ensure legal enforceability of purchase-sale contract.

Five, In most instances, 'Sales-purchase contract' in International Trade is not a binding (mostly) agreement and not legally enforceable. This could pose challenges for traders, particularly Small and Medium-sized Enterprises (SMEs). The concept of 'open account' is likely to gain traction soon, and it's crucial that it's underpinned by a legally binding agreement. In such a scenario, it's essential to have the UN Vienna Convention on the Sale of Goods (CISG) and the UNIDROIT Principles of International Commercial Contracts (UPICC) ratified. The roles of the Ministry of Commerce, Bangladesh Bank, and trade organizations are significant in this situation. Moreover, the CISG and UNIDROIT principles have been widely applied in the harmonization of national laws worldwide over time. This consistency is highly beneficial for SMEs when there's a direct connection and collaboration between local trade and international trade activities. As the world becomes more interconnected, there's a rational argument for updating and modifying the Contract Act to align with the CISG and UPICC standards.

Six, Cluster development (with the required element of export clusters) and cluster financing approaches might be workable in minimizing all types of SME financing gaps including trade finance. Targeted cluster development and financing models for SMEs might contribute to handling even greater challenges for SMEs associated with marketing, costs, collateral, research, global networking, and informational asymmetry. Alongside policy support, banks and NBFIs need to invest to streamline their SME clusters to draw maximum benefits. Identification of the status, performance, and level should be the primary job to lend to a particular cluster. Based on the given criteria, banks may assign a score and standardize the assessment model for the selection of the performing cluster in the process of trade financing. In the cluster financing approach, clients will have greater risk absorption capacity. The growth of clusters and the funding that goes with it involves a collaborative effort among various groups. This approach emphasizes the need for both policy and operational alignment to encourage new ideas, use resources wisely, and address environmental and social issues. It's important for all involved parties to understand that if financing for Small and Medium-sized Enterprises (SMEs) is seen as a 'Credit plus approach,' then financing for clusters of SMEs must also adopt a 'Credit Plus Plus approach.' This means it demands more financial resources and hard work, but the rewards are also greater and more enduring.

Seven, Capacity development of SME and trade finance bankers, and SME traders is a crucial need for minimizing the trade finance gap. SME training and capacity development contents hardly cover trade finance products, processes, documentation, and associated risks and requirements. Bank executives who handle SME entrepreneurs must have knowledge about all types of SME financing needs including trade finance products and services. Trade finance bankers must also be trained about the difficulties and challenges of SMEs and their special needs. SME traders must have reasonably good understanding of the KYC and AML requirements to get access to trade finance.

Finally, it is important to reiterate that promoting SMEs through adequate financing support is a fundamental prerequisite to accelerate and sustain growth and development of the economy. For efficiency and adequacy, 'CMSME Financing' of the country should be an integrated approach where 'Trade Finance to the CMSMEs' must be an integral but distinct component; and 'Trade Finance to CMSMEs' should find distinctive position as part of 'Trade Finance' by banks.

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Appendix 1: List of Responded Banks for the Questionnaire and FGD

State Owned Commercial Banks

1. Agrani Bank PLC.
2. Janata Bank PLC.
3. Sonali Bank PLC
4. Bangladesh Krishi Bank
5. Rajshahi Krishi Unnayan Bank

Private Commercial Banks

1. First Security Islami Bank PLC.
2. Union Bank PLC.
3. Uttara Bank PLC
4. Mercantile Bank PLC
5. NRB Bank PLC.
6. Islami Bank Bangladesh PLC
7. Mutual Trust Bank PLC.
8. Jamuna Bank PLC.
9. Standard Bank Limited
10. Dutch Bangla Bank PLC.
11. United Commercial Bank PLC.
12. Shimanto Bank PLC.
13. Trust Bank PLC.
14. EXIM Bank PLC.
15. Community Bank Bangladesh PLC.
16. BRAC Bank PLC.
17. Eastern Bank PLC.
18. The Premier Bank PLC.
19. The City Bank PLC.
20. The Meghna Bank PLC.
21. United Commercial Bank PLC.
22. Dhaka Bank PLC.
23. National Bank Ltd.

Foreign Commercial Banks

1. State Bank of India
2. Habib Bank Limited

Appendix 2: List of Participants at Focus Group Discussion, Head of International Division

SL.	Name	Bank Name
1.	Mr. Indrajit Sur	BRAC Bank PLC.
2.	Mr. Shibly Sadeque	The Premier Bank PLC.
3.	Mr. Mahmudul Aziz Mostazi	Community Bank Bangladesh PLC.
4.	Mr. Taslima Nasrin	National Bank of Pakistan
5.	Mr. Reaz Ahmed Khan	National Bank of Pakistan
6.	Mr. Mustafa Zaved Bin Shaheed	Union Bank PLC.
7.	Mr. Kazi Nazim Ahmed	Trust Bank PLC.
8.	Mr. Mohammad Masud	Islami Bank Bangladesh PLC
9.	Mr. Mobayana Shireen Mahazaben	Dutch Bangla Bank PLC.
10.	Mr. Rabbi Ahmad Chowdhury	National Bank PLC.
11.	Mr. Md. Sahidul Islam	National Bank PLC.
12.	Mr. Md. Khaledur Rahman	Sonali Bank PLC

Appendix 3: List of Participants at Focus Group Discussion, Head of CMSME

SL.	Name	Bank Name
1.	Mr. Mohammad Anamul Hoque	BRAC Bank PLC.
2.	Mr. Md. Aminul Islam	Dutch Bangla Bank PLC.
3.	Mr. Reaz Ahmed Khan	National Bank PLC.
4.	Mr. Md. Aminul Islam	Dutch Bangla Bank PLC.
5.	Mr. Sharif Hasan Mamun	Community Bank Bangladesh PLC.
6.	Mr. Mizanur Rahman	Union Bank PLC.
7.	Ms. Fatema Kabir	Trust Bank PLC.
8.	Md. Shahidul Islam	Islami Bank Bangladesh PLC.
9.	Md. Motiur Rahman	Rajshahi Krishi Unnayan Bank
10.	Md. Shah Alam	Sonali Bank PLC.
11.	Mohammad Toufiq Imtiam	Eastern Bank PLC.
12.	Md. Nazmul Hasan	Citi bank.

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