

# **JOB OPPORTUNITIES AND BUSINESS SUPPORT (JOBS) PROGRAM**

## **INSTITUTIONAL REFORM AND THE INFORMAL SECTOR (IRIS)**

University of Maryland at College Park

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### **Secured Finance for SMEs in Bangladesh**

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## **Executive Summary**

Enterprises and financial institutions in Bangladesh face an insuperable obstacle to efficient credit transactions. Policies and legal institutions prevent these parties from reaping the potentially huge gains that are available on the basis of secured finance transactions. The transactions make up an estimated 80 percent of finance for small and medium enterprises in the U.S., and are critically important to other industrial economies. Modern secured finance mechanisms offer a powerful means of mobilizing the value of a broad range of capital as a loan security, and thereby creating profitable opportunities for a wide spectrum of potential users and providers of financial services.

The report presents a series of options to the JOBS Project for activities aimed to improve the access of small and medium enterprises (SMEs) to secured finance – a constraint identified as critical to the enterprises. The report also summarizes the key findings to date of our assessment of issues and problems in this area. In brief, we would recommend that the project focus on expanding access to working and expansion capital for SMEs through advocacy and technical assistance (TA) particularly in the areas of (1) legislative reform to expand and simplify the use of non-real estate security, (2) efficient and functional systems for security registration and credit information, and (3) improved enforcement of loan and security agreements. Such an approach should be supplemented by support for complementary governance reforms, and follow-on TA and training in the use of secured finance instruments.

### ***Tight Credit and its Causes***

- 1. Credit is constrained for SMEs, being limited to certain forms of secured credit, along with family and informal credit. Formal credit comes on very difficult terms for SMEs, since the use of security in credit agreements is highly inefficient, and non-real estate (movable and intangible) security is largely ineffective.*

For SMEs, neither unsecured commercial credit or debentures equity capital in the form of publicly-traded shares and private placements, nor NGO micro-credit is a viable option. Banks and non-bank financial institutions (NBFIs) such as finance and leasing companies require real estate security for loans (land and buildings) in nearly every case – the exceptions being very large firms, firms with longstanding client relations with the banks, or firms benefiting from either political favor or a close relationship with a bank director.

SMEs almost universally start their operations using own funds or family finance. Typically, these firms face a significant operating capital constraint in the early years of operation, and often become “sick” or lose their investment. Expansion credit is also severely constrained.

In secured credit transactions, interest rates vary from 14% (subsidized in cases defined by Bangladesh Bank policies) to 22% or more (in the case of finance leases). Fees, delay, and transaction costs appear to be prohibitive in many cases, especially transactions of one lakh or less. Documentation requirements for all loans (but not leases) are onerous, raising fixed costs of borrowing.

Real estate security, required in nearly every case, is normally taken in the amount of 200% of the loan amount. Lenders define “collateral” as liquid non-project assets, usually real estate. Even where charges and hypothecations are taken of machinery or inventory, these appear to be considered as extra insurance, especially in the case of bankruptcy, and add little or no value to the loan amount. SMEs, indeed most new clients of financial institutions, are frequently required to provide real estate, guarantees, and movables/intangibles valued at some multiple of loan value.

Possessory security interests in movables and intangibles are used to secure loans, especially short-term working capital. Here, the financial institution takes possession of goods (normally inventory – “stocks” – kept in a bank warehouse or in some cases a separate warehouse controlled by bank agents), or of a limited set of documents: most frequently government bonds, sometimes corporate securities (these are rarely owned by SMEs, however). Pawns of equipment, vehicles, and perhaps other valuables are known but not practical for SMEs.

Forms of security that have played a leading role in contemporary SME finance in the U.S. and other industrialized countries apparently are not used at all – or to a very minor extent -- in Bangladesh. These include accounts receivable and chattel paper.

A few financial institutions have proposed alternative practices. A bank proposal to accept as security the ‘*salami*,’ or pre-paid possession right to shop premises, confronts the fact that these are entirely informal and are in fact illegal under rent control law (illegal in their own right and as mortgageable assets). Newer competitive entrants to the financial market, including investment banks, are looking at ways to use movables and intangibles not normally considered valuable by the banks.

2. *Systems for security registration and credit information are complex, time-consuming and incomplete.*

Banks are said to take as much as a year or two to make decisions on loans to new customers. The mechanisms for checking credit and lien information contribute significantly to delay and expense. Real estate title searches require lengthy and complicated searches of paper records. Deeds and non-encumbrance certificates can be unreliable, since they can be based on false information, incomplete checks, or outright forgery.

Only certain forms of non-real estate security are required to be registered. Charges on company assets, and floating charges, must be recorded in the Registry of Joint Stock Companies. Pledges and hypothecations as such do not need to be recorded. Encumbrances against assets of sole proprietorships (a common legal form for SMEs) are either recorded or apparently not registered at all.

Credit reporting is in its infancy in Bangladesh. The Credit Information Bureau (CIB) of Bangladesh Bank requires regulated financial institutions to provide information periodically (quarterly or monthly, depending on size of debt) on all debts of 10 lakh and above. Unfortunately, several factors reduce the utility of this system. Only regulated financial institutions and “interested” government agencies can obtain access to the information. Also, information enters the system with a time lag and is normally about 60 days old when it reaches the user. The receipt of this information can be speeded up when the request is urgent – where the institution and the transaction are of sufficient importance, and where the time constraint is severe. At this time, the process of information retrieval therefore appears to be subject to wide discretion, which at least allows for the possibility of delay and grease payments. (NB: this is an initial impression and has not been confirmed.) Financial institutions using this system report that, in any event, they perform additional credit checks, including sending letters to all other financial institutions (or at least those who have had contact with the customer).

The incentives in the systems of security interest registration and credit information appear to weigh strongly against efficiency and probity. Company law requires firms themselves to register mortgages and charges against firm assets (although financial institutions often do it instead). Failure to do so triggers a fine. CIB requires financial institutions to seek and provide information on debtors. Again, those who do not comply are subject to fines. The information is provided to requestors free of charge. In both cases, market incentives, which could make the systems operate efficiently, are absent. If creditors were required to record security interests against firms as a condition of the “perfection” or effectiveness of their interests with respect to third parties, they would likely do so speedily. If the CIB system were a useful credit tool, financial institutions would have an interest in providing all relevant information on a timely basis as a condition of their being allowed to use the system, and would moreover be willing to pay for it.

As a result of the forgoing, uncertainties and inefficiencies appear to constrain severely the extension of credit to new market entrants, unrelated parties, and enterprises not owning significant real estate assets. Rapid and reliable assessment of prior liens and credit history make efficient SME finance possible in industrial countries, but these are not currently possible in Bangladesh. Lien registries, credit information agencies, and other forms of information and networking are critical to the efficient working of financial markets. Information asymmetries tend to increase risk, raise the price of credit, and constrain its allocation to existing customers, large established firms, and related parties.

3. *Enforcement of credit and security agreements poses severe problems of delay, expense, and uncertainty.*

The ability to extract value from collateral quickly and efficiently plays a major role in the price and allocation of secured credit. In Bangladesh, this does not appear to be possible in most cases. In the formal financial system, “self-help” repossession without court intervention (a core element of modern secured finance) is virtually unknown. Mortgages, charges, and finance leases all present severe problems in this regard. In most such cases, recourse is to the “Money Loan Courts,” established in 1990 with the aim of simplifying and speeding up civil suits for money judgments. Estimates for the time needed to complete a case for the enforcement of a mortgage agreement range from about three years to a generation. Even repossession of leased equipment, to which the leasing company has title, is estimated to take a year or even several years. The culprit here appears to be a combination of clogged courts, inflexible procedure, easy availability of interlocutory appeal and other delay tactics, uninformed or undisciplined lower court judges, and corrupt court clerks.

The bankruptcy procedures and court established in 1997 have yet to be tested. To date, there appears to be practically no experience with bankruptcy – the prevalence of “sick” firms, budget allocations to support such industries, other forms of political intervention, and strong sentiment against closing businesses, support the view that bankruptcy is to be avoided in nearly all cases. Unless the new bankruptcy regime can reverse this, “exit” will continue to be unavailable, and the liquidation of secured assets and concerns will remain impossible.

These enforcement weaknesses explain much of the risk management strategy of financial institutions (dealing with known parties and large firms, requiring multiple security including land, etc.), as well as the risk premia factored into the price of credit. Only possessor security – pawns, pledges of inventory in a bank warehouse, and pledged bonds and shares in the creditor’s possession – appear to offer reliable and timely value. The overall efficiency of these latter approaches, and their availability to smaller firms, is doubtful.

4. *Financial market distortions undermine efficient pricing and allocation of credit, constraining credit availability to SMEs.*

Here, the problem is one of system governance. According to one informant, “The problem for nationalized banks is one of directed lending, while for private banks it’s lending to directors.” Practice since the nationalization of banks in 1972 appears to have encouraged a phenomenon well-known in post-socialist transition countries: the system provides the greatest certainty to illicit deals involving cronies (whether state or private), and the least certainty to arm’s length deals that rely on legal enforcement. Furthermore, many informants cite the prevalence of bribery and kickbacks among loan officers, especially in nationalized banks. Directed lending, credits to the state by nationalized banks, and the relative attractiveness and safety of government bonds all disfavor allocation of credit to SMEs via transparent and

market-based channels. To the extent that top-down reforms have begun to squeeze some of these distortions out of the system, the availability of effective legal mechanisms for market-based credit allocation should draw private financial institutions further into the SME credit sector. Whether the premise of effective high-level reform is valid remains an open question. Secured finance reform will yield tangible benefits only to the extent that reform, or pressure for reform, enables the market to compete effectively with, and eventually to displace, corruption and cronyism as an allocation mechanism.

## *Reform Options*

In the report, we propose certain priority reforms for the JOBS Project group to pursue in order to free up the SME credit market in Bangladesh. These follow the focus of the report on secured finance methods, which play a major role in industrial-country SME finance (particularly in North America) but are underutilized in Bangladesh.

### *1. New legislation to expand and simplify the use of non-real estate security.*

Reformed laws can (a) expand the universe of legally effective collateral to include forms not currently useable in Bangladesh, such as accounts receivable, chattel paper, inventory (non-possessory), consigned goods, fixtures, equipment and vehicles, proceeds of sales, and future interests; and (b) simplify the system of secured finance by creating a clear, unified concept of security interest that applies uniform legal formalities, registration requirements, and enforcement methods to all forms of non-real estate collateral. Such a reform package would need to take certain additional steps, such as keeping formal requirements to a minimum, repealing the prohibition against ‘salami’ and including it among legally effective forms of security, and where possible advancing complementary reforms (see below).

The options here include a comprehensive reform including all of the above, or a “quick fix” that only deals with major hurdles to the use of certain collateral contemplated by existing law. Here, the priorities would be to support the use of security in accounts, chattel paper, inventory, equipment and vehicles, and consigned goods. This approach would not allow Bangladesh to “leapfrog” into a modern system of secured finance, but would remove major constraints to the operation of its British-derived system.

It is important to note in this connection that the World Bank has produced a draft reform package in this area, in collaboration with a group of Asian and American lawyers, the Bangladesh Bank, and the Ministry of Finance. This package, although it could be improved significantly, offers a possible basis for collaboration to pursue the implementation of reform in the near term, among the JOBS group, the World Bank, the Government of Bangladesh, and other stakeholders in Bangladesh.

### *2. More comprehensive and efficient systems for security registration and credit information.*

Reform in this area can (a) bring all security interests into a system of registration, (b) simplify the system by bringing registration into either a unified registry or a limited set of registries with well-defined roles, and (c) expand the availability and reliability of credit information. On the registry front, creating a more inclusive and unified system would ease the task of potential creditors in checking for prior liens. This should lower the effective cost of credit by reducing the risks of fraudulent liens and by implication the need for excess security as insurance

against risk. A well-crafted registry system could also play the legal role of mechanically determining the priority of security interests (first to file, with very limited exceptions) – thus fostering certainty in the valuation of security, and avoiding unnecessary disputes among creditors. With respect to credit information, a system that provides reliable and timely information, and that is open to access by all interested parties, should provide special advantages to SMEs that are new or do not have a track record with a particular bank.

### 3. *Effective mechanisms for enforcing credit and security agreements.*

This area is one of the most intractable, since it directly implicates the court system. Options here include (a) comprehensive reform of civil procedure, enforcement of money judgments, and repossession of property; (b) tightening procedure in Money Loan Court system; (c) strengthening arbitration and ADR options; and (d) strengthening bilateral enforcement through legal provision for self-help enforcement, the use of “confession of judgment” or *cognovit* provisions in financial contracts, and other means. Increasing the certainty of security interest enforcement, currently at a very low ebb in Bangladesh, should significantly increase the discounted or “repossession” value of collateral, thus increasing the flow and reducing the cost of credit.

### 4. *Complementary Reforms*

Ultimately, the goal of expanding access to credit for SMEs requires broader action to reduce financial market distortions, and to improve incentives for efficient credit allocation. Facilitating the move from statist to market-oriented finance -- through privatization and corporate governance reform, for example -- would help reduce corruption, related-party transactions, “default culture” as it is known in Bangladesh, and other distortions that steer credit away from deserving innovators, SMEs, and new entrants. Despite the difficulty of working in this area, it would be worth building in activities with this aim around the margins of the core secured finance initiative. These activities would center on information and advocacy concerning financial system transparency.

## ***Program Strategy and Implementation***

The report explores some key concerns that arise in supporting the changes outlined above, including those surrounding the advocacy of change (including political economy concerns), and those involved in programmatic support and implementation of reforms.

### 1. *Advocacy*

The JOBS Project includes advocacy as a necessary part of any effort to secure economic reform. With respect to the areas outlined above, following are some observations concerning advocacy strategy.



*Legislative reform and registry/information systems:* These changes, if successful, would address the two major complaints of SMEs, namely the unavailability of working capital and expansion finance on commercially reasonable terms. It would also enable market-oriented financial institutions, such as private banks, investment houses, and leasing companies, to compete more effectively with each other and with the questionable practices of the nationalized banks. Also, it would support trade, dealer, and supplier credit to the advantage of SMEs needing equipment and inputs, as well as importers and raw material suppliers. Finally, NGO lenders and SME associations would benefit, since a reformed system should facilitate onlending of commercial bank funds, using loan instruments as security (this applies more to individual than group loans). Conceivably, the support of Bangladesh Bank could be enlisted, since reform should eventually bring more certainty to the valuation of assets on the books of regulated financial institutions. One could expect disinterest, or even active opposition, from SOEs, nationalized banks, certain government bureaus (possibly including registry offices under the Commerce and Land ministries), deed writers, and perhaps the bar. An advocacy strategy would have to be crafted to maximize understanding of the size and breadth of benefits, to emphasize areas of overlap with the interests of potential opponents, and to highlight the feasibility of reform.

*Enforcement:* The dynamic here is likely to be one of financial institutions strongly favoring effective enforcement, and debtors – potential and especially actual – opposing it. This area is highly subject to populist/leftist politics in the South Asian mode. Any effort in this area should emphasize pre-emptive consensus-building with SMEs, associations, and NGOs to maximize their understanding of the benefits to entrepreneurs and to development generally of effective loan enforcement. This is not a naturally easy-sell and will require some effort and finesse. Of course, the financial institutions – especially private banks and NBFIs – are natural allies.

*Reducing distortions due to faulty governance:* Constraining corruption and crony finance faces a difficult collective action challenge: tangible advantages are to be taken from the powerful few in exchange for benefits spread across the SME sector and the economy as a whole. For this reason, this should not be the primary program focus of this component of JOBS. Nevertheless, secured finance and corruption/cronyism/ transparency concerns are closely related. An analysis and decision will be required as to whether the political and reform benefits of including such an emphasis are likely to outweigh the short-term costs.

## 2. *Implementation*

This final section considers both program components aimed at supporting reform and the implementation of reforms themselves, an important consideration since legal changes are not-self enforcing but interact in complex ways with economic behavior.

*Technical assistance and training:* In order for a secured finance system to work, bankers and other financial intermediaries, firms, officials, lawyers, and judges, among others, will need a critical mass of technical capability. Elements of this component could include (a) legal drafting assistance, (b) registry set-up assistance, (c) court reform and upgrading assistance, (d) TA and training on non-court dispute resolution and enforcement, (e) asset valuation and other aspects of banking in this area, (f) training/upgrading of lawyer and judge capability in this area, and (g) assistance to SMEs in business and financial planning. Training and TA are, of course, easy to sell and to package in a way seen as beneficial to all. More hands-on assistance would likely be worthwhile, and could include advising on particular secured finance deals, default and bankruptcy cases, development of loan procedures and documentation, etc.

*Pilot and demonstration activities:* There should be activities aimed at both ensuring the implementation of new laws and demonstrating the concrete benefits of those laws to their potential users. Thus, for example, JOBS could work with NGOs, associations, and others acting at times as financial intermediaries for SMEs, to help them structure transactions in ways that efficiently use forms of collateral such as chattel paper in the onlending of commercial bank finance. Another example, equally important but less of a “win-win” proposition, is to assist in debt enforcement and bankruptcy actions, perhaps in certain high-profile cases. Defeating the “default culture,” a critical part of this reform program, will require predictable and even-handed application of the law to non-performing debtors. “Frying a big fish” or two in this way can send an important signal of seriousness about financial market discipline.

# Introduction

Enterprises and financial institutions in Bangladesh face an insuperable obstacle to efficient credit transactions. Policies and legal institutions prevent these parties from reaping the potentially huge gains available on the basis of secured finance transactions. These transactions make up an estimated 80 percent of finance for small enterprises in the U.S., and are critically important to other industrial economies. Modern secured finance mechanisms offer a powerful means of mobilizing the value of a broad range of capital as loan security, and thereby creating profitable opportunities for a wide spectrum of potential users and providers of financial services.

This report presents a series of options to the JOBS Project for activities aimed to improve the access of small and medium enterprises (SMEs) to secured finance – a constraint identified as critical to these enterprises. The report also summarizes the key findings to date of our assessment of issues and problems in this area. In brief, we would recommend that the project focus on expanding access to working and expansion capital for SMEs through advocacy and technical assistance (TA) particularly in the areas of (1) legislative reform to expand and simplify the use of non-real estate security, (2) efficient and functional systems for security registration and credit information, and (3) improved enforcement of loan and security agreements. Such an approach should be supplemented by support for complementary governance reforms, and follow-on TA and training in the use of secured finance instruments.

The discussion in this report does not purport to address all of the factors that constrain SME credit. Rather, it proposes a focused program of institutional reform that addresses core problems amenable to change in the medium term with the support of the JOBS Project. As the suggested changes are put into place, important complementary reforms become more feasible. The report begins with the findings of the IRIS/JOBS assessment, first on credit terms and access, and second on institutional causes of the credit constraint. The report then moves on to propose a set of reform options to be pursued by the JOBS Project group. In the last section, we touch on the major issues of political economy, advocacy, and implementation that are likely to arise with respect to such reforms.

## Chapter One: Tight Credit Markets

Owners of small and medium-sized enterprises in Bangladesh complain that, as soon as they have tapped their own resources to start their business, they encounter financial obstacles. They may need to pay cash, even in advance, for supplies of inputs. They may need to supply their products to retail outlets on credit. They need to pay wages and rent. Yet, when they turn to the financial institutions for credit, the terms are frequently beyond their reach. The financial institutions, on the other hand, complain of risky borrowers, high fixed costs of lending, problematic central bank regulations, and a “default culture.” Chapter two will delve into the institutional reasons behind these constraints. The purpose of the present chapter is to understand the credit constraint, and to appreciate its extent and impact. One particularly interesting question is as follows: what does the pattern of finance practices described here tell us about the quality of institutions governing the financial system?

### *1.1 SMEs face significant credit constraints.*

Credit is constrained for SMEs, being limited to certain forms of secured credit (mostly on the basis of real estate), along with family and informal credit. Formal credit comes on very difficult terms for SMEs, since the use of security in credit agreements is highly inefficient. SMEs almost universally start their operations using own funds or family finance. Typically, these firms face a significant operating capital constraint in the early years of operation, and often become “sick” or lose their investment. Expansion credit is also severely constrained.

For SMEs, neither unsecured commercial bank credit or debentures, equity capital in the form of publicly traded shares and private placements, nor NGO micro-credit is a viable option. Banks and non-bank financial institutions (NBFIs) such as finance and leasing companies require real estate security for loans (land and buildings) in nearly every case – the exceptions being very large firms, firms with longstanding client relations with the banks, or firms benefiting from either political favor or a close relationship with a bank director.

As the discussion below will demonstrate, the most important sources of the credit constraint are institutional. However, a shortage of know-how reinforces these problems. SMEs and potential finance providers often have limited capacity and information concerning the use of modern financial, business planning, and legal techniques. With a higher level of professional business and legal experience, and a lower level of inefficiency and cronyism in the system, Bangladesh could well sustain significantly higher levels of secured credit for SMEs *even under its current laws and regulations.* The

SME economy is mired in a low-level equilibrium at present. This is in part due to established credit patterns based on negative past experience by the banks, lack of competition, scarcity of professional business know-how, and illegal practices that are not disciplined by the law. Some examples will make this clearer.<sup>1</sup>

(i) *Plastic goods.* The experience of the plastic goods industry confirms the existence of a serious credit constraint. Almost all of these firms are small and finance their startup capital through the sale of land. Banks are simply not interested in financing startups. Once this hurdle is past, firms face a need for working and expansion capital. Private banks, which operate on market principles, are difficult for SMEs to access because experience (including defaulting and fraudulent debtors), has made them conservative, and they are very cautious with respect to the collateral and guarantees they accept. For any loan greater than one lakh, these banks require real estate security and/or a guarantee from a prominent and credible person connected with the project. Any substantial fixed capital loan of medium- to long-term duration takes a very long time to process. Delays of one year or more are not unknown and come with borrower equity requirements of 20 to 50 percent. In general, plastic goods firms can only get short-term credit to finance either sales orders or the importation of inputs.

In the latter case, the bank will provide 90-day finance in the form of a letter of credit, secured by a pledge of inventory kept in the bank's warehouse. The borrowing firm is required to put up ten to 25 percent of the equity for the importation. In the case of a sales order, a bank will finance goods in process through the account at that bank of the buyer of the goods, who issues a check in advance.

A further need that is not met by the financial institutions is to support the established practice of manufacturers extending credit to buyers. Firms will ship goods on credit, worth 50,000 to one lakh tk, with repayment expected after one week or up to two months. This outstanding credit is replenished and augmented as the transacting firms gain experience with each other, so that, in the plastics industry, a manufacturer would typically have a credit outstanding of two to three lakhs to a buyer of five years' standing or more. If the system in Bangladesh better supported accounts receivable financing, for example, this form of credit could expand to much more significant dimensions. Supplier credit exists but plays a small role, meeting, by one estimate, at most five to ten percent of working capital needs for some firms.

Since private bank credit has been limited to the types of short-term working capital described above, firms in the plastics industry, among others, look for other options. Government credit policies encourage selected sectors

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<sup>1</sup> A table presenting additional examples is included in Annex 2.

(e.g. jute and poultry) through subsidized or directed lending, credit guarantees, and SME lending quotas for banks of five percent, but these programs appear not to meet outstanding needs. Several banks offer unsecured loans up to 50,000 or one lakh taka, but these amounts are insufficient for SMEs. The most attractive alternative is a National Commercial Bank (NCB) loan. These loans apparently come on easy terms for the well-connected due to rampant self-dealing, but can be difficult for SMEs to access. Another option is to finance equipment purchases through a leasing company, but this is relatively unattractive due to onerous collateral requirements and high interest rates--in the range of 25 percent, including fees. Finally, informal moneylenders are only a small part of this picture, providing credits of 1,000 tk or so.

Another possibility for SMEs is subcontracting and similar arrangements, with credit. This would enable firms to access both know-how and credit. The BATA Company apparently subcontracts with informal sector footwear producers, but does not give credit. BTC supplies technology and credit to contract growers. In other parts of the world, farming and production subcontracts, agency and distributorship appointments, and franchises have helped small entrepreneurs obtain the credit and experience to gain a foothold in the market.

As a result of these and other constraints, some 50 plastics firms are listed by the government as "sick," and have applied for a waiver of interest payments. Apparently, some 60 crore are being set aside in the state budget for this purpose.

*(ii) Textiles.* The experience of one dyed cloth enterprise is instructive. The firm was started five years ago by a woman with existing contacts in the market, and the first production was in her kitchen. After six months, the amount of production on order required her to expand. She invest two lakhs of her own savings and rented a building from her family, equipping it with tables, sewing machines owned by her family, and other basic tools. Her one substantial capital investment was in an embroidery machine. Her only experience of credit outside of her dealings with suppliers and customers has been with an NGO. She sought an expansion loan of two lakhs from Sonali Bank, against an order of 5,000 pieces of dyed cloth from a large client, but balked at the terms: 18 percent interest and a mortgage on her family's building. Other banks offered equally unfeasible terms.

Now, instead of seeking bank credit, she mainly relies on her earnings and on maintaining favorable payment streams and credit terms with suppliers and customers. She sells some of her production on credit or consignment with repayment after a lapse of two to three weeks. These sales agreements are sometimes oral, sometimes in the form of purchase orders that specify amounts, prices, delivery and payment times. Most customers have difficulty

paying, and she has been forced to take some merchandise back. She will make further shipments if the client can pay a part of the outstanding bill, say 10-20 percent. She avoids court, and relies on negotiation with problem customers and restricting sales to large buyers or buyers with whom she has long-standing relationships. A large customer will sometimes make advance payment or supply raw cloth. On the supply side, she usually takes shipment of inputs with delayed payment, although with other suppliers she makes advance payments. Credits and advances are cleared once a year, during the *Eid* holiday. Her outstanding credit from suppliers totals about one lakh.

(iii) *Electrical goods.* BEMMA, an association of small electrical goods manufacturers, has a proposed plan to develop an industrial park under its auspices, for 50-60 industrial units. The plan envisions a 99-year lease of the land, and a mortgage on that land to finance development and operations. BEMMA will serve as the intermediary in those arrangements, onlending commercial bank funds to members, against whom the banks will have full recourse. The difficulty BEMMA has identified on the financial side is a 50 percent equity share requirement being imposed by the banks (Janata and Sonali).

Another concern of BEMMA is its members' distribution networks and the financial dimensions of this. Due to an increasingly competitive market for electrical goods, local manufacturers are losing their exclusive distributorship arrangements with retailers and facing pressure to increase outstanding wholesale credit to those retailers. Again, accounts receivable or chattel paper finance, if it could be made effective, would make this situation much easier to bear for BEMMA members.

(iv) *Footwear.* BPPS, an association of footwear manufacturers, complains as well of a severe credit constraint. Of its 175 members, the association heads say that none has a loan from a financial institution. Since imports are costly and finance unavailable due to bank collateral requirements and sectoral risk assessments, BPPS members tend to rely on locally-made or second-hand machinery. Their "dream" would be to obtain credit at reasonable rates to buy upgraded machines, using the machines themselves as security. This is impossible currently, since both banks and leasing companies require real estate security (including registered mortgages on a portion of the collateral), which the shoe manufacturers generally do not have available, and the banks' repayment terms of one to two years are considered too short. These firms use similar distribution networks and finance arrangements to those discussed above, starting with known and nearby shops as customers for small amounts, and increasing these amounts while identifying additional retailers.

Several surveys of SMEs and their finance practices confirm the presence of a credit constraint as well as its importance. A survey of a small

sample by a Swiss-Bangladeshi team found that the large majority of successful firms questioned used credit. Of those that used credit, the average credit outstanding was two lakh tk. Initial capital was generally inherited, raised from own savings, or borrowed from relatives or friends. These firms relied largely on the same sources for expansion capital, although almost one-third obtained institutional credit of some kind.<sup>2</sup> The JOBS Project SME survey obtained similar results.<sup>3</sup>

A 1994 World Bank study produced detailed results similar to these findings. Formal credit was found to rely heavily on security in improved land, and to follow rigid debt-equity formulas (at the time of the report, 80:20, but reports in 1998 put it at 50:50). Firms generally did not need formal credit to start up and grow to a viable size, although some industries such as print shops relied substantially on credit for start-up, since machinery makes up much of their fixed capital. (Also, this does not reach the issue of expansion and working capital, which our assessment found to be significant constraints.) Interestingly, small firms were found to be major suppliers of credit to the poorer sectors of society. Experience across sectors, although varied, consistently showed high levels of cash purchases of inputs (40 percent or more) as well as considerable pressure to sell outputs on credit (40-50 percent in several cases), which in some sectors was successfully resisted. Trade credit tended to be short-term, with repayment periods of 2 to 4 weeks being typical. Problems with receivables were reported in many sectors, often due to willful default by clients. Where firms used credit, they relied heavily on family and friends, and in a few cases moneylenders. Overall, costs of credit in this study ranged from 10 to 120 percent per annum for initial startup capital, and up to 240 percent for working capital finance.<sup>4</sup>

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<sup>2</sup>SDC-BUP (1998) pp. 3-9.

<sup>3</sup>IRIS (1998).

<sup>4</sup>World Bank (1994).



## ***1.2 The financial sector can offer only limited, high-cost, credit facilities to SMEs.***

In Bangladesh, as elsewhere, enterprises occupying the middle ground between very large firms able to draw on equity markets and unsecured credit lines, and microenterprises that draw on special credit programs, must rely largely on secured loans to meet their institutional credit needs. However, the financial sector in Bangladesh, when it makes such credit facilities available, does so on terms that create serious difficulties for most SMEs. This section provides an overview of these limitations. The underlying causes of these constraints are explored in the subsequent sections.

Lenders define “collateral” as liquid non-project assets, usually real estate. Real estate security, required in nearly every case, is normally taken in the amount of 200% of the loan value. Even where charges and hypothecations are taken of machinery or inventory, these appear to be considered as extra insurance, especially in the case of bankruptcy, and add little or no value to the loan amount. SMEs, indeed most new clients of financial institutions, are frequently required to provide not only real estate, but also guarantees and movables or intangibles, with the total collateral valued at some multiple of the loan amount. This duplication of collateral stems directly from the uncertainties of land titling, information on prior encumbrances, and enforcement priorities (see below).

Forms of security that have played a leading role in contemporary SME finance in the U.S. and other industrialized countries apparently are not used at all – or to a very minor extent -- in Bangladesh. These include accounts receivable and chattel paper. In Bangladesh, possessory security interests in movables and intangibles can be used to secure loans, especially short-term working capital. Here, the financial institution takes possession of goods (normally inventory – “stocks” – kept in a bank warehouse or in some cases a separate warehouse controlled by bank agents), or of a limited set of documents: most frequently government bonds, sometimes corporate securities (these are rarely owned by SMEs, however). Pawns of equipment, vehicles, and perhaps other valuables are known but not practical for SMEs. The other alternative form of “security” (not what international practice would consider a security interest) is the guarantee – personal, bank, or insurance guarantee. The most viable of these options for SMEs is a personal guarantee – their use providing further evidence of the primacy of personal relationships in Bangladeshi financial markets.

For any sizeable deal, creditors will require that the collateral be insured in the joint name of the debtor and creditor, or in the name of the creditor alone. Premiums are said to amount to about one percent of the

insured value of the asset. With small loans, where insurance would make the deal too costly, some banks simply require the borrowers to indemnify them.

A few financial institutions have proposed alternative practices. A bank proposal to accept as security the *salami*, or pre-paid possession right to shop premises, confronts the fact that these are entirely informal and are in fact illegal under rent control law (illegal in their own right and as mortgageable assets). Newer competitive entrants to the financial market, including investment banks, are looking at ways to use movables and intangibles not normally considered valuable by the banks.

In secured credit transactions in Bangladesh, interest rates vary from 14 percent per annum (subsidized in cases defined by Bangladesh Bank policies) to 22 percent or more (in the case of finance leases). Fees, delay, and transaction costs appear to be prohibitive in many cases, especially in transactions of one lakh or less. Documentation requirements for all loans (but not leases) are onerous, raising fixed costs of borrowing.

Following is a more detailed discussion of financial sector practices based on interviews with a number of banks and NBFIs.

### *1.2.1 Banking Sector Experiences*

The main groups of banks are:

- (i) the NCBs;
- (ii) the banks created in the early 1980s;
- (iii) the newer private banks founded since 1993;
- (iv) the specialized banks; and
- (v) the foreign banks.

All non-NCBs are “scheduled” or subject to full Bangladesh Bank oversight. “Private” banks, including denationalized and newly-founded banks, in fact have a maximum of 95 percent private ownership. The older private banks are reputed to suffer from many of the same syndromes as the NCBs. Private banks are said to pay their employees some five times the staff salary rates of NCBs. The banking sector generally does not have a high level of formal organization, but tends to rely on informal cooperation among members and contacts with officials. For example, there is no bankers’ association as such, although there is a Bankers Club that features once or twice-monthly meetings of bank Managing Directors in Dhaka.

Typical of the NCBs, Bangladesh Shilpa Bank lends to industrial sectors, mainly medium to large-sized firms in the textiles, leather, and information technology sectors. BSB normally requires collateral (non-project assets) in the form of land. BSB will in certain cases take an interest

in non-real estate collateral such as industrial machinery where the borrower is operating the enterprise in rented premises and can provide additional security--e.g., a residential building, urban land, crop land, a bank guarantee, a personal guarantee from someone of known status, or a hypothecated vehicle, plane, barge, tanker, or the like. BSB will provide a 60- to 90-day “packing credit” to export businesses against security in a confirmed letter of credit (in this case, the bank puts an officer in the place where export goods are handled in order to supervise), or goods in a warehouse owned or secured by the bank. BSB will take an interest in accounts receivable to secure 45 to 60-day working capital loans, but only in cases where the accounts arose from bulk sales to a single party, and only where the accounts are supplemented by collateral in land or a house (including a relative’s house). Where land or buildings are given as security, BSB usually provides 50 percent loan-to-value (more for preferred clients), down from 70 to 80 percent in the past. Sonali Bank, another NCB and the largest Bank in Bangladesh, reported similar experiences.

Rupali Bank is not considered a “Nationalized” bank even though it is 94.65 percent government-controlled. It is incorporated under the 1984 Companies Act, and has one of its seven directors elected by shareholders. The bank always takes a mortgage on immovable property, although it will accept certain other assets such as heavy industrial machinery and count its value (or some portion of it) towards its standard figure of 200 percent collateral (i.e. 50 percent loan-to-value). In project lending, the bank will require 40 to 60 percent equity participation by the borrower, in addition to collateral. The bank also will frequently take a floating charge on an entire enterprise -- the value including land, buildings, and machines--and have company sales proceeds deposited into the company’s account at the bank. This strategy is sometimes used in order to preserve a legal claim in case of bankruptcy.

BASIC Bank is a wholly government-owned bank that devotes half of its lending portfolio to commercial lending, and the other half to small and cottage industry lending. It tries to follow NCB policies for collateralization, providing loan-to-value amounts of 75 percent for new buildings, 50 percent for new equipment, and less for land. BASIC estimates its recoveries at 87 percent for term loans. In loan recovery litigation, BASIC has used the strategy of offering a 50 percent interest remission as an inducement to settlement-- after a decision is rendered but before execution.

Private banks have struggled to meet customer credit demands as well as prudential standards. In doing so, some have been forced to take creative steps. Al-Baraka Bank has introduced consumer credit cards based on personal guarantees. It also intends to soon begin *salami* or pre-paid rights to shop premises as collateral for loans up to 2.5 lakh tk. Documentation requirements include the *salami* agreement and the usual loan documents,

which specify that the bank has the right to sell the *salami* right upon default, and that the borrower cannot transfer this interest. Al-Baraka will give 60 to 80 percent loan-to-value on this basis. Bangladesh Bank is said to be pressuring banks to do this. Al-Baraka will provide a maximum of 90 percent loan-to-value against bonds, 80 percent of the face value of Investment Corporation of Bangladesh (ICB) managed funds, and 50 percent against “blue chip” stocks. It will also lend against life insurance policies, fixed deposit receipts, and goods in its warehouse.

City Bank makes lots of small trader loans, perhaps 2,000 of them in the range of one lakh to one million tk. The bank takes land, buildings, CDs, bonds, and other items as security and is also considering *salami* financing. It takes a hypothecation of inventory as well, largely as a monitoring device--the borrower is required to send inventory reports biweekly or monthly, and visits the nearest bank branch once a week. With pledges, the bank can rely on the provision in the loan documents that allows it to sell goods unilaterally upon default--since the pledged goods are in its possession. The preferred means of reducing risk is to deal only with known parties who have a track record or an existing relationship with the bank, to contact other creditors, and/or to obtain personal guarantees.

According to Prime Bank, its average loan is about one crore tk, and of the approximately 100 loans in this range, none was extended without real estate security (although perhaps two were largely financed by receivables and inventory, but these loans were to the bank’s best customers). The bank has approximately 1,200 vehicle loans, though many are underperforming, and fully 20 percent of payments are overdue.

Foreign banks in Bangladesh rely on a local deposit base due to hard currency constraints. Their lending is based more on cash flow than security. Hong Kong Bank offers loans at a 14 to 16 percent rate, with 90 to 120-day loans for importers at 15 percent and two-year term loans at 14.5 percent. Hong Kong takes as security equitable mortgages and hypothecations of machinery, stocks (inventory), and book debts. For good customers, it will sometimes provide 200 percent loan-to-value. In light of this, there is some question whether the foreign banks are “cream-skimming,” leaving local banks with the weaker customers.

The denationalized banks, such as Pubali and Uttara, which were purchased, often by pre-nationalization owners, in the 1980s, are thought to be in the financial sector’s worst position. The banks were sold before the current loan classification system was put into place. Buyers felt they had overpaid for very weak banks, and as a result, they have little incentive to invest in the banks’ growth. These banks have largely inactive loan portfolios.

### *1.2.2 Non-Bank Intermediaries*

Bangladeshi NBFIs include leasing companies, investment banks, and other financial companies. Of course, NGOs are an active presence in credit markets, but usually do not have legal status as financial institutions. Trade credit and subcontracting (or similar arrangements such as franchising and commercial agency) provide additional credit options for SMEs. The equity market is largely unavailable to SMEs, and involves mainly large manufacturers. Some 212 firms are listed on the Dhaka Stock Exchange, with about 130 traded daily and ten mutual funds dealing in stocks and debentures. Investment banks however, have begun to look into handling fixed maturity debt instruments for unlisted companies, which may open further opportunities for SMEs.

Leasing companies are regulated as financial institutions.<sup>5</sup> Two major leasing companies, IDLC and United, operate in Bangladesh with some international financial institution and donor agency equity participation (including the IFC, ADB, Commonwealth Development Corp., and Korean Government). There are also several smaller leasing companies. However, leasing does not operate according to international standards. For example, leasing companies do not look primarily to the leased asset itself for security, but to separate collateral in land and buildings. United Leasing leases vehicles as well as industrial and construction equipment for terms of two to five years, at an average interest rate of 20 percent. It will finance up to 50 percent of a firm's total capital investment, similar to the banks, and will take 100 percent collateral in real estate, shares, guarantees, etc. In these leases, it will put a sticker on the equipment, hold the original import bill of entry, and in some cases visit the premises once or twice per year. The equipment itself appears to count for little in terms of security value. This is largely because of its relative illiquidity: the market in Bangladesh is small, firms tend to lease used and reconditioned equipment since new equipment may be too costly, and this equipment depreciates and is apparently difficult to repossess in original condition. Finally, these leases are finance leases, which means they require full-payout; i.e. the lease cannot be terminated and equipment returned before the agreed term. It is an indication of the modest size of the equipment leasing market in Bangladesh that United, the second leading leasing company with 30 to 40 percent of the market, has only 200 to 300 active leases at any one time.

Another force in the credit markets is the NGOs. MIDAS, for example, provides project and term loans to small and micro-enterprises, directly lending funds supplied by USAID, normally at 14 percent interest. MIDAS has applied to license a financial subsidiary as an NBFI. Until this license is obtained, MIDAS and its affiliates have no access to the Money Loan Court. Its current procedure for non-performing loans is to send a notice

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<sup>5</sup> Financial Institutions Act, 1993 art. 1.

of payment due with a threat of legal action, and if this does not result in repayment, to supply the name and address of the non-paying debtor to all banks and to the Credit Information Bureau (CIB) of Bangladesh Bank. There is a recognized reciprocal obligation among financial institutions to supply such information. MIDAS reports a 100 percent repayment rate by microenterprise debtors and 80 percent by small firms. This repayment rate is likely due in large part to intensive monitoring--MIDAS sends officers for routine inspection visits at intervals of one day to over a month, and may even post someone at an enterprise for a time. MIDAS extends "micro" loans under two lakh tk without security, and requires security for larger loans in the form of land, bank guarantees, or CDs. MIDAS in turn provides 100 percent loan-to-value against these forms of security, and less for others, e.g. 50 percent for machinery and 70 percent for buildings.

Commercial bank onlending programs include the following. Sonali Bank has lent funds through the Thana Central Cooperative Associations to Village Societies, which onlend to their members. These loans were secured in part by book debts owed by the Societies to the Associations. The bank, however, was unable to recover such debts from defaulting Associations<sup>6</sup>. Sonali also lends to Proshika against collateral, and Proshika extends unsecured micro loans--in this case, there is no recourse by the bank against the micro borrowers. Proshika also lends to lower-end SMEs, under its "SEED" program extending some unsecured loans of two lakh in connection with business training programs.

A major problem is the difficulty that graduates of Grameen-style programs have in obtaining commercial finance. Some continue simply to borrow the maximum from those programs, in the absence of alternatives. One suggestion has been to enable these programs to provide guarantees on behalf of these graduates to commercial banks, as is being done in some other countries such as Malaysia.

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<sup>6</sup> World Bank (1996a) p.29.

## Chapter Two: Institutional Sources of the SME Credit Constraint

This chapter deals with the institutional framework of finance-related law and administration. Precisely why is this important? There is a growing consensus that legal institutions which strengthen property rights and contract enforcement thereby support economic growth.<sup>7</sup> Only in a system that creates and protects legitimate investment expectations, by settling certain entitlements in advance and providing access to third-party dispute resolution where necessary, can anyone really be said to have property and contract rights at all (as distinct from physical possession and superior force). Where institutions provide legal certainty, economic actors can move from self-enforcing “spot market” transactions characteristic of a bazaar economy to specialized, high-growth investments with such features as intertemporal and interspatial exchange, fixed investments, and complexity.

Modern financial transactions are especially dependent on the quality of legal institutions. In this area, legal certainty makes possible loans and other transactions based on objective criteria – i.e. without significant reliance on personal relationships.<sup>8</sup> Legal certainty, in the form of settled legal rules and efficient enforcement, promotes the certainty of asset values in the context of repossession and forced sale. Since entrepreneurs must discount for risk in appraising asset values, the likelihood of enforcing a property right in an asset through contractual arrangements or litigation must be factored into the net valuation of the asset.<sup>9</sup> Legal certainty in terms of the rule of law protects the value of property rights from disorder, theft, expropriation, and corruption. It also helps minimize transaction costs by obviating the need for extra protections, bribes, long delays and high costs in civil suits, and the like. Related to this is the cost of information, the backbone of financial markets. Appropriate and certain legal rules can minimize search and information costs by supporting stable asset values, maintaining corporate accounting standards, imposing market discipline on the banking sector, and making reliable information available on liens, credit history, and the like. Finally, the quality of legal rules and enforcement mechanisms determines what types of property can be used as collateral. In other words, it determines how much existing and future capital can be mobilized through secured finance techniques.

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<sup>7</sup>See, e.g. North (1990), Clague et al (1995), and Williamson (1985).

<sup>8</sup>Evidence for this proposition has been found in research showing a relationship between (a) evaluations of countries’ legal environments, and (b) ratios of currency to other dimensions of the money supply or “contract-intensive money.” Clague et al (1995).

<sup>9</sup>See Pinheiro (1996).

The discussion below examines the most significant failings of the institutional environment for SME finance in Bangladesh, and their likely impact. An understanding of these issues is critically important as the basis for reform and program proposals to be developed later in the report.



2.1.1 *Institutional weaknesses make systems for security interest protection and credit information complex, uncertain, and incomplete.*

Law and practice in Bangladesh place stringent limits on the use of many secured finance techniques prevalent in industrial countries. This has potentially enormous economic effects.<sup>10</sup>

By one gross estimate – in this case for selected Latin American countries – the inability to use moveable property to finance capital investments could cost anywhere from two to ten percent of GNP.<sup>11</sup>

What are these limitations? As discussed previously, real estate is considered the only truly valuable collateral (although its forced-sale value is low), and movables such as vehicles and machinery only rarely are taken as primary security – and then only if they remain in the lender’s possession. Security in inventory, known as “stocks” comes in two forms: hypothecation, under which the goods are kept in the firm’s warehouse, and pledge, where the goods are kept in the bank’s warehouse. Only pledged goods are considered “real” collateral, and the possession requirement obviously raises their cost and restricts their use. Accounts receivable financing is virtually non-existent in practice. Legally, in Bangladesh, one cannot make a general assignment of receivables, only a specific assignment. This raises the cost and reduces the efficiency of accounts receivable financing. In any event, loans on the basis of accounts are essentially considered unsecured. Pledges and assignments of chattel paper (commercial financial documents) are also ineffective. According to a World Bank report of two years ago, the opportunities lost as a result of these particular weaknesses are significant:

These forms of financing could be important means of channeling funds from banks and private investors to dealers and to non-bank private and NGO lenders. Accounts receivable financing would permit the dealer to use the paper generated in credit sales as collateral for a bank loan. Chattel paper financing would permit the non-bank private and NGO lenders to use the loans they make – their account debt or book debt – as collateral for a loan.

Weaknesses in the legal basis for collateral create demand for substitutes. One example is the use of *salami*, mentioned above, as security. *Salami* agreements and their use as loan security are prohibited under the Premises Rent Control Ordinance of 1963, amended 1986. Nevertheless, banks are proposing to use those agreements as security. It is possible that

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<sup>10</sup>World Bank (1996a) p. 29.

<sup>11</sup>Fleisig, cited in World Bank (1996a) p. 27.

this represents a move to formalize an existing usage in informal credit markets, but the legal basis for such a change does not yet exist. As another collateral substitute, post-dated checks are used as an inducement to timely repayment, since writing a check with insufficient funds is subject to a jail term<sup>12</sup>. By way of example, the procedure for buying a vehicle on credit from a dealer has been described as follows: the dealer retains title and conveys possession to the buyer; the buyer, in the case of a three-year installment payment period, provides up front 36 postdated checks representing monthly payments; a further guarantee is provided by a bank or insurance company. Such procedures, dictated by severe legal and commercial risk, make high volumes of such transactions all but impossible due to gross inefficiencies.

The roots of the secured finance problem in Bangladesh lie in both law and practice. In the following discussion we consider, first, the substantive legal basis for security interests, and second, the institutional framework of security registration and credit information. In each case, weaknesses in the law drive financing practices in particular directions. Of course, the machinery of enforcement plays a critical role here; the laws, organizations, and practices affecting the enforceability of loan agreements and security interests are considered in the next section.

### 2.1.2 *Secured Finance Law*

As for the legal basis for secured transactions, the critical problem is the priority of form over substance. This problem has plagued all common law systems in the course of modernization. Secured finance law in Bangladesh is British-derived, almost all of it dating from before decolonization in 1947. The law consists of a patchwork of statutory provisions and judicial precedents creating a series of security instruments each with its own content, formalities, and notice or perfection requirements. One could summarize them as follows:

*Mortgage:* An interest in real estate, constituting an enforceable property right (right *in rem*), securing (and incorporating) a personal obligation to repay a debt. This familiar definition applies to the simple or legal mortgage. There are a number of other mortgage-like instruments in use in Bangladesh, most of them artifacts of judicial precedent. The equitable mortgage secures a right to repayment through the deposit of title-deeds. The main difference with the simple mortgage is that the equitable mortgage does not require costly registration – but at the same time, it is less secure, being based on a simple title deed rather than an exhaustive search of property records. The English mortgage involves an absolute transfer of the property to the creditor with the proviso that it be re-conveyed to the debtor upon payment of the obligation. Under a usufructory mortgage, the creditor takes

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<sup>12</sup> Negotiable Instruments Act 1996.

possession of the land in order to work it and derive crops and other goods in-kind that constitute payment of principal and/or interest, in whole or in part.

We are not primarily concerned with mortgages of real property in this report, since SMEs frequently do not own land or buildings that could be mortgaged, and also because the land titling and mortgage systems will require reforms that are likely to be slow and politically difficult. As mentioned elsewhere, these reforms are needed because of the uncertainties introduced by incomplete and outdated surveys, the unreliability of many title documents, the extremely high cost and delay involved in title and mortgage registration, and the consequent diminished value of real property as security – despite its being by far the preferred form of collateral from the perspective of financial institutions in Bangladesh.

Case law in Britain established the applicability of mortgage provisions to movable property. As with real estate, the debtor remains in possession, the mortgage is registered in the case of a legal mortgage, and the creditor has a property right enabling it to seize the property in certain defined circumstances of default – subject to court intervention and rights of redemption.<sup>13</sup> These legal principles do not apply to corporate debtors, to whom the charge provisions of the Companies Act, 1994 apply (see below). For enterprises that are neither limited companies nor partnerships, the mortgage on personal property, or chattel mortgage, would in principle provide a vehicle for financing. Unfortunately, this mechanism suffers from the same deficiencies as real property mortgages, and is not much in evidence in Bangladesh.

*Pledge:* The basic possessory security interest, in which movable property or instruments such as stock certificates are placed in the possession of the lender until the obligation is repaid. Legal provisions on pledge are contained in the Indian Contract Act, arts. 172-179, and further elaborated in applicable case law. Colloquially, pledge is known in the U.S. as *pawn*. Possession by the creditor itself is deemed to signal the existence of a security interest, and so registration is not required. In Bangladesh, pledges appear to be most frequently used for the financing of inventories (*stocks*), which are kept in bank warehouses or under the control of bank agents, and some short-term informal financing.

*Hypothecation:* This is a creature of case law that substitutes for the possessory pledge. The difference is that hypothecation does not require delivery of the goods to the creditor, nor the creditor's effective control over the good.<sup>14</sup> The lack of a requirement of either possession or notice to third

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<sup>13</sup>Sauveplanne (1974) pp. 33-5.

<sup>14</sup>Dalal (1984) p. 263.

parties for its legal effectiveness limits the utility of this mechanism. As a practical matter, creditors under hypothecation agreements would generally either place a plaque or sticker on capital goods announcing their security interest, or have a charge registered in the JSC Registry, if a limited company or partnership is the debtor (see below). Most importantly, creditors in Bangladesh do not usually consider hypothecations to be valid security in and of themselves.

*Charge:* This is an encumbrance on property or on a company, representing a debt to be paid. The Transfer of Property Act, 1882, art. 100, applies the concept of charge to real property, defining it as a security interest not amounting to a mortgage – presumably the equivalent of an equitable mortgage. At common law, a charge can be placed on movables and companies as well, but unlike the mortgage, it does not represent the transfer of a legal property right (right *in rem*), which would be valid against subsequent transferees, nor does it include a personal covenant to pay.<sup>15</sup> The Companies Act, 1994, arts. 158-176, requires companies to register all charges and mortgages at the JSC Registry as a condition of their validity (see below). Companies and financial institutions in Bangladesh use the *floating charge* to encumber all assets of a company. Since the effect of such a charge on other competing forms of security, and the relative priorities, do not appear to be clearly defined, the enforceability, and therefore the net value, of floating charges is somewhat uncertain. This arises in part from their case law origins as equitable interests, and their consequent subordination to legal interests. While the floating charge elsewhere has developed somewhat into an instrument for taking security in all assets of a firm, or all of a category of assets, this – especially the latter – has not been the practice in Bangladesh. In practice, charges are used as secondary security, after sufficient collateral in valuable assets such as land has been secured, and in order to preserve legal rights in bankruptcy.

*Leasing, Hire-Purchase, Conditional Sale, etc.:* Leasing has become an option for capital finance in Bangladesh in recent years. There is no specialized body of law on leasing, which is governed by general contract law. Finance leases entail payment of the full value of the leased goods plus a premium representing the financing costs, in the form of multiyear lease payments. These leases cannot be terminated before payments are complete, and generally require the return of the asset at the end of the lease period to the lessor, who can sell the good for its salvage value. The lessor (dealer, leasing company, or financial institution) retains legal ownership of the goods while the lessee takes possession. As practiced internationally, this system allows lessors in high tax brackets to take depreciation and other tax shelter provisions, and to share these benefits with the lessee through reduced lease payments. In industrial countries, leasing is used as a way to secure finance

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<sup>15</sup>Chowdhury (1991) p. 337.

for the acquisition of a capital asset, using that asset itself as security. In Bangladesh, the lease value is generally fully secured by other assets, thus defeating one of its potential benefits. Since this type of leasing is a financing mechanism, secured transactions law in the U.S., for example, treats leases just as it treats secured loans. In Bangladesh, the collateralization of finance leases using other assets comes within the laws on secured finance, but not the lease itself.

Other similar transactions are also treated under separate provisions. Hire-purchase is a lease with option to buy. Conditional sale involves retention of title by the seller until all purchase price installments are paid. These and other transactions (e.g. trade credit in the form of customer advances) are brought within secured finance laws in the U.S. and some other industrial countries, but not in Bangladesh.

The upshot of this patchwork system is that the form of a transaction determines its legal consequences much more than can be justified in light of modern commercial practices. Not only does this result in uneven treatment of different interests that are commercially equivalent in many ways, it makes it difficult, both legally and in terms of the cost and delay involved in multiple formalities, to structure flexible security agreements incorporating many different types of collateral. One facility that such a system cannot easily provide is the ability to identify whole classes of existing and future collateral, and to subject them to a single reliable security agreement. Also, apart from the case of registered mortgages, this system does not legally recognize a security interest as an enforceable property right. Such a recognition would enable creditors to seize collateral when their property right matures, i.e. upon default, either through self help or by using expedited court procedures. Otherwise, these creditors would need to litigate in order to establish a property right to an asset or a claim on a larger asset pool.

The other major piece of the secured finance picture concerns the treatment of creditors upon default or bankruptcy. We will deal more directly with enforcement in the next section. Here, it is worth pointing out that the Civil Procedure Code in use in Bangladesh dates from 1908, though with some more recent amendments. Expedients used in modern systems to channel into the courts only cases that cannot be resolved otherwise – such as summary judgment and court-annexed arbitration – are not much in evidence in the Bangladesh Code. Moreover, substantive and procedural law place a large burden on the courts in terms of loan enforcement and security liquidation. Self-help enforcement (e.g. repossession without court intervention) may be implied by existing law, but any defendant can make a plausible contest in court where such an attempt is made, and inevitable delays reward such tactics. Enforcing a security interest can include as many as three major steps: a civil (or money) suit to establish a right to the collateral, repossession or attachment of the collateral, and liquidation of the

collateral. Each of these steps presents multiple opportunities for delay. Still, at least as much of the problem of lawsuit delay is caused by the failure of courts to dismiss cases where no real issues of fact or law are presented, and the tendency of the courts to allow multiple interlocutory motions and amendments of the pleadings. As discussed below, the procedures of the Money Loan Court were intended to shortcut these procedural bottlenecks in cases involving financial institutions. They have not succeeded.

The bankruptcy system has not yet been tested, but there are reasons for concern here. The Bankruptcy Act, 1997 represents an improvement on the prior status quo, in that it provides rules and procedures for liquidation and reorganization. Most importantly, in articles 46 and 54, the Act protects the interests of secured creditors by providing for transfer of the collateral or proceeds of judicial sale to such creditors. Unfortunately, the term “secured creditor” is nowhere defined. This appears to leave it up to the Bankruptcy Court to decide whether this term includes mortgagees, pledgees, holders of charges and hypothecations, or all of the above; and whether this protection applies only to banks, financial institutions generally, or all creditors. Should the term be defined narrowly, then those creditors not included in the definition will be subject to the Act’s priority provisions (art. 75), under which debts are satisfied in the following order:

- (a) taxes and debts to government
- (b) certain wages
- (c) bank debts
- (d) unsecured claims
- (e) subordinated claims.

Where the assets of the estate are insufficient to pay all bank debts (defined in art. 2 as debts owed to banks and financial institutions), these debts shall be discounted in such a way that payments for unsecured claims amount to at least 50 percent of bank debts.

There are several problems with this priority scheme that undercut certainty and transparency in the valuation of debts to which it applies. There appears to be no legal provision in this or other relevant statutes requiring the government to provide notice to other creditors by registering its claims against a debtor. Even if there were such a provision, later-arising government claims would take precedence over prior debts subject to this scheme. It is also unclear exactly how broadly government claims are defined. These explicitly include taxes and debts – the latter presumably including debts to the NCBs, which thereby obtain automatic priority even against debts contracted earlier by other financial institutions. Trade credit and other obligations to entities not having legal status as financial institutions, as they are nowhere mentioned, would have the status of unsecured claims in this scheme, whether they are collateralized or not.

Therefore, a critical issue with respect to the Bankruptcy Act, and to the valuation of secured claims, is which types of debts fall under art. 54, and which under art. 75. In light of the patchwork of law and practice applicable to secured lending in Bangladesh, it is not entirely clear how this issue will be decided. The Act also places wide discretion in the hands of the Bankruptcy Court to dismiss bankruptcy complaints and to provide special relief to debtors<sup>16</sup>. This level of discretion is not entirely inconsistent with the standards of modern bankruptcy legislation. Its impact depends on the quality of the Bankruptcy Court, the discipline provided by the judicial system generally, and the intensity of the pressure that will inevitably be brought by defaulters and their allies as bankruptcy cases move forward in the Dhaka court.

### *2.1.3 Lien Registration and Credit Information*

Even apart from limitations on the use of collateral, the process of transacting a secured loan entails significant difficulty and cost due to information asymmetries. Banks are said to take as much as a year or two to make decisions on loans to new customers. The mechanisms for checking credit and lien information contribute significantly to delay and expense. Real estate title searches require lengthy and complicated searches of paper records. Deeds and non-encumbrance certificates can be unreliable, since they are sometimes based on false information, incomplete checks, or outright forgery.

Moreover, the patchwork nature of the Bangladeshi system also means that information about security interests in various types of assets is neither uniformly available nor held in a rational and consistent registry system. Nor does such information reliably determine creditor priorities, as mentioned above. A related problem is the cost of registration (which in many cases means multiple registrations) – reasonable in the case of company assets, but exorbitant in the case of mortgages, i.e.:

- 10 percent stamp duty
- 2.5 percent registration fee
- 6 percent capital gain
- 4 percent property tax
- 1 percent transfer tax
- 1 percent Union Parishad tax (or 2 percent if non-Union Parishad)

for a total of over 25 percent. Since the volume of secured finance is low in Bangladesh, one could perhaps say that the above problems have not yet become a binding constraint. However, one could just as fairly claim that the failure to rationalize and update the system – both substantively and in terms

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<sup>16</sup> Articles 28, 46, and 111.

of perfection or registration – has contributed substantially to the current low levels of secured finance.

Only certain forms of non-real estate security are required to be registered. Charges on company assets, and floating charges, must be recorded in the Registry of Joint Stock Companies (JSC). Pledges and hypothecations as such do not need to be recorded. Encumbrances against assets of sole proprietorships (a common legal form for SMEs) are apparently not registered at all. Laws on companies and registration make registered instruments effective as of the date of their execution, not of registration itself. The possibility of conveyances in the interim introduces uncertainty. Priorities among creditors can therefore be uncertain, and are not moreover widely known. One prominent lawyer asserted that priorities are determined by either usage or agreement.

The process of registering a real estate mortgage requires a personal visit to the Land Registration Office, and the submission of a title document, power of attorney, tax receipt, and non-encumbrance certificate. The process takes between two weeks and two months. For this and for cost reasons, many lenders avoid legal or “registered” mortgages in favor of easier but less secure equitable mortgages. A sample checklist of documents required for a mortgage loan is presented in Annex 5.

Mortgage finance is especially complex and costly due to the processes involved in tracing title, registering mortgages, and enforcing a mortgage interest. Accepting land as security is risky, since most titles are clouded. The last full survey of land ownership in what is now Bangladesh took place in 1918, and hence professional due diligence would require tracing the chain of title at least to that date. There is also some uncertainty as to which plot a given title document refers to. Since there is no central point at which all changes of title are recorded and kept up to date, it can be difficult to determine who actually has title. Moreover, the system in Bangladesh does not rely on a single authentic document of title, and the deeds that are used are usually not considered secure. Both delays (and corruption) in recording “mutations” or changes of title, and the real possibility of a forged deed (or simply incompetence on the part of the deed-writer), open the door to abuses. Land has often been sold or mortgaged to two or three different parties at the same time. As a result, an estimated 80 percent of civil litigation concerns land title. These uncertainties, in addition to problems with enforcement (see below), lead to low valuations of real estate.

Additionally, fees and taxes applicable to registered land transactions put downward pressure on property valuations. In the case of registered mortgages, and valuations estimated at 25 or even ten percent of real value are apparently common. Creditors often opt for a non-registered equitable mortgage, sometimes accompanied by a “token” registered mortgage at a



fraction of real value, in order to preserve legal leverage. To further complicate matters, registrars and other official personnel sometimes object when properties are valued at an abnormally low price, but can be persuaded to look the other way in return for a bribe. In extending credit against real property security, banks frequently provide 50 percent loan to value, largely due to uncertainties introduced by the registration and enforcement processes. However, assuming a loan is provided for 50 percent of real value, this could be higher than the registered value, although, according to prudential rules, the loan amount should not exceed the registered value of the property. Due to the valuation problem, auctioning property upon execution raises problems of fairness, if the registered value is used as a baseline. Further, potential buyers are wary of buying disputed properties, and threats of violence against potential buyers at auction are not unknown.

Charges, by contrast, are somewhat easier to register. Fees are modest: about 600 tk for a loan up to one crore, then 400 tk for each subsequent crore. The registration process is as follows:

- (i) the creditor financial institution sends a “sanction” letter through the borrowing firm, stating the items to be charged, with the registration fee;
- (ii) before registering the charge, the registry checks for any title problems, encumbrances, unpaid rent, or other problems with the property to be charged;
- (iii) the registry checks whether the agreement to charge the property was approved by a duly constituted meeting of the company board of directors, and if necessary checks the company’s articles of association;
- (iv) if necessary, the registry checks whether any outstanding taxes are due on the property; and
- (v) the registry issues a registration certificate to the company.

Registration normally can be done within a week or even three to four days. Companies are required to register charges within 21 days, although delays can be obtained with permission from the High Court. Companies whose charges are subject to registration include corporations and partnerships, but not sole proprietorships or cooperatives. Most commercial loans are extended by banks without registration of a charge. A bank can check prior charges upon payment of a 20 tk fee. The Companies Act, 1994 (articles 163 and 164) requires the JSC Registry to keep indexes both by company and chronologically, although the Registry appears to operate without written administrative rules.

With respect to both mortgages and company charges, registration fails to play its optional role as a system of “perfection” or creation of legally effective interests entitles to protection against third parties. The problem here is that even when registration is required for legal effectiveness, this legal

protection does not begin on the date of registration but relates back to the date on which the subject agreement was created. Time lags of 21 or even 30 days permitted between creation and perfection mean that, for such period of time, third parties have no notice of prior security interests. This introduces significant uncertainty into the scheme of security interest priorities. Furthermore, the registries are called upon to perform the kind of due diligence that is best left to interested parties. This explains much of the system's ineffectiveness. At least with respect to non-real estate security, this system would be much clearer and efficient if the registries were limited to the mechanical task of posting notices of asset encumbrances, and running searches of these notices, without having to ensure the legal validity of the encumbrances.

Credit reporting is in its infancy in Bangladesh. The Credit Information Bureau (CIB) of Bangladesh Bank (BB) requires regulated financial institutions to provide information periodically (quarterly or monthly, depending on size of debt) on all debts of 10 lakh and above. Unfortunately, several factors reduce the utility of this system. Only regulated financial institutions and "interested" government agencies can obtain access to the information. Also, information enters the system with a time lag (approximately 45 days in the case of quarterly information), and is obtained with a normal time lag of 10 to 15 days. This means that information is normally about 60 days old when it reaches the user. The receipt of this information can be speeded up when the request is urgent – where the institution and the transaction are of sufficient importance, and where the time constraint is severe (e.g. a letter of credit needs to be opened the following day). At this time, the process of information retrieval therefore appears to be subject to wide discretion, which at least allows for the possibility of delay and grease payments. (The existence of such payments has not been alleged, to our knowledge.) Financial institutions using this system report that, in any event, they perform additional credit checks, including sending letters to all other financial institutions (or at least those who have had contact with the customer).

In practice, credit information in Bangladesh works as follows. If a borrower with a loan outstanding from one bank goes to a second bank, the latter will require a "no objection" document. If the proposed loan is less than the 10 lakh threshold at which financial institutions are required to inform the CIB, banks will send a circular to other banks informing them of the loan or proposed loan. Some banks will do both for a large loan.

The incentives in the systems of security interest registration and credit information appear to weigh strongly against efficiency and probity. Company law requires firms themselves to register mortgages and charges against firm assets and to deposit copies of the instruments that create these obligations (although in practice financial institutions often do it for them).

Failure to do so triggers a fine<sup>17</sup>. CIB requires financial institutions to seek and provide information on debtors. Again, those who do not comply are subject to fines. The information is provided to requestors free of charge. In both cases, market incentives that could make the systems operate efficiently – e.g. user fees - are absent. If creditors were required to record security interests against firms as a condition of the “perfection” or effectiveness of their interests with respect to third parties, they would likely do so speedily. Instead, company law places this burden on firms, with the result that charges become void and debts payable, upon failure of the *firm* to record. If the CIB system were a useful credit tool (instead of a prudential measure for BB, which is the way it seems to work now), financial institutions would have an interest in providing all relevant information on a timely basis as a condition of their being allowed to use the system, and would moreover be willing to pay for it. Discretion and multiple responsibilities on the part of CIB and the registries further undermine integrity and effectiveness.

As a result of the forgoing, uncertainties and inefficiencies appear to constrain severely the extension of credit to new market entrants, unrelated parties, and enterprises not owning significant real estate assets. Rapid and reliable assessment of prior liens and credit history make efficient SME finance possible in industrial countries, but these are not currently possible in Bangladesh.

## ***2.2 Enforcement of credit and security agreements poses severe problems of delay, expense, and uncertainty.***

The ability to extract value from collateral quickly and efficiently plays a major role in the price and allocation of secured credit. A rational creditor would discount the value of a loan, or of a bundle of accounts or chattel paper, by the likelihood that the underlying repayment obligations will be performed. Bilateral economic relations are always at risk of the opportunism of one party. Several mechanisms can potentially restrain such opportunism, such as norms of reciprocity that evolve in repeated bilateral interactions, reputation effects within a commercial network in which business partners frequently interact, self-governing organizations such as commodity exchanges or chambers of commerce, commercial or traditional arbitration bodies, and the formal law of contract and its attendant state adjudication mechanisms.<sup>18</sup>

The operations of commercial banks and other formal financial institutions are particularly sensitive to the quality of legal institutions,

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<sup>17</sup> Companies Act, 1994, articles 159-176.

<sup>18</sup> See Kahkonen and Meagher (1997).

because these provide the ultimate recourse for extracting value from a defaulting debtor. Evidence exists for a postulated relationship between the quality of legal institutions and the extent of non-cash financial flows.<sup>19</sup> In their relationships with commercial banks, SMEs are especially affected by the quality of legal institutions, since many of them do not have established relationships or networks, and must rely on the objective merits of their business plans and assets. Alternatively, intermediaries such as NGOs and associations could forge commercial bank links for SMEs, but in the long term, this is very unlikely by itself to increase SME financing in significant and sustainable ways. Therefore, just as a legal structure of property rights and contract enforcement is important generally for the emergence of complex transactions and fixed investments, an effective framework for loan enforcement is a necessary condition for significant flows of medium- to long-term SME credit.

In Bangladesh, contract enforcement weaknesses contribute substantially to the SME credit constraints. Creditors often have difficulty vindicating their rights in court. In the formal financial system, “self-help” repossession without court intervention (a core element of modern secured finance) is virtually unknown. Mortgages, charges, and finance leases all present severe problems in this regard. In most such cases, recourse is to the *Artha Rin Adalat* or Money Loan Court, established in 1990 with the aim of simplifying and speeding up civil suits for money judgments. In repossession cases, for example under finance leases, recourse is to the regular civil courts. In neither case can creditors obtain the security or its monetary value in a commercially reasonable time. Estimates for the time needed to complete a case for the enforcement of a mortgage agreement range from about three years to a generation. Even repossession of leased equipment, to which the leasing company has title, is estimated to take a year or even several years. Even once a money judgment is obtained, a suit for execution, e.g. attachment of assets, must then be filed-- these, in principle, are supposed to be resolved within three months, although this does not appear to be the case in practice (by one estimate, execution against real property can take five years or more). Making this problem worse, Bangladesh does not recognize most foreign judgments or arbitral awards<sup>20</sup>.

There are four means of obtaining summary relief spelled out in the Civil Procedure Code (Order 37, rules 1 and 2)--and the law provides for relief within a maximum of three months, if the plaintiff has “clean hands.” Apparently, these remedies are easily defeated.

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<sup>19</sup>Clague et al (1995).

<sup>20</sup> Government testimony in Parliament indicated 720,000 lawsuits pending in Bangladesh’s courts as of July 1996, a 50 percent increase over the previous year. Abdul Quader, *Bangladesh*.

Multiple opportunities for delay--such as interlocutory appeals, petitions for extra time, postponements due to busy schedules in the courts, and other tactics such as engaging a new attorney in order to win a delay--mean that these suits tend to take a minimum of three years to resolve, and suits lasting ten years or more are not unknown. This puts tremendous pressure on creditors to settle cases – even after a judgment is rendered, but before execution. In one example, a group of local importers bought books from foreign publishers and failed to pay. Even in such a straightforward case, 70 to 80 percent of the creditors in this situation settled rather than go to court.

The culprit here appears to be a combination of clogged courts, inflexible procedure, easy availability of interlocutory appeal under the Civil Procedure Code, uninformed or undisciplined lower court judges, and corrupt court clerks. As for the judges themselves, the High Court and Supreme Court are considered clean, but the lower courts are more dubious, and these subordinate judges handle civil money cases up to a maximum value of one lakh tk. The judiciary does not have full formal independence from the executive, since the Home Ministry and Ministry of Law exercise more control over appointments and budgets than the Supreme Court.

In response to problems with the enforcement of loan agreements and security interests some parties apparently are able to “purchase” results in court. Others pursue alternative remedies. Lawyers report that creditor clients sometimes prefer criminal to civil cases, because the *in terrorem* effect of a criminal warrant is greater than that of a civil summons. A criminal search warrant also provides a relatively efficient means of locating and attaching property. Sections 406 and 420 of the Criminal Code, concerning criminal breach of trust and fraud, provide the basis for relief against debtors.

The costs of litigation also pose a barrier to legal recourse, and raise costs generally. Court fees are *ad valorem* on a graduated scale: starting with 10 percent of the value of cases up to one lakh in value, and rising to a maximum of 28,000 tk. One must add attorney fees, stamp taxes, and other costs to reach the real costs of a lawsuit.

There are six Money Loan Courts (*Artha Rin Adalat*) in Dhaka, all of them legally available only to financial institutions. Apart from one court that operates full-time as a Money Loan Court, the other courts of this kind are held in premises and staffed by judges that must accommodate other civil and criminal matters as well. The judges are not specially trained. The Money Loan Court Act and Rules attempt to short-cut procedure, and in doing so, curtail the rights of debtors. One of the ways in which this is done is to require borrowers who seek to appeal decisions to post half of the claimed amount. Still, defaulters find other means of delay, such as failing to appeal in court, then objecting to an *ex parte* judgment on the basis of fundamental rights (i.e. a constitutional claim). The Money Loan Court, it has been

observed, has never rendered a judgment against a powerful debtor. Moreover, by one estimate, some 25,000 to 30,000 cases are pending in the six Money Loan Courts. These courts are also subject to the same corrupt and dilatory practices as plague the regular court system.

The Bankruptcy Act of 1997 brought into being a Bankruptcy Court. There is one such court for Bangladesh, in Dhaka, staffed by a single judge. The judge has received special training and apparently enjoys a good reputation. At this point, records are being kept by hand. The bankruptcy procedures and court have yet to be tested. To date, there appears to be practically no experience with bankruptcy – the prevalence of “sick” firms, budget allocations to support such industries, other forms of political intervention, and strong sentiment against closing businesses, support the view that bankruptcy is to be avoided in nearly all cases. Unless the new bankruptcy regime can reverse this, “exit” will continue to be unavailable, and the liquidation of secured assets and concerns will remain impossible.

Since the court opened in late April, eight cases have been filed, five by Al-Baraka Bank and three by Agrani Bank. The value of these cases ranges from 25 lakhs to 4 crore. By way of example, one of the suits began as a mortgage enforcement action in June 1992 at the Money Loan Court. Judgment in the creditor’s favor for the debt, plus cost of profit and costs, was rendered in November 1994. Having as yet gotten no relief, the plaintiff creditor filed suit in the Bankruptcy Court in November 1997<sup>21</sup>.

These enforcement weaknesses explain much of the risk management strategy of financial institutions (dealing with known parties and large firms, requiring multiple security including land, etc.), as well as the risk premia factored into the price of credit. Only possessory security – pawns, pledges of inventory in a bank warehouse, and pledged bonds and shares in the creditor’s possession – appear to offer reliable and timely value. The overall efficiency of these latter approaches, and their availability to smaller firms, is doubtful.

### ***2.3 Financial market distortions undermine efficient pricing and allocation of credit, thus constraining credit availability to SMEs.***

Here, the problem is one of system governance. According to one informant, “The problem for nationalized banks is one of directed lending, while for private banks it’s lending to directors.” Practice since the nationalization of banks in 1972 appears to have encouraged a phenomenon well-known in post-socialist transition countries: the system provides the greatest certainty to illicit deals involving related parties or “cronies” (whether state or private), and the least certainty to arm’s length deals that rely on legal

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<sup>21</sup> Application for Order, Bankruptcy Case No. 1 or 1998, Court of Bankruptcy, Dhaka.

enforcement. Furthermore, many informants cite the prevalence of bribery and kickbacks among loan officers, especially in nationalized banks. Directed lending, credits to the state by nationalized banks, and the relative attractiveness and safety of government bonds all disfavor allocation of credit to SMEs via transparent and market-based channels. To the extent that top-down reforms have begun to squeeze some of these distortions out of the system, the availability of effective legal mechanisms for market-based credit allocation should draw private financial institutions further into the SME credit sector. Whether the premise of effective high-level reform is valid remains an open question. Secured finance reform will yield tangible benefits only to the extent that reform, or pressure for reform, enables the market to compete effectively with, and eventually to displace, corruption and cronyism as an allocation mechanism.

Banking regulation and the structure of financial market competition in Bangladesh do not instill confidence. All private banks are required to have five percent state ownership. Bangladesh Bank (BB) circulars still set interest rate bands for agricultural, small and cottage industry, and export loans<sup>22</sup>. BB requires banks to hold a total of 20 percent reserves, including a five percent Credit Reserve Ratio and a 15 percent Secondary Liquid Reserve, apparently because the banking insurance scheme is considered ineffective. Prudential rules require that no defaulters get loans without rescheduling, that there be adequate security (with defined minimum requirements), and that loan terms be kept to a minimum. Unwritten policies on margin requirements affecting imports and other transactions in particular sectors apparently change frequently, reflecting the industrial policy of the time.

The approximate shares of deposits and loans held by the different types of banks are:

- The four NCBs: 61 percent of all deposits and 54 percent of loans.
- Private banks (over 20): 26 percent of deposits, 26 percent of loans.
- Foreign banks (13): 8 percent of deposits, 6 of loans.
- Specialized banks (five): 5 percent of deposits, 14 percent of loans.

Most loans in the system are to manufacturers, traders, and export-import firms. According to BB, some 45 percent of all loans are classified (i.e. substandard, doubtful, or non-payment/loss), and 2,178 accounts in the banking system represent non-performing loans, for an estimated value of over 2,000 crore (20 billion) tk--almost all of this resulting from NCB loans in 1991 or earlier.

Lending procedures in the NCBs (and probably some of the scheduled banks as well, including older private banks and banks with heavy state equity

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<sup>22</sup> See sample interest rate schedule in Annex3.

participation) are said to be fraught with corruption. The initial requirement is a high bank official with a personal interest in the project. These officials, and others directly involved, will sometimes agree to extend the loan and allow the borrower to default in return for a kickback of a share in the proceeds. This often requires payments on the order of five percent of the loan amount, each, to a loan officer, an appraiser or inspector, and a director or other high official. After defaulting and even falling into the sick industry categories, promoters have been known to return to these banks for further loans, often through newly established companies.

The large scale of government recourse to the financial markets causes further distortions, including a likely crowding-out effect<sup>23</sup>. Banks (primarily NCBs) provide direct credits to government and purchase T-bills. Interest rates are approximately 14 to 15 percent for local banks, with similar or slightly higher rates offered by foreign banks (but with higher service charges), and subsidized rates for selected industries. Inflation is estimated at 9 percent, and the BB refinance rate is 7.5 percent. T-bill rates are in the 10 to 15 percent range, with defense bonds paying as high as 18 percent. This credit market structure by definition restricts access by SMEs, keeping competition low, demand high, and prices rigid<sup>24</sup>.

In this context, an effective secured finance system would provide a central component of a larger financial structure that determines the pricing and allocation of credit through market forces. Market-orientation is only one possible model for the governance of a financial system. In this model, actors such as competing banks, substitute capital market mechanisms (e.g. investment banks and other NBFIs), suppliers of funds, credit reporting agencies, and non-partisan prudential regulators and central bank officers impose market discipline on bank managers. These managers face budget constraints and competition, and in turn try efficiently to satisfy the demands of their depositors, shareholders, and borrowers. In this model, loan transactions are relatively arm's-length and depend to a large extent on the institutional framework. By contrast, a government-dominated financial system would rely much less on market signals and much more on directing the flow of credit through state banks to favored firms or SOEs. In this model, the legal framework is less important in coordinating action to meet expectations. Political intervention and bureaucratic networking become much more important. In a third model, that of group control, cross shareholdings and integration of financial institutions into industrial conglomerates or networks provide the mechanisms of coordination. Competition becomes severely constrained, and cooperative relations with sympathizers or cronies in government take on great importance as means of

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<sup>23</sup> World Bank (1996b) p. 40

<sup>24</sup> By one account, interest rate regulation is the single most important factor limiting the sustainability of financial institutions worldwide. HIID, cited in World Bank (1996a) p.41.



protecting a given pricing and allocation structure. Here again, legal institutions are less important than informal relationships.<sup>25</sup>

In other words, the legal basis for SME finance is one part of a larger order of governance that determines the extent to which credit is allocated and priced on a market basis – i.e. whether credit flows to firms and projects most likely to earn a profit, or to those that are either well-connected or favored by industrial policy. This is an important point, because the utility of secured finance reform is likely to be minimal in a situation of strong government- or group control. On the other hand, a well-functioning secured finance system is critically important in liberalized financial markets. It can provide for cost-effective signals, through the presence and monitoring of collateral, of the credit-worthiness of borrowers. This use of easy proxy signals, though it may cause inefficiency through overreliance, makes possible large-volume, low-cost credit for SMEs by reducing monitoring and other transaction costs.

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<sup>25</sup>Wellons (1998).

## Chapter Three: Reform Options

In this chapter, we suggest a number of priority reforms needed in order to free up the SME credit market in Bangladesh. These follow the focus of the assessment and this report on secured finance methods, which play a major role in industrial-country SME finance (particularly in North America) but are underutilized in Bangladesh. The reform options relate to legislative reform, strengthening information flows, improving enforcement, and broader governance issues. The chapter that follows will suggest a strategy for JOBS Project intervention to support these reforms and to ensure their implementation in practice.

### *3.1 New legislation to expand and simplify the use of non-real estate security.*

Reformed laws can (a) expand the universe of legally effective collateral to include forms not currently useable in Bangladesh, such as accounts receivable, chattel paper, inventory (non-possessory), consigned goods, fixtures, equipment and vehicles, proceeds of sales, and future interests; and (b) simplify the system of secured finance by rationalizing the current patchwork of law and creating a clear, unified concept of security interest that applies uniform legal formalities, registration requirements, and enforcement methods to all forms of non-real estate collateral. Such a reform package would need to take certain additional steps, such as keeping formal requirements to a minimum, and where possible advancing complementary reforms (see below). Reform would also need, at least eventually, to include strengthening the Bankruptcy Act. The changes needed here include clarifying the scope of secured creditor priorities and limiting the discretion of the Bankruptcy Court.

An additional change that would expand useable collateral would be to repeal the prohibition against *salami* and include it among legally effective forms of security. This would require amending the 1963 Premises Rent Control Ordinance (with 1986 amendments) to exempt commercial property and to lift the prohibition on *salami* and its use as loan security. It seems likely that *salami* as a tradition predated the 1963 act, and was driven underground because of it. A reformed law could require the *salami* to be documented by a simple written agreement, and empower lenders to use and repossess them as loan security.

The legislative options include a comprehensive reform including all of the above, or a “quick fix” that only deals with major hurdles to the use of certain collateral contemplated by existing law. In the latter case, the priorities would be to support the use of security in accounts, chattel paper,

inventory, equipment and vehicles, and consigned goods. This approach would not allow Bangladesh to “leapfrog” into a modern system of secured finance, but would remove major constraints to the operation of its British-derived system.

A 1996 World Bank report suggested further changes worth mentioning at this point:

- (i) elimination of usury laws, substituting truth-in-lending disclosure to encourage competition and increased provision of financial services by private lenders;
- (ii) rationalization of homestead and exempt property provisions to allow for a general reserve, not specific property, to improve the collateral value of the poor’s assets;
- (iii) regulation and supervision of loans secured by accounts receivable and chattel paper; and
- (iv) linking the age of maturity to verifiable civil status (e.g. marriage) to permit more of the young married poor or heads of households to sign lawful contracts.<sup>26</sup>

The Bank recently produced a draft reform package in this area, in collaboration with a group of Asian and American lawyers, the Bangladesh Bank, and the Ministry of Finance. This package, although it could be improved significantly, offers a possible basis for collaboration to pursue the implementation of reform in the near term, among the JOBS group, the World Bank, the Government of Bangladesh, and other stakeholders in Bangladesh. This possibility will be explored.

The World Bank reform package includes drafts of the following proposed new laws:

- (i) Financial Institutions (Security of Loans) Act;
- (ii) Debt Recovery Agencies Act; and
- (iii) Money Loan Court Act.

In addition, the package includes amendments to seven existing statutes. These drafts aim to bring the law in Bangladesh up to date, and more in line with standards in Britain and some Commonwealth countries. While these proposed laws would improve the situation in Bangladesh noticeably, they fail to draw on important elements of the most modern systems such as those of Canada and the United States. As a result, this reform package would cause Bangladesh to lose the opportunity to leapfrog over intermediate stages of financial law reform in a way that would allow secured finance to become

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<sup>26</sup>World Bank (1996a) p. 45.

an engine of SME growth. Detailed comments on these drafts are presented in Annex 10. Following is a short summary of the comments.

The centerpiece of the package, the Financial Institutions (Security of Loans) Act, adopts a conservative approach to the “charge” or security interest. It makes the charge available only to financial institutions, thus denying coverage to trade credit and to other alternative forms of finance. The draft brings real estate and other forms of property under the same rules. Applying the paradigm of discrete and separately titled items of property to movables and intangibles would make it difficult and expensive to use liens on broadly-defined categories of property – although these types of floating liens are a building-block of modern small business financing where they work efficiently. The draft also appears to be unduly complicated, and more worrying, to leave open a large scope for administrative and judicial discretion in this area. Related to this problem are the unjustifiably large costs (including fees based on an *ad valorem scale*), documentation requirements, and time lags contemplated in the draft with respect to registration of charges. Finally, rules governing creditor priorities in bankruptcy create unnecessary uncertainties and require further clarification. The other draft legislation suffers from similar difficulties.

The package was produced by lawyers from the U.S. (FDIC), Malaysia, Sri Lanka, and Pakistan (Pakistan has adopted some similar reforms). The package was hurriedly prepared and submitted in November, 1997. The Government of Bangladesh has not yet responded, although in the meantime, the World Bank team is reviewing the drafts and correcting them. (These drafts have also been reviewed by a Bangladeshi lawyer named Fariz Ishtiar, a former government legal advisor.)

What would legal reforms change in practice? One can expect them to have several potentially important effects. Even to the extent that some banks extend working capital finance on the basis of pledges or hypothecations of inventory, in either case these credits are liquidated as the goods are sold. As a result, the borrower obtains credit only during the life of a particular block of inventory, which usually means that the borrower obtains only a fraction of necessary working capital in this fashion. This assumes cash sales. In practice, sales are often on credit, and generate an account receivable. If borrowers could finance their accounts receivable, this would enable banks to continue extending credit after inventory is sold, on the basis of security in the accounts. This would require legal provisions to facilitate transfer of and security in accounts, as well as credit bureaus capable of rating such accounts.<sup>27</sup> If these changes were made, costly and time-consuming procedures for transferring accounts could be avoided, the efficient use of this mechanism would become feasible, and accounts would begin to be used

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<sup>27</sup>World Bank (1996a) p. 30.

more frequently, perhaps at a steep discount, but on better terms as the practice established itself.

Similarly, if provisions on chattel paper were also improved, this would enable banks to use outstanding loans in addition to real estate to secure credits to NGOs that lend to small enterprises. A bank could take these loan portfolios as security and obtain the right to collect repayment from the loan debtors should the NGO default. Alternatively, the bank could resell the debt to another NGO specializing in the handling of such loans.<sup>28</sup> Again, an improved system would not prompt sudden changes of behavior, but new and more efficient practices could spread over time, especially with practical assistance in this area. Finally, improving the legal basis for hire-purchase and leasing would enable more equipment suppliers to obtain the necessary bank finance to support credit sales and leases of capital equipment to enterprises. Cumulatively, such changes could have a dramatic impact over time on the SME sector.

### ***3.2 More comprehensive and efficient systems for security registration and credit information.***

Reform in this area can (a) bring all security interests into a system of registration, (b) simplify the system by bringing registration into either a unified registry or a limited set of registries with well-defined roles, and (c) expand the availability and reliability of credit information. On the registry front, creating a more inclusive and unified system would ease the task of potential creditors in checking for prior liens. This should lower the effective cost of credit by reducing the risks of fraudulent liens and by implication the need for excess security as insurance against risk. A well-crafted registry system could also play the legal role of mechanically determining the priority of security interests (first to file, with very limited exceptions) – thus fostering certainty in the valuation of security, and avoiding unnecessary disputes among creditors.

With respect to credit information, a system that provides reliable and timely information, and that is open to access by all interested parties, should provide special advantages to SMEs that are new or do not have a track record with a particular bank. In this connection, CIB is planning to extend its scope and begin charging fees over the next few years, assuming that bank branches continue their trend of computerizing. When half have computerized, CIB intends to change the reporting threshold from ten lakhs to three, to put all credit information online, and to make this information available, first, to the head officers of all banks, and subsequently, to the NBFIs. These are important steps to open up access and introduce market principles. Further

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<sup>28</sup>World Bank (1996a) p. 30.

steps will be needed to make this system truly available to the public, and to improve the quality of information in the system.

### ***3.3 Effective mechanisms for enforcing credit and security agreements.***

This area is one of the most intractable, since it directly implicates the court system. Options here include (a) comprehensive reform of civil procedure, enforcement of money judgments, and repossession of property; (b) tightening procedure in the *Artha Rin Adalat* or Money Loan Court system; (c) strengthening arbitration and ADR options; and (d) strengthening bilateral enforcement through legal provision for self-help enforcement, the use of “confession of judgment” or *cognovit* provisions in financial contracts, and other means. Increasing the certainty of security interest enforcement, currently at a very low ebb in Bangladesh, should significantly increase the discounted or “repossession” value of collateral, thus increasing the flow and reducing the cost of credit.

In response to very low public faith in the courts, a recent World Bank report suggests major reforms of the judicial system, including: activating the Law Reform Commission (currently in existence on paper but inactive); enhancing the capacity of the courts by improving court administration and information systems, and setting up specialized courts; upgrading judicial selection procedures and compensation packages; increasing the independence of the judiciary; and enhancing supervision and monitoring of lower courts through a permanent unit for this purpose attached to the Supreme Court.<sup>29</sup> All of these steps appear necessary for the certainty of enforcement that underlies efficient operation of credit markets.

The World Bank reform package mentioned above touches on some of these matters. The Bank is also now designing a comprehensive judicial reform project, to be submitted to its board in late 1998 or early 1999. Diagnosis and project design are now ongoing. The project will deal with administration of justice issues such as case management and court administration; increasing judicial independence at least on the civil justice side; and arbitration and alternative dispute resolution. The project is expected to last five to six years. The lead team member at World Bank headquarters in Washington is Mr. Akhtar Hamid.

### ***3.4 Complementary Reforms***

Ultimately, the goal of expanding access to credit for SMEs requires broader action to reduce financial market distortions, and to improve

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<sup>29</sup>World Bank (1996b) p.xxvii.

incentives for efficient credit allocation. Facilitating the move from statist to market-oriented finance -- through privatization and corporate governance reform, for example -- would help reduce corruption, related-party transactions, “default culture” as it is known in Bangladesh, and other distortions that steer credit away from deserving innovators, SMEs, and new entrants. Despite the difficulty of reform in this area, market-based, sustainable credit for SMEs is very unlikely to emerge without such changes.

Secured finance reform can stimulate the market for middle-range credits of the type demanded by SMEs. However, this is not a simple case of “build it and they will come.” The structure of banking sector ownership, competition among financial institutions, corporate governance, and prudential regulation needs to be strong and disciplined enough to encourage bank managers and loan officers to respond competitively to market signals. Obviously, the supply of loanable funds, interest rate spreads, and the level of crowding out by government borrowing also play a critical role in shaping the market power of SMEs. On the other hand, if the newer competitive financial institutions can be insulated from the worst effects of directed lending, crony finance, and “default culture,” it is possible that secured finance reform would help them grow significantly in the SME lending niche. The question is how to achieve this. One approach might be to segment the financial market further, not through interest rate bands (which should be eliminated), but through such means as special legislative or regulatory standards for SME banking. Another means of insulating the SME market segment would be to complete the restructuring and cleanup of the NCBs and denationalized banks, perhaps through a mechanism similar to the U.S. Resolution Trust Corporation, with some provision to prevent the spread of contagion.

Many of these ideas are more properly within the realm of banking reform and monetary policy, rather than secured finance. Still, these changes will be needed in order to create an efficient credit market that can sustainably supply the demands of SMEs. A coordinated reform of secured finance and of banking sector governance warrants consideration.

## Chapter Four: Program Strategy and Implementation

This section explores some key concerns that arise in supporting the changes outlined above through the JOBS Project. This discussion deals with issues surrounding the advocacy of change (including political economy concerns), and those involved in programmatic support and implementation of reforms.

### 4.1 *Advocating Reform*

Any attempt to change the *status quo* will eventually confront disinterest or active hostility from some quarters. In advocating change, the JOBS team will need to focus on the various “plusses” that come with the reform program suggested above, i.e. *more* of the following:

- (i) ability to mobilize the value of a diverse array of assets for credit;  
reliable information available about borrowers, debts, collateral, and encumbrances;
- (ii) certainty of enforcement with respect to loan agreements and security interests;
- (iii) types of potential secured creditors (e.g. banks, NBFIs, dealers) and secured debtors (e.g. SMEs not owning real estate);
- (iv) competition in the financial and real sectors;
- (v) credit available at lower cost; and
- (vi) private sector growth, especially among SMEs.

Who could argue with this? Broadly speaking, two major sources of opposition can be expected to arise: interest groups who fear harm or at least dilution of current advantages, and those whose political commitments and views make them unsympathetic to market-based finance. In countries that have attempted to shift financial systems toward greater market liberalism, and away from either statism or subsidized microcredit, these sources of opposition have often proven intractable. A further dimension to add here is the social stature of the legal system. On the one hand, a society accustomed to operating on the basis of executive fiat and small-scale social norms tends to see little general interest in improving the law. On the other hand, the attitude of legal professionals tends to make this a self-fulfilling prophecy, especially where academically-inclined lawyers dominate the legislative reform process. Fortunately for Bangladesh, this last problem does not seem to apply, though all of the foregoing ones do.

The overall strategy, then, would need to focus heavily on:



- (i) public information about the tangible benefits of reform;
- (ii) close collaboration with the key actors in the relevant legislative and administrative processes;
- (iii) hands-on training where know-how is created and visible benefits conferred through implementing reforms in practice; and
- (iv) coopting opponents by such means as limiting any damage to them or ensuring offsetting benefits.

#### *4.1.1 Legislative reform and registry/information systems*

Secured finance reforms, if successful, would address the major complaint of SMEs, namely the unavailability of working capital and expansion finance on commercially reasonable terms. They would also enable market-oriented financial institutions, such as private banks, investment houses, and leasing companies, to compete more effectively with each other and with the questionable practices of the nationalized banks. Also, reform would support trade, dealer, and supplier credit to the advantage of SMEs needing equipment and inputs, as well as importers and raw material suppliers. NGO lenders and SME associations would benefit, since a reformed system should facilitate onlending of commercial bank funds, using loan instruments as security (this applies more to individual than group loans). Conceivably, the support of Bangladesh Bank could also be enlisted, since reform should eventually bring more certainty to the valuation of assets on the books of regulated financial institutions.

Legal reforms to improve the efficiency and transparency of financial markets do not necessarily draw strong support from SMEs that stand to benefit. For example, manufacturing associations are more interested in pursuing positive benefits from the government -- such as directed credit, VAT relief, and trade protection -- than strengthening finance laws and the legal system. NASCIB has suggested setting aside a revolving credit fund for the sectors it represents (including poultry, horticulture, chemicals, etc.), as well as a special state budget allocation for itself, to enable it better to serve these sectors, providing advice and assistance in intermediating or guaranteeing loans to member industries. One legal issue that does matter to them is intellectual property protection--the Bangladesh Plastic Goods Manufacturers Association has its own committee to resolve disputes among members in this area, and to punish wrongdoers.

One could expect disinterest, or even active opposition, from SOEs, NCBs, certain government bureaus (possibly including registry offices under the Commerce and Land ministries), deed writers, and perhaps the bar. Established firms fearing increased competition, NCBs along with bureaucrats

and politicians peddling influence, registry personnel, and informal intermediaries or “fixers” are all potential opponents.

An advocacy strategy would have to be crafted to maximize understanding of the size and breadth of benefits of reform, to emphasize areas of overlap between the interests of supporters and potential opponents, and to highlight the feasibility of change. However, both the legal reform and the registry dimensions of secured finance reform can be complex. The temptation to split the difference with opponents must be avoided if at all possible, since concessions can easily make the system inefficient, given the interdependence among its many parts. If anything, political horse-trading should be kept on the level of tradeoffs between a fully functional secured finance system and other unrelated benefits.

Within the government, the order of consideration for any legislative reform package is as follows: policy review by Bangladesh Bank, then the Ministry of Finance, followed by legal review by the Ministry of Law and Justice. If the draft passes this review, it will be submitted to parliament, where the opposition can be expected to insist on convening a committee rather than holding a straight vote, but the government majority should prevail in enacting the legislation in essentially the form in which it was submitted. Some observers expect the large defaulter class to intervene at the stage of Ministry of Law review to water the draft down, in order to protect their interests. This approach, apparently, was used successfully by this group to dilute the 1997 Bankruptcy Act. (High officials in the Ministry allegedly have family members involved in major financial frauds and defaults).

The most direct opposition to change can be expected from the large “defaulter” class of well-connected businesses that have benefited from cozy relations with the state and the NCBs. They have already proved to be one of the more difficult lobbies for financial reform to overcome. Some 131 private industrial firms account for 60 percent of non-performing loans in the banking system. Parliament took an interest in this groups’ activities, and seeking to expose them, had CIB draw up a list of the largest defaulters to be published in the newspapers. Apparently, the group intervened in this process as well, diluting the list by the inclusion of small and large defaulters as well as those in other problem loan classifications, with the result that the published list contained 2,117 debtors of various kinds-- thus defeating its purpose. This group has obtained what amounts to an entitlement to the non-payment of loans, which they are likely to defend vigorously against attempts to strengthen governance and legal enforcement in cases of default and bankruptcy.

#### *4.1.2 Improving Enforcement and Governance*

The dynamic with respect to loan enforcement is likely to be one of financial institutions strongly favoring effective enforcement, and debtors – potential and especially actual – opposing it. This area is highly subject to populist/leftist politics in the South Asian mode. Any effort in this area should emphasize pre-emptive consensus-building with SMEs, associations, and NGOs to maximize their understanding of the benefits to entrepreneurs and to development generally of effective loan enforcement. This is not a naturally easy-sell and will require some effort and finesse. Of course, the financial institutions – especially private banks and NBFIs – are natural allies.

Constraining corruption and crony finance faces a difficult collective action challenge: tangible advantages are to be taken from the powerful few in exchange for benefits spread across the SME sector and the economy as a whole. For this reason, this should not be the primary program focus of this component of JOBS. Nevertheless, secured finance and corruption/cronyism/transparency concerns are closely related. An analysis and decision will be required as to whether the political and reform benefits of including such an emphasis are likely to outweigh the short-term costs.

## ***4.2 Implementation Planning***

This final section considers program components aimed at supporting reforms and their implementation once enacted, an important consideration since legal changes are not-self enforcing but interact in complex ways with economic behavior. What would the major components of a program under JOBS in this area look like?

### ***4.2.1 Technical assistance and training***

In order for a secured finance system to work, bankers and other financial intermediaries, firms, officials, lawyers, and judges, among others, will need a critical mass of technical capability. Elements of this component could include (a) legal drafting assistance, (b) registry set-up assistance, (c) court reform and upgrading assistance, (d) TA and training on non-court dispute resolution and enforcement, (e) training on asset valuation and other aspects of banking in this area, (f) training/upgrading of lawyer and judge capability in this area, and (g) assistance to SMEs in business and financial planning. Training and TA are, of course, easy to sell and to package in a way seen as beneficial to all. More hands-on assistance would likely be worthwhile, and could include advising on particular secured finance deals,

default and bankruptcy cases, development of loan procedures and documentation, etc.

The Ministry of Law and Parliamentary Affairs has set up a Law Reform Commission chaired by two former Supreme Court Justices, though this is said to be inactive. The Ministry has also instituted a training program for Money Loan Court judges on financial issues and related matters. The Ministry wishes to be involved in any secured finance reform, and has asked for a concrete proposal. As is often the case, however, it is unclear how helpful the Ministry would actually be. The Legal Reform Commission is tasked with reform of non-commercial legislation. The Ministry of Finance is likely to be more directly relevant and helpful to financial law reform.

#### *4.2.2 Pilot and demonstration activities*

There should be activities aimed at both ensuring the implementation of new laws and demonstrating the concrete benefits of those laws to their potential users. Thus, for example, JOBS could work with NGOs, associations, and others acting at times as financial intermediaries for SMEs, to help them structure transactions in ways that efficiently use forms of collateral such as chattel paper in the onlending of commercial bank finance. JOBS could also cooperate with local governments to introduce secured finance mechanisms into local economic development activities as well as local public (debt) financing. Another example, equally important but less of a “win-win” proposition, is to assist in debt enforcement and bankruptcy actions, perhaps in certain high-profile cases. Defeating the “default culture,” a critical part of this reform program, will require predictable and even-handed application of the law to non-performing debtors. “Frying a big fish” or two through enforcement actions can send an important signal of seriousness about financial market discipline. A further alternative would be to promote commercial practices that incorporate credit (and other components such as know-how), and to demonstrate how secured finance helps make such transactions feasible and sustainable. Examples include various forms of trade credit, onlending of commercial bank funds by NGOs and associations, agency and distributorship arrangements and franchising.

#### *4.2.3 Sequence*

The “roadmap” for an intervention in this area by the JOBS group might look like the following:

- (i) dissemination of this report, summaries of its content, a communique written to encapsulate the findings of the JOBS seminar on SME finance on June 25, 1998, and other materials;

- (ii) establishing collaboration between JOBS and others, such as the World Bank, with overlapping objectives and expertise;
- (iii) discussions with the Ministry of Finance, the Ministry of Law, and other relevant official bodies with jurisdiction in this area, with the aim of obtaining the government's commitment to make secured finance a reform priority and to place it on the legislative calendar;
- (iv) constitution of an officially-sanctioned working group for reforms in this area;
- (v) a workshop bringing together the JOBS group, the secured finance working group, and experts from the region and beyond to study successful reform experiences, identify and prioritize changes needed in the near term in Bangladesh, to fix a reform agenda, and to elaborate a reform strategy;
- (vi) public advocacy and information campaigns on secured finance, aimed at building broad support, coopting opposition, and ensuring a hard core of reform commitment within key public and private constituencies;
- (vii) elaboration of the reform package, including research studies, policy papers, and legislative drafts, by the working group and international collaborators;
- (viii) outreach to parliament, including information, seminars, testimony, and presentation of the reform package;
- (ix) official consideration and enactment of the reform package, with constant support and monitoring by JOBS and partners;
- (x) initial implementation of the reforms through dissemination of enacted legislation, public discussion and information, establishment or revamping of relevant registry and adjudicatory institutions;
- (xi) further implementation through information and training aimed at private and financial sector users of the reforms, along with demonstration projects involving commercial banks, associations, NGOs, local governments, and others in applying secured finance techniques to SME financing under the reformed institutional framework; and

- (xii) analysis and advocacy of complementary economic policy and governance reforms to ensure efficient operation of credit markets.

This sequence of steps is not fixed and represents an ideal or initial vision. This tentative outline or roadmap would need to be discussed with the JOBS group and its collaborators, fleshed out further in the form of a realizable plan and timeline, and adjusted to realities on the ground. Once such a plan is elaborated along these lines, debated, and agreed by the key players, JOBS will need to move forward quickly and press consistently for progress toward achievement of reform in the near term, i.e. within a 12 to 24 month time horizon. Slower progress risks running up against the end of this project and consequent loss of momentum.

# Annex 1

## List of Persons Interviewed

Shamsuddin Ahmad	The World Bank
G.M. Khurshid Alam	The World Bank
Md. Nurul Alam	Rupali Bank Limited
Zahurul Alam	Bangladesh Unnayan Parishad (BUP)
Asif Anwar	Union Capital
Md. Gousal Azam	Bangladesh Shilpa Bank
Ahsanul Azim	United Leasing Company Limited
Khondakar Md. Abu Bakar	Ministry of Law, Justice, and Parliamentary Affairs
Mujibur Rahman Belal	National Association of Small and Cottage Industries of Bangladesh (NASCIB)
M. Biswas	Burns Philp A&B Limited
M. Golam Sarwar Bhuiyan	Micro Industries Development Assistance and Services
Absar Karim Chowdhury	Bangladesh Electrical Merchandise Manufacturers Association
Faisal Ahsan Chowdhury	Prime Bank Limited
Md. Enamul Haq Choudhury	Bangladesh Shilpa Bank
M. Hafizullah	Supreme Court of Bangladesh
Faridul Hasan	United Leasing Company Limited
Manzoor Hasan	Transparency International Bangladesh
Mustafizul Huda	Bangladesh Shilpa Bank
Javedul Huq	HongKong Bank
Syed Jamaluddin	The Federation of Bangladesh Chambers of Commerce and Industry
M.A. Majid Khan	Bangladesh Bank
M. Nazrul Islam Khan	Additional Deputy Commissioner
Alauddin A. Majid	Bank of Small Industries and Commerce
Md. Sirajuddin Malik	The Dhaka Chamber of Commerce and Industry
M.A. Masoom	Bangladesh Electrical Merchandise Manufacturers Association
Kazi Abdul Mazid	Prime Bank Limited
M. Alimullah Miyan	International University of Business Agriculture and Technology
Nasira Mustague (Bashi)	Exporter of Natural Dyed Fabrics, Apparels, and Handicrafts
Muhammed Ohiullah	Orr, Dignam & Co. Advocates
Ziaul Quddus	Swadesh Investment Management Limited
Md. Mizanur Rahman	Bangladesh National Museum
S.M. Aminur Rahman	Sonalli Bank
Syed Shahidur Rahman	Shahid and Associates Law Firm
Richard E. Rousseau	USAID
Mahbub Islam Runu	National Association of Small and Cottage Industries of Bangladesh (NASCIB)
Yusuf S. Sadat	The HongKong and Shanghai Banking Corporation Limited
A.K.M. Sanullah	National Association of Small and Cottage Industries of Bangladesh (NASCIB)
M. Taheruddin	The City Bank Limited
A.S.M. Kamal Uddin	Bangladesh Plastic Goods Manufacturers Association
Md. Nasir Uddin	Bangladesh Paduka Prostukarak Samity
M. Saleem Ullah	Advocate, Supreme Court of Bangladesh





## Annex 2

### SME Sources of Finance: Examples

OWNER/DIRECTOR	BUSINESS TYPE	LOAN TAKEN- SOURCE
Moazzem Hossain	General Shoe Factory	→Initial investment Janata Bank 17% mortgage
Mazi Masuk Ahmed Nabi	Masuk Plastic Industries	→ Initial investment Parents (1 lakh)
Md. Hostafa	Green Rubber Industry	→ Initial investment Bank-3 lakh – 16% Relatives- 8 lakh- 0%
Jashim Uddin	Gamati Rubber and Plastic Ind.	→Initial investment Bank-7 lakh Relatives- 6 lac
Mujibar Rahman	Hafijur Rahman Rubber Industry	→ Initial investment Sonali B- 1.2 lakh – 13% mortgage
Nurul Islam	Islam Enterprise (Wholesale)	→Working Capital Own (4 lakh) Family (2 lakh)
Kazi Mafizul Islam	Ms. Selim Shoes (Wholesale)	→Working Capital 10%-own 60%- advance against orders 30%- family
Monir Hossain	Samrat Shoes (Wholesale)	→ Working Capital 30%- Own 60%- Bank
Kaium Khan	King Iron King	→ Working Capital 25%- Own 50%- Bank 25%- Relatives

## Annex 3

### Sample Bank Interest Rate Schedule

Loan Category	Interest Rate (%)	Subsidy (%)
1. Term loan for large and medium industries	15.00	
2. Working Capital Loan		
Jute industries	15.50	
Others	16.00	
3. Export Loans_	10.00	
4. Commercial Loans		
Jute trading	16.00	
Others	16.00	
5. Term loan for small and cottage industry	12.00	3.00
6. Bridge Loan		
Productive Industries	15.00	
7. Charge/Commission for guarantee	16.00	
Short-term guarantee	+0.75	
Long-term guarantee (guarantee for loan repayment)	+3.00 (Annually)	

## **Annex 4**

### **Sample Loan Checklist**

- 1) Recent passport-size photograph of the borrower
- 2) Picture of proposed property
- 3) Sale deed, khatian, non-encumbrance certificate, dakhila, and valuation certificate of the land. In the case of rented premises, a lease deed for not less than five years.
- 4) Application of the borrower
- 5) Renewed trade license/drug license and registration certificate (if required).
- 6) Declaration from borrower's bank
- 7) Confidential opinions
- 8) CIB report
- 9) Testimony regarding liabilities
- 10) Testimony regarding documentation
- 11) Description of accounts
- 12) Nationality certificate issued by ward chairman 1<sup>st</sup> class gazetted officer.
- 13) Proprietor or partner's C.V.
- 14) List of present machinery (name, number of manufacturer, purchase date, value, etc.)
- 15) Quotation for purchase of machinery and tools.
- 16) Project profile.
- 17) Registered partnership deed/memorandum or Articles of Association, resolution.
- 18) Building and machine layout plan, estimate/expenditure plan, and site plan.
- 19) No Objection Certificate from: Environmental protection officers/Chairman/Commissioner/Housing settlement/Power development Board/Village electricity development no objection certificate.

## **Annex 5**

### **Sample Mortgage Checklist**

1. Borrower's application on letterhead.
2. Borrower's application on prescribed forms.
3. Up-to-date receipt of the land (Dhakhila).
4. Up-to-date municipal tax receipt.
5. Stock inventory statements.
6. Statement of accounts.
7. Up-to-date trade license.
8. Valuation certificate.
9. Income tax payment receipt.
10. Non encumbrance certificate.
11. Mutation Parcha.
12. Original title deed along with receipt.
13. CS, RS, SA Parcha.
14. Road number and holding number of the proposed land.
15. Via-deed.
16. Personal identification of the applicant.
17. Copies of the work-orders (wherever applicable).

## Annex 6

### Sample Procedures from Bank Manual

#### Hire-Purchase

- Bank retains ownership, debtor possesses
- Vehicle registered in *joint* name of bank and client
- Relevant areas: transport sector vehicles, fix investment in machinery/  
equipment, farm machinery, consumer durables
- Asset must be *new*, not obsolete, *not encumbered*
- Cash and collateral securities required (maximum)
- Appraisal of client required
- Purchase price paid directly to supplier's account
- Documents, stamp duty, etc.
- Insurance: book value plus 10%- in joint name of bank and client
- Vehicles: tripartite agreement- bank, client, motor workshop;  
"Owner: X Bank" prominently inscribed on vehicle; delivery and registration under branch officer supervision; hypothecation agent

#### Selection of client:

- Credit report elements: investment (loan) application, market reports through friends/rivals, bank accounts, statement of assets and liabilities/balance sheet, records of Joint-Stock Company (JSC) Registry, income tax statements, wealth/sales tax returns, municipal tax receipts, press reports, chamber of commerce reference, mode of living, personal interview, spot visits, and other bank reports.

#### Creating Charge at JSC Registry:

- Submit form within 21 days of hypothecation agent
- Registry issues "Certificate of Mortgage"
- Submit charge withdrawal form upon discharge

#### Warehousing/Godowns:

- Goods delivered to parties vs. delivery orders signed by *two* officers of bank branch. Verify client signature and adequate payment for goods.
- Godown charges client

#### Hire-Purchase Documents (transport sector):

- Demand promissory note
- Hire-purchase agreement
- Hypothecation agreement
- If partnership, letter of partnership; if limited company, corporate borrowing power
- Personal guarantee of all Directors/Partners

*Bai-Muajjal* Documents:

- Deferred Payment (DP) note
- DP note delivery letter
- *Bai-Muajjal* agreement
- Letter of hypothecation
- Stock report ( one every two weeks)
- Disclaimer letter from landlord in rented godown
- Notarized irrevocable power of attorney to sell hypothecated stock-  
vetted by bank lawyer
- Equitable mortgage, RJSC registration, and personal guarantee of  
directors (if limited company)

## Annex 7

### Sample Documents, Loan Secured by *Salami*

#### UNDERTAKING BY LANDLORD OF THE SHOP NO.....

I,.....(full address) is the owner and landlord of the building at ..... do hereby solemnly affirm and undertake as under:

1. That Mr.....son of.....(full address).....is the holder in possession right of Shop No.....of the building (particulars of the building and shop) who is in possession of the said shops vide contract / agreement dated .....in favour of Mr..... is my tenant in possession of the right and title of the Shop No .....at .....(address);
2. That Mr.....approached your bank for loan of Taka ..... Against pledged of goods and commodities and security of holding the possession right of the Shop No.....of .....and in default of re-payments of the said loan, the Bank being authorised by Power of Attorney executed by Mr .....to sell and transfer the said possession right of the shops to any other person and in that event the undersigned being the owner and landlord of the building shall recognise such transfer and sale as regular tenant like others of the Market/Building.
3. That the undersigned shall co-operate in all respect to realise the loan from Mr. .... as and when so required;
4. That this undertaking is confined and restricted only to the extent of financial facilities allowed to Mr. ....against security of his holding possession right over Shop No. at .....

I sign this undertaking this the

...  
...  
...  
...  
...  
...  
...  
d  
a

y  
of

1998 .....in presence of witness  
mentioned herein.

WITNESSES (with address)

1.

Mr. ....  
Landlord of building at (address)

2.





GENERAL POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS that I, \_\_\_\_\_  
son of..... Dhaka by birth Bangladeshi national by faith  
Muslim by profession business is the holder of possession right of Shop No  
..... at (full address of particulars of the shop) do hereby  
constitute and appoint

my true and  
lawful Attorney to do or cause to do or to be done the following acts, deeds and  
things in the event of default of re-payment of the entire or part of sanctioned or to be  
sanctioned financial facilities of Taka.....  
(.....  
....) in my name:

1. To negotiate sell and deliver possession right of Shop No.....  
together  
togetherwith goods / commodities of the said shops of ..... to any person(s) at  
such reasonable price which my said Attorney in its absolute discretion thinks fit  
and proper;
2. To adjust the financial facilities granted or to be granted to the Executant of this  
Power of Attorney against security of the schedule shops mentioned herein below  
togetherwith goods / commodities of shops and this Power shall continue till full  
adjustment of facilities granted or to be granted in future;
3. To appear in all courts including Civil and Criminal and sign and verify Plaints,  
Written Statements. Petition of claims and objection, Memorandum of Appeal  
and Petitions and Applications of all kinds and to file them in any such courts;
4. To appoint Advocates, Pleaders, Agents or other legal Practitioners;
5. To Compromise, compound or withdraw suits / cases and to confess judgments  
and to refer cases to Arbitration;
6. To take possession or the schedule shops and occupy it for Attorney's own use or  
let out the same to any other person or persons or organisation on such terms and  
conditions as the Attorney deems fit and proper;
7. To realise rents and debts due to me and give receipt for the same and take all  
necessary steps which may be necessary or be expedient for this purpose;
8. To do everything to acquire full control, possession and management of the  
schedule shops togetherwith the goods / commodities stored in the shops;
9. Notwithstanding anything said hereinabove, the Attorney in addition is  
empowered to do or cause to be done (alone at any time, the following acts, deeds and

things namely

- i) to execute any deed or sign any document which may be required or be expedient and to do any other act, matter or things the Attorney shall consider necessary or expedient for carrying out or doing any of the purpose, acts and things hereunder authorised in the same manner and as effectively in all respects as I myself could have done being personally present;
- ii) to appoint any substitute or substitutes and to delegate to him or them all or any of the powers covered other than this powers of substitution and to vary or revoke any such appointment of substitution;

12. That I do hereby ratify and confirm all the aats that the Attorney or any substitute or agent or agents appointed under this powers in this behalf hereinbefore contained shall lawfully do or purported to have been done by virtue of these presents;

Contd-  
P-2



1.3. That this Power of Attorney shall be irrevocable and shall not be cancelled by me without consent of the Bank and till liquidation of my liability with the Bank.

SCHEDULE OF THE SHOP

IN WITNESS WHEREOF, I, ..... set my hand on this the ..... day of..... 1998 in presence of following witnesses.

WITNESSES : (with address)

1.

(Name)  
The Executant

2.



AGREEMENT

THIS AGREEMENT is made at Dhaka, Bangladesh this the day..... of  
....., 1998.

BETWEEN

(hereinafter referred to as the Bank, which expression, unless otherwise  
contrary to the context of this Agreement, shall include its legal heirs, successors-in-  
interest and assigns thereof) on the FIRST PART.

AND

MR. .... (full address) (hereinafter referred to as the  
client which expression, unless otherwise contrary to the context of this Agreement,  
shall include his legal heirs, successors-in-interest and assigns thereof) on the  
SECOND PART.

WHEREAS the client Second Party approached the Bank First Party for financial  
facilities to the extent of Taka ..... (.....)  
against  
security of holding of possession right togetherwith pledge of goods /  
commodities of  
shop No..... at .....

AND

WHEREAS the Bank First Party agreed to extend financial facilities to the extent or  
Taka .....  
(.....) vide its sanction letter  
no..... dated .....

NOW THE PARTIES HEREIN AGREED to the following terms and conditions  
towards  
transaction of the said facilities as under:

1. That the Bank First Party shall pay Taka.....to the client Second Party  
against security of holding the possession tight of Shop No .....at  
.....Fully described in the schedule of shop herein below  
togetherwith goods / commodities (present value) stored in the said shops as  
Pledged and Hypothecated with the Bank;
2. That financial facilities of Taka..... allowed to the Second Party  
shall be repaid @Taka ..... Weekly /  
monthly from the sale proceeds of the shops without fail within (date  
.....)

3. That during the continuation of this financial facilities under this agreement, the Second Party shall not avail or approach any other Bank(s) or Financial Institution against security and pledge of the Shop No ..... Mentioned in the schedule below;
4. That as security of repayments of the loan togetherwith profits, the Second Party has agreed to execute a general Power of Attorney in favour of the Bank authorising the bank to sell the possession right and goods / commodities of the schedule shops to any person/organisation in the event of default of re-payment or adjust the entire or part of financial facilities allowed to the client, Second Party togetherwith profits accrued;





5. The period of this Agreement is valid for ..... months from the date of issue of the Payment Order / Banker's Draft or from the date of crediting the loan amount in the client's account maintained with the Bank and also renewable, if mutually agreed by the parties herein;
6. The physical possession and control of the goods / commodities will be with the client Second Party for his normal business activities but the goods / commodities will be duly insured by a Joint Policy with the Bank at the cost of client covering all possible risk viz. Fire, burglary, theft, riot, civil commotion etc.
7. The client shall make full payment to the Bank as per terms and conditions of the sanction letter mentioned herein above or as may be decided by the Bank or mutually agreed;
8. The client shall sign all the charge documents as may be required by the Bank in this connection;
9. The sanction referred to hereinbefore may be cancelled by the Bank First Party if any of the terms and conditions of this Agreement and the sanction letter is not fulfilled by the client Second Party;
10. The client will furnish weekly stock reports of the goods / commodities pertaining to the Hypothecation of goods signed under this Agreement regularly;
11. The Bank reserve the right to cancel this Agreement either wholly or partially with or without notice or to alter all or some of the conditions hereof at any time without assigning any reason whatsoever to the client;
12. In the case of any dispute arising out of the terms and conditions of this Agreement and the sanction letter or the interpretation thereof, the Arbitration of the Bank's management shall be treated as final and binding upon the client, Second Party;
13. If the client fails to make full payment as described in clause (7) hereof, he will be considered as defaulter and Bank will serve notice upon him to this effect. Upon the service of such notice, the Bank shall have the right to take all the legal actions necessary to recover its dues alongwith costs / damages;
14. In addition to the legal actions, the Bank in the event of default, shall have the exclusive right to take any or all of the following specific steps
  - a) Enforcement of the Power of Attorney to sell the possession right of shops togetherwith goods / commodities in the schedule of shops herein;
  - b) Take over possession of the shops in the schedule alongwith the goods / commodities stored therein as held by the client Second Party at that time;

SCHEDULE OF THE SHOPS



IN WITNESS WHEREOF, the parties herein execute this Agreement on the day and year mentioned above.

WITNESSES : (with address)

1.

**First Party, Bank**

2.

**Second Party, Client**

3.

**Annex 8**  
**Charge Documents, Registry of Joint Stock Companies**

**PARTICULARS OF MORTGAGES OR CHARGES**  
**THE COMPANIES ACT, 1994**  
(See Section 159 & 391)

Name of the Company \_\_\_\_\_

\_\_\_\_\_

Regd. Office  
Regn. No.

Particulars to be tiled with the registrar pursuant to Sections 159 & 391 of a mortgage or charge created by the \_\_\_\_\_

\_\_\_\_\_ and being:

- (a) A mortgage charge for the purpose of securing any issue of debenture ; or
- (b) A mortgage or charge on uncalled share capital of the Company ; or
- (c) A mortgage or charge on any immovable property whenever situated; or any interest therein; or
- (d) A mortgage or charge on any book debts of the Company; or
- (e) A mortgage or a charge not being a pledge on any movable property of the Company except stock-in-trade ; or
- (f) A floating charge on the undertaking or property of the Company.

(Strike out the Sub-Heads (a), (b), (c), (d), (e) or (f) which do not apply)

Presented for filing by

---





Date of the instrument creating or evidencing mortgage or charge and description thereof (a) <b>1</b>	Amount secured by the mortgage or charge (b) <b>2</b>	Short particulars of the property mortgaged or charged <b>3</b>	List of the terms or conditions of extent or operation of relating to any mortgage or charge <b>4</b>	Names (with address and description) of the mortgagee or persons entitled to the charge <b>5</b>	Amount or rate percent of the commission, advance or discount (if any) <b>6</b>

**FORM IX**  
**Consent of Director to Act**  
**THE COMPANIES ACT, 1994**  
(See Sec. 92)

**Filing  
Fee  
Tk, 20/.**

**Name of the Company** \_\_\_\_\_

\_\_\_\_\_ **Consent to act** as Director/Directors of the \_\_\_\_\_  
\_\_\_\_\_ **to be signed and filed pursuant to section 92 (1) (Ka)**

**Presented for filing by** \_\_\_\_\_  
\_\_\_\_\_ **To the Registrar of Joint Stock Companies &**  
**firms,** \_\_\_\_\_

**I/We, undersigned, hereby testify *my/our* consent to act as**  
**Director/Directors of the \_\_\_\_\_ pursuant to section 92**  
**(1) (Ka) the Companies Act, 1994.**

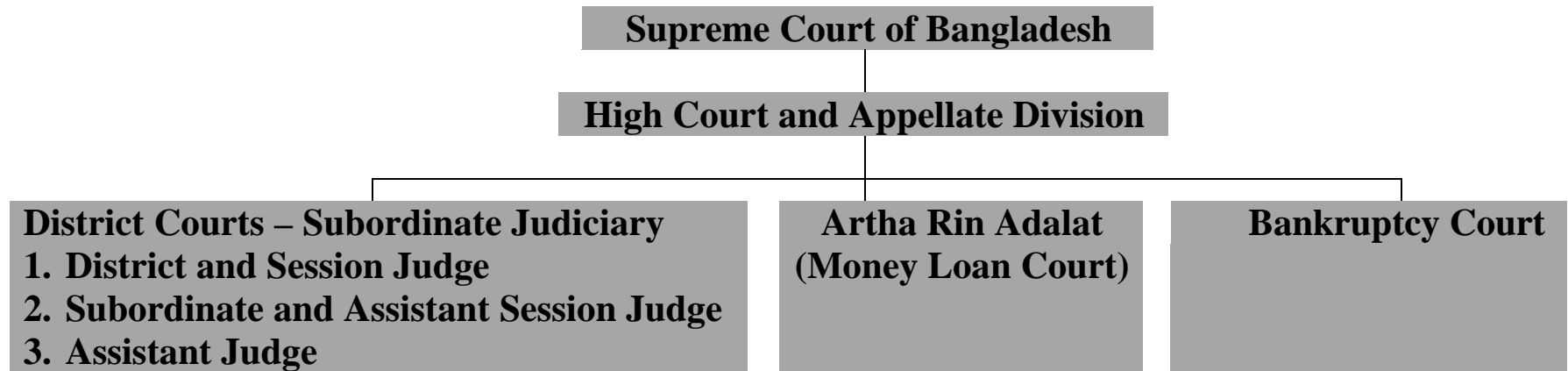
Dated this \_\_\_\_\_ day of 19

**NOTES—If a Director signs by “his agent authorised in writing”  
the authority must be produced and a copy attached.**

SIGNATURE	ADDRESS	DESCRIPTION

## Annex 9

### Bangladesh Court System Chart



## ANNEX 10

### Documentation of June 25, 1998, JOBS Workshop on SME Finance

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# Discussion on Increasing Access to Secured Finance for Small and Medium Enterprises in Bangladesh

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Following is a brief summary of the discussion sponsored by the JOBS Project on June 25, 1998. Each section begins with the main points presented by the discussion leader comments and discussion by the participants

## **Overview**

### **1. SME Finance Issues**

Enterprise and finance provider perspectives

Causes of constraint

### **2. Possible Responses**

Importance of institutions

Reform proposals

Past experience

### **3. Benefits and Costs of Change**

What? To whom?

**4. Strategy for reform**

**5. Communique and conclusion**

## **SME Finance issues: Enterprise perspective**

Access

Cost

Time

Complexity

Margin

Security (collateral)

## **Discussions and Suggestions**

It has been the experience of SME owners that bank officials treat them differently than big enterprises. They claim that banks often do not give enough attention to the SMEs.

Bankers, on the other hand, say that SME owners operate on the assumption that they will not receive any loan from the banks through normal channels, and in many cases go to high bank officials, who are not even concerned with the matter.

Cost and time are inter-related problems, especially in the case of SMEs. SME owners say that excess documentation regarding credit facilities causes unexpected cost/expenditure to them. They have also said that the present documentation system of scheduled banks is unnecessary and time-consuming. Consequently, it takes a much longer period to complete all loan /credit formalities.



Scheduled banks do not have any proper, effective guidelines to provide to the SMEs, explaining how to proceed with the credit system. This lack of accountability gives rise to complexity.

SME owners believe that all banks require a large amount of collateral security from them, which is impossible for them to provide. They have suggested that this requirement be removed, but bankers argue that collateral security creates pressure for the SMEs to repay loans.

### **SME Finance issues: Finance provider perspective**

Risk

Information

Cost

Repayment

Enforcement against defaulters

Security (collateral)

### **Discussion and suggestions**

Some of the bankers said that risk is low for SMEs. Since they are required to provide collateral security, they are more strongly bound to repay than the big enterprises. They have also stated that since most of the SMEs do not have permanent places of residence, they are difficult to locate in case of loan repayment problems.

According to the bankers and SMEs, owners' lack of information on banks affects the entire loan

procedure.

Bankers expressed a very positive view towards SMEs in connection to repayment of loans. In their opinion, SMEs are very efficient in repaying loans. Whenever a bank sends any notice or letter regarding loans SMEs generally respond very quickly to their notice/letter. Big enterprises, however, are not as efficient in their repayment of loans and rarely respond to any letter or notice from the banks.

SME owners believe that most of the banks are biased toward big enterprises because they are relaxed and flexible in respect of



credit/loan facilities and loan repayment. It was agreed in the discussion that government and banks are more interested in helping big, established enterprises than SMEs. In connection to this statement an example was given that in 1977, 82 crore taka was sanctioned for the agricultural sector, and 50% of the loan money was not repaid.

Enforcement against default and recovery of security is not effective due to cumbersome laws and a weak legal system. Some of the bankers believe that there should be separate procedures for the banks to recover loans besides going to court. They also believe that going to the court is not consistent with the banking culture.

### **Causes of the Financing Constraint:**

Conservative bankers and risky borrowers

Macroeconomy

Banking regulation

Directed lending and lending to directors

Corruption

Law and the legal system

### **Discussion and Suggestions**

According to the bankers and SME owners, big enterprises manipulate the banking system through corruption for their own benefit.

Participants in the discussion expressed concern

about bank directors taking out loans under aliases and then failing to repay the loans on time. This was identified as one of the problems causing the financing constraint. An example of a solution to this problem was presented by a



prominent banker, who stated that in Pakistan, bank directors are prohibited from taking out loans from that bank within five years of the start of operations of that bank.

All participants agreed that ineffective and insufficient laws and legal system are the most prominent factors causing financing constraints.

### **Responses to the Financing Constraint:**

#### *Institutional change to Augment the SME Credit market*

Legal reforms: *secured finance, collateral registration and credit reporting, enforcement procedures*

Registries and information flow

Enforcement mechanisms

Governance and regulation

Know —how

### **Discussion and Suggestions**

Participants agreed that a number of reforms are needed. Information regarding banks as well as SMEs should be more public and transparent. Reform packages should be prepared by experienced consultants. Concrete steps should be designed for proper enforcement mechanisms.

Most of the participants agreed that bureaucrats are the biggest obstacles to any kind of reforms.

It was also suggested that steps be taken to sensitize

interested parties. Sufficient information should be given to interested people so that they are encouraged to participate in the reforms





It was also proposed by some that the government should allocate some amount of credit for SMEs. There should be a specific definition of SME for this purpose.

## **Benefits and Costs of Change:**

### *What and to Whom?*

Diversity of collateral in use: *equipment, vehicles stock(inventory), accounts, chattel paper, "salami"*

Information available about borrowers, debt collateral

Enforcement of loan agreements and security interests

Types of potential creditors and debtors

Market forces vs. state, cronies, and subsidy

Competition in financial and real sectors

Credit availability and cost

Private sector growth

## **Discussion and Suggestions**

It was suggested that the group look at change as occurring in a dynamic system, i.e. that although some groups face costs or losses from change, they discover simultaneously that the same changes offer certain benefits and opportunities. Some of the people and organizations that would be affected by change, positively or negatively, are:



### Benefits of Change:

Most Banks, NBFIs, Borrowers Consumers, Lawyers,  
Judges

### Costs of Change

Bureaucrats, Govt Banks, Defaulters

Some Financiers

Corrupt people



## **Discussion Participants**

Discussion Leader: Patrick Meagher, IRIS Center,  
University of Maryland.

JOBS Staff and Consultants: Naushad Faiz,  
Azharul Huque,

Sultana Nahar, Advocate

Shahzia Sultana, Advocate

Nahid Yasmin, Advocate Invited Participants:

[From Attendance List]



# **JOB OPPORTUNITIES AND BUSINESS SUPPORT (JOBS)**

**(Program funded by USAID/Bangladesh)**

**House 101, Block C, Road 13 A, Banani, Dhaka-1213**

**Tel: 608705, Fax: 886154, Email: Info@jobsiris.dhaka-bd.net**

Date June22, 1998  
To Distribution List Attached.  
From Zia Uddin Alimed, Team Leader, JOBS Program

Subject: **Invitation to Participate in a Discussion on Secured Financing  
Issues of Small & Medium Enterprises in Bangladesh.**

Dear Sir/Madam:

The JOBS Program invites you to an important discussion on Thursday June 25, 1998. The topic of the discussion is ***Increasing Access to Secured Finance for Small and Medium Enterprises in Bangladesh***. This discussion will take place at the Conference Room of Bangladesh Unnayan Parishad (BUP) at Road 4, Dhanmondi R/A from 10 AM to 12:30 PM (detailed location & address below). Invitees include the JOBS Working Committee, along with additional guests from the small and medium enterprise (SME) sector, the financial institutions, NGOs and associations, the legal profession, and the Government of Bangladesh.

The purpose of this meeting is to discuss the findings of a team now concluding a study of SME finance issues, to comment on the draft report, to discuss possible ways of achieving necessary reforms in this area, and to chart a strategy and plan of action for the JOBS Program in this field. The discussion will touch on such issues as:

- a. Reformed legislation to expand and simplify lending against movable and intangible security.
- b. More efficient systems for registration, credit information, and financial contract enforcement.
- c. Greater transparency and know-how in SME financial transactions.
- d. Specific areas where improved secured finance systems can increase the flow of SME credit, such as on-lending of commercial bank funds by NGOs and associations.
- e. Strategies for coalition-building and cooperative work among JOBS partners to achieve reform.

The JOBS Program depends on the expertise and commitment of people like yourself, and we encourage you or your representative to attend the meeting and to share your views and comment on our draft presentation.

Venue : Bangladesh Unnayan Parishad (BUP)



33, Road 4, Dhanmondi R/A  
Dhaka- 1205  
Tel: 868809, **508097, 505669**  
Fax: 867021

***IRIS* Center of University Research Corporation,  
International University of Maryland at College Park,  
Maryland, USA**



## List of Invitees

1. Dr. Shamsuddin Abmad, Financial Analyst, The World Bank
2. Mr. A.S.M. Kamaluddin Abmed, President, Bangladesh Plastic Goods Manufacturing Association
3. Mr. Abser Karim Chowdhury, President, BEMMA
4. Mr. Golam Sarwar Bhuiyan, Chief Program Officer, MIDAS
5. Mr. Alauddin Majid, Managing Director, BASIC
6. Mr. M. Taheruddin, Managing Director, The City Bank Ltd.
7. Mr. Kazi A. Majid, MD, Prime Bank
8. Mr. Javedul Huq, Corporate Banking Manager, Hong Kong Bank
9. Mr. Nasiruddin Abmed, Executive Vice President, Al-Baraka Bank
10. Mr. Mohd. Nurul Alam, Deputy General Manager, Rupali Bank
11. Mr. Ahsanul Azim, Manager, United Leasing Company
12. Mr. Majid Khan, Executive Director, Bangladesh Bank
13. Mr. A.M.A Muhit (Former Finance Minister)
14. Dr. Mizanur Rahman, Law Department, Dhaka University
15. Dr. Momtaz Uddin Ahmed, Economics Department, Dhaka University
16. Dr. Zaid Bakht, Division Chief and Senior Research Fellow, BIDS
17. Mr. Shamsul Alam Miah, Senior Scholar and Program Director, BUP
18. Dr. Zahurul Alam, Research Director, BUP
19. Mr. Azim Syed, Management and Training Consultant, JOBS Program
20. Mr. Ziaul Quddus, Executive Director, Swadesh Investment Management Ltd:
21. Mr. Manzoor Hasan, Executive Director, Transparency International Bangladesh
22. Prof. Mozafar Ahmed, Advisor, Transparency International Bangladesh
23. Ms. Raka Rashid, JOBS Program Manager, USAID
24. Dr. Najmul Hossain, Food Security Team, USAID
25. Mr. Gaziul Huq, Joint Chief, Planning Commission, GOB
26. Mr. A.K.M. Sanaullah, Secretary General, NASCIB
27. Mr. A.K.M. Khairul Alam, Joint Chief, MOI
28. Mr. Nurul Islam, Deputy Secretary, ERD
29. Mr. Fazlul Kader, Deputy General Manager, PKSF
30. Mr. Fakir Abdus Salam, Director Registration, NGO Affairs Bureau
31. Mr. Md. Shahabuddin, Deputy Director Programmes and Head of PRD, Proshika
32. Mr. Madhab Sarker, Senior Program Coordinator, SEED Program, Proshika
33. Ms. Rafiqua Akhter, JOBS Coordinator, Proshika
34. Ms. Shamira Haider, SME Specialist, Proshika
35. Mr. A.A. Sabri, JOBS Coordinator, Proshika
36. Mr. G. Kibria, Joint Coordinator, Proshika
37. Ms. Shahin Akter, Deputy SME Coordinator, JOBS Program, IRIS/Bangladesh

38. Dr. Naushad Faiz, SME Coordinator, JOBS Program, IRIS/Bangladesh

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