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**THE MARKET FOR LOAN CAPITAL FOR
SMALL FIRMS IN BANGLADESH: LOAN
EVALUATION, MONITORING AND
CONTRACTING PRACTICES.**

**A THESIS SUBMITTED TO THE UNIVERSITY OF
MANCHESTER FOR THE DEGREE OF DOCTOR OF
PHILOSOPHY IN THE FACULTY OF ECONOMIC AND
SOCIAL STUDIES.**

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ABSTRACT

There are different strategies for economic development which a country may choose, considering appropriateness and practicability. In the Bangladesh case, small firm development was adopted as a strategy for attaining economic development. Such a strategy may not bring the envisaged level of success or may fail due to problems of implementation and institutional difficulties related to the economic units concerned with its execution. One key institution is the financial market. It is evident that an economic development strategy through small firm development needs financing to secure development objectives.

The purpose of this research is to evaluate and ascertain the role and contributions of the financial institutions involved in lending to small firms in line with macro and micro economic framework adopted and practised in the financial markets in Bangladesh. To evaluate and analyse the financial institutions' role this research has four broad hypotheses and will endeavour to test those by adopting qualitative research approach. In addition, there is one hypothesis concerning the entrepreneurs who own and manage small firms.

The theoretical frameworks is established through a interdisciplinary literature review which seek to establish links between financial institutions and economic development. This theoretical framework is established at two levels, macro and micro. At the macro level, models and literature relevant to economic development for a country such as Bangladesh is reviewed. At the micro level theoretical frameworks literature and models for lending in general and for small firms in particular are discussed and reviewed.

The research attempted to analyse practices of lending to small firms by financial institutions in Bangladesh by considering a general framework for lending developed from the standard procedures evolved and practised in developed countries such as the UK and the USA. Empirical data and other information has been used to develop an overall review of lending practices in existence among financial institutions for financing small firms. This demonstrates that ineffective lending procedures are persistent.

The important inferences which may be drawn from the empirical work done is that lending procedures are not a complete and sharply directed to deal effectively with the economic development strategy based on small firm development. The other important aspect is the demand side comprising small firm owners/entrepreneurs'. It is observed that the entrepreneurs are lacking important characteristics to make the strategy a success. Additionally, macro and micro economic policy formulators and persons involved in implementing those policies are also found to be party to the ineffective growth performance of small firms.

It is therefore recommended that lending procedures be pursued which will be objective-oriented and be best-practice based on special criteria conducive to the development of small firms. A concept of 'participation' banking/lending is developed. The lending model should continue to be applied and the lending function should not cease to operate after the loan is sanctioned. Rather it is essential to have regular monitoring of loan, and contracting should be viewed as a means of establishing longer term relationships with the counselling and advice necessary for growth of small firms.

The research issues and hypotheses and empirical work done will provide a basis for further research in related areas.

There are twelve chapters in the thesis. Chapter one refers to Bangladesh and a brief overview of the country. Chapters two to six covers detailed literature reviews on economic development, small firm growth, lending to small firms and a standard lending framework for Bangladesh. Chapter seven deals with research issues. Chapter eight refers to field work, and chapter nine refers to financing culture in Bangladesh. Chapters ten and eleven deal with the analysis of empirical data. Chapter twelve concludes with recommendations.

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LIST OF ABBREVIATIONS

ADB : Asian Bank Development.

ADP: Annual Development Programme.

BDTk.: Taka, Bangladesh Currency

BIBM: Bangladesh Institute of Bank Management.

BOI: Board of Investment

BPC: Bangladesh Planning Commission

BSCIC: Bangladesh Small and Cottage Industries Corporation.

Cr.: Crore, Taka 100,00000 makes a Crore

DFI: Development Financial Institution

GB: Grameen Bank

GOB: Government of Bangladesh

IDCP: Interest During Construction Period

Lacs (in Taka): 100, 000 Taka

PDB: Power Development Board

SAP: Structural Adjustment Facilities

SCI: Small and Cottage Industries

Tk.: Taka, Bangladesh Currency

UNDP: United Nations Development Programme

UNIDO: United Nations International Development Organisations.

WB: World Bank

DEDICATION

MY PARENTS AND WIFE

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THE AUTHOR

The author received his Bachelor of Commerce with Honours and Master of Commerce in Finance from the University of Dhaka in 1988 and 1989 respectively. In 1990 he joined a leading DFI, Bangladesh Shilpa Bank (Industrial Development Bank of Bangladesh) as a Senior Officer and served there for a year. In 1991 he joined Bangladesh Civil Service: Audit and Accounts Cadre, as an Assistant Accountant General, he worked at the office of the Comptroller and Auditor General until he came to Manchester in September 1993 to study for the degree of MSc. He completed his MSc in 1994. As a part of the MSc course he did research, titled: Uses of Accounting Information for Bank Lending Decision: With Special Reference to Small Business.

In 1995 he started PhD the topic: The Market for Loan Capital for Small Firms in Bangladesh: Loan Evaluation, Monitoring and Contracting Practices. He went to Bangladesh in mid 1995 and spent about six months for field work. On coming back at the end of 1995 he resumed his research work by analysing data.

He tutored on the Financial Decision Making course to the students in the Department of Accounting and Finance, Manchester University.

He has published some articles (non-research) in the Journal published by the Institute of Cost and Management Accountants, Bangladesh and he used to write in Daily News Paper on various economic issues.

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Chapter One

An Introduction to Bangladesh.

1.1. Geography and a Brief Historical Background.

Bangladesh is a unitary and sovereign republic known as the People's Republic of Bangladesh. It is a riverine based country of 147,570 Square Km area, surrounded by India in the north, west & east and by Myanmar in the east and in south by the Bay of Bengal (Bangladesh: Economic Review, 1995; Bangladesh: A New Horizon for Investment, 1994).

Recorded history of what is presently known as Bangladesh is traceable to the 4th century B.C. with clear evidence of a flourishing civilisation consisting of cities, places, temples, forts, seats of learning and monasteries. Islam spread in the eleventh century through the missionary activities of the Muslim Sufis and Arab traders and through Muslim conquests. In 1200 A.D Muslim rule emerged in the Indian sub-continent and for about five hundred years this region had been under the rule of the Turko-Afghans and the Mughals. History says people had enjoyed periods of prosperity under Muslim rule. By the end of the 16th century Europeans started coming in and British rule began in 1757 and remained until 1947. It is also noticeable from history that during the 17th century economic well being was attained. In 1947 on the departure of the British from the Indian subcontinent the area now known as Bangladesh became 'East Pakistan' as a part of Pakistan. In 1971 Bangladesh emerged as a sovereign state through an armed struggle for freedom (Abdullah and Zeidenstein, 1982; Bangladesh-A New Horizon for Investment, 1994; Media Guide, 1996).

Since its independence Bangladesh has been trying to attain sustainable economic development. And with this end in view Bangladesh has been undertaking various types of policies and programmes, and one of the most important of these is the pursuit of industrialisation through the development of small firms. Experience from neighbouring

countries especially the Newly Industrialised Countries (NICs) some of which are also known as Asian Giants (i.e., South Korea, Malaysia, China, Japan) has encouraged the country to seek development through small firms. The focus of this thesis is on economic development via small firm development in Bangladesh and it seeks to examine the macro policies of the country in this respect, by evaluating the role of financial markets and institutions, and other related agencies and economic units to assess their role in the success or failure of this policy and also try to locate the position of small firms' owners/entrepreneurs in this important aspect of the economy.

1.2. Demography.

Bangladesh has a population of 117.7 million according to the 1994 census, with a density of population of 798 persons per square km. The rate of literacy is about 32.4 percent. Out of the total population about 85% live in villages, 86.6% are Muslims, 12.1% Hindus, .6% percent Buddhist, .3% is Christian and .4% others. About 1.2 million tribals live in the country, half of them in the hilly areas. The Sex ratio is 106 males per 100 females. The territory comprising Bangladesh was inhabited in pre-historic times by certain types of ethnic groups but predominantly mixed groups of proto-Austroloids/Dravidians and Proto-Mongoloids. Later came the Dravidians, Aryans and Mongolians. Migration from other countries has not been experienced by Bangladesh excepting a very few cases e.g., individuals who have come to Bangladesh having job with international/multinational organisations and who have taken up residence.

1.3. Education, Culture and Society.

In Bangladesh there are four strata of education, namely - Primary (having five years schooling), Secondary (five years high schooling), Higher Secondary (two years college) and University Education (duration depends on the type of courses, from two to four years in graduation level and from one to two years in post-graduation level).

Bangladesh has 96,367 primary educational institutions, 11,095 secondary schools, 989 colleges, 17 universities including 6 in the private sector. There are some specialised colleges to produce technical manpower in areas like agriculture, engineering etc. There are 17 medical colleges, 4 engineering colleges, 20 polytechnic institutes, 2 agriculture colleges. Apart from these there are also madrasahs (educational institutions to teach Islamic religion based courses). The culture is predominantly biased by the people's religious belief, but the country has inherited many cultural festivals, functions from migrants and the neighbouring countries, especially India as Bangladesh was a part of the undivided Indo-Pak subcontinent. Bangladesh is a country of several origins, cultures, ethnic groups and religions. The society of Bangladesh both pre and post independence periods is plural. As the majority of the people are brown skinned, societal segmentation have not been based on colour but on the wealth and resources. Income levels generally determine class divisions but other factors such as profession and education are relevant.

1.4. General Economic Condition.

Generally speaking Bangladesh is a country where economic development has not yet been achieved despite various efforts towards development. It can be termed as a developing country having all the relevant criteria of a developing nation. Bangladesh like many other countries, has undergone a major shift in its economic philosophy and management since independence. On its birth more than two decades ago it embraced socialism as the main economic ideology with a dominant role for the public sector. But with the change that took place in political and economic thought shortly thereafter, Bangladesh was quick to undertake a major restructuring towards establishing a market economy with the major thrust coming from the private sector (Bangladesh: Economic Review, 1995). At present Bangladesh is a market economy where both private and public sectors are present. Currently certain strategies for acquiring stable and sustained economic development have been identified for the country for example maintaining macro economic stability, enhancing competitiveness, increasing investment both in public and private sector, alleviating poverty and generating employment etc. (ibid,

1995). Bangladesh remains an economy based primarily on agriculture and an 'import' based country, with a permanent negative balance of payments (International Trade, 1995), although it earns foreign exchange through exporting several traditional products i.e., jute, jute goods, tea and non-traditional products such as garments, fish, vegetables, and manpower.

Bangladesh has industries of various kinds i.e. manufacturing, non-manufacturing and service. Manufacturing industries which are large, medium and small scale are present in jute, textiles, electronics, food processing, pharmaceuticals, garments, knitting, and paper amongst others. Attaining economic development through reducing dependence on the pure agricultural sector and by increasing investment in industrial sectors has been adopted by successive governments. It is the government's policy to seek to ensure that investment takes place in activities with the greatest potential for creating economic flexibility and efficiency in line with the country's comparative advantage and poverty alleviation needs. Consequently investment activities with high labour intensity has been identified as crucial to achieving sustained increases in growth and employment opportunities, given Bangladesh's limited domestic market and a large and fast growing (3 percent per annum on average) labour supply, which is its principal source of comparative advantage. Within this framework, government policies and programmes have been undertaken to pursue industrialisation which give top priority to small firms' development.

In addition to the manufacturing sector there are some other economically significant sectors like transportation (roads, and water) and tourism which have received promising attention from prospective investors. Private investment in luxury buses, passenger carrier launches and also in making bodies for these carriers has been significant, which has aided the expansion of linkage industries. Investment in the tourism sector by neither the private sector nor by the public sector has been important yet. The private sector has been reluctant to provide the large investments needed in tourism but the public sector has not invested in the opportunities offered in this sector. It may be noted that this sector Bangladesh has the longest uninterrupted strand of golden sand in the world in Cox's Bazar.

It is obvious that Bangladesh has to strive for much higher economic growth given its current low level of income and the tremendous challenge offered by the need to reduce poverty reduction. While the 2.5% average per capita GDP growth achieved in the last five years i.e., 1990-1994 compares favourably with many developing countries, it is significantly below the growth rate (above 4 percent) that is needed to tackle Bangladesh's extreme poverty problem (Islam, 1978; World Bank, 1995). To achieve such a higher rate of economic development Bangladesh would need to increase its rate of investment from 12%-14% of GDP to a level of approximately 20% of GDP as observed in other low income countries (ibid, 1995). A number of general factors may be identified as potentially significant in determining investment in the business sector of an economy.

In all economies financial markets and financing institutions have a potentially significant role to play in fostering proper growth and development. It is because financial markets can encourage individuals to release their savings for productive investment by reducing their holdings of unproductive tangible assets and can also improve the allocation of investible funds in several ways: pooling funds and acquiring information that enables them to allocate capital to its highest valued use; providing maturity intermediation by offering liquidity to savers and, at the same time, longer term funds to investors, so stimulating productive investment; and evaluating investment project and valuing the expected profits from expected innovative activities (Fry, 1995).

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange which reduces the costs of transactions. It facilitates trade and, therefore, specialisation in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price, and exchange risk. Trade, the

efficient use of resources, saving, investment, and risk taking are the cornerstones of a growing economy (World Bank, 1989). In the next chapter a broader discussion on the role of financial system and financial institutions will be made.

This argument may be offered in the Bangladesh case. In other countries e.g., Japan, Germany, the UK, India, and South Korea, financial institutions have been seen to exercise an influence on the success or failure of businesses especially small firms. Financial intermediaries are the only source of external funds for majority of small and many medium sized businesses because information costs are prohibitively high for them to issue equity or bonds (Cameron, 1970; Bolton, 1971, World Bank, 1989; Germidis et al., 1991; Fry, 1995). The ability of the financial system and financial institutions in Bangladesh to finance the business sector (particularly the small firm sector) has been addressed by the government through support from some international organisations like, World Bank, and ADB etc.

It is also noticeable that economic development and the over all growth of an economy may depend to an important extent on the legal framework or legal system and proper accounting in the lending arena of the country (World Bank, 1989). Bangladesh has not yet pursued law reformation with regard to trades and businesses as a means of facilitating economic development although the government has initiated some steps to reform the legal framework for markets and the judicial system, the process is incomplete in many instances and progress has been very slow in other cases (World Bank, 1995). In addition to business law other aspects of the legal system, such as tariff, licensing and business registration may have an important role in affecting the total pace of economic development. Finally, fiscal incentives to investment may be important. In Bangladesh there exist liberal investment policies to encourage local private and direct foreign investments (Industrial Policy, 1991; Bangladesh: A New Horizon for Investment, 1994; Guide to Investment in Bangladesh, 1995) but there is as yet little evidence that effective responses from investors are satisfactory (World Bank, 1995; World Bank 1996). We now turn to a more detailed discussion of the financial system of Bangladesh.

1.5. Financial System in Bangladesh.

1.5 (i): General.

A financial system, fairly narrowly, may be defined as a set of markets, and individuals and organisations who trade in those markets. The end users of the system are people and firms whose desire is to lend and to borrow; in other words it may be stated that the job of a financial system is channel funds from those with a surplus to those with a deficit by using some means i.e., financial instruments through some platform i.e., intermediaries (Howells and Bain, 1990). From the above statement it may be said that the financial system is composed of several economic units i.e., financial and non-financial. Non financial but actively related and involved with the total financial system in adding value to the economy organisations may be termed as the trade and business organisations. On the other hand the financial economic units constitute financial markets, wherein some sort of financial product is being traded. Apart from that the financial system has some sort of regulatory body to contain and control financial irregularities in the financial market i.e., central bank (Kohn, 1993; Howells and Bain, 1990).

Financial markets are a means whereby command of the resources arising from acts of saving is made available to investor (Lewis, 1995). Financial markets can be effectively divided into two types: (i) the direct financial market serviced by brokers, dealers, and investment bankers; and (ii) the intermediary market where banks, savings and loans, and other intermediaries participate (Meyer, 1986).

Financial systems in developing countries are often either a legacy of colonial times or copies of the financial set-up in developed countries. From the institutional point of view, the developing countries would seem to be well endowed, with a vast range of both banking and non-bank institutions and intermediaries. This may thus include: a central bank, a treasury administration, capital market e.g., stock exchange, commercial (nationalised or private, local or foreign) banks, merchant banks, development banks, savings banks, specialised financial institutions, building societies, insurance companies, a post office savings network, and credit co-operatives (Germidis et al., 1991).

The financial system of Bangladesh is not different from those of other developing countries about which some examples have been provided in above discussion. The financial system is composed of a central bank i.e., Bangladesh Bank, a treasury administration i.e., Finance Division, Banking Division under the Ministry of Finance and Banking to formulate further macro-banking policies in consultation with the central bank, commercial banks: state owned, private, and foreign, development banks, specialised banks, insurance companies: state owned and private, stock exchange, investment banks, postal savings bank, and co-operative banks.

The financial system of Bangladesh entered into a new era when the then east Pakistan became after the inception of Bangladesh as an independent country in 1971. At that time all the commercial banks and other financial institutions then in the private sector were nationalised. Six nationalised commercial banks (NCBs) were established taking over the assets and liabilities of the private commercial banks as part of a policy of introducing a socialist economic framework in the newly liberated country. Under this nationalisation programme of financial institutions all general and life insurance companies were taken into public sector under the names of Sadharan Bima Corporation (General Insurance Corporation) and Jiban Bima Corporation (Life Insurance Corporation). In 1972 two development financial institutions were established especially for financing industries ranging from small to large size. These were the Bangladesh Shilpa Bank (Bangladesh Industrial Development Bank) and the Bangladesh Shilpa Rin Sangstha (Bangladesh Industrial Credit Corporation). From 1976 the government's philosophy towards national economic policy began to change as nationalised industries were gradually privatised and more participation in industry from the private sector in the form of private entrepreneurs and investors was encouraged. In 1982 macro-economic policies were further modified and liberalised so as to attempt to ensure stronger participation by the private sector in all the sectors of the economy including the industrial and banking sectors. Due to this a considerable number of banks, insurance companies and investment banks were established between 1982 to 1989 in the private sector. In 1986 the government issued its New Industrial Policy 1986 (NIP 1986), which was further revised in 1991, and as part of this programme further efforts

were made to extend the participation of entrepreneurs in the economy and strengthen the role of banks, for example, by lowering bank rate from 9.75% in January 1990 to 5.5% on March 1993, providing funds from the government for some specific purpose e.g., financing small firms, and reducing control from the central bank as far as credit ceilings and interest rates are concerned to ensure competitiveness among banks in the pursuit of economic development (Perspective Plan, 1995-2010; Bangladesh Economic Review, 1995).

1.5. (ii). Financial Institution.

The role of financial intermediaries such as commercial banks, in capital formation, investment and narrowing savings-investment gap cannot be overemphasised (Lewis, 1995; Peasnal and Ward, 1985). The financial intermediaries can be identified as having a number of functions, for example risk pooling, reduction and allocation, shifting maturities, transforming illiquid assets into liquid liabilities and breaking up large denomination bonds and loans into amounts convenient to small savers, combining debtor obligations into large amounts convenient to the wealthy. A satisfactory fulfilling of these functions may contribute to the effective running of a financial system (Kohn, 1993; Meyer, 1986; Peasnal and Ward, 1985; Tobin, 1989). The presence of financial intermediaries is inevitable for promotion and development of trade, business and industries (World Bank, 1989).

At present there are forty financial institutions/credit granting bodies for financing various types of trading and businesses, excluding the central bank i.e., Bangladesh Bank (BB) in Bangladesh. Of which twenty seven are commercial banks in the private and public sectors, and local, joint venture and foreign investment oriented; four of these twenty seven are owned by the government and the rest i.e., twenty three are in the private sector. Out of these twenty seven commercial banks, nine are foreign banks. All banks have to comply with certain banking regulations and norms as far as their banking businesses are concerned by following the Banking companies Act 1991 (Resume of the Activities of the Financial Institutions in Bangladesh, 1995; Bangladesh Economic

Review, 1995; Guide to Investment in Bangladesh, 1995). Apart from that the banks are free to operate their own businesses in accordance with their respective policies and objectives. The central bank of Bangladesh, the Bangladesh Bank (BB) has given full autonomy to banks to determine interest rates and service charges on the loan given for all types of businesses excepting loans for agriculture, exports and small and cottage firms. From mid eighties, in comparison to the past a very competitive atmosphere appeared to be prevailing in the financial market of Bangladesh as far as the products' merchandising of financial products is concerned. It is due to the entrance of a good number of banks and financial institutions i.e., about eight to ten in the financial market in the early 1980's (Resume of the Activities of Financial Institutions in Bangladesh, 1995). Apart from twenty seven commercial banks, there are thirteen financial/financing institutions composed of development financing institutions, specialised and programme based financing institutions. Out of these thirteen, there are two development financing institutions i.e., Bangladesh Shilpa Bank [Industrial Development Bank of Bangladesh (BSB)] and Bangladesh Shilpa Rin Sangstha [Bangladesh Industrial Credit Corporation (BSRS)] for lending to industries, usually to large and medium size firms, there are two banks for agricultural loan and vis-a-vis this sector's development i.e., Bangladesh Krishi Bank [Bangladesh Agriculture Bank (BKB)] and Rajshahi Krishi Unnayan Bank [Rajshahi Agriculture Development Bank (RKUB)], there are two financing institutions to provide financing for small firms, these are: Bank of Small Industries and Commerce (BASIC) and Micro Industries Development Assistance Services (MIDAS), there are two banks based on some objectives e.g., poverty alleviation, these are Grameen Bank (GB) and Bangladesh Shamabai Bank [Bangladesh Cooperative Bank Ltd. (BCBL), there is one investment bank i.e., Investment Corporation of Bangladesh (ICB), there is one specialised financing body for lending to house building i.e., Bangladesh House Building Finance Corporation (BHBFC). In addition to these there are two leasing companies e.g., Industrial Development and Leasing Company of Bangladesh (IDLCB) and United Leasing Company Ltd. (ULCL). There are two other joint venture specialised financing bodies for financing large industries and firms i.e., Saudi-Bangladesh Industrial and Agricultural Investment Company Ltd (SABINCO) and Industrial Promotion and Development Company of Bangladesh (IPDC). The existence of

multivariate financial institutions in Bangladesh depicts the complex nature of financial markets and possibly provides some scopes for a competitive business atmosphere among the financial institutions.

1.5. (iii). Market for Loan Capital for Small Firms in Bangladesh.

It may be argued that without a market for loan capital to finance small firms, any policies and programmes to enhance their development and through them economic development in general would be unlikely to succeed. The Government planned for the equivalent of £135 million (at current prices) to be invested in small firms during 1985-90, under the Third Five Year Plan (TFYP, 1985). Of this about £95 million was planned to come from the financial market i.e. Banks, DFIs and some specialised banks and the rest from the private sector i.e., from private entrepreneurs in the form of equity. During the Fourth Five Year plan covering the period 1990 to 1995 a comprehensive programme for the development of small firms was identified with an investment of the equivalent of £256 million (at current prices) planned for both public and private sectors of which about 60%-70% was planned to come from 'credit' sources i.e. financial institutions.

During the Perspective Plan, which will cover the period from 1995 to 2010, the total investment outlay planned for this period for the implementation of the public sector programme of developing small firms was envisaged 1860 crore Taka (equivalent to £300 million) of which almost the total amount is planned to be utilised by government bodies in charge of discharging public policies regarding developing small firms, for example either through Bangladesh Small and Cottage Industries Corporation (BSCIC) or Government nominated banks or specialised banks to cater for the needs of finance to entrepreneurs. This is planned to involve, as many as possible, banks and financial institutions and also the apex body for small firms development i.e., BSCIC in a rather rigorous way to generate much more small firms and to help to create entrepreneurs in comparison to the previously planned periods (Perspective Plan, 1995-2010). It has also been envisaged that total

investment on the part of the private sector in programmes of small firms development during 1995-2010 will be 7000 crore Taka (equivalent to £1129 million) of which 80% (i.e. £903 million) is expected to come from financial institutions as credit and only 20% of total investment is expected to come in the form of equity investment (Perspective Plan, 1995-2010).

Until 1995 there was a Government directive for all commercial Banks and DFIs to lend 5% of their total loanable funds in small firms. It is proposed in the Perspective Plan for the period of 1995 to 2010 that this should rise to 15%. This policy proposal was in addition to the envisaged total credit supply noted above (i.e. £903 million) on the part of the financial institutions during the 1995-2010 period. This means almost all financial institutions, excepting a few foreign banks, are obligated to lend in this area of small firm lending.

The discussion above indicates that the small firm sector has been identified as central to plans for economic development and, significantly, development plans for small firm financing rely usually on funding coming from financial institutions, both private and public. Hence, the market for the funding of small firms is potentially large and hence the operation of that market is itself important for the success of plans for economic development. These operations include lending, monitoring and contracting practices of the financial institutions, the culture of the borrowers and the behaviour of the owners and managers of small firms. These issues will be examined in later chapters.

Chapter Two

Issues in Economic Development.

2.1. Introduction: General Issues in Economic Development.

Economic Development is a subject which did not exist before the Second World War. For example, Seligman's 'Encyclopaedia of the Social Sciences', appearing in the 1930s, contained no entry on either economic development or development economics (Eatwell et al 1989). Although one could claim that Adam Smith was the first 'development economist' and that his *Wealth of Nations*, published in 1776, was the first treatise on economic development, the systematic study of the problems and processes of economic development in Africa, Asia, and Latin America has emerged only over the past four decades (Todaro, 1994). Of course the same is true of several other important sub disciplines of economics, such as game theory and financial economics. But while their creation was part of the inevitable specialisation that accompanies the natural evolution of economic (or any other) theory, the birth of economic development as an academic research subject was primarily a response to new and powerful historical forces at work in the outside world.

The European colonial empires were almost completely dismantled between 1945 and 1965, in a process whose speed turned the attention of colonised and colonisers alike to the problem of how fast the newly independent countries could be made to grow. The cold war focused attention on the forced-draft investment policies of the Soviet Union and China, which in turn raised the question whether that was not a faster (and therefore better) path to wealth than that of western capitalism. Meanwhile, the trauma of the

Great Depression of the 1930s had driven both the industrial countries and their raw material suppliers into greater readiness to accept governmental intervention intended to maintain employment and prices, as well as to secure steady growth in output and trade. So therefore, after the Second World War the concept of 'independence' of colonised nations' emerged and colonisers felt it their responsibility to assist either individually or collectively through international bodies to assist in achieving the objective of economic emancipation/development.

The majority of national and international bodies currently involved in promoting development, such as national development banks, the World Bank and its affiliates, and the agencies of the United Nations, have all been established since the Second World War. Before the war, when the most of today's poor countries were still colonies, there was very little concern with the economic and social problems of developing (dependent) economies. Perhaps the facts of underdevelopment were not so well known, or perhaps it was that the attention of most people was focused on depression and underemployment in developed countries. Whatever the reason, the situation today is very different. The development of the third world (the collective name for the developing countries), meaning above all the eradication of primary poverty, is now regarded as one of the greatest social and economic challenges facing mankind (Thirlwall, 1986).

A number of factors account for this change in attitude and upsurge of interest in the economics of development and in the economics of poor countries. First, in the wake of the great depression and in the aftermath of war there was a renewed academic interest in the growth and development process and in the theory and practice of planning. Second, the poor countries themselves became increasingly aware of their own backwardness, which led to a natural desire for more rapid economic progress. Third, there has been a growing recognition by all concerned of the mutual interdependence of the world economy. The political and military ramifications and dangers of a world divided into rich and poor countries are far more serious now than they were in the past; at the same time the cold war has led the major developed countries to show a growing economic and political interest in poor and ideologically uncommitted nations. The

recognition of interdependence has been heightened in recent years by fears of shortages of basic raw materials produced primarily in third world countries, and by the rising price of oil.

The subject of development economics, was created with two main objectives (Eatwell et. al 1989). The first aspect is important and enduring. At any moment some nations will be regarded as poor and under-developed, and it will be natural to enquire what must be done to make them wealthier. This is a permanent mission since there will always be relatively poor economies.

The second aspect is the putting into practice of a then widespread belief that, with its 'marginalist' revolution in the last quarter of the nineteenth century, economics had left behind the concern with growth that was central to classical political economy, and that it was time to return to those earlier concerns. This belief led to greater attention within standard economics to problems of growth and planning. The above two aspects are the 'applied' side of development economics and various models and theories have emerged from it.

2.2. Statement on Development: Nature and Definition of Development.

The concept of economic development raises a number of normative issues, one of the most important of which concerns the degree of economic equality thought to be necessary or desirable, both as a means of stimulating, or as a trade off against economic growth, and as a development objective (Colman and Nixon, 1994).

However achieving income equality is not a short-term proposition and not easy although it could be possible to reduce income inequality in the developing countries and which actually possible by virtue of empowering economically, the people living under poverty level without having basic necessity. Both greater economic and social equality may be regarded as a means of accelerating development and growth. The very features of

developing countries do not let them have the expected and required level of economic activities which could ensure productive employment of available input for producing output for the market. Apart from the outside or foreign market these developing nations have a large internal or home market for their products, this is due to their vast population, a common feature of all developing countries.

In a very crude form the possible answer to the underdevelopment might be the distribution of the world's wealth is glaringly unequal, and the single most important factor in any individual's share of this wealth is where he or she happens to be born. But for any less developed or developing country this answer is not enough at all as far as eagerness of attaining development is concerned. The emergence of development economics was being pursued through discussing, analysing and developing theories for attaining economic development in the developing/less developed countries.

Economic development is difficult to define precisely. Some development economists measure economic development using per capita income and this is in fact is the commonest measure of economic development. By simple per capita income comparisons, Kuwait is more economically developed than West Germany or France, Hong Kong is more economically developed than New Zealand or Spain, and Trinidad and Tobago more economically developed than Portugal or South Africa. However, each of these rankings based on the crude measure of per capita income conflicts with some popular perceptions of economically developed countries. Development may be assessed in other ways. Development in the eyes of Seers (1969) is creating the conditions for the realisation of human personality, which he recognises as involving three interrelated criteria: reducing poverty, reducing unemployment and reducing inequality. High income levels indicate potential for development, but if it is not shared by all then, in an important sense, development may not be considered to have occurred- the Kuwait and South Africa inconsistencies could be explained by this reservation. A related approach is to define economic development in terms of the satisfaction of universal basic needs for food, shelter, health care, education and so forth (Pomfret, 1992; World Bank, 1991). Hence, poor

countries which cannot ensure these basic necessities may be considered to have economies which are underdeveloped although this term has been substituted by 'developing' in general usage, a term which is more optimistic. However, since there remain opinions and views regarding the development concept, following are some discussions on this issues.

Development: Traditional Economic Measures.

In strictly economic terms, development has traditionally meant the capacity of a national economy, whose initial economic condition has been more or less static for a long time, to generate and sustain an annual increase in its Gross National Product (GNP) at rates of perhaps 5% to 7% or more (Todaro, 1994). A common alternative economic index of development has been the use of rates of growth of income per capita or per capita GNP to take into account the ability of a nation to expand its output at a rate faster than the growth rate of its population (Todaro 1994). Levels and rates of growth of real per capita GNP (monetary growth of GNP per capita minus the rate of inflation) are normally used to measure the overall economic well being of a particular population-how much of real goods and services is available to the average citizen for consumption and investment.

Economic development in the past has also been typically seen in terms of the planned alteration of the structure of production and employment so that agriculture's share of both declines and that of manufacturing and service industries increases. Development strategies have therefore usually focused on rapid industrialisation, often at the expense of agriculture and rural development. These principal economic measures of development have often been supplemented by casual reference to noneconomic social indicators- gains in literacy, schooling, health conditions and services, and provision of housing, for example. On the whole, therefore, prior to the 1970s, development was nearly always seen as an economic phenomenon in which rapid gains in overall and per capita GNP growth would either 'trickle down' to the masses in the form of jobs and other economic opportunities or create the necessary conditions for the wider distribution of the economic and social benefits of growth. Problems of poverty, unemployment, and income distribution were of secondary importance to 'getting the growth job done'.

The New View of Economic Development.

The narrow definition of development i.e., GNP and its growth rate failed to convince many development economists and policy makers both within and outside the developing nations particularly since the condition of people in developing countries did not change that is the levels of living of the masses of people remained for the most part unchanged through the experience of the 1950s and 1960s despite the achievement of economic growth. This was taken as a signal that something was very wrong with a definition based on economic values only. The definitional inaccuracy may be observed in the presence of certain basic features of developing countries, which would, if the country were developed not persist; these include- absolute poverty, increased level of poverty, increased level of inequitable income distributions, low level of human resources development and a high level of unemployment. If all of these factors have moved from high levels then a period of development may be identified for a country. If one or two of these central problems have been growing worse or have remained static, especially if all three have, it would be difficult to call the result 'development' even if per capita income doubled (Seers, 1969).

A number of developing countries experienced relatively high rates of growth of per capita income during the 1960s and 1970s but showed little or even no improvement or even an actual decline in employment, equality, and the real incomes of the bottom 40% of their populations. By the earlier narrow growth definition, these countries were 'developing'; by the newer poverty, equality, and employment criteria, they were not. The situation in the 1980s worsened further as GNP growth rates turned negative for many LDCs and governments, faced with mounting foreign debt problems, were forced to cut back on their already limited social and economic programmes (Todaro, 1994).

Development implies change, and this is one sense in which the term development is used; to describe the process of economic and social transformation within countries. Development is not a matter isolated from the people of a society or in more general way from society itself. When one talks of development, an important question arises of

development for what? The concept of development, was until recently, conceived of almost exclusively in terms of growth targets, with very little regard to the beneficiaries of growth or to the composition of output. Considering development more broadly, a concept of development is required which embraces the major economic and social objectives and values that societies strive for. The best attempt, to date, was by Goulet (1971) by outlining three basic components in this wider meaning of development, these are- life sustenance, self-esteem and freedom. According to Goulet development has occurred when there has been an improvement in basic needs, when economic progress has contributed to a greater sense of self-esteem for the country and individuals within it, and when material advancement has expanded the range of choice for individuals. The fact that many of these ingredients of development are not measurable but does not detract from their importance. According to Goulet the condition of being developed is as much a state of mind as a physical condition measurable by economic indices. It is noteworthy that all three of these basic components are interrelated. Lack of self-esteem and freedom result from low levels of life sustenance, and both a lack of self-esteem and economic imprisonment become links in a circular, self-perpetuating chain of poverty by producing a sense of fatalism and acceptance of the established order (Thirlwall, 1980)- the accommodation to poverty as described by Galbraith (1980). Therefore from the Goulet description of development, economic improvement and life sustenance is the prime mover of 'development'. We will now turn to describe and analyse various development models in line with all possible and well accepted development definitions and concept.

2.3. (i) Development Models.

Growth and development, the big long run issues in economics, had been the preoccupation of the classical economists who were the founders of modern economics. Adam Smith, David Ricardo, J.S. Mill and the Reverend Malthus were writing at a time, the 50 years around the turn of the nineteenth century, when Britain was undergoing profound social and economic change associated with the Industrial Revolution. The economics of the classical writers reflected these changes, and contained indications of a

theory of development which has lived on in the modern tradition of development economics (Ingham, 1995). Many of the pioneering development economists followed in this tradition and we may mention specifically Arthur Lewis, Peter Baucer, W. W. Rostow, Chenery and Bronfenbrenner in this regard (Agarwala and Singh, 1990). The objective of such economists was to address economic underdevelopment, a common feature in more than two-thirds of the earth's land surface, and which by the year 2000, will account for four fifths of the world's population (Ingham, 1995). Early approaches to the problem of underdevelopment were largely contributed by economists like Jacob Viner (1953), Colin Clark (1953), Paul Baran (1952). Economists like Simon Kuznets (1954) and W.W. Rostow (1956) examined the problem of underdevelopment from the historical point of view.

Economically underdeveloped countries have some common features, which will be cited at different parts of this thesis. However, a key characteristic is referred to as the 'vicious circle' of low income, low savings, low investment, and under employment. In social terms underdevelopment may be characterised as a situation where basic needs are not met for a vast majority of the population (World Bank, 1991).

According to Kuznets (1973) Less Developed Countries (LDCs) are countries which have not experienced modern economic growth (MEG); by the term MEG, Kuznets intended to indicate such countries where there was a significant rise in the share of savings and investment in national income and which he defined in terms of observed regularities in the economic history of more developed countries. One component of MEG is accelerated growth in per capita income, but due to the presence of vicious circle i.e., low savings-low investment-low employment-low income in the developing countries the growth of per capita income does not increase.

This vicious circle does not only restrict or stop increase of per capita income, which is usually used as a yardstick for economic development, but it also eventually reduce or stop material consumption, education, health, and housing i.e., basic needs or in other words the standard of living which in totality may ensure economic development for an underdeveloped country (World Bank, 1991). Development is broader concept, which encompasses, alongwith economic development attributes e.g., raising standard of living, other important and related aspects like, more equality of opportunity, and political and

freedom and civil liberties (World Bank, 1991). However economic development has a unique role in terms of the integral attribute to the 'development' to play, while without economic development, as a process, the goal i.e., development cannot be achieved (Ingham, 1995).

The literature on economic development contains a great many alternative models dealing with these and other features. In this chapter we will consider three distinct groups of models of economic development. These are not free from criticism but nonetheless these models are used as the basics for other models which are interrelated to these basic models or are developed from there [models - Fei and Ranis (1964), Lele and Mellor (1972), Uzawa (1961, 1963), Jorgenson (1961) and Harris-Todaro (1970)]; a brief overview on these models will be made in this chapter.

However, before turning to overview of various models it will be worth to mention about the works of Harrod (1939), and Domar (1947), on which the basis of neo-classical model for economic development stands (Due, 1988). The models of Harrod, and Domar stressed the importance of capital formation and thus economic development. Savings was regarded as the key to capital formation and thus economic development, since it assumed that there was little possibility of substitution of labour and capital. The argument that capital was the crucial scarce factor limiting growth was based in part on the surplus labour argument, namely, that in the least developed countries there is a substantial surplus of labour which can be withdrawn from agriculture without lessening agricultural output. The assumption was, implicit or explicit, that savings would be reflected in real investment, given the urgent need for new capital goods and thus its high productivity.

Referring to our earlier discussion on Kuznet's MEG and its non achievement due to the presence of vicious circle we may now intend to proceed with possible break through for this circle. To break out of the vicious circle and attain economic development in the developing countries development economists have proposed and advocated different economic development models. Among the models of economic development which have been offered in the literature are: the Lewis's (1954) model of economic development with unlimited supply of labour, Chenery's (1955) model of economic

development via industrialisation and Bronfenbrenner's (1955) model of economic development through confiscation.

The Lewis model has earned a place of repute, and its treatment of industrialisation, savings and investment, and surplus is well articulated and realistic for a large number of developing countries including Bangladesh. Chenery's contribution is a useful exercise in model-building in that it provides scope for the treatment of factor disequilibrium, of the foreign exchange gap, and the interconnectedness of productive sectors. Bronfenbrenner's model is also important, because it contains an exploration into the communistic line of thinking. This provides an analysis of the role of confiscation in economic development. There are some other models those have emerged and developed in line with the above mentioned models.

These models each have some relevance to the case of Bangladesh, and we have chosen these models for review as they reflect consideration of important features of the Bangladesh economy. We will now be reviewed these models briefly in turn.

Lewis Model:

Lewis (1954), a Neo-classical economist, developed his model of economic development on the assumption that developing countries usually exist with unlimited supplies of labour, because the rate of growth of population in such countries is very large in relation to capital and natural resources. Due to lack of resources investment is low, and consequently total employment of labour is low. On the other hand the marginal productivity of labour is negligible, zero or even negative in such developing countries. Where the supply of labour is 'unlimited' in the Lewis sense new industries can be created or existing industries expanded.

In his theory Lewis advocated effective employment of surplus labour to increase the level of income and it is possible by investing in industries capable of using surplus labour. More specifically this may be achieved by investing in industries exhibiting labour intensiveness rather than in high-technology capital intensive firms. Because it is

argued that an unlimited supply of labour is available at subsistence wages. Although this model has certain dissimilarities with other growth models economists have to consider and recognise the inherent effectiveness of the Lewis model (Findlay, 1989). Many modern economists recognise the importance of technical progress (and resource discovery) as a creator of profit opportunities, but they also recognise the importance of effective demand, profits and investment (Higgins 1968). It was Lewis who first observed that conditions in less developed countries are in some ways more similar to those which prevailed in the industrialised countries before the industrial revolution than they are to conditions in those same countries to day. The Lewis model utilised the Ricardo-Marx assumption that labour is available in unlimited quantity at a fixed real wage, rather than being a scarce factor of production. So modern economists have accepted Lewis model's main theme of 'creation of effective demand'. Effective demand without the increase of income as a whole may not be expected. The labour surplus model discusses the employment of labour which will increase income level and create demand and induce more investment, with a resulting trend leading to reduced inequality in income. Typically in a labour surplus economy initially there will exist income inequality but this actually absorbs surplus labour in the end. As, a section of people have surplus and savings caused by higher income this leads to such a situation of 'inequality'; however when this savings are invested that eventually absorbs surplus labour by creating employment opportunities.

In the Lewis Labour-Surplus model inequality is not only a necessary effect of economic development- it is simultaneously a cause of growth. Inequality that is, a distribution of income that favours high income groups- contributes to growth since the high income groups are the elements of society that save, and saving is essential for investment and thus output growth. Lewis (1954), in his famous quotation says that,

"the central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 or 5 percent of its national income converts itself into an economy where voluntary saving is running about 12 to 15 percent of the national income or more."

The answer, he argues, lies with the 10 percent of the population which receives 40 percent or more of national income in labour surplus countries. Economic development comes when there is more income which leads to savings and investment. In the Lewis model investible funds come from the savings of the high income groups in the unequal income distribution. These investments are directed at employing surplus labour due to its low cost in labour intensive firms. This tends to lead to the generation of income in the hands of the employed labour which makes them consumers which in turn ultimately causes the total income level to increase and accelerate the path of economic development.

In addition to 'inequality' concept of the Lewis model, there is another important aspect of this model is its presentation of two sectors for the typical poor countries. The Lewis's model tells about 'traditional' and 'modern' sectors, under these two sectors the developing countries are divided. The former consists of peasant agriculture as well as self employment of various sorts in urban areas, where the primary objective of economic activity is to maintain consumption. The 'modern' sector comprises commercial farming, plantations and mines and manufacturing, in which there is hired labour and profit is the motive for production organised by a class of capitalists and entrepreneurs. Lewis adopts two crucial features of his model (Findlay, 1989). First, the real wage of unskilled labour in the modern sector is exogenously given, with employment and profits then being determined by the demand for labour corresponding to the fixed stock of capital in the short run. The second feature is that the accumulation of capital is governed by saving out of profits and income. The process of economic development is viewed as the development and expansion of the modern relative to the traditional sector until such time as the 'surplus labour' pool in the traditional sector is drained and an integrated labour market emerges with a neoclassically determined equilibrium real wage.

Here, instead of further elaboration of Lewis model we may look at some of the important features of this model:

- (i) In many economies an unlimited supply of labour is available at a subsistence wage.

- (ii) The main sources from which workers come as economic development proceeds are subsistence agriculture, casual labour, petty trade, and the increased population.
- (iii) The subsistence wage at which this surplus labour is available for employment may be determined by a conventional view of the minimum required for subsistence. When the surplus is exhausted, wages begin to rise above the subsistence level.
- (iv) In such an economy employment expands through capitalist modern sector as capital formation occurs; and this leads to rise in the national income which in turn leads to re-investment.
- (v) Capital is formed not only out of profit but also out of credit creation.
- (vi) The law of comparative costs is valid in case of countries with surplus labour

The implications of Lewis's model may be seen as consistent with Kuznet's (1973) generalisation about what has actually occurred in economic growth experience. There are two features of expecting the initial rise in inequality to take place. One is that the share of the capitalists in income (who in the Lewis model could be either private capitalists or governments running state-owned enterprises) rises as the size of the modern, or capitalist sector increases. The second feature is that inequality in the distribution of labour income also rises during the early period of growth when increasing but still relatively small numbers of labourers are moving from the subsistence wage level to the capitalist sector wage level, which Lewis says tends to run about 30 percent higher in real terms.

There are several other economic development models based on surplus labour theory, to which Lewis's contribution will always be pronounced and acknowledged. Among them reference of models of Fei-Ranis (1964), Uzawa (1961,1963), Jorgenson (1961, 1967), and Harris Todaro (1970) may be drawn. It has not been attempted to discuss these models in detail, but a brief idea and comparison among the models in line with the Lewis's is being done below to find the possible implications to this research.

Fei and Ranis Model:

In addition to Lewis, Fei and Ranis (1964) presented a complete model for economic development of labour surplus economies. According to Ranis (1989) the modern version of the labour surplus economy model is based on the existence of a particular kind of asymmetry among sectors of a developing economy. Specifically, one or more of the major production sectors is characterised by the absence of clearance in its labour market. Such a condition of 'labour surplus' may exist in large portions of the agricultural sector, as well as in some non-agricultural activities such as services and in small firms. It was argued by Ranis that success in development can be defined as the achievement of the end of the labour surplus condition via the gradual reallocation over time of a growing population from the non-commercialised sector (having agricultural/traditional/raw product characteristics) to the commercialised (non-agricultural/industrial/final product characteristics) sector. The commercialised sector of the labour surplus economy behaves neoclassically or conventionally. The only thing that really distinguishes it from the familiar one-sector commercialised economy is that the supply of labour is determined by conditions in the non-commercialised sector.

The existence of substantial disguised unemployment in the non-commercialised sector is significant because it represents a population which is consuming output but unable to make a commensurate contribution to it. Thus the major problem, as well as opportunity, in the labour surplus economy consists in the reallocation of such relatively parasitic portions of the labour force into alternative employment where they are able to make a commensurate contribution to total output. And this could be effectively done through giving attention to the significance of certain linkages i.e., the inter-sectoral labour market, the inter-sectoral commodity market, and the inter-sectoral financial market (ibid, p.194).

Uzawa Model:

The Uzawa (1961-63) model works like this. There are two sectors are identified i.e., product sector- which produces consumer goods/final product and factor- which produces machineries and other raw material for production of final product. There are two productive inputs are in use, capital and labour, (although with different production

functions), and production decisions in both sectors are characterised by profit maximisation. In this model these two factors of production are smoothly substitutable for each other in the production of consumer goods and in the separate industry which produces new machines; and labour and machines are freely transferable from one sector to the other (Solow, 1961).

Jorgenson Model:

The neo-classical approach to dualistic development begins with two famous papers by Jorgenson (1961, 1967). In his model, Jorgenson was concerned with conception of the dependence of the modern (manufacturing) sector on traditional (agricultural) sector. Here dependence means the actual physical dependence of manufacturing workers on food supplies from agriculture as well as the implicit relationships that are consequences of this. From the statement below by Jorgenson (1961), the models characteristics i.e., dualism, and two factors, may be observed.

“..... in the theory of a dual economy the output of the traditional or agricultural sector is a function of land and labour alone; there is no capital accumulation.... land does not appear as a factor of production in the manufacturing sector; the level of manufacturing output is a function of capital and labour alone”

Harris Todaro:

Another model which also bears importance in respect of the economic development is the celebrated model of Harris and Todaro (1970). It is a standard, two-sector new classical model except for one particular asymmetry- the wage in manufacturing is above the market clearing level. Otherwise, and on the contrary to the models of Jorgenson and Lewis, both sectors use capital and labour. This model has got similarity, as far as factors of production use, with that of Uzawa model.

Kanbur and McIntosh (1988) analysed the dual sector model for economic development put forward by Lewis, Jorgenson, Uzawa, and Harris and Todaro. In a general term all these models are two-sector model. There exists a closeness, as far as the uses of factors of production are concerned, between the Lewis and the Jorgenson model as both the sectors use labour as the main input in the production function. While the output in the traditional sector is a function of land and labour; and the modern sector's output is a function of capital and labour. The contrast that exists between these two models is the conception of 'dependency' among the sectors. As Lewis model agrees on the mutual dependence of the sectors in terms of mobility of an important factor of production i.e., labour; but the Jorgenson model tells about the physical dependence of modern sector on the traditional sector, since the workers of the modern sector depends on food supplies from traditional sector. However, both the models assume total immobility of both capital and stock, and labour plays as a catalyst to the development of any sectors, and especially the modern sector which in fact saves and consequently create investible funds. Another assumption is taken by the Lewis model and which is also endorsed by Jorgenson model is that manufacturing sector's production decisions are made with the objective of maximising profits, while in the agricultural sector the distribution of product is according to conventional norms rather than marginal products. Which indicates that modern sector is to run by encompassing all market attributes i.e., competition, competitive compensation package for labours, and skill of productive input e.g., labour etc; that consequently will ensure generation of incomes in the hands of the labour force by way of their employment.

The central idea of the Jorgenson model is dependency via the food market and the manufacturing workers are dependent physically on supply of food from agriculture/traditional sector; and only in a closed economy, workers consumption of food must be equal to what the agricultural sector is willing to supply. From these points of view the Jorgenson's model is that of a closed economy (Kanbur and McIntosh, 1988) in which the terms of trade between agriculture and manufacturing determine accumulation and the rate of growth, and these terms of trade are themselves determined by the balance of supply and demand. On the contrary the Lewis model considers both the closed and the open economy model. So, the implications may be in the form that

the applicability of the model put forward by Lewis in countries is wider than that of the Jorgenson's model, since the concept of closed economy has been losing its acceptability in modern days

The Lewis model bears similarity with the Uzawa model in respect of having two sectors i.e., product and factor and factors of production in general terms i.e., capital and labour by the later one. However, as far as the practical working of the models, the Lewis model contrasts to the Uzawa model. Because the two sectors of Uzawa model uses both capital and labour, while in Lewis model its two sectors i.e., traditional and modern use labour. Additionally, production decisions in both sectors are characterised by profit maximisation in the Uzawa model; and in case of the Lewis model production decisions are made with the objective of maximising profits while in the agricultural sector the distribution of product is according to conventional norms rather than marginal products.

The inference that may be drawn from the above discussion may be put by stating that like the Lewis model, models of Jorgenson, Uzawa, and Harris-Todaro have assumed two-sectors in developing countries. Reference of three factors of production has been cited i.e., land, labour and capital in total but the uses of factors varied from one to another, as described above. The central idea, that is essential to accelerate the pace of economic development process, is to break the vicious circle (Harrod, 1939 and Domar, 1947) and that can be done either by balanced investment or by forced savings. Savings and investment comes from profit/wages in manufacturing or modern sector all of which are put into the accumulation process. Mentionable, firms in modern sector are competitive and pay marginal productivity wages (Kanbur and McIntosh, 1988). This in fact advocates for investment in modern sector, because accumulated funds of modern sector will be invested for more productive uses, although there is investible funds' immobility assumption of the Lewis model exists side by side movement of investible funds from modern to traditional sector (Taylor, 1983); and uses accumulated funds eventually tend to bring economic development through multiplier effects from savings and investment generated out of the sectors especially from the modern sector (Harrod, 1939, Domar, 1947, Lewis, 1954). Since the modern non-traditional sector i.e.,

industries is in a position to absorb surplus labour to a greater extent, which is crucial for economic emancipation and subsequent development of a developing country, as this sector saves and creates income for labour through investments and these are some of the important tools of breaking the vicious circle to attain economic development (Jorgenson, 1961; Findlay, 1988).

The basic theme of Lewis model is to pursue employment of surplus labour by modern non-traditional sector in the developing countries for possible ensured process of economic development. Since this sector, as stated in above discussion, creates incomes, savings, investments and which in turn generate employment opportunities and thus absorb surplus labour, which i.e., surplus labour constitute a crucial attribute to the underdevelopment. This model of Lewis has been acknowledged and advocated by other two development economists Lele and Mellor (1981), whose area of concern is also to deal with labour and its effective transfer and employment, they observed:

“Unemployment and maldistribution of wealth are at centre stage in the drama of economic development. Throughout the developing world population growth has added immensely to the army of unemployed while economic policies have failed to increase incomes rapidly and have raised employment even less. Unfortunately, however, increased employment exacerbates the equally explosive problem of inflation”.

In response to the problems identified in the foregoing statement Lele and Mellor advocated the employment oriented economic development as a solution to them. They, like other development economists Lewis, Jorgenson, Fei Ranis and Todaro deal labour in line with two sector model. According to them scopes of creating employment opportunities lie with these two sectors. However, the traditional/agricultural sector has been a slow generator of employment and income; and through inadequate supply of wage goods it has also constituted a major constraint to the growth of modern non-agricultural employment. This in turn lay reliance on the modern sector to lead the situation of such a nature which will generate more employment in the dual sector economies, this modern sector will not only create employment but it will attract labour

from traditional sector to it, which will develop a competitive situation in the labour market in the modern sector and will tend to ensure marginal efficiency of labour and increase productivity those eventually will promote further development of the modern sector and create opportunities to absorb surplus labour in the long run.

Researches conducted by international organisations, for example, the OECD have advocated for an 'Employment-Intensive Development Strategy'. Based on the experience of a gradual and steady improvements in wages and employment level observed in some Asian countries. These improvements have been judged to have been associated with a labour intensive growth strategy involving trade, exports of manufactures, plus high savings, large investment in education, and a strong emphasis on competition and the use of market instruments (Turnham, 1993). The rate of growth achieved by these countries-e.g., South Korea, Taiwan, Hong Kong and Singapore averaging between 8 and 9 percent a year during 1980s is very much above the average to contain the level of unemployment of 6 to 8 percent during that period and to become newly industrialised countries. Indeed, economic growth in East Asia at 6 percent per annum would have been enough to secure very satisfactory improvements in both employment and earnings (Turnham, 1993).

From the brief discussion of different models above, we may have observed that the Lewis stated about the severity of unemployment in the developing countries and put forward his model to deal with this problem by promoting the modern nonagricultural sector; and other development economists like Fei, Ranis, Jorgenson, Harris, Todaro and Uzawa had accepted the real theme of the Lewis model by agreeing one important aspect i.e., modern sector saves, accumulates investible funds, and through investment absorbs surplus labour, which is essential for economic development. At the end of discussion above regarding the mentioned models, one finding that put forward by the OECD concerning development strategy i.e., labour-intensive firms does bear remarkable implications in the formulation of development policies in developing countries. The model discussed below is in fact acknowledged by the models elucidated above and also by the OECD, because the model below tells about the 'means' of

creating labour intensive development programmes which will tend to absorb surplus labour.

Chenery Model:

The economic development model advocated by Chenery (1955), approaches the achievement of development in developing countries through industrialisation. According to Chenery industrialisation is the main hope of most poor countries trying to increase their levels of income. As level of income is deemed to be the commonest measure of economic development, so every economic development model gives emphasis on it. The Lewis and the Chenery models contain complementarities in respect of attaining development. The Chenery model suggests that in the 'overpopulated countries', where pressure on the developed resources, primarily agricultural, is high, industrialisation is more desirable than in countries where a shift of the labour force from agriculture to industry (without investment or technological improvements) would cause a significant fall in agricultural output. The model assumes that there will be a fairly unlimited supply of labour available for non-agricultural employment.

Due to inequality in the distribution of income and other resources a section of the population of a developing country, where labour is abundant, can be expected to have savings available for investment. Therefore the use of this savings either in the form of equity or loan capital as finance for investment in firms and industries employing surplus labour may form the financing element of industrialisation programmes based on a Chenery model of economic development.

It is described by Chenery that there are three key factors in industrial development-factor proportions, availability of foreign exchange and the rate of growth. The industrialisation programme depends on the aggregate natural resources, labour and investible funds, those constitute factors of production. One of the important elements of the Industrialisation model of Chenery is the assumption that total demand for labour does not exceed the total supply. The existence of surplus labour, is a common characteristics of most of the developing countries; and thus this satisfies the Chenery model's assumption and in turn

leads to its successful implementation with the objective of economic development through industrialisation.

In the industrialisation model Chenery stresses the need for a planned industrial development programmes, by encompassing some basic factors of a developing countries- highly dependent on traditional/agricultural sector, highly populated and existence of surplus labour. Chenery suggested a procedure for industrial development which will introduce some of the elements of a general equilibrium analysis into the usual sector approach is the following:

- (i). Divide the economy into as many sectors as can be managed and arrange them in the order of one-way interdependence.
- (ii). Within each sector, rank projects according to their marginal return on investment, using expected prices and correcting for tariffs, subsidies, etc., where possible.
- (iii). Estimate the final demands in the economy which would result from the increase in income expected from the investment programme.
- (iv). Using an assumed marginal productivity of investment, exclude projects in each sector which have lower returns. Include all import substituting and export projects which exceed this rate of return. Start at the bottom of the list in making this estimate (with services and primary production) and revise the cost of purchased materials where possible on the basis of previous decisions as to imports or domestic production.
- (v). Starting at the top of the list of sectors, compute the required output in each from the final demand and the estimated use in preceding sectors. Compute imports, exports, and the payments deficit.
- (vi). Revise the size of the programme downward if the available investment funds have been exceeded. Revise the productivity of investment downward if the trade deficit is excessive. Repeat the calculation until limits on investment, foreign exchange, and other resources are satisfied.

Clark (1940) urged that changes occur in the structure of production and employment in developing countries by which agriculture, that comprises the greater part of the primary sector, declines relative to the secondary and tertiary sectors i.e., manufacturing and services. Clark's thesis developed in the 1940s still has its modern-day adherents (Ingham,

1995). Clarks's contemporary, Fisher (1939), similarly dealt with the sectoral transformation which has accompanied modern economic growth, and to Fisher and Clark is owed the primary-secondary-tertiary distinction which is still regarded as important in developing countries. One reason why this distinction is seen as important is that structural change can be identified as a source of growth. Productivity tends to be higher in the modern sector i.e., manufacturing and services than in agriculture. As Clark argued, transferring labour from less to more productive spheres can be an important source of economic development. In economic theory, economic growth results from capital formation, which increases the size of the capital stock, from expansion of the labour force and from technical progress; and these are outcome of structural change in production. This is because, arguing in the tradition of the Clark, Kuznets, and Chenery labour and capital can shift from less productive uses in the primary sector to more productive uses in the secondary sector.

Bronfenbrenner Model:

Bronfenbrenner (1955) is the advocate of the economic development via confiscation model. Bronfenbrenner is of the opinion that through the confiscation of capitalist property, assets, and income financing of economic development programmes is possible by shifting income to developmental investment from capitalists' consumption, from transfer abroad, and from unproductive investment like luxury housing. The main philosophy of this model is to confiscate personal properties and wealth and to put those in the hands of the government for investment in the productive sectors through preventing them from investment in unproductive and luxury sectors. Nationalisation of privately owned businesses and trades is another concept of this model, which according to this model, ensures production and distribution centrally and that tends to formation of a socialist economy- absence of market economy. Bronfenbrenner model illustrates that confiscation model leads to the economic development of overpopulated developing countries.

Bronfenbrenner's confiscation model states its process of working by defining three stages. In the first stage the model brings idea regarding income and per capita income, and savings issues. Which also brings rationale for this model. It assumes, a developing country has a net national and personal income of 100, after depreciation and before direct taxes. Income is divided between service income and property income in the proportion of 85 to 15. Of the assumed property share of 15, one third i.e., 5, comprises net savings. The model ignores net savings out of service income, as it is unimportant quantitatively. Of the total net savings of 5, 40 per cent (or 2) takes forms available for domestic economic development, either as capital goods or as social overhead capital. The remainder (or 3) is dissipated in foreign investments, inventories, or residential housing of a luxury variety. This means only 5 per cent of total national income is saved, and only 2 per cent of national income is invested productively. Again, it assumes, with population growing at 1.5 per cent per year and aggregate income at 1.7 per cent, the annual growth rate of per capita income is only, to a first approximation, 0.2 per cent. If there is no change in the income distribution, per capita service income also grows at this same rate. This is near-stagnation, which widens annually the developmental gap separating this developing economy from the advanced countries.

In the second stage the model describes about the revolution. It may be, according to this model, a social revolution, with or without substantial violence and destruction. It may be a capital levy at rates close to 100 per cent. It may be 'nationalisation'. Under this scheme, at any rate, all capital goods which yield incomes become state property. Certain consumer durable goods which can be converted to income-yielding uses, or sold abroad for capital imports, also become state property. All incomes from this property goes to the state, none to the former property owners, even though they may retain the bare legal title to certain of the assets. None of the income from property is paid to the service-income classes directly; there is no immediate redistribution or 'social dividend' in this model. Because of the absence of redistribution, this model, according to Bronfenbrenner, is called 'confiscation'.

In the third stage, there will be an opportunity to receive and enjoy benefits of 'confiscation' by the people. When diversion of property income from consumption to productive investment is made, there will be situations like-higher income and higher growth. Here,

one third of property income is redistributed to the recipients of service income, as for example by increases in industrial real wage. Property income, at this third stage, has therefore been divided into three equal parts: developmental investments, leakages (provision for inefficiencies in resource allocation, the slowing of innovation and the increased population growth rate), and transfers to service income. So, in these ways the model of Bronfrenbrenner approaches to secure economic development.

However, as stated by Bronfrenbrenner while describing the model, it is argued persuasively in developed countries that accomplishment of economic development via 'confiscation model' require totalitarian dictatorship and that development is not worth this price. The model builder, Bronfrenbrenner agreed to some limitations of this model's applicability. Because in some countries it is contradicted the state principle of not owning personal assets, and confiscation is not permitted. Additionally, the model of economic development i.e., through confiscation of wealth of rich or resourceful men may not be easily applicable to every country excepting those of socialist countries. Moreover, the success of this model is questionable as there are evidences of economic development that development of Western Europe, North America, Australasia or Japan did not credited significantly by confiscation of capitalist property and property income (Bronfrenbrenner, 1955).

From the above discussions on three basic models put forward by Lewis (surplus labour model), Chennery (industrialisation model) and Bronfrenbrenner (confiscation model), and also other related models, the major problems and issues of economic underdevelopment have been identified and the models have prescribed ways to resolve the problems and thus attain economic development. The problems that are hindrances to development have been located by the models include: low income, low savings and low investment, that means the presence of vicious circle, surplus or abundant labour due to overpopulation and unemployment. Although the treatment procedure of underdevelopment by three models i.e., Lewis, Chennery, and Bronfrenbrenner are not similar in absolute terms, conceptually they are similar on one very specific point. That is, 'surplus labour', by keeping this very important factor of production out of the economic activities the problems like, low savings, low investment and underdevelopment of sectors e.g., modern sector cannot be resolved.

The Lewis model tells about two sectors, that ideally be present in a developing country- modern nonagricultural, and traditional agricultural sector. There might be dependence on the sectors concerned, but the modern sector, which is essentially composed of industries and service firms, is needed to be developed. It is because, this sector is able to produce required capital for investment and can provide assistance to the development of traditional sector as well by making linkages e.g., forward or backward. The Lewis model is acknowledged by several development economists, as described above, e.g., Fei-Ranis, Uzawa etc. The Chennery model tells about the development of modern sector by industrialisation, and according to the model this may be the answer to attainment of economic development by using surplus labour of developing countries, while this model put some procedures for undertaking industrial development, for example-fixing priority avenues where investment is needed for economy's quick response to development e.g., exports. The Bronfrenbrenner's model advocates for confiscation of properties by the state, and distribution of income and savings for economic developmental programmes by the state. And where there will be no private ownership of properties but at a later stage contribution towards the recipients of service income may be made out of that surplus income from confiscated assets. The confiscation model is very firm about productive investment of savings, which eventually will generate employment, and savings and investible funds.

Bangladesh is a developing country, and possible attributes that may present in a developing country as mentioned and stated by economic development literature and development models, are in existence here. The acceptability and effectiveness of confiscation model have not been unquestionable even by Bronfrenbrenner, especially on the aspect of 'confiscation' of properties by the state, and the model also states about its possible implementation in socialist countries. In Bangladesh case, neither its fundamental law making source i.e., the Constitution of Bangladesh provide the state any authority of confiscation of properties, nor there exists any centralised form of economy or distribution system. So, Bangladesh may not go for 'confiscation' model, excepting one very important aspect of this model i.e., productive investment of savings. However, Bangladesh may follow the lessons from two other models-surplus

labour model and industrialisation model of Lewis and Chennery respectively. These two models illustrate that there will be two sectors, modern and traditional; and development of the modern sector by investing more will lead to economic development. Because, income, savings and investible funds can only be generated in this sector; and eventually that will absorb surplus labour of a developing country.

According to Chennery the modern sector is to be developed by industrial development or industrialisation. Bangladesh has policy framework i.e., macro policy like industrialisation, micro policy like small firms development in the modern sector, to follow the models in attaining economic development. Therefore, in a single statement it may be said that, Bangladesh for its economic development may go for productive industrialisation by using its surplus labour. Now, the concept of industrialisation and form or pattern of industrialisation is being illustrated below in a general form for a better understanding of the models' message for economic development.

2.3.(ii) Industrialisation as a Strategy for Economic Development.

It is obvious that the process of choosing a development strategy there involves public debate, and decisions about the relative roles of industry and agriculture as well as about other questions of economic growth and structural factors, such as savings, investment and trade alongwith the agents of these factors for example financial markets and entrepreneurs attitude and ability. Increasing output in agriculture has usually involved increasing productivity through machines and other industrial inputs. Developing agricultural production either requires industrial imports, or a national process of industrialisation to reduce a country's import dependence and also to establish a base for exporting products abroad. Strong arguments have been made that industry should be the driving force for more general economic development and that, to achieve rapid and lasting economic growth, investment in the industrial sector should be given priority over agriculture (Hewitt, et al., 1992).

Just as the British and later industrial revolutions gave for the first time the real possibility of ending material want and suffering (Kitching, 1982), so industrialisation

has often been seen as the most important means of developing the third world (Hewitt et al., 1992). The basic argument for industrialisation as a development strategy is the central role it may play in respect of increasing productive capacities and productivity accompanied by several other key factors for economic development like employment generation, raising of income level, increasing savings and investment. The industrial revolution enabled Britain to raise its industrial production by 400 percent over the first half of the nineteenth century (Hobsbawm, 1969). Since then until the present the dominant criteria for development has been the rise in per capita incomes brought about largely by industrialisation. The basic views for industrialisation is, its central role to play in respect of increasing productive capacities and productivity accompanied by several other key factors for economic development like- employment generation, raising of income level, increasing savings investment etc.

Ingham (1995) states that policy makers in developing countries from the 1940s onwards tended to assume that the principal reason for the poverty of their economies was the low proportion of national income derived from secondary sector (rest of agriculture sector i.e., industry sector), when compared with richer societies, hence the emphasis given to industrialisation as a development approach. The objective of development policy was to increase the share of industry in national income, to levels comparable to those of developed countries.

Sutcliffe (1971) argued that industrialisation is in one sense a process which has invariably been the outcome or accompaniment of economic development. No advocacy of even the soundest industrial development as an answer to the problems of underdeveloped countries can be made honestly without frankly admitting industrialisation (Bryce, 1960). The concept of development and the process of industrialisation have often been treated as synonymous (Gillis et al., 1987). However, Bryce opined about careful planning of industrialisation in the developing countries. Bryce stated that, economic development through industrial development should be based on appropriate economic analysis which often underlies investment decisions since industrialisation has a necessary and, ultimately, a large role to play in almost any sound development programme. However, its part, particularly in the very early stages of a country's economic growth, is likely to be

relatively small in the total programme if decisions are not made on the basis of thorough study of the economic costs and benefits involved (Bryce, 1960).

Developing countries have long been mainly producers of raw materials, and it may be observed that there are strong and positive connections between the income, wealth formation and standard of living of a country and the extent of its industrialisation. It is also observable that as prices for raw materials fluctuate much more than prices for finished goods an economy which is dependent on the export of one or a few basic commodities suffers more from instability of national income than economies which are industrialised and more self sufficient. Having observed these facts, development policy makers in many underdeveloped countries have naturally come to believe that in order to achieve greater security, stability, and a higher standards of living, their countries must become industrialised (Bryce, 1960; Ingham, 1995). It is often suggested that in overpopulated countries where pressure on developed resources- primarily agricultural-is high, industrialisation is more desirable than in countries where a shift of the labour force from agriculture to industry (without investment or technological improvement) would cause a significant fall in agricultural output (Chenery,1955). An industrialisation model of economic development might, it is argued, work better where there is an unlimited supply of labour available for non-agricultural employment. Since such labour might be employed in the non-agricultural sectors without adverse affects on agricultural output. In such cases the relationship between the opportunity cost of labour and wage levels is crucial.

Structural interdependence and investment priorities need to be taken into consideration in determining the content and aims of an industrialisation programme. The role of industrialisation in economic development cannot be evaluated by looking only at individual sectors. Since the desired level of output in each industrial sector depends on developments in the other. Interdependence of sectors or their products in an underdeveloped economy is not general, but is largely 'one way' (Chenery, 1955). The demand for basic materials depends on the demand for finished goods; the demand for minerals and agricultural products depends on the first two categories; and finally, the demand for fuels, power, transport, and producer services depends on all of the others.

So, 'two way' interdependence and linkage both forward and backward is needed among industrial sub-sectors and between industrial and traditional sectors for effective industrialisation (Chenery, 1955; Sutcliffe, 1971; Pomfret, 1992).

2.3.(iii). Pattern of Industrialisation.

The pattern of industrial development, as well as the overall desirability of industrial development, needs to be considered. It is often been argued that the base for economic development in general and industrialisation in particular should be heavy industry, and that this base must be created first even at great sacrifice. This notion is largely founded on the idea that heavy industry is essential to support other industries. For the world as a whole, this is obviously true. But for an individual country it is not necessarily the case, and for many small underdeveloped countries it may be a dangerously misleading idea (Bryce, 1960). Generally it is cheaper for developing countries to import the products of heavy industry from highly industrialised countries and use those to make finish products by small industries which can make them more efficiently, and specific policies in developing countries may be required to strengthen small firm/industry sector for a considerable contribution to the economic development (Jenkins, 1992). However occasionally a developing country can hope to build heavy industry successfully if it has an unusual natural advantage in one or more materials, such as vast reserves of good iron ore and coal for a steel industry- and then it will be doing so because the industry is sound in itself, not because it happens to fall in the category of heavy industry (Bryce, 1960). However, Bagchi (1989) states an industrialisation process leads to accomplishment of some essential characteristics those are the necessities of a developing country to attain economic development. These are (a) the proportion of the national income derived from the modern sector in general goes up; (b) the proportion of the working population engaged in the modern sector in general also shows a rising trend; and (c) while these two ratios are increasing, the income per head of the population also goes up. Evidence for these industrialisation led results also comes from the development economists like Datta (1952), Kuznets (1966), and Sutcliffe (1971).

A more logical way to find new areas for industrialisation may be to look first for projects and firms which offer opportunities to increase the value of agricultural and mining, products already being produced for export Bryce, 1960). This involves a focus on industrialisation via export oriented firms (Jenkins, 1992). A second promising approach might be to seek projects which can produce economically goods those are already being imported in large quantities. This involves a focus on industrialisation via import substituting firms (Jenkins, 1992). Occasionally sound projects may be discovered outside of these two areas, but in most countries starting on the road to industrialisation, this is where industrial development is most likely to produce safe and early results which are needed to spark further industrial investment and provide the environment in which industrialisation will flourish (Bryce, 1960). However, developing countries should, at the same time, have policies to protect local market based firms and industries i.e., firms other than export oriented and import substituting (Jenkins, 1992).

In addition to the issue of the types of firms which might be favoured by an industrialisation strategy e.g., manufacturing, service oriented, export oriented and import substituting firms, there is the question of the size of firms to be encouraged for example large, medium and small. A size classification of firms for industrialisation might be determined by the nature of products, investment outlay or number of employees. The definitions of firms by size may not be unique for all countries. A specific type of firm with a given industrial strategy may be of different sizes, as for instance, an export oriented garment producing firm can be established in small, medium and large sizes. The focus of industrialisation by firm size will depend in part on the goals of development strategy, but also on the appropriateness and suitability of firms of different size for a particular country. Nonetheless, development literature shows small firms can be a good industrialisation strategy for economic development. According to Gerschenkron (1962) industrialisation in England and in Germany began and continued to contribute towards industrialisation and thus economic development; and this is also applicable to Japan's case (Yamamura, 1972). This industrialisation strategy commensurates the philosophy of Lewis and Chennery model for economic development of developing countries, because for absorption of surplus labour creation of labour intensive small firms is essential.

For a developing country like Bangladesh, with low income, low savings, low investment, severe poverty, absence of significant natural resources with the exception of an abundant supply of labour, and undeveloped in high-technology it may be argued that, industrialisation via Small Firms might be the most effective means of development using the unlimited supply of labour which is available. In addition, the experiences of many present developed countries and NICs in Asia and South America have led to the rise of a new theory of industrial organisations. The theory believes that the 'old orthodoxy' of large enterprises is untenable and changing and small firms are in a more advantageous position, with their relatively lower scale of production, as far as their competitiveness is concerned; and also they may be more humane and less alienated (Hewitt et al., 1992).

The process of economic development cannot start or gets its desired result unless it receives social institutions' support and innovations. And one of such innovations is financial system, which provides services of financial institutions like banks in materialising economic development programme through industrialisation (Cameron, 1972). Schumpeter (1933) regarded the financial intermediaries as one of the two key factors (the other is entrepreneurship) in the economic development process. So, it can be inferred that economic development process, may be with industrialisation with small firms, without involvement of financial system is not possible; since this system does such job which are indispensable for industrialisation i.e., intermediation of investible funds or lending for projects. In short it can be said that financing development without financial system is not possible. The discussions below will try to explore these statements.

2.4. Financial System and Economic Development.

2.4.(i). Introduction.

A financial system may be defined as the 'settlers' of needs of various economic enterprises and agents by locating, securing, and channeling funds for their uses and investment (Carter and Partington, 1981). In a very simple manner Kohn (1993) defines

the financial system as a 'facilitator' to borrowing and lending; where presence of borrowers and lenders is in existence, and constitutes an essential part of the functioning of the financial system. A financial system is consist of a set of markets, and individuals and organisations who trade in those markets (Howells and Bain, 1990).

So, there are two distinct types of components in a financial system i.e., financial markets, and non financial organisations or borrowers and related agencies. The non financial component is composed of individual borrower, investor or business bodies. These may, in general, be termed as the borrower or deficit units (Tobin, 1989). The financial market, as already mentioned in chapter one, is composed of two markets i.e., the direct financial market, and the intermediary market (Meyer, 1986). The participants of direct financial market are investment bankers, dealers and brokers; and the stock exchanges are used by these participants for their businesses in addition to their own premises.

The intermediary market, which is usually termed as financial intermediaries, is composed of commercial banks, development financial institutions (DFI), insurance companies, specialised banks and central bank (Kohn, 1993).

There are various types of products which are produced by the financial markets, and traded in it among the interested parties. These products or instruments may be: bank deposits, finance or investment companies deposits, savings certificate, treasury bills, bonds (government/private), shares/equities and life insurance policies etc. Based on the maturity, instruments may be classified under capital markets (markets for long term claims) i.e., markets for bonds and equities, and money markets (markets for short term claims) i.e., the discount market, the certificate of deposit market and the inter-bank market. However, the financial intermediaries (indirect financial market) use their deposits as instruments to deal with the deficit units, as this is one of their important functions to do under the financial system. The information and liquidity supplied and channeling savings to investors by financial intermediaries are central to the efficient operations of financial markets (Lewis, 1995).

2.4. (ii). Role of Financial System in Economic Development.

Economic development policy formulation and its achievement ultimately depends upon decisions taken by individuals or groups in a political and social context which result in the mobilisation of human activity for the task of transforming traditional modes of production, development policies and strategies and the social relations associated with them. However, without the presence and active participation of an efficient financial system the financing of economic development will be constrained and may even be stopped (Newlyn, 1977).

The development of a financial system leads to general economic development (Patrick, 1966) through making funds (created out of savings) available for financing deficit expenditure by ultimate users i.e., investors. However, financial institutions and markets influence economic welfare and development, in other ways than through the flow of aggregate spending. Financing institutions, for example commercial banks, provide an efficient medium for payments and thereby help the market system itself to function more efficiently. Access to credit from financial institutions allows entrepreneurs to undertake productive investment by providing opportunities for the establishment of new small and medium firms. Allocation of productive resources in a planned or orderly way rather than in disorganised ways may be possible through the existence and operation of financial institutions. In particular, financial institutions facilitate the orderly allocation of resources between consumption and investment; and it is the investment which adds to the nation's real wealth and contributes to economic welfare (Trescott, 1965). Financial markets and their operation have much to do with the processes by which productive capital, in the narrow sense, and real wealth, in the broad sense, are increased.

Historically, the process of development involves interactions among four broad categories or classes of factors, or variables: population, resources, technology, and

social institutions. But for the purposes of precise analysis, these bundles of variables are not single-valued, nor, except for population, can they be easily quantified. However for a clear understanding of the process of development it is necessary to take them into account. When a society has unchanging technology and stable social institutions, the situation in most societies for much of human history, the resources available to that society set the effective upper limits to its economic achievements in terms of the number and well being of its members. But of course the essence of economic development is change in both technology and social institutions, change that permits those upper limits to be expanded. Technology has been a powerful driving force in respect of rapid industrialisation, which is necessary for economic development, together with its concomitants, urbanisation and modernisation of agriculture. Social institutions may either hinder or facilitate technological innovation. In general, institutions tend to be stable and to resist change; but the possibility of institutional innovation does exist. One such innovation of considerable importance in the history of industrialisation was the invention of modern banking systems (Cameron, 1972).

Theoretical Aspects:

As an economic institution, the financial system might be expected to be more directly and more positively related to the performance of an economy than most non-economic institutions. According to Gurley and Shaw (1967), a financial system operates with two principal types of techniques. Distributive techniques (information collection and dissemination, including broker services) increase the efficiency of markets on which ultimate borrowers sell and ultimate lenders buy primary securities. Intermediary techniques bring financial institutions into the bidding for primary securities in the portfolios of ultimate lenders. Both techniques play a major role in determining the structure of primary securities (Fry, 1995).

Economists have expressed a wide variety of opinions on the effectiveness of financial systems in promoting or facilitating economic development. Schumpeter, the first modern economist to study the relationship between financial system and growth

regarded the banking system as one of the two key agents (the other being entrepreneurship) in the whole process of development (Schumpeter, 1933). Other economists have argued more strongly that the banking system may bear the axiom of 'indispensability' (Fogel, 1964) and it is one of many institutions that impinge on an economy and affects its performance for better or worse (Cameron, 1972).

The way the financial system functions for economic development, as described by Cameron (1970), may be explained as follows:

(1) The first and essential function of any financial system to act as an intermediary between savers (or holders of idle money balances) and persons able and willing to borrow. As intermediaries, they may vigorously seek out and attract reservoirs of idle funds which will be allocated to entrepreneurs for investment in projects with a high rate of social return; or they may listlessly exploit their quasi-monopolistic position and fritter away investment possibilities with unproductive loans.

(2) The second function, which makes financial institutions of special importance in market economies- is that they furnish part or all of the means of payments, or money supply (Sayers, 1960). They may do this either by issuing their own promises to pay (i.e., bank notes); or by holding or transferring the monetary deposits of the public. In either case they are in a position not merely to serve as the custodians of the stock of money, but also to increase or decrease that stock. As creators and providers of the means of payment, they may redirect real resources into more productive activities; or, as a result of government pressure or private corruption, they may swamp the economy with a flood of inflationary paper issues.

(3) A third possible function, although it is not inherent in the definition of a financial system however many economists are advocates of this function, namely the provision of entrepreneurial talent and guidance for the economy as a whole. That is, instead of restricting themselves to a purely intermediary function, banks and other financial institutions may actively seek out and exploit profitable undertakings in manufacturing, commerce, or any other productive activity and thus may set their country on the road to

continuing growth, or they may waste its resources in uneconomical or fraudulent activities.

The financial system influences the size, composition and utilisation of a country's stock of capital, and so may promote growth of real national income (Drake, 1980). Patrick (1966) believes that the financial system can exert a growth influence on the capital stock by improving the composition of the existing stock of capital, efficiently allocating new investment among alternative uses, and raising the rate of capital formation by providing incentives for increased saving and investment. This underlies his advocacy of what he terms the *supply leading* policy of financial development in poor countries. Supply-leading denotes the conscious creation of financial institutions, instruments, and services in advance of the demand for them. Supply leading is contrasted with *demand following* finance, in which the financial system and its services develop in response to demand for financial services by investors and savers.

Supply-leading has two functions: to transfer resources from traditional (non-growth) sectors to modern sectors, and to promote and stimulate an entrepreneurial response in these modern sectors. Financial intermediation which transfer resources from traditional sectors, whether by collecting wealth and saving from those sectors in exchange for its deposits and other financial liabilities, or by credit creation and forced saving, is akin to the Schumpeterian concept of innovation financing (Patrick, 1966; pp. 175-6).

Patrick's supply-leading policy may not be a permanent policy for a developing country, since a country's economy develops there may be increased demand for money supply and other financial instruments and services on the part of entrepreneurs (which may be a result of a supply-leading policy) and a demand-following policy may emerge in due course.

Financial improvements may also facilitate international movements of capital, although it is doubtful if they have hitherto motivated capital inflows to any territories that were not already so destined for other reasons (Howells and Bain, 1990). In the contemporary world, however, it is very likely and important that local financial development will

deter capital outflow by providing attractive financial assets in the home economy. The brevity with which this point is made should not cause us to underestimate its great importance. There is considerable evidence showing diversion of savings from foreign to local financial assets, as the opportunities to acquire the local assets were created by the development of a local financial system (Bank Negara Malaysia, 1979).

There is a beneficial division of labour in the process of financial intermediation by institutions. The argument for this type of financing rests chiefly on the grounds of improved allocation of resources. Just as direct finance breaks open the restraints imposed by an investor's dependence on his own saving, so indirect finance circumvents the direct link between any individual saver and an individual investor. In other words, financing conducted through financial institutions removes the 'marrying' difficulty that the direct form of finance imposes (Drake, 1980). The essence of the allocational argument for intermediation is that different financial institutions cultivate particular finance specialisations at which each institution becomes very adept. Given this specialisation, a network of such intermediaries should lower the real cost of financing and, by efficiently sorting out and ranking the various investment proposals, improve the allocation of investible resources in total (Patrick, 1966; Drake, 1980).

Historical Evidence:

Historically, in developing economies, the function of the financial system has been of great importance. And over the last 15 years, a growing number of economists-Adams, Chandavarkar, Fry, Shaw and McKinnon, among others have agreed that a well developed financial system does matter in economic development (Germidis et al., 1991), ranking *pari passu* with other necessary 'inputs' such as natural resources, labour markets, management, technology, entrepreneurial ability, and this at a time when the need to relay foreign financing with domestic resources is becoming increasingly urgent and hence must be met through the reform and development of domestic monetary and financial systems (Germidis et. al., 1991).

The industrial countries of this present time are in part the results of their efficient financial systems (Gerschenkron 1962, 1968; Cameron 1970; UNIDO 1990). Industrial countries have exhibited two distinct patterns of financial system development. The Anglo-Saxon countries developed commercial banks that supplied short term finance for trade. Two important principles were self-liquidating paper and arm-length relations with business enterprises. In contrast, the universal and multipurpose banks that developed in eighteenth-century Germany supplied both short and long term finance and had close associations with their borrowers (Fry, 1995). Gerschenkron (1968) believes that the banking system played a key role at certain stages in the European industrialisation process. In Germany, the banking system was the primary source of both capital and entrepreneurship. He argues that the inadequacy in the number of available entrepreneurs could have been remedied or substituted for by increasing the size of plant and enterprise above what otherwise would have been an optimal size. In Germany, the various inadequacies of the individual entrepreneurs were also offset by the device of splitting the entrepreneurial function: the German investment banks- according to Gerschenkron (1968) a powerful invention, comparable in economic effect to that of the steam engine- were in their capital supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major- and sometimes even not so major- decisions of individual enterprises. It was they who very often mapped out a firm's paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases (Fry, 1995).

The present time developed countries came out of backwardness and attained their development through the process of industrialisation and while the financial system contributed tremendously in this regard (Gerschenkron, 1968). The approach analysed by Gerschenkron has also proved a useful starting point for the discussion of non-European late comers in the world economy, including Japan and the newly industrialised countries-NICs e.g., Korea and Singapore (Fishlow, 1989). Gerschenkron views industrialisation as a process that spread from its birthplace in England to 'more

backward' countries. In general, 'backwardness' in this sense and viewed in the context of the Industrial Revolution varied directly with the distance from England, as do the dates for the inception of industrialisation. The 'degree of backwardness' thus became an organising principle according to which Gerschenkron classified a number of features of the development process. Depending on a given country's degree of economic backwardness on the eve of its industrialisation, the course and character of the latter tended to vary in a number of important respects (Gerschenkron, 1968, p. 353). Gerschenkron stated that the more backward the economy is:

“ the greater ... (is) the part played by special institutional factors designed to increase supply of capital to the nascent industries and, in addition, to provide them with less decentralised and better informed entrepreneurial guidance; and it (industrialisation) leaves a smaller role for agriculture”.

There have been numerous pieces of research which have sought to test the Gerschenkron hypothesis. The main idea behind these is to analyse the role of financial systems in economic development, within a strategy of industrialisation. According to a case studies (Cameron, 1972), in the cases of four European countries (Austria, Italy, Spain and Serbia) it was seen that two of these countries i.e., Serbia (Lampe, 1970), Spain (Tortella, 1970) had failed to achieve significant industrialisation and the rest two's i.e., Austria (Rudolph, 1970), Italy (Cohen, 1970) industrialisation was tardy and incomplete before 1914. On the other hand, Japan (Yamamura, 1970) and the United States (Sylla, 1970) were extraordinarily successful- both achieved high rates of industrial growth. In studying the European countries, researchers have found that there are various possible answers to the question: what went wrong ? Perhaps the countries were so poorly endowed with resources, natural and/or human, that industrialisation was simply out of the question. On the other hand, although not every country has a Ruhr Valley, there are other possibilities for industrialisation, as the case of Japan shows. In the countries that failed to industrialise was the banking system at fault? Or did their governments' economic policies stifle the natural possibilities for growth? In each of the cases investigated in the research considered above it was detected that it was likely that many factors were at work in hampering economic growth that even a drastic

restructuring of the banking system would have resulted in only a slightly better over-all performance (Cameron, 1970).

The Gerschenkron hypothesis received considerable academic attention in the late 1960s and early 1970s. It was taken up again by Khatkhate and Riechel (1980) and Patrick (1984). They advocate, in line with the Gerschenkron hypothesis, universal or multipurpose banking in developing countries. The World Bank also recommended the adoption of universal or multipurpose banking systems, wherein there will be banks and financial institutions to cater needs of various types for example-banks with programmes for poverty alleviation/industrial development in developing countries and also advised on the strengthening of the financial system for the sake of economic development (World Bank, 1980).

2. 4. (iii). Financial Intermediaries in the Financial System.

Financial institutions first emerge in an economy to reduce to liquidity and productivity risks for savers. They allow Individuals to reduce the number of their transactions, so economising on transaction costs, by holding their savings in a bank or other financial institutions rather than in a diversified portfolio of direct financial instruments. At the same time, savers may achieve a preferred trade-off between liquidity and return. Financial intermediaries exploit economies of scale in evaluating and monitoring borrowers. Financial intermediaries are the only source of external funds for many small and medium sized businesses because information costs are prohibitively high for them to issue equity or bonds (Fry, 1995).

Goldsmith (1969, pp. 395-7) argued that financial institutions can raise the totals of savings and investment above the levels that would have occurred in the absence of institutional borrowing and lending, when savers and investors would be limited to direct financing. The main support for this argument lies in the observation that most

savers and lenders prefer to hold claims against financial institutions rather than the primary securities issued by actual investors (Drake, 1980).

Empirical support for the view that the existence of financial institutions raises the savings ratio can be obtained from the work of Hooley (1967), which shows that savings in the Philippines responded positively to development of the financial system in that country over the decade 1951-60. Similarly, many prefer to borrow from financial institutions than from individual lenders. Institutional finance may be more tailored to particular investment projects, may be in more continuous supply, may be more flexible (in amount and in terms) should circumstances change and may well be cheaper (Drake, 1980).

The existence of financial institutions does not of itself resolve the problems of uncertainty, costly information, transaction costs, and economies of scale in information collection but it may help to augment the process of economic development by reducing these problems by making financial transactions more effective. For example, the financial intermediaries can encourage individuals to release their savings for productive investment by reducing their holdings of unproductive tangible assets and can also improve the allocation of investible funds in various ways: pooling funds and acquiring information that enables them to allocate capital to its highest valued uses, so raising the average return to capital; providing maturity intermediation by offering liquidity to savers and, side by side, long term funds to investors, so stimulating productive investment; enabling individuals to diversify away idiosyncratic risk of individual projects, so encouraging capital ownership and productive investment; evaluating investment projects and valuing the expected profits from specific innovative activities.

Improved financial intermediation is likely to increase the rate of economic development and growth through increased quality or quantity of investment in firms in the economy. There is a close interconnectedness among financial intermediation, savings, investment, income and economic development and growth (World Bank, 1989; Fry, 1995). Financial intermediaries operate to raise the level of savings which leads to higher level of investment

which in turn increases the level of income and income then raises the level of savings. In a modern economy, investment is carried out by one group of individuals and institutions, while much of the savings is done by other groups.

From the above discussion it can be inferred that financial systems are not 'neutral' with respect to economic development. Where they exist, they do so because there is a demand for their services, and such a demand is usually evidence of a growing, developing economy. It cannot be argued that financial systems invariably make a positive, unambiguous growth inducing contribution. They are not separate from the multivariate characteristics of the economy of which they are a part and thus may not be an independent variable in the growth process. As Tortella (1972) points out, the financial system can be 'tilted' by unwise legislation and policy. A financial system can distort and even thwart the growth of the economy. Although the fundamental dynamics of development lie outside the financial system, the way the system is structured can either significantly hasten or retard development. It is thus a matter of great importance for policy makers to know what structural characteristics are especially favourable or unfavourable. For better performance of financing development there should be a competition in the financial system i.e., among financial institutions, which may be possible, at the initial stage of development financing by following the supply-leading policy and then demand-following policy afterwards. This competition in the financial system can act as a spur to the mobilisation of idle financial resources and to their efficient utilisation in trade, commerce, and industry. These inferences do not arise from any doctrinaire attitude, but solely from examination of and reflection on historical experience (Cameron, 1972).

This chapter has reviewed a number of issues in economic development which relate both generally and specifically to the subject matter of this thesis. Definitions and interpretations of development have been examined and a number of models of development reviewed. In addition we have considered research on the role of financial systems in development. We now turn in the next chapter to the particular issue of small firms and development.

Chapter Three

Small Firms Growth and Economic Development.

3.1. Introduction: International Views on the Definition of Small Firm.

The significant role which small firms can play in economic development and growth is accepted across the world. Irrespective of the economic position of a country i.e., developing countries or developed countries aspiring to a better and strong economic performance there has been widespread realisation of the need for an efficient and better performing small firms sector.

Significance of small firms can be observed by its contributions to economic growth. Small firms make three main contributions (Mayes and Moir, 1988): First, the increase in the number of small firms increases employment. Secondly, some of these small firms assist the rate of growth by advancing the pace of innovation, increasing utilisation of capital and tackling projects with higher risk. Thirdly, some small companies contribute to growth directly by growing into medium and large companies. In addition, small firms help improve overall efficiency, particularly during periods of structural change, by providing flexibility and a source of increased competition to larger firms. By exploiting new markets which larger firms find uneconomic, they increase the variety of new products and services available.

In the USA the small firms sector has formed an integral part of American life since early times and certainly before the onset of rapid industrial change, it dominated the economy. While its economic position is far less prominent in most sectors today, it retains a surprising degree of importance in the growing service sector and also serves as an adjunct

to large manufacturing enterprises. Its place among American values seems scarcely eroded by economic and technological change. As Sylla (1980) observes,

“a small business ideology has been present throughout American history”.

The importance of this sector in the economy may be understood from the statement made by Storey (1985):

“..... no longer is the large firm regarded as the motor for growth and no longer is the emphasis upon scale economies at the plant level. Instead public policy is increasingly directed towards the smaller enterprise. Several European governments have over the past five years, initiated for the past time programmes of assistance to small businesses, whilst the United States, which has a much longer history of encouraging small firm sector is planning an increased emphasis on the sector in its efforts to increase economic growth and employment”.

This statement shows the role of small firms in economic development to be recognised as having contemporary importance. In the latter part of this chapter the historical role of small firms in attaining economic development, together with their current position in growth and development will be reviewed.

However, before beginning our discussion we should clarify some issues in definition and organisation concerning such firms. Numerous definitions of small firms have been put forward without general agreement. In the UK, a committee of inquiry on small firms known as the Bolton Committee was set up in 1969 which submitted its report in 1971. The committee recognised that one single definition would not cover firms divergent as manufacturing and service, and instead the committee used eight definitions of small firms for varying firm and industry groups. These definitions ranged from under 200 employees for manufacturing to under £50,000 turnover for retailing and up to 5 vehicles or less for road transport. But any definition which is based on turnover, or indeed any other measure of size expressed in financial terms (such as capital employed or net assets) suffers from serious inherent disadvantages in times of inflation. The Wilson Committee (1979) on the financing of small firms updated the Bolton turnover requirements for small firms by an

index based on the general index of retail prices. This brought the definitions temporarily in line but did not solve this particular problem. In the Europe for legislative and administrative purposes firm size is usually categorised by number of employees, but there is no general agreement on the number that is covered by the term 'small'. Probably the most common definitions are that firms with less than 100 employees are small and those with 100 to 500 are medium. But many countries (e.g., Germany) regard 10 employees as the top limit for small firms, and France and Sweden agree with the Bolton Committee's 200 employees limit (Dewhurst and Burns, 1983). As does Storey (1985), who also defined a small firm as having less than 200 employees. However, the Bolton Committee was certainly right in arguing that one definition would not work easily across the boarder. As it states, in retail distribution a firm employing 200 employees would typically have at least 10 shops with a total turnover of several million pounds and would be a very large organisation in terms of the distributive trades'. Nevertheless, in the UK, the 1981 Companies Act laid down for the first time, formats for the Balance Sheet and Profit and Loss accounts, and though not of importance here, these prospective formats apply to all companies, but only for the copies of their accounts filed with the Registrar of companies. From that source a definition for small firm arises, which is -a company may be classified as small if, for the financial year and the one immediately preceding it, two, (at least) of the following three conditions apply:

- (a) turnover did not exceed £1.4 million
- (b) balance sheet total did not exceed £.7 million
- (c) average weekly number of employees did not exceed 50.

The Bolton report contrasted the statistical definitions of size with what it referred to as the 'economic' definition. Bolton identified this definition having three parts as follows:

1. market share
2. independence
3. personalised management.

The characteristics of a small firm's share of the market is that individually it is not large enough to enable it to influence prices or national quantities of goods sold to any significant

extent. Independence means that the owner has control of the business himself. This therefore excludes those small firms which, though in many ways fairly autonomous, nevertheless have to refer major decisions to a higher level of authority. Personalised management is the most characteristics factor of all. It implies that the owner actively participates in all aspects of the management of the business, and in all major decision making processes. There is little devolution or delegation of authority. One person is involved when anything material is concerned. However if one owner/manager has to manage everything, a wide range of skills is needed. Unlike the Chief Executive of a large corporation who can employ a secretary, a financial director, a treasurer, a solicitor and an accountant, all well informed in their own professional fields, and all willing and able to advise him, the small business proprietor has to undertake all or many of these functions.

Other researchers have defined small manufacturing firms in line with the floor-area occupied by them. Perry (1986) in his research defined small manufacturing firms, as having floor area of 5000 sq. ft. or below. This definition excludes measures involving capital or employment level. Also this research imposes certain conditions in respect of uses of premises. Small manufacturing firms are defined as premises provided for industrial use. Properties designed exclusively for warehousing and/or retailing activities would be excluded. However, dual purpose buildings designed to accommodate both services and manufacturing activities need to be given special consideration.

Although Curran and Stanworth, (1986) argue in favour of size of employment for classifying firm size, they also argue that the size distribution of firms, as measured by the number of persons employed is highly skewed. As for example in manufacturing firms well over 90 percent of firms employ less than 100 people (British Census Report on Production 1980, 1983).

In addition to criteria such as volume of output or sales, number of employees, or size of investment. A functional approach in defining small firms has also been suggested. Thus, a small firm would be one 'small enough to be operated with no more than one layer of supervision between owners and workers'. Still others confine the category to non-

incorporated enterprises that do not do business across state lines and are under the control of a single family, or a group of associates who are in personal contact day by day, the owners' of the firms participated in management and the relationships between proprietor and customer were personal (Bruchey, 1980).

Here, the definition of small firm in Bangladesh may be illustrated for the purpose of understanding this research work, and the definitional variety internationally. The definition of is as under:

"Small Industry means an industrial undertaking engaged either in manufacturing process or service activity whose total fixed investment excluding the prices of the land, expenses for inland transportation and commissioning of machinery appliances and duties and taxes, is limited to taka three crore i.e., Tk. 30 million (including initial working capital). In the case of BMRE, even if the total investment limit exceeds Tk. 30 million, it would still be considered as a small industry. However, the extent of extended investment for BMRE shall not be more than 50 per cent of the total investment" (Industrial Policy 1991, a GOB publication).

The discussions above indicate definitional unanimity of small firm, and which is not an unusual matter. According to Mayes and Moir (1988) a major difficulty in the study of small firms is the definition of what constitutes one. The research undertaken by Mayes and Moir on small firms in the United Kingdom states that definition of small firm does not only vary among countries but they vary within countries as well. They have cited example of Bolton Committee (1971) in the United Kingdom in defining small firm, this committee used no fewer than seven definitions for the industries it covered-and it omitted consideration of agriculture and financial services altogether.

Nonetheless, whatever the definitional variety and unanimity, we, for the purpose of this research consider and concentrate on the definition of small firm put forward by the Government of Bangladesh; since this research is on small firms development and financing in Bangladesh.

3.2. Economic Development via Small Firms Development.

Countries which are today developed have not come to this stage without having passed several stages of development. The stages of economic development identified by Rostow (1959) provides a model of the progress of development. Rostow designated the sweep of modern history in five stages: the traditional society, the preconditions for take-off, the take off, the drive to maturity, and the age of high mass consumption. The first three stages represent the historical sequence through which the developing country is expected to pass. The decisive stage is the take-off. The rate of investment at this point rises to over 10 per cent of national income, and one or more substantial manufacturing sectors emerge. These sectors operate as 'leading sectors'. Their high rates of growth induce growth elsewhere, that is associated industries, service occupations and export production. At this stage too, a social, political and institutional framework emerges which is conducive to self sustained growth. In a country where the pre-modern tradition is weak, economic development takes time. In case of Japan, it took more than a century to come to the present level of income from the subsistence level of the 1870s and its present level development is the outcome of the successive evolution of the economy in the past few centuries. However a developing country, if successful, can develop faster than Japan, as demonstrated by Korea, Taiwan, and Singapore, but it still requires time and an economy has to adopt appropriate and sustainable strategies for development (Kunio, 1994).

The history of economic development suggests that to have an accelerated economic development there should be a dualistic development strategy, from illustrations below this strategy may be understood. However for countries that are still in pre-take off stage it may not possible or desirable to pursue a capital intensive strategy based large scale industrialisation. Rather it may be preferable to establish a strong industrialisation base through pursuing labour intensive techniques of production by promoting small firms. In the case of European countries such as, Germany, France, the UK, Spain which followed a dualistic development approach, their economic development process was initiated by adopting traditional sector development methods i.e., promoting and

developing small firms and businesses as well as developing modern sector- firms based on large scale capital and advanced technology.

In the discussion below experiences, with regard to small firm development towards economic development, from various groups of countries i.e., now developed, NICs and developing are put forward. Which demonstrate this sector's significance to development over the periods.

Small firms and businesses have made a large contribution to the economic development of Japan, a unique feature of Japanese economic development. Currently, in Japan, modern sector capital intensive large firms are using advanced technology the largest foreign exchange earners, but for a long period during the initial stages of economic development, the small firm sector was the largest foreign exchange earner (Kunio, 1994). In the Meiji period for example, the agricultural sector exported raw silk and earned the foreign exchange necessary to import machinery and raw materials for industry. Silk remained the largest foreign exchange earner until the early 1930s. After that, until the early 1960s, small scale labour intensive firms took over as the major engine of growth and source of foreign exchange. Japan exported such labour intensive products as garments, toys, plastic goods, rubber products, and ceramic wares to the United States and Western European countries, who were at that time unable to compete in labour intensive production because of high wages. After the take-off period, since the 1960s, small firms have declined in importance as a foreign exchange earner, but have nevertheless indirectly supported the exports of the modern high technology capital intensive sector by functioning as the supplier of parts and raw materials, thereby helping maintain the competitive advantage of the large firm sector. This has happened because of the development of a linkage firms approach to industrialisation. Where linkage industries, according to Kunio (1994), may be e.g., thread industries and packaging industries in relation to garment industries. That is, industries those emerge, due to establishment of a typical industry such as garment manufacturing firm, may be termed as linkage industries. So, if garment manufacturing firms were established there would be possible emergence of firms such as garments packaging and thread as linkage industries. The active participation of small firms in the industrialisation process has allowed both small and large firms to perform efficiently (Kunio, 1994).

In case of America, industrialisation was not alien to, but often emanated from, the pre-industrial American artisan class, who invested small amounts capital in enterprises involving comparatively large numbers of people. Likewise, the inventiveness, entrepreneurship, and capital of small producers and businessman was a vital force in the early nineteenth century industrialisation. American economic development history shows no sign of a jump from a very primitive and traditional form of industrialisation to a modern high-technology capital intensive one. It was the small businessman, shop owners, craftsmen, small clothing factories, shoe factories, leather factories, garment factories whose accumulated funds led the country towards a phase of capital intensive industrialisation (Hirsch, 1980).

In case of American industrialisation the emergence of large scale enterprises was a relatively late phenomenon. In 1870 only a handful of plants primarily the textile mills of upper New England, and a few iron and steel plants employed many more than 1000 workers. In the USA's sixteen leading industries, the number of workers per plant averaged only 52 in 1870. The number reached 127 by 1900. The Small Business Administration Authority (SBA) in the USA defines a small firm as one employing under 250 workers (Body, 1980), which means the American economy was (and currently remains) dominated by small firms.

In the United States, contemporary research on the employment effects of small firms and businesses is largely associated with the work of Birch (1979), whose initial study was based on a very large data file of firms collected by Dun and Bradstreet, a credit rating body. According to his estimates, firms with twenty or fewer employees accounted for 66 percent of net employment growth in the United States between 1969 and 1976 (Markusen and Teitz, 1985). Subsequent work has both supported and challenged Birch's work. Teitz et al (1981) found by analysing an unemployment insurance data set which represents all firms in California for the period of 1975-1979, that firms in this size category produced some 56 percent of net new jobs in the state.

Moreover, this work suggested that the dynamics of employment generation were such that much of that total may be the result of fast growing small firms.

In the late 1940s and early 1950s small firms growth was remarkable in the UK economy. The concentration of investment in small firms at that period was encouraged by post world war phenomenon, the absence of large amounts of available capital (Lloyd, 1980). Although there had been small firms in the pre and immediate post war periods their economic contribution did not become important in economic growth until the late 1960s. However, in the years of post war reconstruction, the property needs of small firms had received little attention from profit conscious developers or image conscious local councils. At the time of redeveloping city areas after the war, small firms whose locations were inconsistent with local development plans were often weeded out. During the 1960s, politicians and economists tended to view small firms as an outdated form of economic organisation: it seemed that the needs of a modern economy required complex technological processes and large units of production (Lloyd, 1980) and also small firms were considered inappropriate vehicles for advanced technological systems thought essential to development and growth (Perry, 1986). Although the 1960s was a decade of belief in large scale firms, the 1970s witnessed the rehabilitation of the private small firms in terms of their perceived role in stimulating innovation, creating wealth and generating employment (Perry, 1986). This changing recognition of the importance of small firms, is illustrated by the UK government forming two committees of inquiry i.e., Bolton (1971) and Wilson (1979) committees to evaluate the role of small firms and recommend policies to encourage their development in order to pursue better and sustained economic development and growth.

We may now consider what lessons can be drawn from the experiences discussed above. Throughout the post 1945 period of rapid world industrialisation, there have been numerous and strong advocates of small firms who have sought to promote them as either a complement or an alternative to large modern industry as a economic development strategy. Presently, in many developing countries the development of small firms has been accepted by policy makers as one of the prominent strategies for economic development. The actual pace-setter in the industrialisation process, in Japan

as in Britain, was textiles, and for a long time, handicraft methods continued to be used alongside of machine methods in Producing Japan's industrial goods. And these industries were set up in small sizes at the beginning using cheap labour including women (Lockwood, 1968). The experience of Japan and other developed countries such as the USA, the UK, Germany as well as the more recent experience of the NICs of South Korea, Singapore, and Taiwan have been taken as a guide towards this end. One of the main prime movers of Japanese economic development has been recognised as the 'family firms' which are basically small firms (Kunio, 1994).

India, which has probably been the post-independence leader in planning for large-scale industrialisation, has also pursued small scale development with vigour, a legacy of Gandhi's well known advocacy of smallness. Small firms is answer to problem arising from abundant labour force, and these small firms can be promoted both in industry and service sector (Dhar and Lydall, 1961). China's use of small scale rural industry in support of local self reliance is equally well known (Gillis et al., 1987). Throughout the developing world there are probably very few development plans that have not paid homage to small industry. It is because small firms, factories, and workshops, as well as helping to generate more employment, also permit greater decentralisation, raise income levels, promote income equalisation, and mobilise latent entrepreneurship (Gillis et al 1987) and these are necessary for ensuring economic development of the developing countries.

The importance of small firms in developing countries can be understood with reference to Banerji's (1978) work. This indicated that for twenty one developing countries during the 1960s, a mean of 79 percent of all manufacturing establishments had less than ten employees and could be classified as being in as traditional industries. Those establishments were responsible for 31 percent of the workers and 11 percent of the value added in manufacturing. Firms of up to fifty employees constituted 91 percent of the total in manufacturing for this sample, employed 52 percent of the workers and produced 24 percent of the value added.

Although we have argued that one of the main reasons we have argued that for favouring small firms is to generate employment some research has questioned the effectiveness of this strategy. According to Armington and Odle (1982) the large proportion of employment generated by small firms may be due to the use of establishment data that suppresses the connection of small units to larger parent firms. This argument can be criticised by considering the theory that Kunio (1994) put forward using the term 'keiretsu' (a system used in Japanese firms that develops linkage firms). In this system, at the top of the hierarchy is an assembler (final producer) for example, Honda, which takes different parts from different small firms i.e., sub-contractors. In turn each of these sub-contractors usually has its own sub-contractor who supplies the necessary parts and raw materials. Each of these firms is independent in operating their business as far as their business activities, employment and so on are concerned.

A further question of the quality and stability of jobs created in small firms is raised by Gordon (1979) and Bluestone and Harrison (1980), all of whom assert that the higher attrition experienced by small firms dooms most of the jobs that they create to be short term (Markusen and Teitz, 1985). This characteristic has long been noticed in studies of the dynamics of the population of firms, as for example in the work of Ijiri and Simon (1977). In addition, small firms may exhibit lower productivity and pay lower wages than large firms. Teitz et al (1981) also showed that there may be a lower rate of job generation in manufacturing by small firms.

Despite these criticisms, the idea that small firms are important to economic development and employment growth is now well established. Small firms may be able to generate more employment than large firms because such firms generally use more labour and less capital per unit of output. In addition, small firms may tend to manufacture those products that are more labour intensive, but use the same capital- output and labour- output ratios as large firms in the same sector or industry (Gillis, 1987). Thus, it may be that small firms are indeed capable of increasing income levels and decreasing income inequality by accelerating industrialisation and bringing economic development.

From experiences of different countries, as stated above, it may be concluded that small firm sector can play as an effective vehicle for economic development. While this did not exist only during 1940s or 1950s but it still can act as a significant vehicle for the same purpose.

Certainly, local, regional, and international development agencies in many countries are incorporating small firm development explicitly into their development strategies. And also the countries those are still striving for attaining economic development have adopted small firms development as a strong strategy in this end. However, research on small firm behaviour and performance, and its contribution to economic development and employment is continuing.

3.3. Macro-Economic Framework for Development of Small Firms in Bangladesh.

In this part of the chapter we will consider government policies towards the development of small firms in Bangladesh and the participants in the implementation of that policy. The basic reason underlying the choice of small firm development in Bangladesh as one strategy in the overall economic development strategy for the country is the perception that they can be an effective means for reducing some root causes of poverty i.e., unemployment, low income, and low investment. Adoption of policies to foster small firms will not bring economic development unless the policies are actively supported by the different sub-units of the economy which are responsible for implementing the policies and the programmes. The economic units involved in small firm development include, among others, financial institutions, and organisations providing services to groups, such as entrepreneurs and organisations supplying utilities to small firms. The role and activities of these units will be described in subsequent sections of this chapter and in later chapters. However, the macro-economic framework for development of small firms will be discussed first.

Macro-economic planning effort in Bangladesh started in 1973 under the very trying circumstances associated with the establishing of the country. It took the economy about four years to return to a base year (1970) production level following independence. The first five year plan (1973-78) had to struggle primarily with the problems of economic rehabilitation and reconstruction. The second five year plan (1980-85) tried to set up a basis for systematic planning but the efforts subsequently faltered partly because of the rapid deterioration of the international economic situation following the two major oil price rises of that period and partly because basic needs orientation in the plan required social mobilisation but the political and administrative processes and institutions were not adequately equipped for this. The third five year plan (1985-90) was credited for its achieving substantial progress particularly in agriculture and infrastructure development as well as in the field of structural adjustment.

However, experiences of the later part of the Third Five Year Plan (TFYP) shows that structural adjustment may be a necessary condition but is not a sufficient condition for economic growth (Fourth Five Year Plan, 1990). Therefore it became obvious that the economy needed sharply focussed strategies for attaining economic development. Of those, industrialisation via growth of small firms was identified an important and essential element.

The importance of small firms in combating non-economic development in Bangladesh may be observed from the manner in which the constraints on the overall development process were outlined in the Fourth Five Year Plan (FFYP, 1990-95):

“..... the labour productivity in Bangladesh is still low. So long as the labour productivity remains low, income, savings, investment and hence labour productivity cannot rise. However, small farmers and small enterprises have been found to be relatively more efficient in the utilisation of both capital and labour.....Bangladesh has surplus labour but shortage of capital. It is possible to convert labour into capital through appropriate investment strategy” (FFYP, 1990).

In this statement, several key economic-development issues and strategies are being clearly focused. It implied that development of small firms was one of the key focusses of development strategy.

Bangladesh has experienced four Five Year Plans and is also currently in the midst of the Perspective Plan (1995-2010). All these plans have some common objectives. And one of the major approaches is to enhance investment level-which will contribute to generation of savings and creation of additional capacities to absorb more labour i.e., create more employment opportunities and these are possible through ensuring growth of investment in small firms. For effective functioning of such policies government macro-economic framework also advocates for reorganisation of existing 'small enterprises related' economic sub-units and setting up of new institutions for supplying credit and other infrastructural/utilities services.

Officials statements on economic growth objectives and policies are available in various government documents. The latest views of policy makers in relation to this are revealed in the Perspective Plan (1995-2010). In this documents some of the key issues relating to the planning and execution of developmental programmes are linked to the small firms sector. The Perspective Plan indicates the following economic development objectives:

- i. Elimination of unemployment through generation of new employment.
- ii. Increase the income of poor people by self -employment generation, proper utilisation of indigenous resources, raw materials, skills and technology.
- iii. Human and entrepreneurship development for generation of new employment opportunities through delivering training and other services via establishing small enterprises training facilities.
- iv. To promote people's participation in the industrialisation programme.

Additionally, different international bodies like, World Bank, UNIDO, UNDP and regional bodies like ADB recommended to pursue industrialisation through taking strategy of small firms development while the investment in the large firm and

industries may not be abandoned rather restructuring of these sector is essential to reduce and finally eliminate government subsidy which causes available 'resources gap'. Small firm led industrialisation is being suggested on such principle that, a country like Bangladesh, small firms would create employment, generate income flow, reduce income inequality, reduce poverty, ensure savings and investment and finally break the vicious circle to accelerate the pace of economic development. A World Bank country paper on Bangladesh published in 1988, suggested for an industrial strategy which would be a labour intensive one. The government has been putting all necessary policies for inducing establishment of industries in order to create more and more employment opportunities.

A report by UNIDO (1989) also justifies small firm growth, the report states that:

"In Bangladesh small and cottage firms employ about 80% of the total industrial firm's related employment and it is due to the labour intensiveness characteristic of this sector, although Bangladesh's industrial sector is characterised by industrial dualism i.e., large and medium and small enterprises, and rest 20% is accounted for the large firms sector. The large-scale firms are concentrated in the textiles, chemicals and pharmaceutical, food manufacturing and metal products branches. While theses have been benefitted from government subsidization and produce mainly for a protected domestic market employing capital intensive method of production; and also they remain dependent on foreign concessional assistance as a source of financing the purchase of raw materials and for the acquisition of technology, since its operation and maintenance requires large amount of fund unlike small firms."

In order to identify the macro-economic policies of Bangladesh as well as the policies programmes for growth of small firms from primary sources (in addition to secondary sources e.g., published documents) I interviewed six high officials at policy level in different government organisations. This was part of the field work. While in this discussion, aspects relating to macro-policies regarding small firm are illustrated, and in the Analysis Section policy makers views on other issues, for example-financial market will be discussed. These included, one from each of the following organisations:

Ministry of Finance and Banking (Banking Division), Board of Investment (BOI), Bangladesh Bank, Bangladesh Small and Cottage Industries Corporation (BSCIC) and two officials from Bangladesh Planning Commission. These organisations and the high officials are either directly involved in formulation and implementation of macro and micro economic policies and strategies for economic development in general and vis-a-vis the implementation of policies for the development of small firms or indirectly have an impact on small firms and development through the formulation of credit policies for industries and firms by financial institutions. An example of the latter is provided by the Banking Division of the Ministry of Finance. These interviews indicated that the major macro-economic policies pursued by the Bangladesh government have been, in a summarised form, as follows:

1. Macro-economic stability with inflation at a reasonable level.
2. Enhancing government revenue.
3. The development of the private sector by reducing and removing all obstacles involved in it.
4. Reducing unproductive expenditure.
5. Enhancing competitiveness.
6. Increasing investment.
7. Generation of employment.
8. Developing of the human capital of the country.
9. Alleviation of poverty.
10. Improving the quality of governance.
11. The introduction and operation of structural adjustment programmes.
12. Increase the value and quality of public sector investment.
13. Adoption of Industrialisation programme for sustainable economic development.
14. Sustainable progress.

All the interviewees stressed the key role of several objectives namely increasing investment in both private and public sectors in order to encourage industrialisation, and the pursuit of structural adjustment programmes, and human resource development.

The interviews with these senior policy makers reveals, in addition to the published government policies like Five Year Plans, Industrial Policies and other related policies,

that industrialisation has been taken as a major approach to economic development. All the interviewees were asked the Question "*Do you think that economic development could be ensured via small firms development in Bangladesh?*". The unanimous view was that this approach to industrialisation could work effectively, indicating a degree of commitment to this strategy.

The interviewees were asked to Describe the background to the adoption of a strategy of small firm growth as for economic development and comment on the justification for such a policy. The policy makers' answers proved to be symmetrical with other of the objectives of development policy. Hence their answers indicated that they considered small firm development to be linked to the generation of employment, poverty alleviation, human resources development as a backward linkage to entrepreneurship development and skill development, a response to a situation of scarcity of capital. In addition, they also stressed that it represented an attractive alternative strategy to the development of agriculture as this sector was already oversaturated and there existed little or perhaps no scope for the creation of additional capacity to absorb abundant labour supply in agriculture. Linked to the relatively small capital investment of the small firm sector, there was a universally held view that this sector could flourish based on indigenous (non high) technology and indigenous raw materials, possibility producing those products which have export potential in international markets owing to an opportunities of employing cheap labour, as in the case of the garments industry. In addition, such small firms could, it was argued, produce low cost consumer goods for the local market and for local low income groups.

Apart from the above, the Structural Adjustment Programmes (SAPs) pursued by the Government of Bangladesh (GOB) provides a broad based framework for growth of the small firm sector. Under this programme, the government was able to identify the real sector or in other words factors on which achievement of real growth is dependent; and also the 'structural' sector. For example, the fourth five year plan 1990-95 states real sector is that which lead to increase the growth in national income and to help poverty alleviation; and financial sector was identified as a 'structure' to the existence and

growth of real sector. Amongst other things these SAPs aim to reduce the regulatory role of the Government. In the sub-chapter 3.4 we will discuss about fiscal and monetary policies, while in the analyses and concluding chapters we will try to identify, evaluate and analyse the economic issues related to the role of financial sector i.e., financial institutions, and policies such as tariff policy to the development of small firms.

3.4. Fiscal and Monetary Measures for the Growth of Small Firms.

The policy makers of Bangladesh taking assistance from some international bodies like the World Bank (WB), and UNIDO, have directed efforts at reforming policies in order to make the macro and micro economic atmosphere conducive for investment. Since 1991, the GOB has introduced important reform measures in fiscal policy, policies towards the financial and monetary sector, exchange rate, trade and industrial policies, and in the area of public resources management and the public enterprise sector. In early 1991, the GOB, building on the structural reform initiatives of the 1980s, launched a more determined and comprehensive structural reform programme to open up and establish a liberalised, market and private sector driven economy, operating within a stable macro-economic environment.

The GOB's development plans and other official documents do not identify any particular fiscal measures to be applicable directly for the small firms sector. Instead, there are some fiscal policy measures for example tax holidays for a certain period, import duty waive facilities and exemption from export duty are available to companies, but these measures are directed to firms which fall under the category of Export Oriented and Import Substituting Firms. Such firms may of course be small firms as far as their definition (total investment up to 30 million BDTk.) is concerned. However, there is no such policies for providing incentives like above for local market oriented small firms-manufacturing or service sector.

Monetary policy contains general measures for growth of the small firm sector. Which are contained in the GOB's published papers and documents. Details of these policies were

sought from policy makers in interviews. Among the monetary measures identified were the earmarking of funds and special interest rates for borrowing by the small firms promoters and owners. Under the 15 year perspective plan (1995-2010) total investment outlay has been earmarked at 9360 crore BDTk (93,600 million BDTk). Currently (prior to Perspective Plan, 1995-2010), according to a GOB directive Commercial Banks are required to invest 5% of their total loanable funds in the Small and Cottage Industries Sector (SCI). Government planners have proposed to increase this percentage to 15% from the start of the Perspective Plan (1995-96 financial year). Other important measures planned by the GOB in the Perspective Plan include establishment of a lead banking system for industrial estates, more specialised banks for small firms, making provision for credit for distressed firms, and relatively lower interest rate for the small firm sector. During interview the policy makers were asked about the specific financial measures undertaken by the GOB under these policies, they did not specify exactly what is the rate of interest is being charged for this sector, is it different among the small firms viz., local, export oriented etc, how much or what percentage of total investment outlay is being given for the small firm sector. The central bank of Bangladesh, Bangladesh Bank's (BB) states that there exists separate interest bands for lending to agriculture, exports, and small and cottage industry (World Bank, 1995).

The above discussion indicates that the growth of small firms in Bangladesh is related to several key issues. Importantly, implementation of various state policies i.e., fiscal, export and import policies for growth of small firms may be limited in its effectiveness unless those financing institutions, responsible for providing finance to small firm development play their role as required. As a part of the macro economic growth sector, financial institutions and through them their financing methods, culture and models act as an indispensable factor to growth of small firms. In the following three chapters (four, five and six) we will discuss the lending practices in general and lending models applied to small firms by financial institutions. In chapter nine we will examine other aspects of the loan capital market for small firms and the general culture of financing institutions in Bangladesh.

Chapter Four

Lending Models and Lending Practice.

4.1: Introduction.

In previous chapter we have discussed the role of small firms in development strategy and some of the problems of defining firms as small. In this chapter we examine the issue which must be dealt with if a programme of industrialisation is to be based on the financing of small firms, namely the identifying of new opportunities for small firm lending. This is concerned with the evaluation processes of financial institutions involved with small firm financing and also with establishing criteria for identifying new industrial opportunities in an economic development context.

4. 2. The Viewpoints of Commercial Lenders and Investors.

Financing for projects or firms can be sought in the form of equity or loans or both. This research is concerned with the 'loan' portion of financing and through it the suppliers of this loan capital. Lenders, we may assume, willingly accept a lower return on their capital than they could obtain in equity investments. They do so we may again assume because they place a greater value on reducing risk than on getting a higher return. Therefore they are more concerned about the security offered to their capital by any features of the loan or borrower which indicate that interest and principal payments will be met. A project or firm which makes high profits will do nothing for lenders, except add to the security of their loans. They are more likely to be interested in features which lend stability and reduce the risk of default (Bryce, 1960; Sharpe and Alexander, 1990). According to Ross (1989) investment decisions are primarily made upon considering risk and return, investors always try to reduce risk by ensuring increase of returns (by way of earning profits) to capital and stable profits is indicative to the security of money invested in project. Prospects of spectacular growth are not needed to make a project

attractive to lenders. Primarily, lenders want such assurance that failure is unlikely and that they can salvage all or most of their loan still outstanding if failure does occur.

Investors in equity have a very different outlook, as stated by Bryce (1960). They are in the business of taking calculated risks because they want the higher return on their capital which is only available if such risk is involved (Brealey and Myers, 1988). Investors may also prefer equity investment because it enables them to gain if there is inflation, while lending would make them victims of deteriorating currencies. Unless investors buy foreign stock purely to hold in portfolios, they may prefer equity investing because they believe they can improve the results of the enterprise through influencing or controlling its policies. In other words, their role may be active, whereas that of the lender is more likely to be basically passive. Now we will turn to discuss about lending models and standard procedures beginning with general review provided below.

4. 3. Lending Models and Standard Procedure.

Lending to firms and businesses of any nature requires evaluation of loan proposals because of risk. So, it is fundamental to loan evaluation procedures to understand the risks involved in a business and for the lender to develop a system to efficiently gather financial information and the types of information. Although modern financing methods overwhelmingly use computers, the basic methodology of loan appraisal may be the same for financial institutions irrespective of the economy or country where they are operating (Laudeman, 1994).

Every lending decision is based on certain minimum required standards and both lenders and equity investors appear to be agreed upon two basic principles: the projects they finance must be thoroughly prepared; and they must be technically, economically, and financially sound since no lender or investor can afford to be associated with failures (Bryce 1966).

There are several themes in the literature on lending standards and procedures which may be identified. Firstly we will review some of significant models of lending, then we

will turn to review some of the literature on small firm lending, and finally we will try to identify a workable model of lending for small firms in developing countries, in particular for Bangladesh.

We shall start with a discussion and review of literature on issues such as loan evaluation, monitoring and contracting. This section will be followed by a separate chapter (i.e., five) devoted to discussions on lending model which may be a classical one in terms of time, but nevertheless, which describes various stages of lending procedure in an elaborate way. This model was adopted from Cohen et. al (1966). However, in order to broaden our understanding of lending procedures and models and provide a framework of good practice in respect of small firm against which lending practices in Bangladesh can be assessed another chapter (i.e., six) will be followed the Cohen model. In this chapter (i.e., six) models for lending to small firms will be reviewed at the first section, and at the second section a model for small firm lending in Bangladesh will be put forward as a basis for assessing lending practices.

4.4. Review of Issues in Loan Evaluation, Monitoring and Contracting.

While the next chapter represents a systematic and integrated model of loan evaluation, this sub-chapter examines a range of issues related to loan evaluation which may be used to develop our model.

Bryce (1960) prescribes financial standards which lenders should apply in judging whether loans should be granted. These are as follows:

- (a) The total capital cost of a project should have been thoroughly investigated and is reasonable, complete, and sufficiently conservative so that it is virtually certain to be on estimated on the safe side.
- (b) All necessary financing for a project has been assured except for the portion now being sought.

- (c) The operating cost and revenue estimates are meet qualitative characteristics such as completeness, accuracy, safety, and realism.
- (d) The project can service its total debt (both interest and principal repayment instalments) with a wide margin of safety.
- (e) Operating at a realistic level of production, a project can meet all costs and provide a reasonable return on shareholders' investment.
- (f) Financing arrangements made or proposed will ensure that the project will have the cash it needs when it is required.

Lenders may require the presentation of financial information on these issues before a lending decision is made. These issues are important for the following reasons.

(i) Total Project Investment:

Experience suggests that problems may arise if capital costs are underestimated and projects are begun without adequate financing. Project failures often occur due to inadequate capitalization. This may reflect on the judgement of lenders and may involve them in supplying more money for salvage operations to safeguard the original loan. Hence, a loan officer may wish to be satisfied that a loan application is based on estimates which are complete and reasonable and conservative with a generous allowance for contingencies added. This discussion obviously raises many issues concerning the accounting information on which loan applications are based.

An important part of the total cost of a project (but one which is often omitted or underestimated) is net working capital. A loan officer should examine the presentation and estimates of anticipated current assets and liabilities, cash, and credit terms of suppliers of raw materials or contractual services (Lister and Evans, 1988).

(ii). Financial Structure:

In case of a public company a loan officer can observe the share structure, and the proportion of debt and equity. For private companies similar information would have to be disclosed by the sponsors/promoters of the firm. Lenders are interested to identify

any loan that already exists or for which application has been sought, the amount, lender's name, terms and conditions, repayment schedule, interest rate, and security offered for that loan. It is important that this is examined by the lender for reasons of priority and adequacy of financing. Many project presentations make some attempt to outline the proposed financing for the project, but many may fail to present a realistic picture of the financing to meet the total cost of the project. A bank may ask for a pro-forma balance sheet as of various dates during the life of the project which shows that financing needs have been or will be met for the project.

(iii) Earnings Forecasts:

Earnings forecasts are also important since they indicate the profitability of the project as well as costs of production, selling prices, margins and profits available for repayment of debt, and reinvestment and retention, for reserves, and for dividends or profits to the owners. It concerns estimates which show how safe the project is for the lender and how attractive to the equity investor (Stevens, 1980).

The period chosen for estimates of profits is important. For example, it may be necessary to forecast profits for a plant financed from a loan up to and beyond the period when the plant is fully established in the market with production up to capacity and costs down to normal. It is unfair to expect early years to be normal, so a lender may require forecasts of profits into a 'steady state' condition.

iv. Cash Flow Statement:

Each prospective lender is vitally concerned with when a project or firm will need cash and where cash will come from (Emmanuel, 1988 and Ginzl, 1988). This is as important as eventual earning prospects. Cash flow forecasts will indicate whether financial planning is sound and whether the project will have the cash it needs during vulnerable years before it reaches maturity.

It may be necessary for a lender to require not simply annual cash flow statements by estimates which are quarterly, semi-annual or for other periods.

(v). Debt Service Coverage:

As noted in the presentation of the model of loan evaluation a matter of primary interest to the prospective lender is the probable availability of cash to meet scheduled principal repayments to him and to other lenders, and to meet interest on all outstanding debt. A measure of a project's ability to pay the interest due on its long term debt and to repay the principal itself as instalments come due is the ratio of debt service coverage. This measure is a valuable tool for testing what margin of safety exists in the prospects of a project to service a proposed loan, so this is important to include in the part of the financial evaluation section of the lending model. This measure is obtained by dividing the cash availabilities for a given year, that is, estimated net profits before interest plus depreciation accruals, by the total of interest charges and principal instalments which would be due on all long term debt. As these amounts vary from year to year, the coverage is usually calculated for each year for which financial forecasts are prepared; frequently they are made up for each year through to the time when all long term debt would be repaid. For this calculation the lender will use a pro forma balance sheet and income statement and may also take assistance from the statement of sources and uses of funds.

(vi). Balance-sheet Estimates:

Lenders require the submission of estimated or pro forma balance sheet to analyse the firm's assets and liabilities position. It depends on the bank's policy how many year's balance sheet have to be prepared and submitted. For a project which is an entirely new entity the necessary figures all come from the cash flow. For a project which is an addition to a going concern, the starting point is the summary balance sheet of the enterprise as of the end of the period before the financial forecasts related to new lending commence.

Hester (1966), without describing lending procedures in detail, provides a list of information which bankers frequently refer to, when judging loan applications; these include;

(i) financial and quantitative: present and past size of the firm's current assets, liquid assets, working capital, current ratio, inventories, total assets, outstanding debt, net

worth, profits, sales, and deposit balances; the age of the firm's inventories, plant, and equipment; the stability of demand for product; and

(ii) certain qualitative information, the purpose of the loan, the business of the borrower, the integrity and competence of management and the labour relations of the borrower.

Laudeman, (1994) examines the lending procedures of financial institutions for small and medium sized firms. According to Laudeman lending decisions are primarily 'financial', and involve:

1. Collection of financial information through collecting multi-period balance sheet and income statements
2. Production of a report of the most common financial ratios. These ratios are collected to measure the financial success of a business. Studies have found that certain financial measures are good predictors of the financial problems of a business and therefore may deserve the highest weight in a scoring model.¹ Such measures relate to:
 - a) profitability,
 - b) operating efficiency;
 - c) debt service coverage, (as measured by the ratio of net cash after operations divided by scheduled debt service, principal, interest, and dividend payment);
 - d) leverage, (as measured by total liabilities divided by tangible net worth;
 - e) liquidity.
3. Preparing reports on cash flow.
4. Calculating a financial score by taking into account how a borrower's ratios compare to benchmark ratios for the borrowers industry.
5. Preparing a financial projection based on the financial information supplied.
6. Interpreting the results and making a lending decision.

¹ See Keasy and Watson (1986) and Zimmer (1980, 1981).

Altman (1980), argues that the lending process essentially involves four steps:

(1) application for a loan; (2) credit evaluation; (3) loan review; and (4) repayment performance. If the repayment experience is unsuccessful renegotiation and/or loan 'work-out'² procedures are likely to ensue; if successful, a loan renewal application is often forthcoming.

A loan request manifests a perceived need to add to firm's external debt financing and reflect capital expenditure plans, and cash flow analysis. Formal credit analysis follows the receipt of an application and involves forecasting and other traditional techniques such as financial ratio analysis and industry analyses. According to Altman the essence of good credit analysis is to determine repayment probabilities. When combined with the analysis of relevant qualitative factors credit analysis also is the basis of the pricing and structuring of the loan agreement. Altman identifies firm-insolvency analysis as an analytical credit tool increasingly used by financial institutions in quantifying the likelihood of continued company existence.³ When quantitative credit scoring techniques are used to evaluate new loan requests, it is common to consider the historical repayment experience of the financing institution on similar loans in the past. What is not usually considered is the cost of making errors in lending decisions. This cost is a function of the repayment and recovery experience and this experience, in turn, can assist in refining the process for the determination of optimal cutoff-score criteria in the accept/reject decision.

After an initial lending decision is made, the process either ends with a rejection, or continues with structuring the loan. At some point all banks perform a review of their existing loan portfolio (Arsenault, 1989). This review relies on many of the same procedures applied to the evaluation of an initial loan with the exception of financial requirement forecasts. If a loan is showing serious signs of difficulty, financial

² Work-out refers to procedures and discussions between lender and borrower designed to mitigate problems of repayment and can apply to corporate borrower and sovereign borrower (Eichengreen et. al., 1995).

³ Such techniques are also relevant to loan review.

institutions may choose to classify the loan for special consideration (Dietrich and Kaplan, 1982). The decision to classify is usually an internal one but often is encouraged by external bank examiners. Classification implies a close and continuous analysis and an action programme to keep the loan from being written-off. When intermediate repayments are missed, or the final repayment is not received, a bank may decide that all or part of the loan is not collectable and a decision is made to write-off that amount. The decision to write-off is evident if the firm formally defaults and petitions the courts for bankruptcy. A common practice by banks at this point is to 'setoff' existing credit balances in the customer's account against the outstanding loan amount. The remainder of the loan may then be turned over to a special team of workout personnel who try to recover as much as possible. When these efforts are exhausted, the lending process is usually ended. Assuming successful repayment of the loan throughout, or delinquencies that are eventually cleared up, the customer will decide whether to submit a new request.

Dorfman (1991), illustrates six basic standards for commercial lending by financial institutions, careful observance of which he argues may eliminate most problems concerned with lending. These standards are:

- 1) *Loan Officers recommending approval of a loan must-*
 - (a). Have a thorough knowledge of the borrower's business,
 - (b). A thorough analysis of the credit. This must include a good understanding of the credit taker's environment, including the economy, the industry, the credit taker's business or personal strategy, and the credit taker's capacity to successfully implement that strategy.

- 2) *Owners, managers, and individual credit takers must be people of integrity with substantial relevant business experience.* Experience in business and competence can often be judged by track record. Character, in the sense of integrity, is one of the hardest items to judge. Loan officers will consider reputation in the community and the willingness of the borrowers to be open and provide information, even if there is

evidence of unscrupulous business practices or imprudent or extravagant personal behaviour, the existence of law suits, and other matters (Strischek, 1990).

3) *Ownership equity of the borrower must be significant in relation to the credit sanctioned.* Steps must be taken to ensure effective involvement on the part of the borrower, because someone who has only a bank's money at risk is less likely to be a prudent user of that money than is someone who also has a significant amount of his or her money at stake.

4) *Credits must have two clear sources of repayment.* The primary source of repayment should be the reasonably expected cash flow from the borrower's operations. Unpledged assets can be an appropriate secondary source of repayment from a credit taker with a high credit standing. However, a security interest in collateral supporting the loan may be considered as a secondary source if ,

- (i) there are appropriate margins for possible decline in collateral value and difficulties in realising on the collateral, and
- (ii) the value of the collateral is not likely to decline at the same time as a decline in cash flow from the borrower's operations.

If condition (ii) is not met, margins required by condition (i) must be much larger, and, even then, the credit should be regarded with caution.

5) *The bank's position as lender should be as good or better than any other significant creditor with respect to collateral security, guarantees, default clauses, and similar matters.* If a borrower experiences difficulties, negotiations will involve not only the borrower and a particular bank but also other creditors. It is important for a bank's bargaining position that it not in a weaker position than other creditors.

6) *The bank must have sufficient qualified staff, facilities, and procedures in places to ensure professional administration of the documentation, continuing credit evaluation,*

and operational support of the credit throughout its life. No matter how good an initial decision, if the credit is not professionally followed up a bank is vulnerable to loss.⁴

Loan sanctioning is composed of various elements including credit analysis. Credit analysis is concerned to judge the creditworthiness of a borrower and to design an appropriate structure for the loan (Dorfman, 1991). Creditworthiness is a function of capacity to repay and willingness to repay. For an effective analysis the lender is required to understand the environment in which the firm operates, (e.g., political and economic) and the borrower's industry (e.g., barriers to entry and substitute products). The availability of multiple sources of supplies, changes in foreign exchange rates, regulatory, legal and other related factors may also be taken into account. This analysis will allow the loan officer to judge the borrower's strengths and weaknesses compared with those of its competitors and to judge the borrower's business strategies to see how realistic they are.

A company's financial capacity to repay a loan depends on producing a sufficient excess of revenues over expenses. Attention must be paid to absolute figures and in percentages. A company with a profit margin that is narrowing through time may eventually have difficulties. Balance sheet, profit and loss account and the cashflow statement (both pro-forma and normal) provide necessary data for financial analysis. In conducting financial analysis, a spread of years of financial statements is required. A loan officer should consider quality of earnings, that is the conservatism or aggressiveness of the borrower's accounting practices (Baker, 1990 and Reeve, 1983) and the volatility of revenues and expenses. Trends and comparisons with similar companies are very important. Unusual accounting practices should be disclosed in the credit memorandum (Dorfman, 1991). For extended term loans i.e., long term or medium term, loan officers are likely to forecast and analyse future financial statements (Donaldson and Donaldson, 1985) by obtaining borrower's forecasts and comparing them with the lender's own forecasts (e.g., 'most likely' and 'downside'). This

⁴ Lack of sufficient resources has been cited by the banks as reason why credit protections such as financial covenants may be difficult to apply (see Day and Taylor, 1995).

comparison may reveal important information about the view of a borrower regarding likely developments in its environment and its internal strategy and operations.

According to Morsman (1991) in analysing long term earnings potential, the lender must have a fundamental understanding of the company's future long term cash generation potentiality. The lender should include a sensitivity analysis using different assumptions for sales volumes, margins, current assets and liability turnovers, expenses, interest rates, and taxes. Sensitivity analysis should help the lender in determining the maximum payment that can be applied to debt while still maintaining enough liquidity for growth, fixed asset maintenance, and other agreed upon expenditures, such as asset purchases and servicing other debt.

A loan should be structured appropriately for its purpose and sources of repayment (Dorfman, 1991). When extending credit for more than one year (i.e., term loan) it is generally advisable to have the credit repaid in periodic instalments spread more or less equally over the life of the loan, rather than in a single repayment at the end. The payments of the instalments tends to demonstrate periodically that a borrower has the capacity to service the loan. Failure to make a payment will allow the financier to exercise legal remedies against the borrower at the time of the payment default, rather than waiting until maturity, at which time things might have deteriorated further (Donaldson and Donaldson, 1985).

It is often advisable, except for financially strong borrowers, to take a security interest in real estate or personal property to secure a loan (Dorfman, 1991). Having this collateral makes the loan safer in two following ways:

- (i). it may provide an alternative source of repayment. If necessary, the collateral can be sold, with the proceeds going to the bank rather than to the borrower's general creditors.
- (ii). Having the loan collateralised gives a bank a better bargaining position with both the borrower and general creditors.

However, as noted above loan officers need to be cautious in evaluating collateral because it may decline in value and there may be difficulties in liquidating it and it may decline in value at the same time that a borrower's cash flow also declines.

According to Nutt (1989), assessment of loan applications is affected by what he describes as cultural factors. These he classifies as : intuition-thinking (NT), sensation-thinking (ST), sensation-feeling (SF) and intuition-feeling (NF). These can be defined as follows:

(a) An NT lending culture implies loan officers with intuition and thinking preferences. This suggests a speculative decision culture in which information is sought to discover the influence of external factors, such as market demand with speculation about plausible outcomes before a decision is made.

(b) An ST lending culture involves loan officers who utilise sensation and feeling and have preferences for careful analysis with hard data. This creates a dependency on formal analysis and suggest an analytic decision culture.

(c) An SF culture involves sensation and feeling under which loan officers have preferences that suggest a consultative culture. The need for objective data and consideration of people calls for talking with others involved in a decision and using factors, such as bargaining, to sort and reconcile data.

(d) An NF culture involves intuition and feeling with loan officers who prefer to cater to people with track records and the organisations they represent or seek to establish, using politics and mutual adjustment to balance the conflicting claims of people with power. These preferences suggest a charismatic culture. Table 4. 4. (1) summarises the factors involved in these lending cultures and their implications on lending decisions:

Table 4. 4. (1)

Factors Involved in Lending Cultures

	ST culture	NT culture	SF culture	NF culture
Applicant Characteristics:				
Purpose of loan (for example, value of equipment to applicant).	Cut cost to increase profits	Increase capacity to meet forecasted demand	Respond to demands of best customers	Permit firm to develop new product ideas of owner.
Information provided (establish case for the loan)	Shows stable profitability over 5 years using financial statement	Cites a strong three year growth record	Demonstrate that the firm has many loyal customers	Give illustrations of the firm's innovations
Loan assessment process:				
Inference	Analysis of financial position	Favourable and unfavourable assumptions about sales	Consensus about analysis	Checking business prospects with people who knows firm and its products.
Validation	Checking calculations and details of data acquisition process	Allows company to capitalise on trends in sales	Members of bank's board known to believe firm has an excellent future.	Improves visibility of innovative product in its market

In the table 4. 4. (1) the culture factor, as stated by Nutt, was specified using both loan applicant characteristics and the bank's loan assessment process. A loan application offers two types of information: purpose, in this case indicating the value of the equipment to the applicant, and the arguments used by the applicant to make a case for the loan. The loan assessment process was described in terms of the analysis and validation steps that were taken by both the loan officer.

The ST (which was termed as analytic culture by Nutt) culture was captured by loans for equipment to cut the applicant's operating costs. The equipment was expected to reduce manufacturing expenses and thereby improve profit. To make a case for the loan, the applicant submitted financial statements for the past five years attempting to show a

stable record of profitability. The loan officer cited a careful analysis of the applicant's financial position in which calculations and details were checked to ensure that the profitability track record was accurate, to support granting the loan.

The SF (which was termed as consultative culture by Nutt) culture was captured by loans that were sought in response to the demands of the applicant's best customers. To make a case for the loan, the applicant demonstrated the depth of loyalty of customers, offering client lists and testimonials. The loan would allow the firm to be responsive to the needs of its best customers. The loan officer also cited support from members of the bank's loan sanctioning committee who believed that the applicant had an excellent future to support sanctioning the loan. Other loan officers were described as concurring with these assessments and preliminary reviews of a loan committee were cited as supportive.

The NT (which according to Nutt is speculative culture) culture was represented by loans from an applicant attempting to increase capacity to meet a forecasted increase in demand. The applicant cited a strong three year growth record in sales to make a case for the loan. To justify sanctioning the loan, the loan officer had made favourable and unfavourable assumptions about sales in the application finding that the equipment would allow the firm to capitalise on apparent trends.

The NF (which was referred as charismatic culture by Nutt) culture was captured by loans that permitted the applicant to develop new product ideas. The applicant made a case for the loan by giving illustration of the firm's record of innovation. To justify lending the loan officer had checked on the firm's business prospects by seeking out and consulting with trusted people who knew the firm and its products such as its key customers, suppliers and competitors who were also bank customers. These investigations suggested that the equipment could improve the visibility of an innovative product in the marketplace.

Henderson (1989), argues that three principles should provide the basis of the appraisal of loan applications. These he identified as follows:

- (i). Partnership doctrine: Creditors should be in an effective partnership with the owners of a business and should expect no more than an equal sharing of the risk in funding the enterprise or project.
- (ii). Liquidating solvency: Borrowers should always have adequate investment in a business to prevent creditors from suffering a loss in the event of a liquidation, and the lender should take necessary steps to ensure this.
- (iii) The five Cs of Credit: These are Character, Capacity, Capital, Collateral, and Conditions and are according to Henderson, the keys to making sound credit decisions.

However, Henderson states that the central issue of concern to a lender in considering loan requests is, *inter alia*, the prospect for proper repayment. Therefore, the fundamental usefulness of credit evaluation is the insight it provides about whether or not a firm will be able to pay its debts as they mature. Thus:

“ to succeed in today’s credit environment, commercial lenders need a concept for judging loan requests that focuses on a firm’s ability to service its debt”.

With this concept in mind Henderson advocates debt service-based credit criteria for loan evaluation. Accordingly, a business loan request should be supported by two factors-

- (i). A plan which, after careful analysis of proposed changes within the firm’s financial structure and such factors as management’s ability and economic conditions, leads to the conclusion that firm should be able to produce a satisfactory profit and maintain the capacity to service its debts within commonly available terms.
- (ii). Sufficient reserve to minimise concern that a debt service problem might develop, considering the uncertainties surrounding the firm.

It is useful to explore Henderson’s discussion of debt service capacity for insights which it provides for loan evaluation generally.

Henderson model identifies two approaches for analysing debt servicing ability: cash flow approach and reserve funds approach. Under the *cash approach* forecasts of cash receipt and disbursements are made. If a cash flow projection allows for payment of debts as the debts mature, it will reveal a firm's debt service plans. But if the projection only allows for payment 'as the firm intends to pay,' (that is, if the firm chooses to ignore the terms of its debt) it can give an erroneous impression of a firm's debt service ability.

Where cash flow forecasts are readily available and the lender has both the time and accounting skill to determine whether they allow for the payment of debts within terms and ascertain the many assumptions used in their preparation, such forecasts may provide a useful basis for understanding of a firm's debt service plans. However, where these prerequisites are not met, (a not uncommon occurrence in lending institutions) cash flow forecasts can become an impractical or misleading analytical device.

The reserve funds approach is based upon the premise that because of the uncertainties with which businesses have to contend, it is impossible to forecast the ability to service debts with precision. To allow for the unexpected, firms should leave room for error in servicing by having reserve funds.⁵ Businesses that operate without adequate financial reserves are in effect assuming that things will work out the way they expect. The more uncertainty a firm faces, the greater the chance situations will not work out as expected.

If either reserves are inadequate or the firm requires a long pay back period for its borrowings one or more of the following safeguards should be required by a lender:

(a). Control features that permit a timely awareness of and reaction to problems in meeting financial projections. (Such features could be the preparation and monitoring of periodic budgeted financial statements and the regular internal monitoring of loan agreements).

⁵ Reserves may be supplemented by (or, in this context, replaced by) lines of funding set up with financial institutions (Donaldson, 1985).

(b). Collateral that provides meaningful incentives for the borrower to cooperate in resolving the legitimate concerns of the lender and offers some hope of preventing (or minimising) loss by the lender.

(c). Guarantees backed by resources sufficient to offset any remaining concern about the borrower's ability to repay the loan.

Danos et. al. (1989) refer to three phases of the lending decisions as follows:

(i). Examine publicly available data on the potential borrower to make a preliminary judgement on the quality of the proposed loan.

(ii). Make personal contact with the prospective borrower, normally at the borrower's place of business, to size up the borrower's operations and future financial and operating plans.

(iii). Perform detailed credit analysis and evaluation of historical and forward looking financial data to determine the likelihood of a successful loan. A brief review of lending phases illustrated by Danos et. al. is given below.

Phase 1 of the credit evaluation process involves gathering background information on a prospective borrower, including a brief history of the firm and a credit report if it is an existing customer/firm. This background data includes highly summarised financial report information, such as credit rating, details about location(s), number of employees, when the firm began, names of key officers, and so on. The combination of the credit reports and the lender's knowledge of the client's officers, major owners, lines of business and industry position provide the background data included in phase 1.

Phase 2 of the process involves personal 'sizing up' of the borrower's business prospects and managerial skills. This phase normally includes an on location visit by the lender. Any background data missing from what is normally collected in phase 1 is usually collected during phase 2. Also, phase 2 normally contains a discussion with the client as to the purpose of the loan, their future operating plans and their financial plans

for the repayment of the loan. Detailed historical and forward-looking accounting data are normally either collected by the lender during their visit with the borrower, or else forwarded to the bank soon after the visit. These accounting data help lenders to assess the need for the loan, its purpose, and the quality of the borrower's organisation.

In phase 3 the lender performs detailed evaluation of the historical and forward-looking accounting data. This process is designed to determine whether the forward-looking data provide for the successful repayment of the loan from future operations, and whether the underlying assumptions about the future along with historical facts from past performance are sufficiently supportive of such a plan. The phase 3 analysis, along with the other data collected in earlier phases culminates in a decision to grant or not grant the proposed loan.

This chapter has reviewed issues in lending which have been addressed by a number of researchers, particularly in the UK and US. The material discussed, whilst illustrating matters of concern in corporate lending, does not represent a coherent, integrated model of lending which might be used as the basis of assessing good practice. In the following chapter we set out such a model adopted from the work of a group of US researchers, Cohen et. al. (1966).

Chapter Five

Lending Model After Cohen et. al.

An overall view of the procedures for appraising business loan applications and lending decisions as described by Cohen et. al. is presented in flow-chart form in Figure 5. (F1). The heavy arrows indicate the main flows involved in analysing most business loan applications. This lending model includes loans for seasonal needs (working capital) as well as term loans, secured loans as well as unsecured loans, and loans to small firms as well as to large firms, in short, any loan which fits into the 'commercial and industrial loan' category.

Cohen et. al. identify eight aspects of the loan appraisal process as follows:

- A. *Status of the firm's customer relationship.*
- B. *Evaluation of a new customer relationship.*
- C. *Credit evaluation.*
- D. *Check on legal and policy restrictions.*
- E. *Appraisal of the loan's purpose, amount, maturity, payback, and security.*
- F. *Detailed recommendations.*
- G. *Record analyses and recommendations.*
- H. *Follow-up and review.*

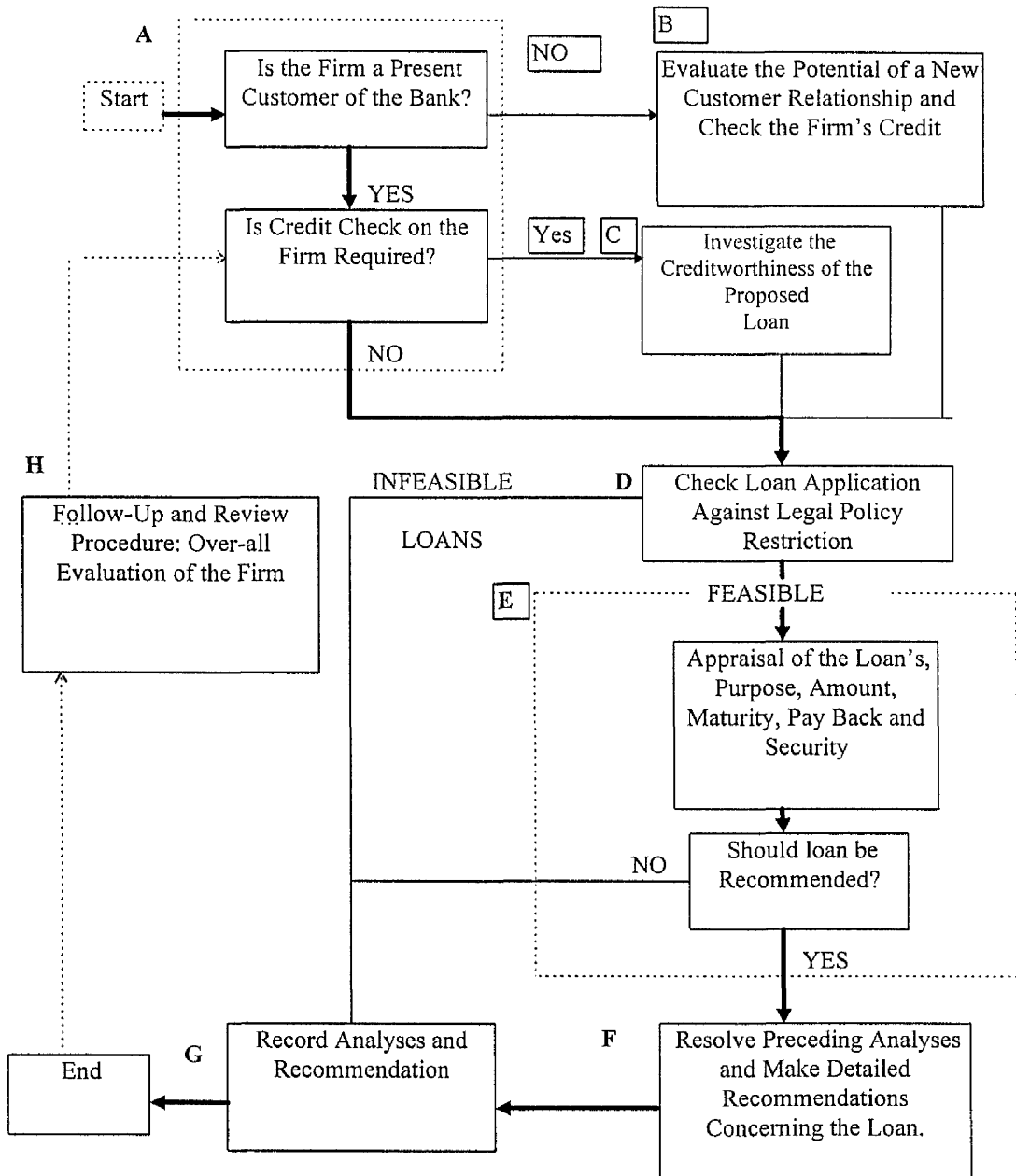
Each of these aspects will be separately outlined in brief below.

A. Status of the Firm's Customer Relationship.

The first in the list of the queries from the loan officer is whether the firm applying for a loan is already a customer of this bank. If it is, the process continues on the main flow,

Figure 5 (F1)

Bank Procedures for Analysing Business Loan Applications



otherwise, it branches to evaluate the potential to be expected from establishing a new customer relationship (Section B).

Next, assuming that the loan application follows the main flow, the firm's general reputation as a customer at that bank is considered. This is a comprehensive evaluation which depends partly on the bank's experience with the firm on previous loans, in (section H, the follow-up and review procedure may be seen) partly on the history of the firm's deposit balances in the bank, and partly on the bank's past experience with the firm in other ways. Any one of three different exits from Section A is possible. If the firm is not presently a customer of this financing body, Section B is entered. If a credit investigation of the firm in relation to the proposed loan is required, Section C is entered. Otherwise, the exit from Section A is directly to Section D.

Every business loan application is processed through Section D, where checks are made to insure that the proposed loan does not violate any legal requirements (loan documentation) or bank policy restrictions. If a loan application is found to be infeasible as a result of these checks, then the reasons why this loan cannot be granted are recorded and no further processing is done on this application. However, when applications conform to these legal and policy restrictions, they will continue on the main flow to Section E. If the loan is recommended, the model continues on the main flow to Section F. Otherwise, the reasons why this loan is not recommended are recorded and no further processing is done on this application.

In Section F the results of all the preceding analyses are resolved into a set of detailed recommendations regarding the terms of the loan agreement (loan contract). These include recommendations as to the amount and maturity the loan, the interest rate, the repayment schedule, the provision for security, and appropriate covenants relating to supervision, monitoring, counselling and advice and also some restrictive clauses.⁶

Section G consists of relatively simple recording and filing processes in which the results of the analysis and the details of the loan recommendation or the reasons why the

⁶ A detailed discussion of loan contract contents is given later in this chapter.

application should be rejected are summarised for communication to appropriate staff and for the financier's files. This terminates the actual processing of a business loan application. There is, however, in section H an important follow-up and review procedure for loans which have already been granted.

B. Evaluation of a New Customer Relationship.⁷

If a business loan applicant is not currently a customer of the bank, the loan officer tries to answer the following four questions:

- Is this firm a sound credit risk?
- Will this firm become a regular customer of the financier?
- Will a customer relationship with this firm strengthen the bank's business base?
- Will a customer relationship with this firm be profitable?

Whether a potential new customer of a financial institution is a sound credit risk depends upon the same factors which determine whether a present bank/financier customer is a sound credit risk. Therefore procedures precisely analogous to those used in Section C to evaluate the credit worthiness of a firm in relation to the proposed loan are also employed in Section B. Section C below describes a bank's credit evaluation process in detail.

The answer to the question: 'Is this firm a sound credit risk?' is provided in detail in section C below.

To answer the second question, 'will this firm become a regular bank customer?' several informational inputs may be considered by loan officers such as the types and number of accounts the borrower may open with the bank (assuming the financier is a bank), the size of the deposits which loan officer feels can be obtained from this new customer (either directly or indirectly from a correspondent bank if this is loan participation requested by a correspondent) over a period of years, for example. A three year time

⁷ For a discussion of the nature and significance of relationships between banks and corporate borrowers see Holland (1993), and the later discussion in analysis section. See also Melbourn (1989), Myers (1987), Loggan (1991) and Cranfill (1990).

horizon may be chosen for example as a reasonable period over which a bank can assess the potential profitability of a new customer relationship. Such a time horizon would indicate that a bank evaluates the expected profitability of a new customer relationship over an entire credit cycle. Obviously a bank wants any new customer to remain with it for an even longer period. It is operationally difficult, however, for loan officers to make projections for more than three years.

In determining the business expected of a new customer loan officer might compute an adjusted average balance (by multiplying the expected average balance by subjective probability estimate) for each type of account. A total adjusted average balance is the sum of adjusted average balances, for all types of balances. This total can then be compared to scale amounts which the bank's senior management consider the boundaries separating different strengths of customer relationship with the bank. Thus relationships may be classified as 'very little', 'moderate', or 'close' for example.

Table 5.1 (NCR) depicts notation used to answer questions concerning the value of a future customer relationships with the bank. Column 2 shows the types of accounts expected to be maintained by a future corporate borrower, column 3 shows expected average balances, column 4 shows subjective probability estimates. These may be chosen from discrete scales such as 1.00, 0.75, 0.50, 0.25, and 0.00. Thus a 1.00 rating indicates that the loan officer is certain of realising the indicated amount of new business. Correspondingly, lower probabilities indicate less certainty. If an officer is unwilling to reply on the estimate of new business activity, the subjective probability rating will be 0.00. Column 5 shows the adjusted average balance and columns 6 and 7 show the estimated profitability factor and estimated profits respectively.

Table 5. 1.

Information for analysing a new customer relationship (NCR).

Subscript	Type of Account	Average balances expected over next three years (\$)	Subjective probability estimate (pure number)	Adjusted average balance (\$)	Estimated profit-ability factor $\frac{\$}{\$/YEAR}$	Estimated profits \$/YEAR
1	Deposits	A_1	P_1	$E_1 = P_1 A_1$	R_1	$\pi_1 = R_1 E_1$
2	Trust funds	A_2	P_2	$E_2 = P_2 A_2$	R_2	$\pi_2 = R_2 E_2$
3	Employment	A_3	P_3	$E_3 = P_3 A_3$	R_3	$\pi_3 = R_3 E_3$
4	Other	A_4	P_4	$E_4 = P_4 A_4$	R_4	$\pi_4 = R_4 E_4$
	Total	-----	-----	$E = \sum_{i=1}^4 E_i$ where $i=1$ to 4	-----	$\pi = \sum_{i=1}^4 \pi_i$ where $i=1$ to 4

Table 5. 2 (Initial Scoring) indicates three arbitrarily scored points, (designated 0, 1, and 2) corresponding to 'very little', 'moderately', and 'a great deal' respectively indicating a judgment concerning the question 'Will a customer relationship with this firm strengthen the bank's business base?'. The values of these scores have to be determined in practice, and can be expected to be vary between financial institutions and even within one bank at different stages of the credit cycle. For simplicity only three zones are shown in Table 5. 2. In applying the model to particular banks, as many zones as that bank's management considers necessary could be used.

Most banks would place additional value on obtaining certain nationally known firms and the up-and-coming smaller local firms as new customers. Most banks would have a list of desired new customers. If a loan applicant is on such a list, a particular value (which is a policy parameter for the bank) could be added to the score arrived at in table 5. 2. Similarly, most banks attach a great deal of importance to their correspondent bank relationships. Thus if a bank has been asked by one of its important correspondents to participate in a loan, it is might be more likely to do so than if there were no correspondent bank relationship involved. Likewise, a bank might look more favourably on a loan proposal, if the applicant were introduced by an existing favoured client or, in

a developing country context, by a governmental development agency, government itself, or an international agency (Petrof, 1987; Levitsky, 1987).

Table 5.2.

Initial scoring (IS) of the extent to which a new customer relationship will strengthen the bank.

Policy parameters	E: Total adjusted average balance (\$)	Initial evaluation	Point scale
		Builds the bank a great deal	2
\$ limit to be set by bank		Builds the bank moderately	1
\$ limit to be set by bank		Builds the bank very little	0

In determining the extent to which a new customer relationship will contribute to strengthening business of a bank, the gross increase in the bank's level of deposits (adjusted for the risk that these deposits might not be realised) is one criterion which might be used. To state this in another way, a customer who (either directly or indirectly through a correspondent) significantly raises the bank's average levels of deposits (or gross receipts from commissions and fees) might be regarded as being a customer valuable regardless of the actual profitability of this relationship to the bank. Other similar criteria might be used which reflect the implied objective of assisting the longer term development of the bank's business. Hence, representation is a certain important business sector or locality or contribution to financing objectives set by external agencies (e.g., government planners or development agencies) might be considered as contributing to the strength of the bank's business base.

The answer to the fourth question: 'whether the new customer relationship will be profitable for the bank?' requires information on estimated profitability for each type of account or deposit. As shown in Columns 6 and 7 of table 5.1, the estimated annual

profits on each type of deposit/account are computed and summed. The total estimated annual profits, π , are compared to a scale of amounts that, according to bank policy, distinguishes 'an unprofitable relationship'. These three zones are scored 0, 1, and 2 points, respectively, producing a profitability evaluation score.⁸

The model now has three different evaluation scores on the potential new customer as follows: the credit worthiness of the firm in relation to the proposed loan (S_1), the extent to which a customer relationship with the firm will add strength to the bank's business (S_2), and expected profitability to the bank of a customer relationship with the firm (S_3). These scores can be combined to produce a recommendation indicating the extent to which the loan applicant is a desirable new customer. Each score may be individually weighted (W_1, W_2 , and W_3) and the result judged against a criterion parameter (C). The weights reflect the bank's management's judgment of the relative importance of the three elements.

The decision criterion C is the minimum overall weighted score that bank policy requires for a potential new customer to be considered worthwhile. The value of C can be expected to change over a credit cycle for a given bank and different banks will have different values of C at any time, depending on their relative aggressiveness in seeking new business and on other factors. W_1, W_2 , and W_3 may also change over time, but probably less frequently than the value of C changes. A model, combining these elements is thus:

$$T = W_1 S_1 + W_2 S_2 + W_3 S_3$$

Obvious decision rules are:

$T \geq C$: the applicant is a desirable new customer

$T < C$: the applicant is not a desirable new customer

⁸ This discussion does not address the problems, both accounting and managerial, of profitability measurement in financial institution. See for example, Kaplan and Cooper (1991), *The Design of Cost Management Systems*; and Maberly (1992), *Accounting Based Costing in Financial Institutions*, especially chapter 10.

Alternatives to this weighting system, could obviously be proposed which would be more suitable to different types of financial institutions, different organisational objectives, and different economic and other environments. For example minimum *aspiration* levels could be used for S_1 , S_2 , and S_3 which must be attained or exceeded before a satisfactory recommendation about a new customer relationship is made. Alternatively more complex decision rules for combining S_1 , S_2 , and S_3 into a single index could be constructed. Such modifications may be partly a question of practicality (do they work) and policy (what is desirable). Both are relevant to the application of such a model to the case of developing countries.

C. Credit Evaluation:

An evaluation of a firm's credit worthiness in relation to a particular loan is essential to credit analysis. It must be done whenever an existing customer seeks a loan or whenever new customer seeks a loan. But the extensiveness of the evaluation may vary between new and old customers. Several different degrees of credit investigation may be undertaken by banks, depending inter alia on the firm's general reputation, the size of loan, the purpose of the loan, its maturity and repayment schedule, and the extent to which security is offered (Donaldson, 1991; Berry et. al. 1991).

In section B above it was stated that S_1 refers to the credit-worthiness of the firm in relation to the proposed loan. S_2 may be related to three subsidiary factors:

- (i) a rating of management competence, (Strischek, 1990; Newburgh, 1991)
- (ii) an outside credit rating, and
- (iii) a rating based on the results of the bank's financial analysis.

The rating of management competence depends on considerations such as:⁹

- i. the ability of the firm's management to recognise change and take appropriate action;

⁹ See also Berry et. al. (1993), especially chapter 10.

- ii. the extent of forward planning in the firm, partially indicated by the existence of regular forecasts, budgets, and product analysis programmes;
- iii. marketing trends in the industry, indicating whether the firm is holding its own, ahead or slipping behind its competition;
- iv. the relation of the firm's present product lines to products offered by competitors.
- v. the extent to which the firm's management has succeeded in the past in getting improvements made within the organisation and in meeting competition;
- vi. management's overall stewardship of the firm, which for a publicly held corporation is partly reflected in the behaviour of share price relative to the market.

Outside credit ratings are not normally consulted on every loan application. On unusual proposals, however, e.g., a loan greater than 50% of a firm's total assets, a bank may wish to substantiate its own judgments by using outside credit bureau. In most countries several different outside credit rating agencies operating (for example, Dun and Bradstreet in the USA¹⁰) and banks may obtain ratings from more than one body and when they differ the ratings can be coded, scaled, weighted, and combined to provide a composite credit rating. Alternatively a single outside source may be relied upon.

Financial analysis is the most detailed of the entire loan evaluation process.¹¹ In doing so, the financier needs the applicant's balance sheets, income statements (both on an historical and on a proforma basis) and cash flow data.¹²

Five main segments of a typical bank credit evaluation model may be associated with the following questions:

- a. Is the bank's share of risk clearly unreasonable?
- b. Does the firm have enough current assets?
- c. Are the firm's current assets sufficiently liquid?
- d. Is the firm sufficiently profitable?
- e. What is the final credit rating of the applicant?

¹⁰ See Danos et. al. (1989).

¹¹ Much research is available on financial analysis methods used by lending institutions. See for example Stevens (1980), Zimmer (1981), Dietrick and Stamps (1981), Harding et. al. (1987), Kemp and Overstreet (1990), Stanga and Benjamin (1978), Walker et. al. (1982).

¹² See Emmanuel (1988), Berry et. al. (1993), Laudeman (1994), Ginzi (1988).

a. Is the Bank's Share of Risk Clearly Unreasonable?

In answering this question a bank needs to analyse a risk measure, normally sheet gearing, such as tangible net worth to total debt for the firm. Typically this would be done from a proforma balance sheet from which intangible assets has been removed and the anticipated amount of the bank loan has been included in total debt. Any debt which is subordinated to the requested bank loan is treated as net worth for this purpose. If a gearing ratio such as tangible net worth to total debt for the loan applicant, is less than a minimally acceptable standard for the industry, the proposed bank loan (as well as the cash account) on the firm's proforma balance sheet might be scaled down so that the net worth to debt ratio becomes minimally acceptable for the industry. If this procedure does not produce a satisfactory result the prospective borrower may fail this risk test. Thus section D (Legal and Policy Requirements) seeks to ensure that the reduced amount of a loan is reasonable. For example, a check in credit evaluation might try to determine whether the cash account on the pro forma balance sheet becomes nil or negative when the proposed loan amount is reduced to meet the minimally acceptable net worth/debt criterion. If so, this would indicate that the proposed loan if sanctioned at all, should be on a fully secured basis.

b. Does the Firm Have Enough Current Assets?

Using a pro forma balance sheet, the amount of net working capital and the current ratio may be computed for the applicant. An average working capital figure for a predetermined period, say three years, is typically computed for the applicant from the latest historic balance sheet and the balance sheets for the preceding years. Distributions of current ratios for other comparable firms in the industry may be used for comparisons. In this way solvency of the firm may be tested. Table 5. 3 indicates structure for testing solvency (tentative) which prescribes five possible solvency ratings: high, average, low, low minus, and reject. Any application whose solvency rating is reject would not be processed further under such a procedure.¹³

¹³ Other versions of this solvency testing are practised. See for example Zimmer (1980 and 1981).

Table 5. 3.

Decision structure table for tentative solvency (TS) rating

Firm's working capital*	net	Percentile value (in its industry) of the firm's current ratio*	Median current ratio of the industry	Ratio of firm's net working capital* to firm's 3 year average working capital	Firm's current ratio*	Firm's tentative solvency rating
≤ 0		>50%				Average
≤ 0		≤50%	≥2	<1		Reject
≤ 0		≤50%	≥2	≥1		Low minus
≤ 0		≤50%	<2			Low
> 0		≥75%				High
> 0		<75%	and		≥2	Average
		≥25%				
>0		>25%			≥2	Low
>0			≥2	<1	<2	Low minus
>0			≥2	≥1	<2	Low
>0		<75%	and	<2 and >1.5	<2	Average
		≥25%				
>0		<25%	<2 and >1.5		<2	Low
>0		<75%	and	<1.5	<2	Average
		≥50%				
>0		<50%	<1.5	<1	<2	Low minus
>0		<50%	<1.5	≥1	<2	Low

* Based on the firm's projected balance sheet

c. Are the Firm's Current Assets Sufficiently Liquid?

Further analysis of solvency may be undertaken by asking, 'are the firm's current assets sufficiently liquid?'. Liquidity may be assessed through ratio analysis or cash flow analysis.¹⁴ Ratio of cash (including marketable securities) to total current liabilities, the ratio of cash plus receivables to total current liabilities may be analysed in relation to the distribution of ratios for other firms in the industry. The ratio of the firm's present inventories to its three year average inventories; and the firm's ratio of its inventories to its total current assets, in relation to the distribution of this ratio for other firms in the

¹⁴ See Foster (1986) and Gibson (1983) for details in ratio analysis.

industry. Table 5. 4 indicates how this information, together with the tentative solvency rating assigned in table 5. 3, generates a final solvency rating. Alike part b, any application receiving a solvency rating of reject is not processed further.

d. Is the Firm Sufficiently Profitable?

The credit evaluation model determines a profitability rating for the potential borrower in a roughly analogous manner to the computation of the solvency rating in segments b and c. There are many different factors on which a profitability rating may depend. Thirteen factors, and their effect on the profitability rating of the firm, are indicated in table 5. 5. Table identifies five possible profitability ratings: high, average, low, low minus, and reject. Any application whose profitability rating is 'reject', would not be processed further by the credit evaluation model.

In factors 5, 6, and 11 (from table 5. 5), a current prime rate of interest such as LIBOR would be used as a very crude measure of the minimum ratio of pre-tax profits to total tangible assets that a firm should be able to earn. It is likely that it will be necessary to replace the prime rate of interest by some multiple of it as an opportunity cost of capital. If the model is computerised there will be some arrangement for this change easily to be made.¹⁵ The main function of the prime rate of interest (or some multiple of it) in the model is to serve as a cyclically sensitive criterion of rate of return. As money becomes tighter, banks become less willing to extend credit to firms that do not earn reasonable rates of return on their assets (Donaldson, 1991 and 1995).

¹⁵ See Duchessi et. al. (1988) for an example of computer based loan evaluation.

Table 5.4

Decision structure table for final solvency rating

Firm's ratio of cash to total current liabilities	Percentile value (in its industry) of the firm's ratio of cash plus receivables to total current liabilities	Ratio of firm's present inventories to firm's 3 year average inventories	Percentile value (in its industry) of the firm's ratio of inventories to current assets	Firm's tentative solvency rating	Firm's final solvency rating
<10%			≥10	High	Average
≥10%			<10%	High	High. Give warning: purchase postponed?
<10%			<10%	High	Average. Give Warning: purchases postponed?
≥10%			≥10%	High	High
<10%			≥10%	Average	Average
≥10%			<10%	Average	Average. give warning: purchase postponed?
<10%			<10%	Average	Average. give warning: purchase postponed?
≥10%			≥10%	Average	Average
	≥50%			Low	Low
<10%	<50%			Low	Low minus
<10%	≥50%			Low minus	Low minus
<10%	<50%			Low minus	Reject
≥10%		≥1		Low	Low
≥10%	<50%	<1		Low	Low minus
≥10%	≥50%			Low minus	Low
≥10%	<50%	≥1		Low minus	Low
≥10%	<50%	<1		Low minus	Low minus

Table 5. 5:

Decision structure table for Profitability Rating* (For a Firm)

1. 3 year av. net profit of the firm	2. Tren d in net profit of the firm	3. Proje -cted net profit of the firm	4. % ¹ in industry :trend in net profit	5. Ratio (i)	6. Ratio (ii)	7. % ¹ in indus try: Ratio (iii)	8. % ¹ in indus try: Ratio (iv)	9. % ¹ in indu- stry: inven tory turn over rate	10. % ¹ in indu- stry: net profit	11. % ¹ ; Ratio (v)	12. Type of loan: WC or TL	13. Indus try medi an trend in net profit	14. Profi - tabili ty ratin g
>0				≥1	≥1	≥75	≥75	≥50					High
>0				≥1	≥1	≥75	≥75	<50					Av.
>0				≥1	≥1	≥75	<75						Av.
>0				≥1	≥1	<75	<75		≥75				High
>0				≥1	≥1	<75	<75		<75				Av.
									>25				
>0				≥1	≥1	<75	<75		≤25				Low
>0				<1	≥1					≥50			High
>0				<1	≥1			≥50		≥50			Av.
>0				<1	≥1			<50		<50			Av.
>0				≥1	<1						WC		Low
>0					<1	<50					TC		Rej.
>0				<1	<1	≥50							Low
>0				<1	<1	<50					WC		Low-
≤0											TL		Rej.
≤0	>0	>0	>50								WC		Low
≤0			≤50								WC		Low-
≤0	≤0		>50								WC		Low-
≤0	>0		>50								WC	≤0	Low

Notes and abbreviations for table 5. 5 : WC: Working capital; TL: Term loan;
Av.:Average; Low-:Low Minus; Rej: Reject. For ‘%¹’ in column 4, 7, 8, 9, 10 and 11
read ‘Firm’s Percentile’.

Ratios:

(i). Industry median ratio of pre-tax profits to total tangible assets divided by prime rate of interest.

(ii). Firm’s ratio of pre-tax profits to total tangible assets divided by prime rate of interest.

- (iii). Ratio of pre-tax profits to total tangible assets divided by prime rate of interest.
- (iv). Ratio of net profits to tangible net worth.
- (v). Ratio of pre-tax profits to total tangible assets (only those firms for which this ratio exceeds prime rate)

*The firm's projected statements are used in 3, 6, 7, 8, 9, 10 and 11, even though projected statements are not available for the industry.

e. What Is the Final Credit Rating of the Applicant?

For loan applications which have not already received a reject credit rating, a loan evaluation model must combine the separate solvency and profitability ratings into an overall credit rating. This is likely to be done differently, according to whether the application is for a seasonal (working capital) or a term loan. A loan evaluation model would give more weight to solvency considerations when the firm wants to obtain a loan for working capital, while for a term loan application profitability considerations are relatively more important.

The table 5. 6 shows final credit ratings and includes four possible credit ratings as illustrations. These are: high, average, marginal, and reject. As already noted that, 'reject' is to be interpreted as meaning that if a loan is made it should be on a fully secured basis. The Table 5. 6 refers to the final credit rating assigned (denoted by S_o) depends not only on the financial analysis (F_3); but also, as noted above on a rating of management competence, and an outside credit rating. Table 5. 7 indicates how a final credit rating is determined by these three elements and the bank's financial analysis.

Table 5. 6.

Credit rating based on the bank's financial analysis of the applicant's statements

Term Loan

<i>Profitability rating</i>	Solvency rating			
	<i>High</i>	<i>Average</i>	<i>Low</i>	<i>Low minus</i>
High	High	High	Average	Average
Average	Average	Average	Marginal	Marginal
Low	Marginal	Marginal	Marginal	Reject
Low minus	Marginal	Reject	Reject	Reject

Working Capital				
<i>Profitability Rating</i>	Solvency rating			
	<i>High</i>	<i>Average</i>	<i>Low</i>	<i>Low minus</i>
High	High	Average	Marginal	Marginal
Average	High	Average	Marginal	Reject
Low	Average	Marginal	Marginal	Reject
Low minus	Average	Marginal	Reject	Reject

Table 5. 7.
Final credit rating (S₁)

F ₁ Mgt. competence	F ₂ Out side credit rating	F ₃ Bank's fin. ana.	S ₁ Final rating	credit
High	High	High	High	
		Av.	High	
		Marg.	Average	
		High	High	
		Av.	Average	
		Marg.	Marginal	
	Fair	High	Average	
		Av.	Marginal	
		Marg.	Marginal	
		High	High	
		Av.	Average	
		Marg.	Marginal	
Average	Good	High	Average	
		Av.	Average	
		Marg.	Marginal	
		High	Average	
		Av.	Marginal	
		Marg.	Marginal	
	Fair	High	Average	
		Av.	Marginal	
		Marg.	Marginal	
		High	Average	
		Av.	Marginal	
		Marg.	Marginal	
Marginal	Good	High	Marginal	
		Av.	Marginal	
		Marg.	Marginal	
		High	Marginal	
	Fair	Av.	Marginal	
		Marg.	Marginal	
		High	Marginal	
		Av.	Marginal	

Notes for table. 5.7.

Av.= Average, Marg.= Marginal, Mgt.= Management, Fin.= Financial, Ana.= Analysis.

D. Legal and Policy Requirements:

A segment of a standard procedure for lending evaluation should aim to check each loan application against legal and policy requirements in order to screens out highly unusual items that may require non-routine attention from the loan officer. Such a check may indicate those loan applications which are infeasible. For example the amount of the

proposed loan should be checked against any legal loan limit which may be established by bank regulatory authorities. If a proposed loan amount is more than such a limit, a loan officer (or a computerised programme) should inform the appropriate loan committee in the bank and perhaps instigate consideration of a syndication of the loan (see also Hurn, 1990).

The model should then compute the ratio of the amount of the proposed loan to the firm's total assets. For term loans (but not for working capital loans), a check should be made against the parameters which banks define as boundaries of what are reasonable minimal amounts for a term loan. Term loan requests which are too small in relation to a firm's total assets are often regarded by banks with disfavour, since most firms should be able to provide for limited credit needs out of funds generated by earnings and depreciation or by short term borrowing. An important consideration here are the fixed administrative costs incurred by banks for lending.¹⁶

Loan applications labelled as 'infeasible' will become special cases for the loan officer. In this type of case a loan officer should carefully investigate any special circumstances which justify modifications to normal policies. This may be particularly important in development finance cases for small firms (Marsden, 1987).

For term loans, further checks should be made on whether the proposed maturity exceeds any upper limit of the bank. In most banks there is a maximum maturity that will be considered for term loans as a policy variable which changes during the course of a credit cycle (Donaldson, 1995). Most banks are willing to make longer maturing term loans during periods of 'easy' money than during periods of 'tight' money. A proposed maturity exceeding the upper limit will render a loan as infeasible.

The model should then checks if the proposed amount of the loan is reasonable in relation to the average deposit balance the applicant has maintained at the bank during the past year and for a predetermined period beyond, say three years. This check is bypassed when the applicant is a new customer. The particular multiple of average

¹⁶ See Bernanke and Mark (1989).

deposit balances used is a policy parameter that may vary over the course of the credit cycles as well as between term and working capital borrowing.

If the proposed amount of the loan does not exceed the predetermined maximum loan limit then the application successfully passes this check. Failure of a loan application at this stage requires further policy decisions. For example if a loan only exceeds the maximum limit based on the firm's average deposits during the past year, a bank may continue to process an application, but might require a loan officer to negotiate with the applicant to increase average deposits because of their unfavourable recent trend.

E. Appraisal of the Loan's Purpose, Amount, Maturity, Payback, and Security:

Feasible Loan applications need to be assessed against five key questions:

- i. For what purpose will the funds be used by the firm?
- ii. What is the proposed amount of the loan?
- iii. What is the proposed maturity of the loan?
- iv. What is the proposed repayment schedule?
- v. What security is offered to the bank in connection with the loan?

Answers to these questions are used to ensure further screening of an application and to provide the basis for a preliminary recommendation as to whether a loan should be granted. In addition, pro forma forecasts of cash, working capital, profit and loss account, and balance sheets are frequently used for this purpose.

It is important for a bank to know the purpose for which a loan is requested, for its own purpose and to ascertain that the reason will be acceptable to the banking authorities. A possible classification of the purposes for business loans might be:

- a) Seasonal needs for financing inventories and accounts receivable during peak business periods.

- b) Plant and equipment replacement.
- c) Plant and equipment for increased capacity and efficiency (in case of an existing firm).
- d) Investment in a subsidiary or an affiliate (for an existing business).
- e) Retirement of other debt.
- f) Retirement of preference shares (in case of a public limited company).
- g) Repurchase of ordinary shares.
- h) Anticipation of permanent financing from the capital markets.
- i) Other purposes.

Each of the above would require separate analysis by a loan officer. There are varying standards of acceptability depending on the particular purpose of the loan, which might be established by different banks.

The checking of some of the restrictions on the proposed amount of the loan have already been discussed in section D. Here additional checks on the proposed loan amount could be made by searching for the records of past projects of a similar nature. If no such records exist then a loan officer would need to decide whether the proposed amount is in his judgement reasonable. Such judgements might require verification by a loan sanctioning committee.

If the proposed maturity on a term loan (e.g., eight years) exceeds the bank's maximum maturity (e.g., five years), a loan officer could propose making a term loan maturing in five years, but with annual payments at the rate of one eighth the total amount instead of one fifth the total amount. There will then be a large 'balloon' (i.e., an unpaid balance) remaining at the end of five years. While the bank retains the option of calling for the complete payment of this 'balloon' at the end of five years, either of two other possibilities will usually occur. First, during the lifetime of the term loan, the firm may be able to make larger payments than the contract requires. In this way the size of the 'balloon' may be reduced by enough to permit the firm completely to repay the loan at the end of five years. The second possibility is that the unpaid balance at the end of five

years may be refinanced by a new loan whose terms are satisfactory to both the bank and the borrower (Donaldson and Donaldson, 1985).

This introduces the question of the feasibility of the proposed payback schedule. Repayment can be approached in several ways (Zimmer, 1981). For example, a forecast 'reliability factor', stemming from the follow-up and review procedures discussed in section H below will usually be available for current bank customers. In case of new borrowers where a forecast reliability factor is not available, loan evaluation procedures can be developed which establish forecast reliability factors for other firms in the same industry which are existing customers of the bank, using the credit ratings of such firms as a guide. Experience indicates that more accurate appraisals result from separately forecast reliability factors for income and expense items (Arsenault, 1989).

The pro forma statements prepared by the firm to cover the duration of the loan may then be modified using the forecast reliability factors, reducing the projected income items and increasing the expense items. Using these adjusted projections, a check can then be made to ensure that the projected cash balances (after allowance for the scheduled repayment of the bank loan) are not less than current cash balances. Next, for term loans, a further check can be made to see that the scheduled term loan repayments do not exceed adjusted projected net profits and cash flows during the duration of the loan. If either of these tests are not successful the loan officer may make further investigations whilst further processing of the loan application takes place.

If the loan's desired maturity exceeds the maximum currently permitted by bank policy, then the two repayment checks described above may be repeated using the maximum maturity with a closing 'balloon'. If none of the proposed payback schedules evaluated appears feasible, the possibility of developing an alternative proposal should be explored. In this search for alternative loan plans, any restriction that the loan be repaid in equal instalments (except for the 'balloon') might be relaxed in an attempt to find a payback schedule which appears feasible. If none of the payback schedules evaluated appear feasible, the evaluation model will indicate that this loan should not be made.

As already noted, in developing a preliminary recommendation as to whether or not a bank should make the loan, a loan evaluation model should consider the extent to which a satisfactory customer relationship with the firm already exists or is in prospect and whether or not the loan should be made only on a fully secured basis. Overall monetary conditions will have an important bearing on a number of aspects of lending policy and its application (Donaldson, 1995). For example, in periods of tight money, loan evaluation models will not normally recommend making any loans which require full security; in periods of loose money, such loans may be more likely to be recommended. Regardless of monetary conditions, loan evaluation models will typically recommend making loans not requiring full security for present bank customers with whom a profitable relationship has existed in the past or for new customers expected (according to the evaluation in Section B above) to contribute significantly to the development of bank a great deal. Unless money is tight, all loan applications which have reached this stage are likely to be given a preliminary recommendation so that they will be processed for detailed recommendation. The loan officer must then personally decide, in periods of easy money, whether the loan application appears profitable enough to justify undertaking it even though it cannot be recommended solely on the basis of past or prospective customer relationship considerations.

F. Detailed Recommendations.

The entry of a loan application into this part of a standard loan evaluation procedure indicates that a preliminary recommendation to grant the loan has been made (although possibly on a fully secured basis only). Details of the proposed loan agreement will be developed on the basis of the earlier analyses (Day and Taylor, 1995). After these details have been specified, the loan officer will review them before reaching his final decision.

This part of a loan evaluation model establishes detailed terms and conditions of the loan, i.e., an interest rate differential (i.e., the increment to be added to the prime rate of interest a bank base rate such as LIBOR) for the loan, a set of restrictive covenants for

the loan, and recommends the degree of follow up and review required during the duration of the loan.¹⁷

The interest rate differential imposed on a loan depends on the credit rating of the firm, the maturity of the loan, and the extent to which it is fully secured.¹⁸ Table 5. 8 indicates how these three factors can be utilised by the model to determine a suggested interest rate differential for the proposed loan.

The suggested interest rate differential (see table 5. 8) is added to the current prime rate of interest. Any proposed interest rate should be compared with external constants such as legal ceilings on interest rates imposed by government or its agencies. If legal limits exist and are exceeded a bank should carefully consider the basis for granting a loan.

Table 5. 8:

Suggested interest rate differential (percent per annum) above the prime rate of interest for business loans*

Final credit rating of firm (S ₁)	Working capital	Maturity of term loans						
		1	2	3	4	5	6-7	8-10
High	0	1/4	1/4	3/8	3/8	3/8	1/2	1
Average	1/4	1/4	3/8	1/2	1/2	1/2	1	1.5
Marginal	3/8	3/8	1/2	5/8	7/8	1	1.5	-
Reject	1/2	5/8	3/4	7/8	1	1.5	-	-

** If full security is offered when it is not required, then the suggested interest rate differentials may be reduced by 50% of the amounts shown above.*

Almost every business loan agreement contains certain standard types of covenants (Smith and Warner, 1979). Some of these are:¹⁹

- a. Continue to provide quarterly operating statements and annual reports.

¹⁷ See Castle (1980), and Day and Taylor (1996).

¹⁸ These factors are usually subject to negotiation between bank and borrower, and there is evidence that such negotiation may result in trade-off between factors such as interest and the presence and the tightness of covenants, see Day and Taylor (1995)

¹⁹ A review of model on contracting is being put forward in chapter six (6. 1) and also see Day and Taylor (1995), Covenants and Debt Contract: A Survey of the Literature, The University of Manchester Working Paper.

- b. Undertake no more than a specified amount of capital expenditures annually.
- c. Agree to no other term loan.
- d. Keep working capital at its current level (or at certain stipulated stepped levels) for the duration of the loan.
- e. Do not increase the dividend rate for the duration of the loan.)

Hester (1966) places great importance on loan documentation which he considers vital to the effective functioning of lending. Possible covenants to be included in a loan agreement relate to:

- collateral;
- restrictions on dividends;
- working capital;
- salary increases;
- plant and equipment acquisitions;
- retained earnings;
- personal loan;
- subordination of outstanding debt;
- costs of audits;
- penalties for early repayment which comes from other borrowing.

The number, type and, where appropriate, tightness of covenants will vary with many influences. Covenants are commonly found in loan documentation in English speaking countries such as the UK, USA, Australia, New Zealand, and South Africa as well as other countries which have been influenced by UK and USA legal and financial systems (e.g., Hong Kong, Malaysia and Singapore). In other countries with different legal and financial traditions, e.g., France and Germany covenants are not normally incorporated into loan documents (Day and Taylor, 1995). In countries where covenants are used their values and types are determined by factors such as:

- (1). The size and type of the loan.
- (2). The size and status of the borrower.

- (3). The competitive state of the loan market.
- (4). The financial needs of the borrower.
- (5). The existence of other loans outstanding to the borrower.
- (6). The purpose for which the loan was being raised.

They are also the result of negotiation between lender and borrower (Castle, 1980).²⁰

In practice, the degree of monitoring and review that banks perform on loans to firms appears to be determined inter alia by the following factors:

- a. The amount of the loan relative to the firm's total assets.
- b. The amount of the loan relative to legal limits to which a bank might be subject.
- c. The extent to which the industry of the borrower has exhibited growth stability or volatility.
- d. The extent to which forecasts made by firms in the industry have proved to be reliable.
- e. The overall credit rating of the firm.

Table 5. 9 illustrates an approach to the determination of the basis of loan monitoring. It has been formulated as a 'decision structure table.' The first five columns represent individual factors relevant to determining the length of review period, and the last column represents a recommended review period.

Table 5. 9 should be read one line at a time, starting at the top. If a particular loan application satisfies the conditions embodied in the first line, i.e., if the amount of the loan exceeds or equals a set criterion (here for example 50 percent of the firm's total assets) then the recommended review period will be monthly. Thus, the model will recommend monthly review of a business loan if one or more of the following conditions hold: the proposed loan is at least 50 percent of the firm's total assets or at least 90 percent of the bank's legal loan limit; earnings in the industry have been very unstable and have exhibited little growth; forecasts made by firms in the industry have proved unreliable; or the firm's overall credit rating is either marginal or reject. If none of the foregoing conditions apply, but if at least one of the following conditions obtain,

²⁰ For discussion of negotiation between lenders and borrowers see Hamilton (1989) and Myers (1987).

then the model will recommend a quarterly review period: the amount of the proposed loan exceeds 25 percent of the firm's total assets; the industry's earnings have been only moderately unstable and have exhibited only moderate growth; forecasts made by firms in the industry have been only moderately unreliable; or the firm's overall credit rating is 'average'. If none of the above conditions hold, then the model will recommend an annual review period.

Table 5. 9:

Decision structure table for recommended review period.

Amount/total assets of firm	Amount /legal limit of bank	Industry growth and stability	Industry reliability of forecasts	Firm's credit rating	Recommended review period
$\geq 50\%$	$\geq 90\%$	$< p_1$	$< p_2$	Reject	Monthly
				Marginal	Monthly
					Monthly
					Monthly
					Monthly
					Monthly
$< 50\%$ and $\geq 25\%$					Quarterly
		$\geq p_1$ and $< p_3$			Quarterly
			$\geq p_2$ and $< p_4$		Quarterly
				Average	Quarterly
					Annually

Clearly, the parameters of such a structured decision process will vary with many factors and the table (5. 9) presented here merely illustrates the value of a structured and systematic approach to the determination of loan monitoring (Arsenault, 1989).²¹

G. Record Analyses and Recommendations:

This part of the lending procedure deals with the recording and filing the specific recommendations and the underlying analyses for each business loan application processed. Suffice it to say that accurate record keeping is vital to effective lending procedures in that it provides a data base to assist in evaluations as well as being essential for monitoring procedures.

²¹ It should be noted that this discussion concentrates upon the practical issues involved in making decisions within a bank on loan monitoring. There is literature devoted to the analytics of loan monitoring which is not considered here. See Haubrich (1989).

H. Follow-up and Review:

The follow-up and review section is essential in determining and maintaining several key items of information used in processing subsequent applications (Arsenault, 1989 and Udell, 1989). These include: payment performance on previous loans, project experience on previous loans (e.g., construction and utilisation of new plant and equipment); quality of forecasts; and general reputation of the borrower and its management. Periodic review procedures may be used to identify unfavourable trends which may require action on the outstanding loan. For term loans, special attention is usually paid to the first twelve months after the purpose of the funds is fully accomplished (e.g., when new facilities can be used for full production). Also average deposit levels of borrowers may be observed, not only for those with loans outstanding but for business customers generally firm's deposit relationship, i.e., the average size of its balances, very much influences the size of future loans a bank may be willing to grant a borrower as well as the general reputation factor a firm has with a bank.

Ultimate development of the follow-up and review part of a lending model is important, however, not only because of its potential normative value, but also to enable the complete development of an integrated model of the dynamic procedures by which banks evaluate business loan applications.

This chapter and the preceding one have set out in detail issues and procedures for lending to companies. Whilst representative of good practice the material presented can be criticised as being derived from experience and research in developed countries. In the following chapter we discuss issues related to the application of corporate lending models to small firms in developing countries such as Bangladesh.

Chapter 6.

Review of Small Firm Lending Models: Framework for Lending Practice in Bangladesh.

6. 1. Lending Procedures for Small Firms.

In this section we will discuss some of the literature on lending models for financing small firms. Firstly, we may start with Jankowicz and Hisrich's (1987) model. They argue that loan decisions for small firms involve both specific, quantifiable information and subjective qualitative judgements based on qualitative information. An important contribution of Jankowicz and Hisrich is to describe eight categories of conditions against which a loan application from a small firm may be judged to see its potentiality i.e., whether there is a good case for a loan, or a poor case. These are as follows:

(1) Experience and Track Record.

A good case for granting a small business loan is likely to come from a person who has had substantial experience in running either this type of business or one very closely related. The applicant should have a track record of managing the business for a sufficiently long period of time that the financial record of efforts to cope with adversity, as well as handling success, is available for inspection. Formal business education, or work in the same area at a non-managerial level, may not be considered as substitutes for experience. A poor case for granting a loan is one in which the proposer has no experience at the managerial level in the business or industry concerned. Business start-ups headed by a young person without a business education would represent the worst possible basis for a loan application.

(2). Nature of the Product and Market Involved.

A deserving loan case is likely to come from a company which serves, or proposes to serve, a relatively large market area, either geographically or in terms of product range. A wholesaler might make a more attractive proposition than a retailer. Companies meeting these descriptions may be seen as less at risk should customer tastes change,

and also as less vulnerable to a single competitor. A poor loan case comes from a geographically localised company with only one major product or service which is discretionary to the buyer, and which has only one other major competitor. Applying such criteria loan officers appear to be concerned with risk primarily from the point of view of the company in its market, and only indirectly from the point of view of ability to repay. Thus, the market potential of a product, then, is of great interest to the banker in deciding whether to grant a loan to a small firm.

(3). Professionalism of Strategic Planning.

A good loan case is likely to include a logical and consistent borrowing request. The clarity of the request is reflected in part by the sophistication of financial expertise used in preparing the proposal, but mainly in the existence of a clear strategic business plan based on knowledge of opportunities for investment of effort and the funds being requested. A clear marketing strategy is also desirable if other strategic considerations have been made explicit in the proposal. A poor loan case reveals an inappropriate approach to debt, defined as a mismatch between the figures and the strategy, i.e., borrowing in the wrong proportions for the wrong reasons, or the lack of a clearly articulated plan. Borrowers who appear unaware of what may be wrong with the firm's performance and/or of how their market is likely to move should receive little consideration.

(4). Short-Term Coping versus Long Term Expansion.

A good loan case is likely to be made by a borrower whose firm seeks to expand, and is following a well defined plan for doing so. A poor loan case is likely to be made by a firm which is experiencing setbacks which have arisen internally, due to uncontrolled growth, an unsound equity base, or uncontrolled cash flow.

(5). Consistency and Integrity of the Application.

A good loan case shows consistency in its details. A variety of issues may be mentioned here: consistency between the figures presented and the stated objectives of the loan; an appropriate level of earnings retention; and, perhaps somewhat less predictably, a 'fit' between the personality of the applicant and the product or service being sold.²² A poor

²² See also Newburgh (1991)

loan case shows lack of consistency between figures and objectives, excessive dividends being paid to the owner/manager, or insufficiently decentralised /diversified management/ownership. A key issue here seems to be the extent to which excessive amounts of funds are likely to be taken out of the business by the owner/manager. While inconsistency between the figures and the stated objectives of the loan need not be seen as proof of dishonesty, such inconsistency may raise serious questions; and this is a matter of 'integrity'. So, it is desirable to have an appreciable personal equity at stake on the owner's part in the firm concerned.

(6). The Financial Case Made.

A good loan case is financially sound; it reflects current profitability, and maintains an appropriate debt-asset composition. A poor loan case reveals inter alia continuing losses, financial weakness, and poor ability to generate profits and liquidity.

(7). Collateral.

A good loan case involves an adequately capitalised firm which offers safe collateral. A poor loan case is presented by firm or promoter which has not adequately dealt with the issue of a second chance: no collateral or capital backing, or a firm which deals with a 'soft-asset' product.

(8). Risk versus Stability.

An acceptable loan case is likely to present a picture of stability, with a secure, conforming, or conservative firm. Several issues may be mentioned here: the proposal should present the firm as methodical and averse to risk, and the firm should continue to do what it has always done, without great innovations. A loan application coming from less 'conformist' firms, or a volume dependent firm, or a firm which wishes to take advantage of a one time opportunity, or an entrepreneurial venture is likely to be questioned by a loan officer as such firms are seen as high risks, other things being equal.

This discussion of risk versus stability displays a strongly conservative approach to lending by loan officers. As such it stresses credit protection but may be criticised as

being unlikely to stimulate innovation or entrepreneurial activity. Its normative basis hence favours conservative lending and the financial stability of the lending institution rather than the dynamism of the economy. As financial institutions in the UK and other countries have been criticised for adopting such practices this approach has an empirical basis.

According to Cranfill (1990) lending to small firms and businesses centres on the following six components:

(a) Understanding, and acting on, small firm owners attitudes and expectations. Where a business owner wants-

- (i) a reliable credit source
- (ii) quick response to the loan application
- (iii) loan officer's skill and stability
- (iv) specific knowledge about their industry by loan officers
- (v) consideration as a relationship to be valued, not a transaction to be processed.

(b) Organising a bank for the benefit of the customer first, and the bank second. This involves, inter alia, loan officers being receptive to small firm owners and explanations of their situation. Furthermore, a focus on the fundamental issues facing a small firm is expected during the discussion between owner and loan officer or senior officer of the bank.

(c) Developing or enhancing, a sales culture. Reflecting this a bank is expected to behave as a seller of a product i.e., lending to businesses, and thus should adopt a sales culture and act accordingly.²³

(d) A commitment to profitability measurement of small firms as customers, not just the profitability of individual lending or financial products. Thus, in determining profitability with respect to a customer, a bank should not only consider the individual products or services of the proposed business that will yield profit but also due consideration should be given to the small firm's owner e. g., his/her attitude and

²³ This approach is now widely adopted, at least superficially, by many financial institutions. Witness the widespread use of product terminology in discussing their activities.

character. This is because, potential returns from small firms come not only from loan fees e.g., interests, service charges and fees but also from deposits made by owners. So, a broad relationship with borrowers may be expected to be good in this situation, and that is why the following component relating to relationship banking is important.

(e) Relationship banking ensures better communication between borrowers and lenders. Meetings, both informal and formal, providing consultancy, advice and listening to an owner's comments on the firm's problems and prospects helps to develop a relationship.

(f) Specialisation of loan officers in dealing with small firms needs to be achieved by a bank. This may involve training and personnel policies being developed within the bank.

These views of Cranfill are also acknowledged by Barrickman and Chagares (1995) who comment:

“ a lending institution should realise that small firm owners expect the following-

- (i) a reliable consistent source of credit
- (ii) an understanding of the borrower's business and industry
- (iii) access to the loan officer
- (iv) quick response
- (v) stability and expertise from the loan officer
- (vi) strong product's/service's market knowledge
- (vi) a relationship orientation” (page 14)

The research findings of Barrickman and Chagares (1995) include an interesting observation, which is that, price is not within the range of expectations (illustrated above) of small firm owners when approaching a bank. Small firm owners are sensitive to price but find other aspects of the banking relationship to be much more important. This customer emphasis on value added fits nicely with the competitive realities of most commercial banks, which are in many countries high cost providers in loan markets plagued with overcapacity. To meet its profit objective, a typical bank may have to compete on value added rather than on price (Barrickman and Chagares, 1995).

Based on UK research Berry, Crum and Waring (1991) have put forward a check list for bankers to be used at the time of assessing loan applications for making business loan. This has been summed up by the authors in the acronym CAMPARI:

- C** character (the person)
- A** ability (to run the business)
- M** margin (bank risk versus reward)
- P** purpose (does the bank understand the business?)
- A** amount (is the loan amount adequate/excessive)
- R** repayment (how does the bank get its money?)
- I** insurance (what is the security?)

The above acronym is intended as a guide to the loan appraisal process and all aspects are always investigated, but emphasis may be shifted between aspects in different loan applications. In particular, if financial statements and other information are available they are always examined. In part such data is used to assess managerial competence and when it is not available personal characteristics may carry greater weight. According to Berry et. al. (1991) for any loan evaluation purposes collection of data has two main purposes:

- (a) assessing the validity of the project being proposed;
- (b) historical review of the organisation to check the feasibility of the proposal in the context of the firm, i.e., can the firm perform?

Berry, et. al. illustrate that three types of data are required for analysis of loan applications, those are as follows:

- (i) Assumptions and forecasts to assess the project proposal with forecasts consisting of budgeted/pro-forma profit and loss accounts and cash flows on a monthly basis for one or two years. Some emphasis may also be given to other forecasts i.e., pro-forma balance sheet.
- (ii) Historical information to assess the track record of the firm. This may normally be, audited annual accounts for the past few (typically three) years. Emphasis may be placed on balance sheets, profit and loss accounts, notes to the accounts, auditors' comments and any text associated with the accounts.
- (iii) Information that may be used to bring the audited accounts as up to date as possible such as management accounts.

In addition to the above information on the personal characteristics of the loan applicant and the industrial or commercial aspects of the loan are required for assessing loan applications. These may be obtained from documentary evidence, if a full business presentation is provided by the applicant, and through interviews and site visits. Berry et. al. stress that financial institutions should develop their own information systems to obtain supplementary information about industrial and macroeconomic conditions. Furthermore Berry et. al. argue that the analysis of data should proceed by translating raw data onto standard bank analysis sheets. These may allow space for raw data and key ratios for up to five years and thus may offer loan officials to have a view of trends. These functions may be performed manually, or financiers may use a computer based programme for this purpose.

For decisions on lending to small firms it is widely stressed that the bankers should evaluate the overall position of small firms to be financed. According to Dewhurst and Burns (1983) for the purpose of evaluating the strengths and weaknesses of small firms in respect of loan sanctioning decisions the banker needs to seek answers to the following questions relating to firm's products or services, finances, personnel and facilities.

Products or Services:

- Are they quality products or services?
- How do the prices compare with other competitors?
- How much resources are allocated for product promotion?
- Where does the firm plan to sell their product or services?
- Should the firm change the product or service in any way?

Finances:

- What is the current or expected level of profit and cash flow?
- Which products or services does it come from?
- How strong is the firm's current/proposed balance sheet?
- What potential sources of capital are available including loans from other financial institutions?

Personnel:

- Is there any gap in the management?
- Are there gaps in the skills of the workers?
- What is/will be the pay structure?

Facilities:

- How old are the business's buildings, machineries and vehicles etc, if it is an existing firm?
- What are plans for the firm's buildings?
- What is the life expectancy of facilities?
- How efficient are facilities?

These questions are by no means exhaustive. They simply illustrate the sort of searching questions that need to be asked and answered truthfully. As far as the environment is concerned, the banker also needs to investigate four key areas: the customer, the competition, the technology, and finally the economy as a whole.

Customer:

- Who is the customer?
- What does a customer wants from the product or service?
- How important to him or her are quality and price?
- Where does he or she buy the product or service?
- How important is sales promotion?
- Why do customers buy a firm's product or service, in particular?
- What developments in the product are taking place?
- Is it possible to estimate the size of the market and its future growth?

Competition:

- Who are the competitors of the firm?
- What size of business are they and where are they locate?
- How profitable are they?

Technology:

- Is technology changing?
- What are the changes?

Economy:

- What are the growth prospects in the economy?
- Is it possible to export overseas?
- Will there be any affect due to changes in the legislation?
- What will be the prices of the raw materials?

Berry, et. al. (1993) illustrates commercial lending to small and large firms as consisting of three phases: (1) approaches to lending, (2) information requirements for loan evaluation, and (3) financial covenants i.e., loan agreements and their contents especially financial terms and conditions. These are briefly described below.

(1). Approaches to lending: There are two basic approaches to commercial lending. They are the 'going concern approach' and the 'gone concern approach'. The gone concern approach, is also commonly referred to as the 'liquidation approach'. The going concern approach seeks to assess whether the applicant is a viable entity and will remain so for the foreseeable future. This approach therefore sets out to analyse the source of repayment. Much weight is put upon the future cash generating ability of the company. The gone concern approach, in contrast, is more concerned with the value of assets. The bank, in this case is interested in knowing what its position would be if the applicant went into liquidation. Depending on the lending approach adopted the sources of information for use in the loan evaluation process may vary, and also the formation and

contents of the resulting lending contract vary. For example, if financial institutions adopt the going concern approach they need ways to help ensure their clients keep to their forecast projections. When the going concern approach is adopted covenants may be used as a means of ensuring that banks have the opportunity to monitor clients' results against their forecasts. Day and Taylor (1996) confirm that UK bankers regard the monitoring role for financial covenants as very important. Accordingly, bankers regard monitoring as a means of obtaining, inter alia, early warning of problems which may be being experienced by borrowers. Financial covenants are discussed further below.

(2). Requirements of information: The question of gathering and analysing information is related to the type of approach used in lending. However, it is unlikely to be the case that a simple distinction can be made between a going concern approach requiring forecast information and a gone concern approach requiring only information on asset values and liabilities. The information used in lending decisions may not in practice be so clear cut; and the differences between the two approaches therefore in practice can become blurred. However, in terms of information used, a large proportion of information is likely to be used irrespective of a lending approach taken, but a point to note is that different figures may be stressed and more attention paid to particular types of information depending on the approach used. The sources of information that are generally used in UK bank lending have been identified as follows (Berry, et. al. 1987; Berry, et. al. 1991; Berry et. al. 1993):

(i). Audited accounts: Balance sheet, profit and loss account, audit report, statement of sources and uses of funds²⁴ are reported to use in the main to assess if forecasts are realistic and as a basis to monitor ex-ante plans provided by the would be borrower. Where such accounts are used to assess if forecasts are realistic, past trends are examined from which projections can be made. When the audited accounts are used for

²⁴ The research cited was undertaken before cash flow statements were required by an accounting standard in the UK.

monitoring purposes the process is also reported to include the reconciliation of differences between forecast and actual results.

(ii. a). Proforma financial statements, and (ii. b). Cash forecasts: These are used to determine whether estimations of projected cash flow and profit have been made realistically, and will seek to ensure repayment of lender's credit in the future. Lenders may use borrower's own produced statements, or they may also prepare them for themselves if there is concern about the acceptability or reliability of a borrower's accounts.

(iii). Management accounts: These are information generated internally by businesses and relating to both the past and future. There are broadly two types information here. One type is concerned with the past and consists of more frequent accounting information than that which is included in the annual audited accounts. The other type of information is planning information relating to the future in the form of cash forecasts, profit forecasts etc. Information relating to the past are often used as a base to monitor the forecasts.²⁵

(iv): Valuation reports: This is usually taken from third parties. Such reports contain valuations of assets and properties of the borrower in order to make security arrangements against the loan sanctioned. The lender may do this valuation itself either to substitute for the third party or to ensure a check against any irregular valuation.

In addition to above sources of information, Berry et. al. (1993) suggest the use of some other sources of information, which may be as follows.

(a): publicly available sources:

²⁵ The ability of lenders to obtain management accounting information from potential borrowers appears to vary with, inter alia, the size of the borrower. Day and Taylor (1995) found that large UK firms were much likely to agree to supply management accounting information than smaller firms. However, it was also found that bankers felt that management accounting information was less reliable from smaller firms and therefore of less potential use. Clearly, this aspect of information supply presents problems to lenders.

- interim report
- memorandum and articles of association
- registrar of companies
- press report
- government statistics
- specialist magazine

(b): sources not in the public domain:

- interviews with the borrower
- borrower's bank account
- financier's/bank's intelligence report on proposed borrower
- bank's own knowledge and experience
- information from borrower's professional advisers.

According to Berry et. al. (1987 and 1993) the loan evaluation process includes, in addition to identifying sources of information to be used for analysis, analysis of important ratios by the lender to assess certain characteristics pertaining to the proposed loan as follows:

(i) Profitability: The banker may normally calculate the firm's profit margin when looking at the profit and loss account. This information is then supplemented by, and used with, past profit trends, and where available, any profit forecasts.

(ii) Financial stability: This is related to gearing and financial risk. So a number of ratios which summarise the relationship between debt and equity, and debt and assets may be calculated. These ratios indicate relative risk in terms of the eventual repayment of any borrowing. The higher the proportion of the business that is financed by debt, the more vulnerable it is to changes in interest rates, assuming that the rate of interest on the debt is variable, and therefore the more risky it is. In addition to these ratios other information, such as the projected balance sheet after the borrowing, and an analysis of debt by repayment dates, is frequently used to judge financial stability.

(iii) Liquidity and Short term Solvency: The liquidity position of the firm may be assessed by ratios like current ratio and quick ratio. In addition the debtors turnover, stock turnover and creditors turnover ratios, each of these expresses the number of times the asset has been turned over in the year, are used frequently by lenders to assess liquidity situation. This analysis is frequently conducted as a complement or alternative to analysis of cash flows.

(iv) Security: As noted above a common way of judging security is by reference to a valuation report prepared either by the third party or by the banker itself. Bankers are also concerned with the cost of stock, and the figure of fixed assets shown in the accounts to judge proposed security.

(v) Consistency of trends: Opinion regarding consistency of trends may be formed by looking at two areas, profits and the growth in the size of the business. Profit trends provide the base information which can be supplemented by profit forecasts. The other area which banks are frequently concerned with is the relative size of the business as shown by the balance sheet total, which can be measured by the total assets or by the total equity.

(vi) Likely cash requirements: A number of factors can be taken into consideration to judge a business's future cash requirements. These include: information from cash forecasts, capital commitments, profit forecasts and an analysis of debt repayment dates.

It is important to emphasise here that a sound lending decision is unlikely to be attainable unless the appraisal examines qualitative information alongside quantitative information. There is evidence to suggest that bank lending to small and medium sized businesses is primarily to firms which operate at the direction of the people who own them, therefore, lenders must pay close attention to those individuals (May, 1994). Lenders must assess the honesty and integrity of the owners or managers (proposed or existing) of businesses to which they lend money. The lending decision to small firms frequently reduces to a single key question: are these people going to honour their

obligation to the maximum extent possible or not? In the case of an existing firm, with historical data and a company history which may include past problems, lenders must know whether the management that got the company into difficulty has the knowledge and experience to be part of the problem's solution. A bank's loan committee must ask itself whether it can ascertain that a business is well run without referring to its financial statement. May (1994) puts high importance on the individual who takes out a loan for his or her firm. He asserts that the success of many small firms depends largely on one or several key people so bankers must be sure that in addition to such capable individuals a strong back up system is in place should there be problems with key personnel. Such a system can include life insurance for key staff, business interruption insurance or consulting services that would help manage companies that have lost key persons from their management. It would also include guarantees from the key persons of the firms at the time of granting loan that they would remain with the firm during the life of the loan.

(3): Financial Covenants:

As noted above in the loan agreement which governs borrowing financial terms and conditions are included to security of lender's finance, and also to ensure monitoring of loan. Financial covenants are included to prevent the borrower acting against the lender's interest after a loan has been agreed. Financial covenants may be of, covenants restricting production and investment policy, covenants on payment of dividend or profit sharing types. Covenants and other aspects of loan contracts will now be discussed.

Review of Models on Loan Contract:

In lending processes documentation or contracting is an important aspect, which has significant implications for both parties i.e., borrowers and lenders. Here we will review some literature on loan contracting and documentation.

The preparation of the documentation governing debt funding is not only a key administrative responsibility of both parties to a loan but is also important in determining some of the risks facing companies and their bankers (Day and Taylor, 1996). Many of the risks of funding are innocently buried in complex documentation (Jones, 1993). Therefore loan contracting needs to be as non-complex but as effective as possible in order that it can act as the guide for both parties in discharging each one's function. Hence covenants in a contract should not be written so restrictively that the borrower is constantly in default over trivial issues on one hand, or so loose that the bank ends up losing its credit on the other (Morsman, 1991). Loan contracting depends on several factors i.e., the legal system that prevails in the country, bank's own source of documentation, the borrower's approach towards contracting and commitment in complying with covenants and other terms by both the parties. It is an essential prerequisite in the case of a loan contract that it is prepared in formal written form with all agreed conditions and covenants between the concerned parties i.e., borrower and lender being clearly stated (Dorfman, 1991).

There are a number of reference works which may provide descriptions of the standard contents of loan contracts. Detailed descriptions of the contents of loan contracts prepared by financial institutions are available from the works of Simmons (1972) and Castle (1980) for the USA. Some sources of guidance on UK practice regarding loan documentation may be obtained from works of Lingard (1988), Day and Taylor (1996), Dorfman (1991), and from *The Treasurer's Handbook* (1991) and *The Encyclopedia of Forms and Precedents* (1988). All these sources indicate that in general contracts covering term loans made by financial institutions will contain three main elements:

1) *Details of the mechanics of the loan, including the amount, interest terms, arrangements for drawdown and repayment.* Mechanics of the loan include the following items:

- i) Purpose
- ii) Offer Period
- iii) Drawdown
- iv) Interest (i.e., interest period, basis of fixing of interest rate, and the rate of interest itself.)
- v) Change of Circumstances (the clause which ensures the bank's interest against the adverse effects of fiscal or regulatory changes on the costs of making the loan)
- vi) Repayment schedule
- vii) Prepayment
- viii) Payments medium (e.g., currency and the bank where payments have to be made)
- ix) Acceptance (i.e., basis on which the borrower accepts the loan on the terms and conditions specified in the contract by duly signing it).

2) Legal protections for lenders, including:

- i) Applicable law (i.e., under which law the loan contract shall be governed, and agreement from both the parties to comply with it)
- ii) Illegality (i.e., restrictions which prevents the lender from providing finance for unlawful business). This term will invalidate the loan and may force repayment of loan by the borrower on, say, thirty days notice in the event of the loan or any aspect of the contract becoming illegal
- iii) Interpretation (i.e., interpretation of clauses that are inserted in the contract, and clarification on certain elements, for example location of corporate head quarters, applicability of contract to subsidiaries in line with prevailing definitions acts e.g., Companies Acts in the UK)

(3) Credit protections including security for the loan, covenants and specifications of conditions of default by the borrower. Items that are included in are as follows:

- (i) Representations and Warranties (i.e., certification by the company that there is authority to borrow under the terms of the contract by the borrower, agreement not to create any security interest in favour of third party without consultation with the lender is not permitted etc.)

- (ii) Information (i.e., the borrower agrees to supply, under the contract, information to the lender for example, audited balance sheet and profit and loss account, and any other information as and when required by the lender)
- iii) Events of Default (i.e., what action will be taken at the failure of certain conditions, for example failure by the borrower to make any repayment of principal, or payment of interest or other moneys when it becomes due, or breaches of covenants).
- (iv) Covenants (all covenants, both financial and non-financial, are included).

Normally three broad groups of covenants have been identified (Day and Taylor, 1996), as follows:

- (a) Negative covenants: These are terms under which a borrower agrees not to undertake certain behaviour. They aim to prevent material changes in the borrower's business.
- (b) Positive covenants: These are terms which aim to provide security to the lender by pledging the borrower to continue with certain specified behaviour and may take the form of explicit guarantees to the lender on the continuing conduct of the business and the provision of periodic financial information.
- (c) Financial covenants: These refer to accounting numbers measuring aspects of financial position or performance, such as gearing, liquidity, profitability, or working capital. These covenants may be expressed as ratios or as absolute values. It is important to mention that these three groups are not mutually exclusive.

There is a considerable literature devoted to financial covenants which, for reasons of space cannot be reviewed here, however see Day and Taylor (1995, Debt Contracting and Covenants: Evidence from the UK, Working Papers in Accounting and Finance, The University of Manchester)

Review of Models on Monitoring:

The lender's job is not finished after the loan is granted and the contract signed. The lender must remain in touch with the borrower so as to understand what is happening in

the borrower's business. This allows the lender to know whether there is some deterioration that requires action to protect the lender's interest. It can also be a source of marketing information leading to new opportunities to do business (Dorfman, 1991).

The need for a loan monitoring facility must be emphasised as it is essential for receiving any signals about the borrower's current financial position and non-financial factors on which the repayment of a loan may depend (Morsman, 1991). Loan monitoring is needed to help borrowers with genuine difficulty in meeting their obligations. A corollary so, of this is that borrowers should receive a fair, prompt, courteous and efficient response and handling of problems identified by the lender's monitoring system. However, providing of such services does not exclude the financier's right to protect its own interest (Dorfman, 1991). According to Morsman (1991), financial and non-financial indicators used in loan monitoring may be as follows:

Financial indicators of potential problems arise from analysis of periodic financial data. This analysis is also used to track compliance with loan contract terms, especially financial covenants.

Nonfinancial indicators, such as changes in personal habits, poor communications, and deteriorating trade relations, can be detected by alert loan officer and investigated through a site visit or the use of outside information services.

The methods of monitoring illustrated by Morsman are as follows:

- (i). Periodic site visits. It should be at least once in a year and should usually follow the analysis of annual financial data. Site visits provide an opportunity to discuss past and projected financial results; reassess management, the industry, and the market; and investigate problems or seek out sales opportunities.
- (ii). A tour of the production or service facility by a loan officer to see the state of repair of equipment, physical capacity, and the value of collateral.

- (iii). Monthly or quarterly financial data should be received and analysed for trends.
- (iv). During bad financial conditions the lender should receive frequent (perhaps at least quarterly) information on key business variables such as accounts receivable and accounts payable to form an idea regarding the firm's credit sales and credit purchase positions respectively.
- (v). The lender may seek periodic audit of the borrower's operations. This is likely to be costly and used only in extreme cases.

As noted above, loan monitoring implies obligations on the part of lenders as well as a means of protecting their interests. This is especially the case where a lender emphasises long-term relationships in its lending, rather than operating on the basis of short-term transactions (Haubrich, 1989). According to Spadaford (1990), in the absence of support service from the lender, effective success of any business which has borrowed cannot be expected. Borrower's success indicates the lender's effectiveness; and bank or financier can use monitoring of loans as an important tool to judge its effectiveness in lending activities. Spadaford illustrates two methods for discharging the monitoring function: (1) Taking Customer Feedback, and (2) Identifying Chronic Concerns. Under 'customer feedback' a bank should develop a list of key service features that are critical for borrowers; and proper steps have to be taken to monitor these matters (as illustrated below) against both the borrower and the loan officer, thus:

- (i) owner/manager of the firm is aware of the terms and conditions of the loan.
- (ii) the borrower is responsive to any query made by the lender.
- (iii) loan officials are knowledgeable about lending conditions.
- (iv) timely approval of loan is made by the loan official.
- (v) transactions are timely and handled accurately by the borrower.
- (vi) borrower receives reliable and friendly service from the loan officer.

Under 'identification of chronic concerns', Spadaford identifies the following indicators which the lender may use to assess the quality of monitoring:

- (i) borrower facing repetitive inaccuracies in invoicing due to data handling problems at the bank.
- (ii) slow response by the borrower in providing prepayment interest, interest breakdowns to the bank.

- (iii) late disbursements relating to the working capital of the borrower.
- (iv) late receipt of documents from the borrower, and late receipts of documents by borrower from the bank.
- (v) lack of follow-up by both parties on open issues relating to the lending.

Martin and Slaybaugh (1994) illustrate certain methods of monitoring loan, these are as follows:

- (i) periodic review of the borrowers cash movement taking into account both normal business situations and unforeseen situations (since the borrower is likely to conduct some or all of its day-to-day banking with the lender).
- (ii) requiring the borrower to submit all periodic financial releases (such as interim reports on financial activities or similar) to the bank, thereby placing the bank in a position no worse than investors and other outside agencies.
- (iii) periodic check of information relating to transactions between the borrower and its customers and suppliers to the extent that this can be obtained.
- (iv) checking the firm's production activities with industry or sector statistics to monitor the firm's market position.

Berry et. al. (1991) emphasises that monitoring of loans is largely governed by the terms of the loan agreement and thus monitoring may come in the form of regular submission of performance figures by the firm with checking by the lender. As with Martin and Slaybaugh, Berry et. al. stress the role in monitoring of observations of the borrower's bank accounts. Likewise, Berry et. al. (1993) advocate site visits to the borrower by officers of the bank as an effective means of monitoring of a loan. They refer to various forms of such visits: such as (i) the follow up visit, where the loan officer visits the firm before formal sanction of a loan; and (ii) the scheduled visit undertaken after the sanction of the loan and during the operation of business to monitor performance.

Apart from the models for lending decisions as discussed above, research has been undertaken on other aspects of the financing of small firms. Among this research is the work of Bachelor (1989), Chittenden (1990), Berry (1991) and Danos (1989). This and other research on small firms financing has confirmed that financial institutions

especially banks are the major suppliers of capital for small firms in many countries and it is difficult to overrate the importance of bank finance to small firms.

6. 2. A Lending Model for Small Firms in Bangladesh.

The research on lending decisions to firms, especially small firms, discussed in the previous two chapters is derived from developed countries like the UK and the USA. Despite the availability of funds in banks, the prospective promoters of small firms and the owners of existing small firms do not always have easy access to funds in such countries; rather there exists evidence of conflict between lenders and borrowers which consequently reduces the growth rate of small firms (Keasey, 1993). So there are bottlenecks which prevent the desired growth of small firms in both developed and developing countries. There is no comparable body of research regarding small firms lending by the participants of loan markets in developing countries. Thus, research on lending for small firms, especially as regards methodologies of selecting and financing small firms by banks and other financial institutions in developing countries must begin with the findings of research from countries such as the UK and the USA. This research may help in understanding, and if necessary improving the procedures of lenders to small firms to ensure economic development in developing countries like Bangladesh. As noted in earlier chapters despite policies undertaken by the Bangladesh government small firms have not been developed to the expected level and their contribution towards economic development has also not reached to the desired level so far. One reason for this could be capital market imperfections and this is taken as one of the basic hypotheses that this work will try to test. Such imperfections may be due to weaknesses in standard lending methods and procedures.

In the discussions of chapters 4 and 5, and sub chapter 6.1 above we have tried to review literature on lending models in general and also models for small firm lending. Though helpful, this literature on lending in developed countries cannot be applied directly to small firms in a developing country such as Bangladesh. However, we can attempt to understand the basic differences between developed and developing countries as far as their economies, financial and legal systems, entrepreneurial cultures and the role of the state in setting and implementing development objectives are concerned. Of course,

these differences may not allow banks in such a developing country as Bangladesh to follow exactly the same procedures as those of developed countries such as the UK and the USA. An appropriate model of lending procedures for Bangladesh which will be useful for small firms is likely to be an accommodative and satisfying one for the three major parties involved, lenders, borrowers and government. The model will be one which can safeguard the interests of the lender and the borrower whilst contributing to the micro and macro economic development objectives set by government on behalf of society.

For a developing country like Bangladesh, a loan assessment model must be effective in identifying investment opportunities for small firms as a first stage. This means that lending does not begin, as it might in a developed country, with the evaluation of loan proposals on private sector financial criteria within a financial institution. Broader economic criteria may need to be added to those discussed in the previous chapters. In this regard the method proposed by the neo-classical development economist Bryce (1960) may be helpful.

Bryce identified a number of criteria which may be examined to identify business opportunities with development potential. These are as follows:

1. *Study Imports*: Considered along with any domestic production, imports indicate an existing market and suggest opportunities for new projects to satisfy a proven demand. Hence, these are business opportunities provided by import substitution as indicated by the patterns of existing imports.
2. *Investigate Local Materials*: The quality or price in a region of certain raw materials or other production elements, such as power, may lead to opportunities to produce competitively for export and for domestic markets.
3. *Study Available Skills*: Labour and management skills which have already been developed in the area, such as in making handicraft items or industrially manufactured goods, may suggest the possibility of producing other things requiring similar know-how and skill.

4. *Make Industry Study*: Many good opportunities are to be found in expanding or diversifying firms already established. A thorough analysis of existing industries may lead to identifying logical new projects.
5. *Apply Technology*: Changing technology continually creates new industrial opportunities which can be identified by reexamining local raw materials and existing products in the light of current scientific and technological advances.
6. *Examine Inter-industry Relationships*: The growth of one industry almost always creates opportunities to establish others. The identification of these possibilities can be done by analysing how the inputs and outputs of industries fit together.
7. *Evaluate Development Plans*: Major development plans create opportunities for producing goods and services not previously marketable in the region. The plans should be studied to discover how they will change the market.
8. *Review Old Projects*: Projects previously developed but not implemented often become feasible when markets or related industries have changed. It is often possible to find new opportunities in old ideas for which the economic circumstances have improved.
9. *Observe Experience Elsewhere*: Familiarity with current and past industrial developments in other countries or regions having somewhat similar conditions will often suggest the possibility of projects which have been successful elsewhere.
10. *Use Industry List*: Industry lists published by the UNIDO, or other industrially developed countries or prospective buyers or importers of goods and services (while the government of a country wants to formulate industrial policy, for example) or by the government financing institutions (for providing funding and other forms of assistance to the prospective promoters of firms in the private and public sector) provide systematic check-lists of opportunities. They are useful for suggesting ideas and for making sure that no possibilities have been overlooked.

The above criteria may serve several purposes. They may be the basis of an educational programme to assist entrepreneurs, actual and potential, in identifying business opportunities which might provide the basis of subsequent loan proposals. Alternatively, lending institutions might be encouraged or required by government to test applications

for lending by small firms against such criteria as an initial test of both desirability (on development grounds) and feasibility (on economic grounds). Similar issues are involved in the discussion of the two previous chapters and one sub chapter (i.e. 6.1) which relates to the role of qualitative factors, and firm, product industry and market factors in loan evaluation and in the importance of examining and questioning underlying assumptions in financial projections as part of the quantitative aspects of loan evaluation. Here, we are advocating that these parts of the loan evaluation processes in developing countries such as Bangladesh be undertaken formally with an explicitly developmental emphasis.

When appropriate business opportunities are identified then the question of financing the small firms which will undertake them arises. Given the characteristics of the financial markets, and their participants in Bangladesh the lending models discussed in chapters 4 and 5, and sub chapter 6. 1 can only represent ideal forms. In case of Bangladesh, applicable lending models can be neither complicated, bureaucratic (in terms of procedures) nor such as will not allow lenders adequate scope for analysing loan proposals to give them adequate protection but which will in turn ensure the interest of borrowers are protected. From the literature review we may see that there are some essential components in lending procedures, which we argue should provide the framework of a lending model for small firms in the Bangladesh context. The broad components of a lending framework may be as follows:

- (1). Objectives of lending in general, and for small firms in particular should be clear and well known.
- (2). The role of lenders as independent institutions with individual objectives and as an economic and societal agent in the country should be clear and well known.
- (3). There should be standard procedures and phases in dealing with lending applications which are clear, well known to both loan officers and borrowers and should be consistent with the resources, skills and knowledge of the lending institutions and borrowers.

- (4). There must be clear and well known criteria in each phase of lending procedure against which loan applications are judged. These criteria should be consistently and fairly applied.
- (5). There should be a certain time frame within which each of the phases of lending procedures are expected to be completed and final lending decision is taken. This should not be unnecessarily long nor too short to ensure that proper decisions are taken.
- (6). The lending procedures adopted should recognise the need for mutual benefit for both lender and borrower and should be designed accordingly.
- (7). Owner/manager of the small firm is the person from whom cooperation and effective handling of business matters with the lender matters most to successful running of the firm. So the owner should be expected to be responsive to the reasonable requirements of lenders (by providing required information for loan evaluation) as far as the small firm financing and monitoring are concerned. Similarly, financial institutions should see the development of a long term relationship with the small firm owner as a potentially important part of lending and should recognise the development of business skills as part of this.

In earlier chapters (1, 2 and 3) we discussed the objectives of economic development, the role of financial markets and financial institutions in economic development, and strategies for economic development using financial institutions in the case of Bangladesh. With this discussion in mind and the above mentioned general framework for lending procedures we may illustrate a lending model for small firm which will be effective in serving the interests of lenders, borrowers and the economy as a whole for Bangladesh. Since this model is proposed on the basis of the literature review of lending models, discussed in previous chapters, elaborate discussion will not be offered here.

The model is expected to be certain-phase-based, be customer focussed and have a code of conduct for both lender and borrower. The lending model should have three broad distinctive phases: (1). Loan Evaluation (2). Loan Contracting and (3). Loan Monitoring. This means that the lending function should not cease after loan evaluation

and subsequent loan disbursement, rather it should go further by making loan contracting not only a mere formality or a narrow source of lender's credit protection but to ensure other services like adequate monitoring and advising take place. After the lending decision is made and when the loan is sanctioned the small firm owner should expect to be valued by the lender. There should be a code of conduct to be observed by lender and borrower to ensure a congenial atmosphere in the lending arena. Now we will briefly elaborate the phases of lending in the following discussion.

(1). Loan Evaluation:

The loan evaluation process is expected to consider and evaluate both quantitative (financial) and qualitative information concerning loans proposed for small firms and their would be owners. It begins with the loan application receipt from the prospective borrower and continues until the financier decides to provide the loan and ceases before making an agreement between the parties. Loan applications should be evaluated against some basic requirements. These may be divided into two categories: criteria that are firm or business-related and criteria that are owner-related. The former firm-related criteria are established to determine viability from economic, financial and technical points of view. The latter deals with criteria to evaluate the person who is borrowing (the owner/manager of the small firm) and his or her qualities that may contribute to the effective operation of the firm. The following discusses loan evaluation from quantitative and qualitative points briefly.

(a). Quantitative Evaluation:

This is also referred to as credit evaluation. The simple objective of credit evaluation is to assess firm's ability to generate sufficient cash and profits to perform its day-to-day operations and provide ability to pay-back the loan in the scheduled time without much variation. This evaluation should be done by taking information from a business plan submitted by borrower containing relevant data such as market size of proposed product or service, forecasted cash flows and audited accounts, projected financial statements, and information from outside sources relating to markets and products.

In making an economic appraisal study based on market forecasts and pro-forma sales statements should be prepared to judge the firm's product or service marketability. In the technical evaluation stage, the lender is required to use its expertise to determine whether adequate and appropriate technology is available to the borrower, and that valuation and pricing of equipment is accurate and at competitive prices, and is of suitable quality.

The financial analysis is expected to focus on profitability and debt-servicing ability of the firm to be financed. Using accounting information from various sources i.e., publicly available or particularly asked for (e.g., pro-forma income statements, pro-forma cash flow statements, projected sources and uses of funds (in the case of a new firm) and for an existing one audited accounts (and projected financial statements if a bank thinks necessary). In addition the bank may use its own data sources, or state-produced statistics or other information, or information from third parties. Financial ratios should be used to measure major aspects like-financial stability, profitability, security, liquidity, consistency of trends, profit retention policy, and gearing and should be analysed against respective industry or sector averages. The average number of years for which past financial statements may be required may vary but may be from three to five years for example. Detailed descriptions have been referred to in the models put forward by Cohen, (1966); Bryce, (1960); Hester, (1966); Laudeman (1994), Nutt, (1989); Berry et. al. (1991); Berry et. al. (1993). Their detailed models may be taken into consideration in the development of methodologies of financial analysis.

(b). Qualitative Evaluation:

Effective lending and subsequent effective running of small firms not only depends on a firm's capacity to earn profit and ability to repay loans. Qualitative evaluation is expected to assess the quality of the owner of the borrowing firm or its managers. Management or owner analysis is done using qualitative data, gathered from sources like the business plan, curriculum vitae, banker's report, the evaluations of loan officials or branch managers of the financing institution, reports from business or trade bodies.

Business track record, experience and educational qualification, purpose of the loan, personal character, capacity to run a business, integrity, responsibility and responsiveness to lender's requests are all criteria which are relevant. However, emphasis on qualitative information which are not relevant or are unreasonable should be avoided, for example reference from a director of the bank which is financing the small firm if it involves preferential treatment or favouritism. We may refer to the lending models of Jankowicz and Hisrich (1987), Henderson (1989), Berry et. al. (1991), Nutt (1989), Hester (1966) and, Dewhurst and Burns (1983) as described in earlier chapters for more elaborate discussions in respect of qualitative evaluation.

(2). Contracting:

The second phase of lending is expected to be loan documentation and contracting. When a decision on a loan to be sanctioned in favour of a small firm is taken by loan officials or loan committee the execution of that decision cannot take place until there is a formal written agreement between lender and borrower by agreeing to certain covenants and other conditions relevant to the lending and appropriate to both parties. The main features of a contract are expected to be those which will ensure timely disbursement of the loan amount, the successful operation of the business of the firm over a given time period, regular repayment of principal and interest, security of the loan against assets or property of firm and owner(s), monitoring of the loan, and the provision of counselling services to the borrower. The last two features are expected to be an integral part of the lending model for small firms, and are separately discussed below. Other features are expected to be included in the loan contract. The contract has to be under the existing legal system that prevails in the banking and industrial arena where such lending takes place. The objective of contracting should be to benefit both parties, and hence there must not contain any illegal or unrealistic clauses or covenants. It is desirable to have clauses specifying the size and type of loan, maturity of loan, interest rate, repayment schedule, security clauses, default clauses, and the banker's terms for the provision of necessary financial information and reports. The contract may also have certain other feature like covenants (financial, negative and positive).

Financial covenants may include certain ratios like liquidity, gearing, profitability, and the level of minimum required working capital. A flexible contract may allow for changes to occur in those figures. The setting and measurement of these figures should be based on standards acceptable by both the parties. For further details we may refer to the lending model of Cohen (1966), and the literature review on contracts in lending where standard forms of contract have been examined see Day and Taylor (1996), Jones (1993), Morsman (1991) and Lingard (1988). From the discussion on contracting earlier it may be understood that the types of features that are expected to be included in contracts should not be unrealistic or place too heavy burdens on any party to the contract if it takes place in a developing country like Bangladesh. Flexibility in fixing covenants in the contract should not be overlooked but attention should be given to ensuring that the interests of both parties are protected.

(3): Monitoring:

The concept of including monitoring in the recommend lending model may seem unnecessary as it is common to most lending model to require this. Nonetheless in a developing country like Bangladesh where both financial markets and entrepreneurial expertise and business culture are not well developed a system is necessary to keep lender and borrower in close contact and make them accountable and responsible to each other. Loan monitoring is expected to be that system. To make this monitoring effective and workable it needs acceptance by way of mutual understanding and some legal binding. Inclusion of monitoring requirements in the loan agreement can make that happen. When monitoring of loans is accepted and implemented there are likely to be some positive benefits i.e, better communication between lenders and borrowers, ease of timely repayment to the lender, and there will be scope for communicating problems which are faced by small firm owners to their banker. Additionally, due to regular monitoring of loans the financier can identify where it is lacking in providing lending services to small firms. Due to the accounting problems faced by small firm owners in developing countries the immediate responsibility for organising monitoring falls on the

lenders to seek possible solutions to those as far as their functional jurisdiction is concerned. The monitoring function is an integral part of the lending model and inter alia, should ensure counselling and advice which are essential along with timely monitoring of loans in the lending market arena for small firms in Bangladesh. The forms of monitoring may be of different types. However, these may include periodic meetings between loan officials and borrower to seek out any current problems that the firm is facing; periodic visits to the site of the firm by the loan official, submission of accounting information by the firm's owner as and when required by the lender, periodic review of cash flows, checking of production and sales targets at least until the firm repays a considerable amount of a loan and checking of marketing of products or services. In earlier chapters where literature was reviewed the monitoring models of Martin and Slaybaugh (1994), Dorfman (1991), Morsman (1991), Spadaford (1990), Berry et. al. (1991) and Berry et. al. (1993) give further details in respect of framing an effective monitoring system, as a part of a lending model. Again, like contracting, the monitoring model which is applicable for lenders in Bangladesh for small firms should be one which takes guidelines from the models described previously, and which does not contain any unacceptable and ambiguous features as far as Bangladesh's lending situation is concerned.

In conclusion it may be stated that small firm financing by financial institutions in Bangladesh is expected to take place in a specified time frame (as far as the lending decision and its implementation is concerned), and be relatively unbureaucratic and uncomplicated, and based upon effective contracting with a proper place for monitoring and counselling services to be provided by lenders. Customer focussed, relationship banking is favoured with the latter being expressed not merely in terms of consideration of qualitative factors, but involving mutual understanding of the requirements and problems of both parties involved with the objective of ensuring effective running of firms. In short, a lending model based on an idea of partnership. However, all of these attributes are not intended to eliminate or reduce unduly the commercial objectives of financial institutions. Lenders which adopt such a model ought to be able to better serve the objectives of both parties to

lending. A doctrine of partnership and relationship banking may be important in respect of a country like Bangladesh. The main idea behind this is that without a good professional relationship with a lender and sense of belonging as far as financed projects are concerned, effective lending to and effective management of and growth of small firms may not be possible. The notion of a partnership doctrine refers to a lender's essential commitment towards financed projects, with lenders expecting equitable sharing of the risks and reward involved in firm and project financing (Henderson, 1989). To achieve this equitable outcome lending processes need to be executed in order to make the financed firm profit earning and such as to enable entities to repay loans on time and in full. Lenders should not see themselves as a mere 'lender of money' but rather as a partner and this approach should be directed towards framing, implementing and attaining lending objectives relating to their own profit earning, to the borrower (by providing required services) and to the economy. The concepts of partnership and relationship banking are complementary to each other. Mutual understanding among the parties (lender and borrower) about their reasonable expectations as well as, and legal requirements is necessary for building a relationship banking culture which will promote a partnership doctrine. By adopting these two concepts in a suitable lending model which is effectively used for small firms financing in Bangladesh, financial institutions may contribute to the effective development of small firms and the more effective development of the economy.

Chapter Seven

Research Issues

7. 1. Rationale for the Research.

In many countries the pace of economic development has been accelerated through the development of small firms as part of a development strategy. Examples are countries like Japan, the USA, the UK, South Korea, China, and even Bangladesh's neighbour India.

As discussed in chapters one and three the Bangladesh government has established various programmes to develop small firms and every government no matter of which political party has been in broad agreement with this approach. During the third five year plan (1985-1990) the total planned investment in small firms was to be taka 850 crore (approximately 135 million pounds at current rates) and of this taka 578 crore (approximately 92 million pounds) was to come from credit institutions and the rest taka 272 crore (43 million pounds) was planned to come from entrepreneurs. Thus about, 70 percent of total planned investment was from the loan market, and more precisely from commercial banks, DFIs and some specialised banks such as Bank of Small Industries and Commerce (BASIC) since an aspect of government policy is to extend incentives and credit facilities for small firms through these institutions. During the fourth five year plan (1990-1995) a comprehensive programme for the development of small firms was to be undertaken with an indicative investment of Taka 1613.69 crore (256.14 million pounds at current rates) with a public sector financial outlay of Tk. 253.69 crore (40.27 million pounds) and a private sector financial outlay of Tk. 1360 crore (215.87 million pounds) proposed. The share of small and cottage firms in GDP was 4.5 percent by the end of third five year plan(1985-1990).

Government plans aim at accelerating industrial growth through improved productivity and capacity utilisation of existing firms and setting up of new firms including small firms. However, this objective has not yet been accomplished, despite the liberal

industrial policy of 1986 and then revised new industrial policy (NIP) of 1991 in Bangladesh and comprehensive programmes subsequent to that.

If we analyse several plans, for example second (1980-85), third (1985-90) and fourth (1990-95) five year plans by considering factors like envisaged investment and actual investment, and small firm sector's contribution to GDP we may be able to see that it could not contribute to the expected level for economic development.²⁶ During the 2nd five year plan total allocation for investment in small firm sector was Tk. 553.53 crore, against which Tk. 401.61 crore was invested. The target for small firms' development during the third five year plan was not achieved according to the Fourth Five Year Plan (1990-95). The fourth five year plan reported that the third five year plan's total investment target of taka 578 crore only about 50% of investment was made available during the planning period. During the 3rd five year plan the target GDP contribution was 6.5% against which a contribution of 4.5% was achieved at the terminal year. During the 4th five year plan (1990-95) some main targets were: investment Tk. 1613.69 crore, creation of employment opportunities 4 lacs, GDP contribution 7.5%. Against these targets the achievements were: investment Tk. 1031.58 crore, employment 2.41 lacs and GDP contribution 5%.

This failure of the financial system to supply sufficient investment is aggravated by other factors present in the financial system recognised in five year plans. The Fourth Five Year Plan and the Perspective Plan identified a range of what it ascribed as 'inadequacies' on the part of financial institutions engaged in small firm financing. These were considered to be constraints on small firms in addition to inadequate funding. They include marketing problems (product design and quality) infrastructure problems, poor management, entrepreneurial problems, and inadequate research and development. All these aspects are also areas of weakness on the part of small firms themselves and the failure of financial institutions to provide support for small firms in these areas further limited access to the loan capital market and contributed to capital market imperfections. Whilst the range of 'inadequacies' noted here are appropriate

²⁶Sources: Plan Documents for the 2nd, 3rd and 4th, and the perspective plan 1995-2010.

bases for criticism of DFIs whose objectives are primarily developmental, including the development of business skills they may appear to go far beyond what might reasonably be expected of commercial financial institutions. However, it may be argued with some force that even commercial financial institutions in developing countries have a broader range of responsibilities to their clients than simply providing funds. In addition, expert support in the areas of business activity identified by the Fourth Five Year Plan could be argued to be necessary ways of commercial banks and other institutions protecting themselves against credit loss by increasing the chances of success of the small firms to which they lend. That such business advice and support is good banking practice is borne out by evidence for banks in developed countries.²⁷

The problems just noted may provide clues as to why the model of economic development based on small firms which has been successful in other countries does not appear to be working effectively in Bangladesh. There are also likely to be other reasons. For example the scanning of credit proposals by financial institutions and the lending methods used may be faulty in respect of factors like the use of accounting information. Problems with the credit proposal evaluation process and project and loan monitoring may be critical in determining the success or failure of the development strategy.

From the experiences of other countries small firms have been successful in accelerating economic development (Nelson, 1987; Levitsky, 1987; Ho, 1980; Sobhan, 1991; Petrof, 1987; World Bank, 1978). However funding institutions for small firms in any country especially in this case in developing countries (such as Bangladesh) have strong and direct implications in this respect (Perspective plan, 1995; World Bank, 1995; Neck, 1987; Germidis, 1991) which may thus requires some important functions to be performed, for effective development of this sector, in the form of proper selection of appropriate projects, suitable counselling and guidance with regard to efficient management of projects, and post sanctioning monitoring of lending (Perspective plan,

²⁷ See Berry et. al. (1993), Bank Lending Beyond the theory, pp. 192-195; Day and Taylor (1996), The Role of Accounting Information in Bank Loan Contracts, JIBL; and Meredith, (1987) Small enterprises development: policies and programmes.

1995; Albregts, 1987; Harper and Jong, 1986; Hunt, 1987; Meredith, 1987; Mersden, 1987; World Bank, 1995).

One of the main rationales of this research is to see what is lacking with Bangladesh's strategy for economic development via small firms development by examining the role of the market for small firm finance and the financial institutions within it. Basically which will be an evaluatory type of research. An aim of this research is to try to establish a financing model encompassing issues like project selection, lending contracts, funding and monitoring which may be more effective than the models currently used and to examine the role of accounting information, attitude and cultures of the policy makers, the financiers and the entrepreneurs involved.

7. 2. Hypotheses to be Tested.

In financing small firms there are various sources of capital available from loan and equity sources. Irrespective of the form of capital, long term or short term, the major portion of the capital of small firms in Bangladesh comes from the loan market and makes up about 70 percent of the total capital for small firms (4th Five Year Plan, 1990; Perspective Plan, 1995; MIDAS, 1994). Thus the loan capital market has strong implications for the development or failure of small firms in Bangladesh.

As already noted the Perspective Plans of Bangladesh (1995-2010) and the five year plans already completed have identified small firms as being important as recipients of funds from the loan capital. This is a key macro-economic policy for boosting this sector for economic development and policies, programmes operating, plans and earmarked funds have been put in place for developing and establishing small firms. However, in spite of all these efforts small firms have not been successful to the desired level as it was envisaged (Fourth Five Year Plan, 1990-1995; Perspective Plan, 1995-2010).

The following general hypotheses have been identified as a means of investigating this problem.

Hypothesis. 1: Imperfections in the market for loan capital have contributed significantly to the failure of small firms to meet the development objectives set for them.

These imperfections involve the process of credit evaluation by lenders as applied to small firms which apply for loans, to the decision criteria applied by lenders to such applications, and the subsequent processes of loan contracting and loan monitoring.

This leads to the further hypotheses:

Hypothesis. 2: Credit evaluation of loan applications for small firms is not based on established standards of best practice which involve formality, the submission of business plans including forecasted accounting information, (where necessary) historical accounting reports, and an appropriate consideration of qualitative factors.

Hypothesis. 3: There is a reliance place by the lenders on inappropriate qualitative factors in loan granting decisions for small firms.

Hypothesis. 4: Lenders do not make use of loan contracting procedures which are efficient for ensuring:

- (a). Adequate credit protection for the lender, and
- (b). Effective support for the borrower to ensure a reasonable chance of economic success for the firm or project financed by the loan.

Hypothesis. 5: Lenders do not practice loan monitoring procedures either in the context of formal loan contracts or informally.

The supply side market imperfections which the above hypotheses refer to are compounded by demand side problems, certain of which lead to the related hypothesis:

6. Owners and/or managers of small firms lack the skilled management, and particularly the accounting skills, to prepare loan applications which could be subjected to best-practice credit evaluation.

7. 3. Research Approach.

Research approaches which are positive and normative have been used in this thesis. In addition, in analysing the data obtained from the field work, including data relating to small case studies, a critical approach which may be classified as normative, has been used.

The positive approach essentially sees and seeks to explain 'what it is', in situations which prevail in areas of observation (Watts and Zimmerman, 1986) and the normative approach tends to state what 'should be'. These two approaches go hand in hand in this research work. The researcher adopted a 'critical approach' not for its own sake but rather for the sake of generating conclusions and recommendations which were normative.

Among others Milton Friedman (1953) produced a very influential essay on 'positivism', 'The Methodology of Positive Economics', which had contributed to a large extent to the development of thinking of researchers and writers in economics and related disciplines such as accounting and finance. Friedman emphasised modelling and predictions as central to a positive approach. This is often taken to imply formal hypothesis testing using quantitative methods.

However, the position of the positivist has been described, more generally, by the following principles:

"there is a mind-independent reality which can be described by an objective observation language. By this we mean that it is possible to talk (or write) in a meaningfully true way about the things we experience. It is this 'observation language' which forms the foundation of logical positivism."

".....logical positivism introduces a verification principle- the meaning of a statement is derived from the method of its verification. If in some way or other, and may be only in principle,

a means can be shown by which a statement can be verified as true then that statement is meaningful" (Ryan et al, 1992).

The research reported in this thesis involves certain comparisons between situations described in models and actual practices and hence is positive in its approach. In these types of research situations, where verifications and comparisons are involved researchers may use different approaches. In a situation such as the current research where there is no formal hypothesis testing using quantitative statistical methods, researchers like Schollhammer (1973) have suggested using a conceptualising, synthesizing, descriptive, analytical and generalising approach. Here a concept is described and analysed for comparison with another and generalisations are drawn. In contrast Boddewyn and Nath (1970) advocated a descriptive, conceptual approach to hypothesis testing. Conceptual studies aim to form a model, while descriptive studies use the methods of case studies to gather data which can be used to frame a hypothesis which finally, may be tested to produce results. These findings may then be analysed to generate certain conclusions.

7. 4. Methodology.

In debates concerning appropriate and acceptable research methodology two extremes, i.e., quantitative methods and qualitative methods exist (Chaderton, 1993). There are those who argue that quantitative research is objective and that qualitative research must by its nature be subjective. This may not be the case in all research situations. However, this is in any case too simplistic a distinction and in the research reported here I have used both the qualitative and quantitative methods in reviewing the relevant literature and in collecting data for empirical study. In analysing the data quantitative and qualitative methods have been used.

In conducting the research two types of research has been undertaken namely theoretical and empirical. Some of the issues involved in applying these approaches to the research issues addressed by this thesis will now be discussed.

1. Theoretical Methods.

A theoretical method of research involves, inter alia, a review of the literature relating to the research project. Research on a particular area cannot be directed empirically without having a good understanding of the extant literature. The literature review forms the basis for developing models which eventually will be used in analysing and comparing data on actual situations with those of the models. The literature review also facilitates the identification of hypotheses and testing tools with regard to the research issues. The theoretical methodology used in this thesis follows Boddewyn and Nath (1970) to a considerable extent although the models developed concerning bank lending for this research, may not always be entirely compatible with the 'destination' of this research, Bangladesh.

The literature available for review which is related to the research topic of this thesis, is dominated by material concerning the culture of lending to small firms in developed countries such as the UK and USA. In reviewing this literature it was tried to temper the discussion with a consideration of the institutional and other differences between these countries and Bangladesh. Similarly, the literature on aspects of economic development and subsequent economic growth of countries such as Japan which have used small firms was taken into consideration bearing in mind differences of time, culture and institutions. Financial systems and their role in industrialising a country in general and through small firms development were reviewed. Also the role of government planning and government programmes will be examined from the point of view of Bangladesh in the forthcoming chapters, especially in analyses and concluding chapters.

A theoretical research method drawn upon is that of ethnographic case studies. A brief definition has been put forward by Yin (1981) who discusses this method as:

"an empirical enquiry that investigates a contemporary situation within its real life context when boundaries between phenomenon and context are not clearly evident and in which multiple sources of evidence are used".

The term 'fieldwork' is often used in connection with case study research. Fieldwork is usually taken to mean studies of social practices in the field of activity in which they take place. This could be a study of a single unit or a number of units. Although, a case study usually implies a single unit of analysis it could also be a more aggregated unit of analysis like accounting practices in a particular country (Ryan et. al., 1992). Field work in the research reported in this thesis has been undertaken in two ways, descriptively and comparatively. A descriptive approach is appropriate and useful in analysing and organising the material collected from the field work in the context of the literature review. A comparative method may also be used to compare two or more entities studied or to assess the position of one entity relative to another. The strength of the ethnographic case study approach is its ability to deal with a variety of evidence: documents, artifacts and interviews. This is a useful research strategy when 'what', 'how' and 'why' questions are being posed (Chaderton, 1993).

Descriptive case studies are those which describe a particular 'system', for example the techniques and procedures of financial institutions in practice. Such studies may be useful in attempting to determine the extent of 'gap' between theory and practice (Ryan et. al., 1992) as is relevant to the issue of lending to finance small firm development.

A descriptive case study method is considered acceptable when background information on context and environment represents an important part of the data base. Such descriptive studies are usually 'exploratory' in nature (Boddewyn and Nath, 1970). Such studies can be used to explore the reasons for practising some particular finance or accounting method or can be used to explore the reasons relating to success or failure of a certain area or sub-system of an entire system of management which enables a researcher to generate hypotheses about the reasons why a sub-system is used and why it may fail to attain its 'functional achievable goal' (Ryan et al, 1992). Such hypotheses can be tested subsequently in larger scale studies. This is relevant to the present research since lending processes, and aspects of them can be considered to be management systems and sub-systems with functions and goals. Similarly, the role of financial systems in development and of small firms in development can be so regarded.

The descriptive case study methodology can be used to describe the situation that prevails in the loan market for small firms in Bangladesh and issues relating to lending in that market and its explanation. This is substantially a positive approach. In addition, the economic development strategy adopted in Bangladesh of using small firms as a vehicle of development is itself a descriptive case study. The comparative approach to ethnographic research is illustrated in the comparisons made between Bangladesh's economic development strategy via small firms development and those of other countries which have sought to attain economic development using the same strategy. Similarly, the lending cultures and experiences of developed countries can be compared with Bangladesh in respect of small firms.

2. The Empirical Method.

The empirical research contained in this thesis is based on the positive, i.e., it seeks to explain what is and the normative, i.e., it states what should be. The positive approach will be used to explain the present situations in Bangladesh relating to the research issues and the normative approach will be used to establish a set of standards or recommendations pertaining to the research issues.

Descriptive and exploratory research primarily employs survey techniques, for example Lauterbach (1961,1966) on 'field work'. In this research survey techniques have been used in the field work to describe and explore the issues relating to economic development paradigms (management practices), suppliers of credit (a sub system) to small firms (a sub system), owners of small firms (a sub system) and lending policies (a finance practice). The empirical- survey methods which have been utilised in the research are of two types: questionnaire and interviews.

7. 5. Sources of Data.

A. Primary Sources.

The organisations and persons that were interviewed and invited to put their answers to the questionnaire were as follows:

Organisations:

1. Ministry of Finance and Banking (Banking Division)
2. Bangladesh Planning Commission.
3. Board of investment.
4. Different financing and specialised institutions related to small firms:
 - i. Bangladesh Small and Cottage Industries Corporation (BSCIC).
 - ii. Bank of Small Industries and Commerce (BASIC).
 - iii. Central Bank of Bangladesh (Bangladesh Bank).
 - iv. Commercial Banks (from both public and private sector).
 - v. Federation of Bangladesh Chamber of Commerce and Industries (FBCCI).
 - vi. Dhaka Chamber of Commerce and Industries
 - vii. Bangladesh Shilpa Bank (BSB), a DFI for development of industries in Bangladesh.
 - viii. Bangladesh Shilpa Rin Sanghstha (BSRS), a DFI for industrial finance
 - ix. Micro Industries Development Assistance Services (MIDAS).
5. Small firms.

These organisations and the field work research methods employed are discussed in more detail in chapter eight.

Questionnaire:

Questionnaire surveys are one of the most widely used methods of data collection for research (Newell, 1993). The questionnaire used had both closed and open-ended questions which aimed to obtain as much data as possible in relation to the research area. Copies of questionnaire and interview schedules are reproduced in the appendix. Interview schedules were used to gather data from policy makers, senior officials of lending institutions and small firm owners. Copies of the questionnaire were distributed among the “professional” loan officials of twenty one different lending institutions, among these institutions one is not a financial institution by banking definition and

constitution (i.e., Micro Industries Development Assistance Services-MIDAS), and that covered all the financial institutions with significant involvement in lending to small firms.

For the purpose of this research we will use financial institutions, lending institutions and financing institutions interchangeably to refer to all lending institutions covered by the field work including the MIDAS. Hence, the sample size of such institutions was approximately 100%. The term "approximately" is used because some foreign banks were excluded from the sample. This was not because of their inaccessibility but rather due to the structure of their portfolio of loan investments. These and other related issues are discussed in more detail in chapter nine.

Loan officials are those who are closely related to the appraisal, screening and selection of proposals for lending to small firms. In each of the financial institutions loan officers were requested to put their answers to questions related to, among others, the followings:²⁸

- a. The presence of any methods or systems used in selecting a small firm lending as prescribed by the appropriate government ministry or the central bank.
- b. The financing institution's own policy in financing small firms.
- c. The extent to which any model of lending (either prescribed by the central bank or a ministry or the bank's own) was followed in decision making or financing small firms.
- d. The model's effectiveness and defects as identified by the loan officers.
- e. The loan officers' views on failure of small firms, and the role of bank's loan evaluation methods in firm failure.
- f. the existence of lending contract and monitoring procedures in lending activities and the role of accounting information in both loan monitoring and contracting.
- g. views regarding small firm owners and their role in lending decisions.

²⁸ See appendix no. 1.

h. views regarding government policies relating to lending and development of small firms.

B. Secondary Sources.

Secondary data was obtained which related to economic development in general, economic development in particular countries such as those, for example Japan, which had in the past pursued small firm development strategies, markets for loan capital for small firms and in particular data on lending and related issues in developed countries e.g., . the UK, and the USA.

Secondary data was also sought which related to Bangladesh's economy in general, its financial system and its activities towards development in general and of small firms, and the lending methods used. This data was obtained from different bodies connected with small firms some of those names have been mentioned above.

7. 6. Data Collected.

In the Questionnaire there are 18 broad questions, most of which contain one or two but up to five sub-questions.²⁹ Those questions attempted to gather data of about seventy types, ranging from 'definition of small firms' to financing bodies views on government policy, their own lending policy and the role of small firm owners.

The interview schedule which was used to gather data from the senior executives in different financing bodies contained 21 questions most of which have one or more sub-questions.³⁰ The interview attempted to collect about 50 different types of data such as the strategy of seeking business, personal information on the interviewee, e.g., the existence of formal qualifications in accounting or finance or business and their comments on the standard of accounting information provided by the owners of small firms in loan applications.

²⁹ See appendix no. 1.

³⁰ See appendix no. 2.

The interview schedule used for small firm owners contained 28 questions having between one and three sub-questions in order to obtain about 50 different types of data ranging from the nature of the small firm's business to the comparative advantages and disadvantages of their smallness.³¹

The interview schedule used for accumulating data from the organisations engaged in policy making³² relating to small firms development and lending and industrial policy formulation contained questions relating to:

- a. The contribution of small firms towards various economic indicators such as GDP.
- b. Credit appraisal methods used by financial institutions for small firms and the attitude of the loan-giving agencies and borrowers with regard to judging the feasibility of project and also the status of loan monitoring.
- c. General and comparative characteristics of entrepreneurs and small firm promoters in Bangladesh and other countries that pursued a small firm development strategy.
- d. The types of small firms and entrepreneurs normally receiving preference in obtaining loans from the loan market.
- f. Policies and programmes for development of small firms in the country and policy making bodies' role in the development of small firms.

³¹ See appendix no. 3.

³² See appendix no. 4.

Chapter Eight

Field Work and Data Collection.

8. 1. Introduction.

A total period of about six months was spent in Bangladesh on account of field work. The objectives of this field work were two fold: to collect all possible and available primary information, and also to gather all available related secondary information pertaining to this research work. It is never easy for any researcher to collect primary data in field work, where this involves active and spontaneous participation from research subjects. In a country like Bangladesh the situation is more difficult in some respects than elsewhere. Where absence of any central information agencies related to different economic units and sub-units does exists. There are some common problems that might have to encounter by researchers in any field and in any country, from which my field work was not free. However, it was tried at the best to contact and cover all potential sources of primary and secondary data both at the organisational and personal levels.

8. 2. Methods of Field Work Used.

Both questionnaire and interview methods were used in collecting primary data from the concerned persons and bodies related to this research work. A Questionnaire was prepared to circulate among the loan officials of all financing institutions engaged in providing loans to the borrowers for small firms in Bangladesh. In total twenty one questionnaires were distributed. Three different types of Interview Schedule were prepared and circulated to three different types of respondent groups. They are: policy makers in various state organisations, top level executives-responsible for respective financing institution's policies and programmes of lending, borrowers/small firm owners. Twenty one high ranking officials of lending institutions were interviewed. Seven interviews were conducted to cover

those persons/bodies related financial policy making or planning having connections with small firms financing and development. Seventy six small firm owners were interviewed. Apart from these, I also informally spoke to a number of persons those either way involved or think about small firms' financing and lending bodies role in it. They are from the World Bank resident office in Bangladesh; some chambers e.g., Federation of Bangladesh Chamber of Commerce and Industries, Dhaka Chamber of Commerce and Industries; and Bangladesh Institute of Development Studies etc.

8. 3. Techniques Used in Contacting Respondent Groups.

It is obvious to state that the success of a field work largely depends on getting contact with the concerned respondents, unless contacts are made in an effective way, it would simply be an impossible task to bring them under questionnaire or interview survey-without which there will be no primary data at least in a research where field work is one of the methods of data collection.

8. 3. 1. Contact with the Respondents other than Small Firm Owners.

It is usual for participants in a study, especially where an active response to an interview or questionnaire is required to express inability to cooperate and or reluctance in sparing time to cooperate. The degree of reluctance and inability depends in part upon the degree and type of contact with the researcher.

The approach of a 'personal presence contact (PPC)' was adopted in contacting potential respondents other than small firm owners for collecting data through interviews and questionnaire. Every expected participant personally visited or telephoned and their co-operation sought directly by the researcher in advance of an interview being requested or a questionnaire sent. Although time consuming the PPC approach helps in maintaining response rates and co-operation levels, and reduces waiting time and the need for follow-up letters and reminders. The PPC approach has the potential benefit of increasing respondents' commitment to the research and willingness to be co-operative.

Some classes of respondent are difficult to contact, e.g., representatives of financing institutions, or small firm owners without knowledge of particular individuals. In these cases I sought co-operation from bodies related to these groups of organisations and persons. The Ministry of Finance and Banking and Bangladesh Bank (Central Bank) were approached for help in contacting a number of various types of financing institutions in addition to some already available to the researcher. In the cases of both groups of organisations, namely those introduced by agencies and those known to the researcher, once named individuals were identified the PPC approach was used. Here it is mentionable that, the researcher did not go to all of the financing bodies or policy level officials straight away, rather initially it was tried to contact them over phone to seek their appointment.

The *personalities*, excepting small firm owners, those were interviewed by using interview schedule include:

- i. One officer of the rank of Division Chief of the Planning Commission of Bangladesh, who were selected for their knowledge of the macro-economic policy of the government towards the achievement of economic development in Bangladesh.
- ii. One officer, of the rank of Joint Secretary of the Banking Division who was selected for his knowledge about government plans and programmes on the development of small firms and the supply of loan capital to them.
- iii. One officer of the Bangladesh Planning commission, Small and Cottage Industry sub-sector of Industry Sector, of the rank of Deputy Chief who was selected for his knowledge of the government policy and plans in developing small firms in line with the government macro-economic plan to achieve economic development in the country.
- iv. One official of the Board of Investment (BOI), at the level of Director to know about the general industrial investment situation in the economy.

v. One officer of BSCIC, of the rank of General Manager, to enquire about plans and programmes of BSCIC in boosting small firms in line with government policy for economic development; together with views on financing of small firms.

vi. One officer of Central Bank of Bangladesh (Bangladesh Bank) of the rank of General Manager to obtain views regarding the role of the central bank in monitoring the activities of banks and other financial institutions involved in financing small firms in line with government objectives on economic development.

vii. Twenty one officers of commercial banks (both public and private sector), DFI(s), specialised banks not below the rank of Assistant General Manager/Assistant Vice President. Officials interviewed, other included Managing Directors, General Managers, Secretary, Deputy General Managers of both private and public sector banks. These officials are directly related to policy issues regarding financing of small firms.

viii. One executive member of the Federation of Bangladesh Chamber of Commerce and Industries was interviewed for his opinion regarding government policy concerning development of small firms in economic development and the role of financial institutions in this regard and especially their method of credit appraisal. A table 8. 3. 1 (1) in the appendix A shows the persons interviewed from different organisations.

8. 3. 2. Contact with Small Firm Owners.

Although Most of the hypotheses in this research are directly related to financing institutions, nevertheless, a sample of small firm owners was chosen for interview to ensure representation from the demand side of the loan market. Consequently, I interviewed a total of seventy six small firm owners. A list of which is given in the table 8. 3. 2. (1) in the appendix A.

The method of selection of small firms and their owners was potentially troublesome. Various methods were considered for selecting the sample of small firms to be investigated. Reliable lists of small firms were not available from directories, industry

listings or other sources. Hence a selection with demonstrably random features could not be pursued in this way. Instead, methods which can be considered as 'purposive' were adopted. Thus, financing institutions were asked during interviews to provide a list of small firms from amongst their clients representing all sectors. A list of seventy two small firms was given by twenty one financing institutions which provided interviews and filled-in the questionnaire. All seventy two were contacted directly by the researcher and asked to take part in the research. Of these fifty eight small firm owners agreed to cooperate, and the fourteen who did not agree to interview gave reasons such as time shortage and confidentiality. Several other methods were used to increase the sample size, which at the end made the sample size of small firm owners seventy six. These methods are illustrated below.

(a). Recommendation Technique(secondary source).

In this method the fifty eight small firm owners who agreed to be interviewed were asked for the name of other small firms which might cooperate in this research. On receipt of those names I went to them and introduced myself and also brought the reference of source name i.e., interviewed owners, which might accelerated in taking interviews from them. By using this method I took interviews of ten small firm owners.

(b). Speculative (Random pop-in).

In this method, I visited two industrial areas and several commercial areas in and around Dhaka city to attempt to identify other small firms and owners who might cooperate. Under this method I just popped in to a firm's office or factory, introduced myself and described my mission; and tried to take an interview of the owner. In this case I had to be sure whether the firm was a small one in the light of the government definition first, and then sought their co-operation in this regard. It was not disappointing at all from the respondents side although in total the number was six only.

(c). Instant Financier's Floor.

Apart from the above two methods, I followed rather an unusual method. While I asked one of the financing institution to give names of some of the small firm owners, the official in addition to providing the names suggested another means to take a chance of interviewing owners. It may be termed as *instant financier's floor* methods. Under this method, I went to the loan operation department of that financing institution and met some of the small firm owners and explained the mission. In this I could manage to interview of two owners in the financier's floor by taking them at the waiting/reception room.

Although the whole process seemed to cause some extra time in compare to other methods it was a successful mission. However I am happy with the respondents number and collected information from those involved in questionnaire and interview survey i.e., loan officials, high level executives of financing bodies, policy makers, and small firm owners. This is sufficient for testing hypotheses related to this research work.

8. 4. Tools Used in Recording Primary Data.

In case of questionnaire survey the questionnaire were filled-in by the respondents, loan officials, directly related in loan appraisals. Some of these were in typed form and some of these were hand written. So, answers to the questions in the questionnaire were duly recorded in writing and no other tools were used in this respect.

There are some scopes in using special equipment or tools in recording interviewees deliberations. My interviewees included policy level officials in different state organisations and financing institutions and small firm owners. I could not use any electronic tool like a mini tape recorder excepting in a single interview with a policy level official of a ministry. The other personalities those were interviewed did not agree to use tape recorder. So, the procedure of taking interviews involved: asking question, listening to the answer and writing those in the interview schedule. Each interview took at least an hour to two and a half hour and in some cases even three hours.

8. 5. Problems Faced in the Field Work.

In every field work making contact with the respondents is a problem. I was able to reduce that problem due to my adoption of a different approach in contacting the respondents. Despite this advantage, I faced several problems. One of these include-delayed reaching of questionnaire to the appropriate person and reaching to the person who consented to give an interview with me. After communicating with a specific financing institution either by phone or personally or in both ways while I went to an official of that financing body (whose name was prescribed by the person I met or talked at the initial stage) to hand over a questionnaire, he or she was not always the person I was looking for, so searching of the appropriate person then started and that used to take a long time. Some times, this 'hunting' of the right person took a couple of days. Of course, this was not the case of all surveyed bodies. For interview purpose while I tried to contact over phone to had an appointment with an official concerned, I could not get through easily in every case. Some times it took me fifteen to thirty minutes to explain and giving answers to queries regarding my purpose of meeting over phone to personal assistant (PA) to the official I was looking for. But if PA could put me through (by phone) to the official concerned I hope the process of contacting would have been relatively faster.

Secondly, the time lag in fill-in the questionnaire and non-compliance of previously committed appointment-time by a number of respondents were also problems. The time taken by respondents in filling questionnaire was varied. Although taking a long time was not common for every financing institution but a couple of them returned the filled-in questionnaire after ten to twelve weeks of receiving the questionnaire. Meanwhile, I had to remind them repeatedly either by phone or by personal presence. If not all, at least forty percent of the respondent financing institutions could not maintain the previously fixed appointment in returning the filled-in questionnaire. Some uncontrollable variables-especially political unrest viz., strike, called by political parties during my field work was also contributed to the delay in taking interviews and getting questionnaire done by the respondents.

Another problem that I faced was 'non-specified' or 'not to the point' answer to a question either in the questionnaire or in the interview Schedule. The respondents without stating the direct and appropriate answer to a question asked used to give irrelevant answer during interviews. This was not absent in the questionnaire survey too. In case of some questions the respondents took much time in describing either less important or irrelevant matter in answering to that question rather giving an expected level of description of the appropriate answer to the question.

In spite of all the above stated problems to the field work, I agree that the rate of response and the degree of co-operation I received from the participants of each group of respondents is appreciable. It is noteworthy that the respondents to questionnaire and interview were busy persons in their own area of activities, and sparing time for field work was definitely a sign of good co-operation. So, with some of above mentioned problems the overall state of field work was up to the desired level.

Chapter Nine.

Small Firm Financing in Bangladesh.

9.1: Introduction.

The final four chapters of the thesis contain the results of the empirical research, their interpretation and the recommendations and conclusions derived from them. This chapter examines broad issues relating to small firm lending whilst chapter ten reviews the results on the lending procedures used by financial institutions. Chapter eleven considers findings relating to demand side issues and chapter twelve offers conclusions and recommendations.

The components of the financial system of Bangladesh were briefly outlined in Chapter 1. In chapter eight we have discussed the field work and data collection phase of the research in detail. In this chapter, which has three sub-chapters, we will look at three aspects i.e., participants for financing small firms, general culture of lending, and lending culture of financing institutions to small firms in Bangladesh.

From discussion in sub-chapter 9.2 below it will be seen that there are a number of financing institutions both in private and public sectors, and types of such financing institutions e.g., DFIs, commercial banks, specialised institutions. A brief review of sample selection and rationale for it in surveying institutions engaged in financing small firms will also be seen in sub-chapter 9.2.

In sub-chapter 9.3, a general review of financing culture on developing countries, as found by OECD study, will be seen. Where OECD found in developing countries financing institutions often divert or change their operational objectives and directives, and may not tend to ensure specialisation through following set financing areas and objectives. Additionally a general review on financing culture of financing bodies in Bangladesh will be discussed in sub chapter 9.3. Where it may be seen that Bangladesh's financing bodies' general culture in financing is to practice 'copying

financing', and financing bodies are rarely involved in seeking businesses for them excepting what potential entrepreneurs bring attractive investment opportunities to them.

In sub-chapter 9.4 the financing culture of financing bodies engaged in lending for small firms will be discussed. In the discussion it will be observed that financing institutions do not provide any special treatment in respect of small firm financing in line with development objectives pursued in the country. Financing bodies feel comfort in giving loans to existing customer rather than to new projects or customers, and often loans given to small firms are highly secured in nature. Now we will turn to discuss these issues consecutively as follows.

9.2: Participants in the Loan Capital Market for Financing Small Firms.

Here in sub-chapter 9.2 we offer a more detailed description of the financial institutions which are concerned with the financing of small firms.³³ The Bangladesh financial market, as already noted, is composed of commercial banks, investment banks and other specialised banks, development financial institutions (DFIs), a housing bank (House Building Finance Corporation, HBFC), and leasing and insurance companies. Some financial institutions are by policy not supposed to finance particular types of firms, for example financing of small firms by the DFIs. Interviews with high ranking officials from commercial banks produced the general opinion that DFIs were best placed to provide finance with the large firms, financing of small and medium firms was better provided by commercial banks and other bank(s) specially established for the purpose. On the other hand, officials of DFIs put their reasons for participating in financing small firms by stating that investment up to 30 million Taka is a big amount in respect of Bangladesh economy, when this investment in a business makes it a small firm. And if loan contribution on any financial institution is sixty percent which is often practised, still it is 18 million Taka which is a relatively big amount, so considering the economic needs and financial resources base DFIs participation may not be unjustified.

³³ Table 9. 2. (1) in appendix B shows some data on the survey-participating financing bodies.

There are forty institutions in the financial market of Bangladesh. Various legal restrictions are placed on certain of these institutions regarding what types of activity they can undertake. For example, leasing companies are restricted to provide loan capital, in the debt form, with the firms; whilst Investment Corporation of Bangladesh (ICB), is permitted to underwrite shares or debenture and take part in equity financing of large firms as part of a consortium of several financing institutions. In other cases the nature of their constitution may not allow them to finance projects and firms e.g., insurance companies. Therefore the total number of institutions which in practice provide loans to small firm is relatively low. Thus the number of institutions providing loan facilities to small firms stands at about twenty two. This research work covered nineteen out of these twenty two institutions. The three exceptions were: (i) Rajshahi Krishi Unnayan Bank (RAKUB- (Rajshahi Agricultural Development Bank)- a regional agricultural bank which was constituted by merging all the branches of Bangladesh Krishi Bank (BKB-Agricultural Bank of Bangladesh, it has branches all over the country) in the Rajshahi Division. (ii) Bangladesh Samabai Bank (Bangladesh Co-operative Bank), and (iii) Grameen Bank (GB).

RAKUB, was excluded since its loan appraisal, monitoring and contracting policies were likely to be the same as those of BKB follows, as this was a part of BKB previously. The two other excluded institutions Grameen Bank and Bangladesh Samabai Bank have very distinctive business philosophies and lending cultures, which sharply differs from those of the majority participants of the formal lending market such as the DFIs and Commercial Banks (RoAFIB³⁴, 1995; Suglesang et. al. 1993). In the case of Grameen Bank the lending policy is absolutely the opposite of that of an objectively commercialised and formalised financial institution. Its business philosophy is stated to be to provide loan for those having no ability to offer collateral against a loan (RoAFIB, 1995; Gibbons, 1992). In addition loans are given out in very small amounts to the poor and land less people who live in village areas. Preference in Grameen Bank's lending is to women (Watanabe, 1993; Grameen Bank Annual Reports 1993, 1994). The third excluded institution Bangladesh Samabai Bank, provides loan to people organised under co-operative principles, where

³⁴ RoAFIB: Resume of the activities of financial institutions in Bangladesh.

people receiving loan are co-owners of the bank (RoAFIB, 1995). The members of this co-operative bank are required to contribute to building the funds of the bank in order to receive loans from the bank. To qualify for loans firms must be co-operatives. The foregoing two institutions are not established on the commercial principles as the other organisations in the financial system of Bangladesh. That is they do not seek to earn profit at the cost of deviating from objectives but pursue objectives which are to assist the poor and reduce poverty level by providing financial assistance at a very minimal quantum for investment in small undertakings. Their approach is personalised or group oriented whereas the other financing institutions approach is 'organisational' or 'firm' oriented, which bring a sharp difference in evaluation of lending proposals and the quantum of money to be lent. Taking into account all these features the above two institutions were excluded from the survey on formal lending procedures, monitoring, contracting and other related matters. It is recognised that useful comparisons might have been made between these two institutions and their commercial counterparts. However, their comparative lending behaviour is perhaps a less interesting question than the relative economic development performance of the individuals and organisations which they finance when compared with the *small commercial* firms financed by other institutions. This is a subject for further research.

The nine foreign commercial banks represented in Bangladesh were approached via Bangladesh Bank for their agreement to be surveyed by questionnaire and interview for this research. In all cases the answer was negative. The reasons given for refusal were that they did not provide term loan for projects and their portfolio of lending comprised predominantly short term financing for working capital of firms financed by other financial institution(s), and export financing. Consequently these banks were excluded from the survey.

Of the nineteen financial institutions included in the research and responding to the survey, two of which completed two questionnaires each due to the largeness and complexity of the organisation and the fact that they financed both manufacturing and non-manufacturing small firms by following separate methods of lending. Therefore, the effective total number

of financing institutions represented in the questionnaire survey was twenty one. This represents effectively hundred percent coverage of the commercial financing institutions providing loans to the small firms. All these financing institutions confirmed in the questionnaire that they were engaged in the financing of small firms and this was also confirmed in the interviews with high officials of the same institutions.³⁵ These nineteen institutions may be classified by several criteria viz., DFIs versus non-DFIs, and nationalised commercial banks versus private commercial banks. In chapter one, it was stated that there are twenty seven commercial banks. Of these fourteen commercial banks which are in either private and public sector, provide loans for small firms. These constitute hundred percent of the total non-DFIs financing bodies. The remaining thirteen consist of nine foreign banks and four newly established local banks. The former do not provide loan while the latter had not begun term lending at the time this research was undertaken. Three DFIs and two specialised financing institutions i.e., Bank for Small Industries and Commerce (BASIC), and Micro Industries Development Assistance Services (MIDAS) also provide loans to small firms and these make up the nineteen financial institutions studied.

9. 3: Financing Culture of Financial Institutions.

9. 3. (i). *OECD observation on Developing country.*

A formal financial system contain a central bank, commercial banks, investment banks, development financial institutions and some specialised private and public financial institutions (Germidis et al., 1991). The culture of lending and financing of financial institutions in an economy depends on the general macro and micro economic framework, attitude and objectives of policy makers and politicians in power, the culture of societies and the policies and programmes of donor agencies and countries whose assistance becomes an essential part of the integrated economic and financial programmes of a country, especially if it is a developing one.

³⁵ Table nos. 9. 2. (2) and 9. 2. (3) in the appendix B shows data from interview and questionnaire on number of applications annually received by the participants financial institutions. In the question there was an option e.g., *other* to receive any other number excepting those in the box or any comment e.g., ' we do not finance small firm'. However none of these financing bodies replied in negative i.e., we do not finance small firm.

In addition to factors which are indicated above each financial institution's financing modes and cultures are regulated and influenced by its policies those have been incorporated during its first launching of operation in the financial market mechanism.

A brief of the financial systems of developing countries is provided in research conducted by the OECD, (Germidis et. al., 1991) provides information on lending cultures in developing countries which may be useful in understanding the behaviour of Bangladesh's financial institutions. The OECD study indicates that commercial banks in developing countries typically collect resources from the public which they then use for lending, discounting, or other financial operations. Financial institutions' deposits are derived primarily demand deposits, short term deposits and savings deposits from both households and business firms. Using these deposits commercial banks play a large role in the provision of both credit and investment funds. Lending operations are characterised by short-term business credits (especially trade credit and working capital) and personal credit. Sometimes commercial banks also grant mortgage loans. Other uses of the collected funds include discounting services and investment in securities. The OECD study concludes that commercial banks in developing countries tend to favour large-scale borrowers in the commercial and industrial sectors and concentrate their activities in urban areas.

However, despite their urban concentration bias away from agricultural lending, commercial banks are usually the most popular of the formal financial intermediaries in the developing countries (from the point of view of their percentage share of financial savings) it only because other financial institutions and instruments are often underdeveloped. In the Philippines, for example, they dominate the financial scene, holding around 43 percent of the total financial resources in the country. A larger concentration is present in Bangladesh where nationalised commercial banks hold 70 percent of total bank deposits in 1984. In Zambia, three of the nine commercial banks in the country accounted for three-fourths of total deposits at the end of 1985.

The same study also described the position of DFIs in developing countries. It concludes that it is usual in the developing countries for DFIs to be under at least partial, if not total, government ownership. Although private development banks do exist in some countries,

development banks are typically viewed as an instrument of government policy with the mission of providing long-term finance (debt or equity which the capital market cannot or will not provide) for bankable development projects in industry, agriculture, services, and infrastructure. This means that they are assigned, in theory at least, the difficult task of reconciling national development concerns with banking profitability criteria. The former may include such functions as:

- a) contributing to the creation of employment;
- b) saving or earning foreign exchange;
- c) improving the distribution of income (between social classes, regions, racial or ethnic groups, men and women);
- d) contributing to the diversification of industry;
- e) modernising the agricultural sector
- f) encouraging the development of small businesses and entrepreneurial activity;
- g) developing capital markets.

9. 3 (ii). *Bangladesh context.*

As we have already discussed about the financial system and markets of Bangladesh in chapter one, and also in the sub-chapter 9. 2 we have been able to know that Bangladesh has a formal financial market comprising of a central bank, and financing institutions i.e., commercial banks, DFIs and specialised financing bodies. In the discussion below it will be tried to describe financing institutions' general lending culture.

As we have come through the discussions above it may be concluded that some of the characteristics of financing culture identified for financial institutions in developing countries by the OECD study can be observed in Bangladesh too. However, certain local characteristics and conditions may be observed, some of which are related to aspects of institutional history in Bangladesh. In Bangladesh the commercial banks had been established initially in the public sector in line with the then state policy i.e., socialism, and historically all the nationalised commercial banks were treated by the government as an instrument for the implementation of economic and social policy although some of them

were subsequently denationalised. Later a large number of private banks came into existence and established businesses based upon the provision of working capital, trade credit or term loans to persons or firms, which has been able to increase competition in the financial markets (Gafur, 1995). Moreover a number of DFIs were established after the independence, in 1972, to specialise in different economic sectors or economic units. The provision of project loans or term loans were initially earmarked for the DFIs only.³⁶ Thus Bangladesh Shilpa Bank (BSB), Bangladesh Shilpa Rin Sangstha (BSRS) were established to provide loans to industry. The finance of agricultural projects was initially the responsibility of Bangladesh Krishi Bank (BKB) and later another specialised bank, Rajshahi Krishi Unnayan Bank (RAKUB), was established in 1987 to finance agriculture. RAKUB is a regional bank for agricultural lending in the region of Rajshahi. There is also a specialised bank namely, Bank of Small Industries and Commerce Bangladesh Ltd (BASIC). This bank was established in 1989 and owned by a private foreign commercial bank, BCCI, later it was taken by the government of Bangladesh in 1992 to provide loan facilities to prospective small firms promoters. From the situation stated above it may be seen that there prevails a competitive atmosphere among the financial bodies in the economy and that they tend to provide desired services to the customers. However it has been observed from the survey that the total quality of service level has not been improved despite the existence of competitiveness among the financial market's participants, which may be understood from the discussion in this chapter and also from analysis section.

Despite the earmarking of financing responsibilities to particular institutions or groups of institutions it is clear from the primary data (gathered through the questionnaire and interview survey among the participating financial bodies) and also secondary sources data i.e., published reports, documents, papers produced by the government of Bangladesh, the central bank and financial institutions themselves indicates various types of institutions have altered their business. For example DFIs have extended their lending beyond large and medium sized firms to the financing of small firms and the provision of working capital

³⁶ DFIs formation order 1972 (P.O. 1972).

also.³⁷ It is also noticeable from published data that commercial banks have been providing loans for large and medium firms independently and if not possible independently then through bilateral loans and syndicated loans (RoAFIB, 1995).³⁸ The commercial banks' investment portfolio also includes loans for housing despite there being a specialised financial institution for this purpose, the Bangladesh House Building Finance Corporation (BHBFC) whose functions are lending for housing and building construction.

Another differentiating feature of the financial system of Bangladesh which does not accord with the conclusions of the OECD relates to financial institutions' urban based operations of their functions via branches. A very recently published government of Bangladesh document (RoAFIB, 1995) states that the total number of branches of all the financial institutions in Bangladesh is 5800; and out of these branches 3606 or 62 percent are in rural areas and the rest (2194) or 38 percent are in urban areas. This distinction might be effective for accumulating savings from the vast majority of small savers in the rural areas. Such a distinction may also assist in geographical peripheral and fostering balanced development through locating facilities for saving investment in rural areas.

A tendency for institutions to favour financing the same type of firms or industries is another feature of the lending culture in Bangladesh, which can be termed 'copying financing'. Under this approach to financing, if a financial institution has gained experience in an area of financing or has undertaken a series of studies finds an area of investment or particular prospective investors attractive, the financial institution may favour extend loans to such projects or investors. Observing this behaviour other financial institutions may copy such practices without market research or detailed credit analysis and start lending to a sector or to the same types of projects. 'Copy financing' tends to lead to oversaturation of the loan market for certain types of businesses, and hence of product markets for certain types of products or services.

³⁷ Table nos. 9. 2. (2) and 9. 2. (3) in the appendix B shows all participated financing institutions including three DFIs, which indicate these DFIs lending for small firms. Apart from primary source a secondary published source e.g., MIDAS, 1994, also confirm this practice of DFIs. When a question (13.b of appendix 1) was asked whether DFIs provided working capital three answered in affirmative.

³⁸ RoAFIB: Resume of the activities of financial institutions in Bangladesh.

The interviews with the senior officials of financing institutions examined the areas of businesses amongst the small firms which they financed. A majority of them identified the same sector of small firm business, for example garments producing related activities such as embroidery. When questioned about their attitude to 'spread of business' the senior bankers generally reported that their institutions were not active in seeking to diversify their lending portfolio by business sector and that they tended to concentrate their lending in a small number of familiar sectors.

A feature of lending culture in Bangladesh is the failure of small firms financed by their financing institutions. Survey indicates that majority, fourteen (sixty seven percent), of financial institutions' funded firm's failure rate is approximately fifty percent, that is the rate of success is fifty percent. Only seven (thirty three percent) financial institutions' financed firm's failure rate ranges approximately from ten to forty percent. This exhibit the failure scenario of small firms financed by participating financial institutions. The following table 9. 3. ii. (1) shows summarised answers to the question "*what percentage of small firms financed by your bank are successfully running their business?*" put by loan officers in the questionnaire.³⁹ The table 9. 3. ii. (1) below shows six financial institutions (approximately twenty nine percent) had 41% -50% successful small firms financed by them, which means rest of the firms (fifty percent) were failed. Only four financial institutions reported that their financed firms' success rate was sixty percent and above, and the rest, seventeen, reported that the success rate was sixty percent at the highest. The likely issues concerning this failure will be dealt with in later chapters in the analysis section.

Table. 9. 3. ii. (1).

Success Rate of Small Firms (in Percentage)

Value label (rate of successfully running small firms)	Frequency	Percentage (of frequency)
11-20%	1	4.8
21-30%	3	14.3
31- 40%	4	19.0
41-50%	6	28.6
51-60%	3	14.3
61-70%	2	9.5
71-80%	1	4.8
81% above	1	4.8

³⁹ Question 17, appendix 1.

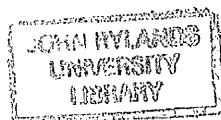
Another feature of the general culture of lending institutions in Bangladesh is that they are not active in seeking new business for themselves rather they tend to strongly favour relying on spontaneous approaches from prospective borrowers. This seems to apply to all types of loans and all types of financial bodies. They neither go for seeking entrepreneurs of small firms/businesses nor for large or medium businesses (excepting a few cases). Representatives of the financial institutions were asked question, during interviews, "*How do you seek business-what is your institution's marketing strategy?*" (Question number 9, Interview Schedule). The three possible answers to this question were: (a) it comes to you, (b) you seek it out and (c) both. Of the twenty one senior officials seventeen i.e., 81% stated that they did not seek new business but wanted for it to come to them and only 4 i.e., 19% stated that they both sought the business for their institutions and also adopted a passive strategy. The results of the empirical research relating to the general culture of financial institutions in Bangladesh are offered in detail in chapters 10 and 11.

9. 4. The Financing Culture for Small Firms by Financial Institutions in Bangladesh.

The general financing culture of financial institutions and the financial market in general will have implications for the financing of small firms. As has been observed in the previous discussion⁴⁰ that there are only two financial institutions i.e., BASIC and MIDAS which operate with the specific purpose of providing loans to small firms. However, it can be noted that commercial banks are the major source of financing for small firms, and the DFIs are not barred from providing funding for the small firm sector. Hence, the nature of financing culture, as well as changes in it, as it concerns commercial banks, the small firm financing institutions such as BASIC, and DFIs will have implications for small firms. In the interviews with the seventy six small firm owners, a question⁴¹ was asked regarding their sources of financing and in particular loan capital of the small firms investigated, fifty six firms or 73.7% of the sample

⁴⁰ See in particular sub-chapter 7.1.

⁴¹ 'What is the source of loan capital?', question number: 3(b) of interview schedule for small firm owner.



received loan capital from commercial banks, fourteen firms or (18.4%) received loan from DFIs and six firms or (7.9%) received loans from specialised institutions for the financing of small firms. Thus, commercial banks are the predominant source of financing for small firms in Bangladesh.

The interviews⁴² with the owners of small firm indicate that financial institutions use almost the same procedures and time frame for sanctioning loans for small firm owners as for other business borrowers. Thus the small firm sector does not appear to receive any special treatment from the financial institutions, despite the general importance attached to this for economic development⁴³ and despite the nationalised commercial banks and DFIs, and other specialised financing bodies being given policies by the government of Bangladesh for the financing of these firms (Fourth Five Year Plan, 1990-95).

An important feature of the financing culture for financing small firms by the financing institutions is an orientation towards 'security'. This is (security) in terms of both *importance* they put on it and *physically* taken assets as security. This feature is evidenced from the survey conducted amongst the loan officials and senior officials of financing bodies, and also the owners of small firms.⁴⁴ During the interviews with the senior officials of the financing institutions it emerged that the 'security' aspect of loan sanctioning varies depending on some factors such as existing customer or new customer. The officials were unanimous on the aspect of ensuring repayment of loans through taking security, and mostly at the *high* level.

⁴² An open ended question, number 27 (a) in interview schedule for small firm owners, '*What would you say are the advantages of being a small firm?*' was asked to small firm owners to find whether they get any advantage in terms of procedure, or time since this is priority sector according to the state policy.

⁴³ Observations from the interviews with the owners, the same observation has also inferred by a research conducted by MIDAS (1994), Report on the Study of Access to Formal Finance for Small and Medium Enterprises and the Role of FBCCI and its Member Bodies as Facilitator.

⁴⁴ See table 10. 3. (8). Security of bank loan was responded by 9 financing bodies as the first concern for their lending decision. During interviews with senior officials of financing bodies they were asked to rank informational items where security of the bank's loan was included (question 14 of appendix 2) 13 of 21 financing institutions ranked the security as the first. During interviews with owners, 62 of 76 stated (by giving answer to an open ended question, 27b of appendix 3) about the importance given by the lenders in respect of lending decision, and loan were highly secured (see also chapter 10).

The interviews with the owners of small firm indicated that approximately 80 percent of the owners were belonged to the middle class and were of the first generation of businessmen in their families at the time of starting their firms. Perhaps because of this the financial institutions which provided finance to their businesses gave emphasis to security matters. The small firm owners reported that the value of security pledged against loans was generally three or four times the value of a loan.

This conservative approach to lending and security by financial institutions is also exhibited in their approach to assessing total capital needs of small firms. The small firm owners were questioned regarding the financial institutions' approach to this matter and a majority reported that where loans were sought for general business needs including working capital, financial institutions were reluctant to supply all the finance entrepreneurs felt that they needed. A total of fifty six owners (i.e., 73 percent of the sample) reported that the initial loans which were provided to them were not adequate and that they considered that financial institutions inaccurately estimated their needs for finance.

Furthermore, a majority, sixty five out of seventy six, (i.e., 85.52%) of the small firm owners interviewed criticised the financial institutions concerning their attitude towards ensuring that business projects were properly functioning and their attitude towards loan monitoring and the giving of advice and counselling once loans were granted.

A lack of concern with these matters on the part of the lending institutions was confirmed by answers to the questionnaire completed by loan officials of twenty one financing institutions. They were asked whether their institutions normally included any clause in their lending contracts in relation to 'monitoring' of loans and only six of the twenty one (i.e., 28.57%) financing institutions reported that their institutions included such a clause. Of the twenty one loan officials only five (i.e., 23.8%) confirmed in the questionnaire that their bank included a clause in relation to counselling and advice to small firm borrowers in the lending contract, while the majority of the respondents i.e., sixteen or (76.2 percent) answered that their institutions did not include any such clause in the lending contract. This finding is strongly supported by the small firm owners through their interviews. Out of the seventy six owners interviewed sixty (i.e., 79 percent) said that they did not receive any counselling or advice from their lenders even in case of financial difficulties for example, what to do at the time of working capital

shortages. This attitude of 'lend and forget' has been observed as common in other countries (Wilson, 1979; NEDC, 1986; Dorfman, 1991; Albregts, 1987). It may be criticised on several grounds. e.g., it is likely to increase the chances of financial distress on the part of borrowers and increase the probability of credit loss by lenders, and implies a strictly 'transaction' approach to lending as opposed to 'relationship banking'.⁴⁵ In the context of a developing country such an approach may be especially troublesome since the gap between loan officers and entrepreneurs in business skills and experience may be greater than in developed countries. Moreover, the development of business skills through transfer of expertise from the relatively developed sector of the financial system to the less developed small firm sector might be viewed as a significant developmental contribution. However, whilst this may be a function expected of public sector institutions, especially DFIs and commercial banks, how far it should be expected of private sector commercial banks is questionable.

An important feature of the lending culture for financing small firms by financial institutions in Bangladesh came from the interview survey that there was a widespread view amongst the financing institutions that they would feel more comfort in lending to existing firms than to new firms.⁴⁶ This culture is unlikely to be desirable for the economy in the long run especially when it is present amongst the DFIs, specialised banks and commercial banks which are primarily responsible for lending to new businesses.

A further feature of Bangladesh lending culture for small firms is the length of time take to process loans and the high transaction costs involved. Among the seventy six small firm owners only twelve said that they had been able to settle loan sanctioning matters within one year's time of application to their financiers and the rest said it took them more than one year (and in a small number of cases up to four years) to complete the process of obtaining a loan from their financiers.

⁴⁵ Holland (1993), Bank corporate Relations: Change issues in the international enterprise', Accounting and Business Research, no. 23.

⁴⁶ During interviews (question no. 8, in the appendix 2) with the senior officials of financing bodies majority of them, 14 out of 21, stated that they preferred existing borrowers/firms for loan.

This chapter has reported that part of the financial system of Bangladesh is devoted to small firm financing. However, despite the presence of institutions committed to small firm financing and institutions such as commercial banks which have a commercial interest in lending to small firms, the lending culture of these institutions may be clearly characterised as having certain features which are likely to inhibit small firm development. In particular, the reported characteristics highly of (security orientation, lend and forget, favouring existing firm to lend, absence of monitoring from the contractual/binding point of view) are important in this respect. From a development point of view it is important to seek ways of improving lending culture towards small firms.

Chapter Ten.

Lending Procedures of Financial Institutions.

In this chapter we will deal with financial institutions activities based on the field work regarding their methods of identification of small firms, loan evaluation, monitoring and contracting practices. The main purpose of this chapter will be to examine the hypotheses related to the financial institutions i.e., supply side. So, out of the five hypotheses both from the supply and demand (owners of small firms) sides, four will be examined here and the hypothesis related to demand side will be examined in the next chapter.

10. 1. Identification of Small Firms.

The identification and generation of prospective projects is significant in the total scenario of firm and project financing. Some aspects of this were discussed in the previous chapter. The survey conducted among the twenty one financial institutions revealed that the majority of them depend on small firm sponsors spontaneous loan seeking approaches for obtaining businesses. A question '*How do you seek business-what is your marketing strategy?*' was asked to the twenty one high officials of the financial institutions and seventeen of them (81%) said 'it comes to us' and only four (19%) said 'it comes to us and we also seek it out'.⁴⁷ None of them said 'we seek it out solely'. These results raise questions regarding the suitability of the policy of obtaining new business by financial institutions in a country like Bangladesh which has clear policy objectives regarding small firm development. It might be argued that financial institutions should take a more active role in seeking small firm businesses. Alternatively, there is validity in the view that they should deal only with those cases which come to them. A majority of the officials of the financial institutions observed

⁴⁷ 'Seeking business' also refers to unearthing new entrepreneurial abilities, because while a financier may seek businesses to lend to, it is also necessary to find a person or group of persons who will run the project successfully.

that seeking or generating projects for financing by them should be done by an agency or a body formed by the government. However while such an idea cannot be discarded, the role of financial institutions as both a commercial and development agencies needs further consideration.

The literature review described a model for seeking small firm opportunities and suggested that the financial institutions should employ their efforts in identifying business opportunities using certain criteria related to the needs and general economic and financial characteristics of the country. In Bangladesh public sector financing bodies have some sort of official units with the responsibilities for locating business opportunities,⁴⁸ while excepting a very few, all private financing institutions do not have such units. However they may use the output produced by other financing bodies relating to it.

There may be a number of possible underlying causes of the passive attitude of private sector financial institutions. They may consider that competitiveness in the market for loan capital favours them with an excess supply of borrowers seeking lending. This attitude may not constitute a characteristics of behaviour in a modern financial system for any sort of firm. For small firms in a country like Bangladesh it is likely to be an unacceptable mode of allocating financing and implies that it is the duty of borrowers to seek funding for their projects and not for financiers to pursue search strategies for prospective promoters and projects. During the interviews with the planners and policy makers a question *'Are you sure that prospective entrepreneurs know enough about the facilities that are available for financing small firms?'* was asked and all of them (seven) stated that prospective entrepreneurs did not know enough about the credit facilities available for small firms. During the interviews with high officials of financial institutions views regarding the same issue was sought while asking them the question *'Are there any other issues relating to small firms which you would like to raise?'* all of them (twenty one) stated the same answer what the policy makers

⁴⁸While answering to the question 9 (appendix 2) relating to seeking business, officials represented public sector financing institutions stated that they had sections which dealt with some sort of research to see potential investment areas.

made. It was mentioned in the previous chapter that the majority of entrepreneurs came to the financial institutions on their own, stimulated and encouraged either by themselves or by non formal external bodies viz., friends, relatives, existing sponsors or by both of these.

Table. 10. 1. (1)

Entrepreneurs Know Enough About Credit Facilities

Interviewees	Agree	Disagree
.Policy makers	-	7 of 7
.High officials of financial institutions	-	21 of 21

It may be argued that private sector financial institutions are behaving rationally in this regard. As profit oriented organisations they should behave commercially and rely on the profit motive on the part of small firm promoters to ensure that an efficient allocation of funding takes place. However for ensuring effective investment portfolios in firms and projects and generating competitive venture projects financial institutions, irrespective of sectors i.e., public or private, should change their approach of seeking businesses by adopting 'seeking out ourselves' means.

10. 2. Evaluation Methods Applied to Loan Proposals.

The central theme of this research is to examine the contribution of financial markets to the growth and development of small firms in Bangladesh and for understanding this, several specific hypotheses have been proposed. One of these is to hypothesise that the financial institutions, which are financiers of small firms, do not follow any established lending procedures for granting loans to borrowers. That is they do not have formal loan application appraisal methods which might involve certain formalities like the submission of business plans (including forecasted accounting information, where necessary) historical accounting reports, and an appropriate consideration of qualitative factors. Another hypothesis, which is closely related to the above is that lenders put

reliance on inappropriate qualitative factors in loan granting decisions for small firms. This section will provide a general review of the loan evaluation process and the two hypotheses mentioned above will be dealt with in the sub chapter 10.3 next by considering the survey data collected during fieldwork together with secondary sources of data.

In the field study, twenty one questionnaires were completed by nineteen financing bodies and twenty one high ranking officials from those financing institutions were interviewed to gather information in respect of lending and its related matters. Seventeen financing institutions completed one questionnaire each and one high official at policy level from each of these financing bodies was interviewed. Two other financing bodies completed two questionnaire each and two high ranking policy level officials were interviewed, because these two institutions define small firms in two different ways as far as their lending activities and certain government directed special policies and programmes are concerned and as a result may apply loan appraisal systems which differ between divisions. It is noteworthy that these two institutions are in the public sector and one of them is a DFI. Thus, the total number of respondent financing institutions is twenty one.

The interviews of the high ranking officials of these financial institutions revealed that of twenty one financing institutions twenty reported that a formal lending procedure existed. This very high rate of positive response clearly suggests rejection of the hypothesis that financial institutions do not have formal lending procedures. However, this issue will be explored in greater detail in the paragraphs below where an overview of the lending procedures which were described is outlined.

The majority of the institutions described the initial contact between themselves and a prospective borrower with regard to financing as beginning when the prospective borrower steps into the premises of that financier. It was reported that it was very unlikely that any such financier would go to the prospective entrepreneurs in order to seek businesses from them. Certain exceptions were however reported. Some financing

bodies reported that they might call prospective investors to approach them to take finance for establishing small firms in addition to the applications they receive from spontaneous prospective borrowers. These financial institutions are: two private sector commercial banks and two state owned DFIs. The methods, they reported, used were making contacts by branch managers or some times by senior officials with the existing customers and tell them about available business opportunities; and by giving persuasive advertisements in the newspapers stating all relevant information i.e., sector(s) of businesses, possible loan amount and interest, and so on.

Table No. 10. 2. (1).

Financial Institutions' Strategy of seeking business

Strategy of seeking business	Number of Financial Institutions (FI)
(a) It comes to FI ⁴⁹	17
(b) FI seeks it out ⁵⁰	-
(c) Both (a) and (b)	4

About 90 percent of the respondent small firm owners (out of 76 small firms owners) answered the question- *"To whom, if any one, did you first go for advice and help in starting your firm?"*⁵¹ by replying that they got the idea to establish their business or were persuaded to do so from their friends, relatives or well wishers and other existing businessmen. When a prospective investor in a small firm approaches a financial institution it was reported by the owners that generally at the very first stage an applicant would talk to a bank employee of various kinds ranging from the manager of a branch or section to a clerk or a guard (in cases where the applicant was a stranger to a bank and needed to know the exact location where he or she could discuss the prospective financing). Some financing bodies (five) reported that they had clear and identifiable locations and persons to be contacted initially in this regard. This initial contact either permits the prospective borrower (PB) to take an application form for completion for the

⁴⁹ Financial institutions adopt this means only, they do not go for (b).

⁵⁰ Financial institutions adopt this means only, they do not go for (a).

⁵¹ Question number 9 of Interview Schedule for Small Firm Owners, see appendix 3.

purpose of initial scrutiny or might lead the PB to a formal interview with an appropriate person (e. g., loan officer or branch manager) whose job would be to determine whether the PB might be given an application form for later submission. Following the completion and return of the application form to the financial institution along with necessary papers and documents the appraisal process was reported to begin. Before undertaking a detailed appraisal of a loan application the representatives of the financial institutions reported that it was usual to attempt to screen-out risky loan proposals at first sight to reduce the total number of applications which would be processed. The initial rejection methods which were used appear to be based on general criteria. These general criteria varied between the institutions which were studied. 'Initial scrutiny' criteria which were reported included a list of discouraged sectors which were discouraged by the institutions for lending, the general attitude of the promoter or owner of the small firm applying (as assessed by the respective loan officer or branch manager), general appraisal of business prospect of the firm or business that the borrower seeks finance for, previous business track record of the borrower (assessed briefly from criteria such as repaying habits) or if the borrower is an existing customer of that institution. The table below shows these criteria and lending institutions used such criteria for initial scrutiny.

Table No. 10. 2. (2).

General Initial Scrutiny Criteria (Used by Financial Institutions)

Initial Scrutiny Criteria	No. of Lending Institutions
List of discouraged sector	18
General attitude of prospective borrower (as assessed by respective loan officer or branch manager)	20
General appraisal of business prospect	21
Business track record	16
Prospective borrower is an existing customer	19

The responses of the lending institutions' officials indicated that the time span required from receiving an application form to apply for loan and the application passing out of

the screening stage ranged from 3 to 12 months, and this is the initial stage. That means the quickest was on average 3 months and the slowest on average 12 months. The table 10. 2. (3) shows time taken by financial institutions at screening stage. Thus a borrower who applies for a loan may not be sure whether or not his or her case is being put through the screening stage until at least three months after submission of an application.

Table No. 10. 2. (3).

Time Taken at Scrutiny Stage

Time taken in screening stage (in months)	Number of financial institutions
3 to 4	4
4 to 6	7
8 to 9	8
10 to 12	2

Once an application form passes the 'initial scrutiny' phase, the final appraisal begins. Out of the twenty one financing institutions twenty answered that they had standard procedures for lending decisions i.e., formal appraisal systems, and as far as the stages are concerned their procedures were reported to be same. It was reported that these formal appraisal systems comprised several stages of analysis, which were identified as economic feasibility study, financial feasibility study, marketing/market study, management study, and technical study. The foregoing list was derived from the answers to the question- '*Does your institution have formal lending procedures? If so, what are they?*'⁵² The senior executives of the twenty financing institutions mentioned several stages of analysis, using different terminology which, when interpreted, may be described as the foregoing. For example, one senior executive of a financing body said that they used 'Bank's Manual' in dealing with lending. This manual was described as comprising 'compact appraisal' methodology which included several studies and examples of analyses. The other institutions did not mention about such manual, rather they reported about the practice of appraisal procedures comprised of the above. The

⁵² See appendix 2, question number 4.

institution which did not report having a standard lending procedure was not in an absolutely isolated position however. In practice, although it did not have any concrete lending procedures to follow but it reported that it took aspects of the above mentioned types of analysis when necessary. The frequency levels of use of the stages of analysis noted above were sought in the interviews of senior executives. Four frequency levels were offered as follows: Always, Frequently, Sometimes and Rarely. From the interview responses table 10. 2. (4) was prepared showing the frequency level of uses of the stages of analysis in lending procedures.

Table: 10. 2. (4)

Stages in Appraisal Procedures and Their Frequency of Uses

Frequency level of uses	<u>Number of Financing Bodies/ Types of Analyses</u>					
	Economic Feasibility Study(EFS)	Financial Analysis (FA)	Management Study (MA)	Market (MS)	Study	Technical Feasibility Study (TFS)
Always	9	18	9	19		9
Frequently	6	3	12	2		12
Sometimes	5	-	-	-		-
Rarely	1	-	-	-		-

Within this overall framework of analysis each institution has its own acceptance criteria as far as the lending procedures are concerned. The responses to the interviews indicated how the financial institutions interpret the five stages of analysis identified. In the following paragraph the features that are covered in each stage are enumerated briefly.

From the table 10. 2. (4) we can see that all twenty one financial institutions did not 'always' use five stages of analysis. Nineteen financial institutions 'always' used market study, eighteen 'always' used financial analysis; while nine used economic, management and technical analysis 'always'. Excepting economic analysis, all other

analyses i.e., financial, marketing, management and technical were used either 'always' or 'frequently' and again twelve financial institutions used economic analysis either 'frequently' or 'sometimes' or 'rarely'; which indicates that financial institutions give relatively less importance to this analysis in compare to other analyses. However, this is likely to be a crucial analysis from both macro and micro economic points of view for a developing country such as Bangladesh. Apart from this, from the table above, we may infer that financial institutions use the above mentioned analyses either 'always' or 'frequently'. For example, financial analysis used 'always' by 18 institutions, and 3 financial institutions used it 'frequently' but none reported used financial analysis either 'sometimes' or 'rarely'. From the data in the table 10. 2. (4) above it may be inferred that the financial institutions are likely to emphasise two analyses e.g., financial and market in compare to others; it may be seen that these two analyses used 'always' by eighteen and nineteen financial institutions respectively.

By 'Economic Appraisal' the financial institutions reported that they might seek to establish the desirability of a proposed project based on macro-economic variables; for example, contribution to GDP, generation of employment, earning foreign exchange or saving foreign exchange, ensuring or enhancing linkages in the small firm sector. However, the application of this stage was mixed. The financing bodies reported that they did not always use this appraisal stage or very rarely used it. There is a significant difference between public sector and private sector financing bodies in this regard. From the survey it is observed that out of the twenty one financing institutions fifteen stated that they undertook Economic Appraisal either always or frequently; of this twelve only two institutions were from the private sector and the remaining ten were from public sector. Nine of this ten stated that they undertook economic analysis on all applications.

In Financial analysis the lending bodies reported that they were interested in knowing the position of the prospective project or firm based on its future costs and benefits considering all cash inflows and outflows. All twenty one of the participating financing bodies stated that for judging financial feasibility they tried to establish the profitability trend of a project or firm, calculate gearing ratios and other ratios like-return on capital.

In addition, Financial Appraisal was stated to include the following aspects, and these are the compilation of aspects those were used by financial institutions. Of the aspects mentioned below all financial institutions, as reported, were likely to use at least any five to six of these:

- a). Projection and estimation of total costs of the proposed project or firm including required level of working capital.
- b). Assessing the continuing needs of working capital.
- c). Assessment of cost of raw materials, administrative expenses and selling expenses.
- d). Projection of total production and sales revenue.
- e). Estimation of cost of goods sold.
- f). Preparation of a projected cash flow statement, income statement, funds flow statement and balance sheet.
- g). Calculation of break-even sales, IRR; and sensitivity analysis.
- h). Calculation of ratios such as current and acid test, debt service coverage ratio and fixed asset coverage ratio.

In the feasibility assessment of management the lenders reported that they looked at basic aspects of the firm like the overall effectiveness of the management in running the business, on which the success and failure of the project might be dependent to a very great extent. The high officials of the financing bodies were asked about the importance of management in the form of the question "*Do you consider the management of a firm as a factor in granting a loan?*"⁵³ all of them (i.e., twenty one) answered in the affirmative. It was reported that Management Appraisal involved, inter alia, the following. It is noteworthy that the following items are compilation of reports in this regard given by financial institutions' representatives i.e., senior officials during interviews:

- (a). Judging entrepreneurs' educational and business records.
- (b). Taking into account of previous experience either in any business or job.
- (c). Consideration of conceptual knowledge in business or related field.

⁵³ Question no. 15(a) of appendix 2.

(d). Consideration of Personal attitude and behavioural pattern of the borrower as far as the proposed project is concerned.

(e). Analysis of Repaying attitude and risk taking ability.

Marketing Appraisal was given high importance by all of the financing bodies in the survey. As shown in the table 10. 2. (4) it can be seen that all the financing bodies apply it either Always or Frequently, and none stated that they used it sometimes or rarely. From the interviews also the high officials of the financing bodies observed that they placed great importance on marketing (at least theoretically). It was explained that the marketing appraisal dealt with the following matters, which are the compilation of what financial institutions' reported and these were adopted by all financial institutions though not all of these by all financial institutions; but every financial institutions reported about uses of (a), (c) and (d), and twelve financial institutions reported about (b).

(a). Assessing and ascertaining actual demand for the product or service.

(b). Examining the possibility of expansion of the applicant firm's present capacity of production.

(c). Examining marketing strategy viz., local sales, export, wholesale or retailing.

(d). Analysing the appropriate pricing of products or services, considering relevant factors like price of the similar product in the market.

In the interviews with financial institutions emphasis was placed on technical feasibility aspects of loan appraisal. Table 10. 2. (4) shows that all of them apply this analysis either Always or Frequently. Participating financial institutions reported that they used engineers (those were also held positions in financial institutions e.g., officer or manager) to perform these types of work for the financial institutions. It was also found that DFIs and commercial banks used same procedures in performing these functions. Under the technical appraisal the appraiser aspects of analysis which were reported as follows:

(a). Whether the proposed or chosen machinery and equipment are appropriate, adequate and compatible for the proposed project.

- b). Whether the pricing and specification of machinery is justified.
- c). Whether the proposed supplier of machinery is genuine and efficient.
- d). Whether the proposed site, type of land, layout of the proposed factory or office buildings comply with the requirement of the project.
- e). Whether the project site has all infrastructural facilities.
- f). Whether the quoted price of land and construction costs are reasonable and justified.

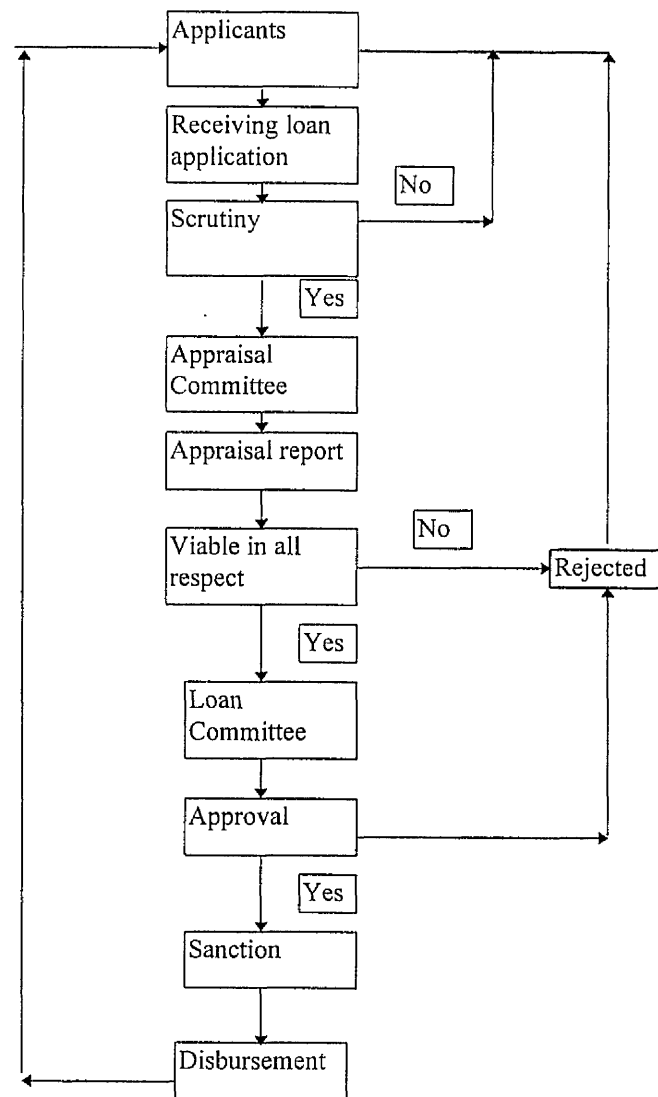
Based on information regarding financial institutions' adopted procedures in dealing with applications for loan for small firms, we may now identify the formal procedures involved in respect of sanctioning loans as follows. The following stages is compilation of participating financial institutions' reports in response to the question concerning lending procedures and stages:

- (a). Receiving of Loan Application from the applicant.
- (b). Short-listing of prospective borrowers by using initial scrutiny method.
- (c). Rejection on the basis of initial scrutiny.
- (d). Processing of Loan Application by using Lending Appraisal method.
- (e). Approval of loan by the respective loan sanctioning official or committee.
- (f). Sanction of loan and disbursement.

These stages are described in figure 10. 2. (F1) in the next page.

Figure no. 10. 2. (F1)

Typical Stages in Processing Loan Application.



The stages of figure 10. 2. (F1) may be described, in accordance with reports from participating financing institutions, as follows.

When an applicant submits an application it is scrutinised by loan officials based on certain criteria practiced by that financial institution, for example industry or firm discouraged list. If that application passes this stage application, along with all other necessary papers and documents, is forwarded to the loan officials or a group of officials, comprising financial analyst, economist and engineer⁵⁴ (often practiced by DFIs, and presently this approach is also followed by commercial banks). These officials might work individually or under a committee to examine the viability of proposed loan/project. In the appraisal stage loan officials usually follow procedures such as financial, marketing, management, economic and technical analyses. When appraisal reports that it is a viable project a proposal for sanctioning loan then sent to the loan approval committee, the committee generally discusses about the prospective project and either approves or rejects the proposal for the loan. After it is sanctioned, an agreement usually made between the lender and the borrower before a formal disbursement letter is sent to the borrower; however contract or agreement was not reported as a part of the processing of loan application or in other words standard procedure for lending.

10. 3. Review of Hypotheses Relating to Loan Evaluation Procedures.

The underlying hypothesis of this research is that imperfections in the market for loan capital have contributed significantly to the failure of small firms to meet the development objectives set for them. This may be tested by bringing and testing the hypotheses as follows:

- i. credit evaluation of loan applications for small firms is not based on established standards of best practice which involve formality, the submission of business plans including forecasted accounting information, (where necessary) historical accounting reports, and an appropriate consideration of qualitative factors.

⁵⁴ High officials during interview reported to that when replying to the question 4, see appendix 2.

ii. there is a reliance place by the lenders on in appropriate qualitative factors in loan granting decisions for small firms.

In the sub chapter 10.2 it was reported that the participating financial institutions had some standards procedure to evaluate loan proposals, including the use of evaluations of economic, financial, marketing, management, and technical aspects. All financial institutions reported that all loan proposals passed through some evaluation phases if loan proposals could pass the initial scrutiny.

On the face of it this result calls into question the hypotheses which links small firm failure to the lack of standard loan evaluation methods. However, before rejecting this hypothesis it is important to consider whether loan evaluation methods are properly used. It might be that in reality these methods are not applied at all, despite the views of high officials regarding their existence, or are not used properly. These methods may exist only in the manuals or project appraisal systems of financial institutions. In practice lending decisions may depend on some other criteria solely or lending decisions may be highly motivated by factors which do not fall under normal lending standards or criteria. It is questionable practice if a lending system recognises essential evaluation methods but finally decides to lend based on other factors. It is also important to stress that rigorous pre-investment analysis of business projects when they are loan proposals does not guarantee of success for small firms. Nonetheless such pre-investment analysis has implications for the effective performance of small firms because effective credit evaluation should consider many issues relevant to business success or failure.

We shall now see how financial institutions undertake their evaluations of loan proposals.

The field work indicated that in general loan evaluation systems of the financial institutions considered financial feasibility as the first priority. In analysing the proposals financial institutions consider both quantitative and qualitative information concerning proposed new projects and expansion of an existing projects; and they also

consider these types of information both in the cases of an existing and new borrowers. A question, "*Does the Standard Procedure include appraisal of both Quantitative and Qualitative Information or only Quantitative or only Qualitative*", was included in the questionnaire supplied to the loan officials. All twenty one financing institutions stated that they did consider both quantitative and qualitative information. However, as far as the relative weightage of these types of information was concerned seven (33.3%) stated that they put more weight to quantitative than qualitative information, two (9.5%) stated they put more weight to qualitative than quantitative information, six (28.6%) stated that they put equal weight to both quantitative and qualitative information and six (28.6%) stated that they did not have such a format for relative weightings regarding consideration of quantitative and qualitative elements but did consider both these two types of information.

Table 10.3.(1).

Comparative Weightage Between Qualitative and Quantitative Information

Frequency and value label									
More	weight	to	More	weight	to	Equal	weight	to	No such format
quantitative		than	qualitative		than	quantitative		and	
qualitative			quantitative			qualitative			
7			2			6			6

Another aspect of variation in weighting was revealed through the field work. Depending on the lending type i.e., lending for existing or new firms, weighting varies. Seventeen of the financial institutions stated that the weighting of the two factors varied and four stated that it did not.

Table: 10. 3. (2)

Variation of Weightage Between Types of Lending

Do weightings (quantitative and qualitative) vary between lendings i.e., existing and new?	
Yes	No
17	4

A question was asked "*What characteristics cause this weighting to vary*". The combined and summarised answers of the twenty one financial institutions provide such an impression that the financial institutions are very cautious and sometimes very sceptical in lending to new customers, irrespective of the person's current status i.e., he/she has an existing or new business. There also appeared to be biases as far as these two types of information are concerned when dealing with an existing and/or new borrower. In case of an existing borrower (may be with an existing or a new firm) they appear to put more weight on the qualitative sources and forms of information but in the case of a new borrower the case is opposite whether or not the new borrower has an existing or new firm. This essentially generates a feature of small firm financing in the Bangladesh financial system, that is 'non-firm personalised financing mode' where a preconceived notion like 'existing' and 'new' borrower is the concept which may dominates in getting funds for financing small firms with, very possibly, the characteristics of the project coming later. Of course this does not exclude new borrowers from finance for existing or new firms, nonetheless these lending cases will usually take longer to evaluate because of the greater information processing requirements which reliance on quantitative information creates. Moreover, in such cases qualitative information is not exempted from scrutiny.

However, irrespective of the borrower's status existing or new financial institutions do consider sources of quantitative information in analysis of both existing and new

firms. Nine financial institutions stated that they used independent credit rating organisation as a source of quantitative information, while the rest i.e., twelve did not use it.

Table 10. 3. (3) shows the sources of quantitative information for existing and new firms and levels of frequencies:

Table: 10. 3. (3).

Sources of Information for Lending Decision

<i>Sources of information</i>	<i>Level of uses and Frequencies</i>				
Existing Firms	Always	Frequently	Sometimes	Rarely	Never
Balance Sheet	16	2	3	-	-
Profit & Loss A/c	16	2	3	-	-
Cash Flow Statement	10	5	4	2	-
Sources & Uses of Funds	10	-	9	1	1
New Firms					
Projected Balance Sheet	16	2	3	-	-
Projected Profit & Loss A/c	17	2	2	-	-
Projected Cash Flow Statement	16	2	3	-	-
Projected Sources & Uses of Funds	15	1	3	2	-

From table 10. 3. (3) above it may be mentioned that the financial institutions clearly place importance on financial information as indicated by the frequencies of 'Always' against all sources of information. In case of existing firms relatively greater importance is given to the Balance Sheet and Profit and Loss Account in compared to the Cash Flow Statement and Sources and Uses of Funds. This may be caused by the concern of financial institutions about existing firm's assets and liabilities position and profit (or loss) position. The number of years for which these accounting reports are required to be submitted proposed range from three to five years.

Table: 10. 3. (4) _

Number of Periods for Which Accounting Reports are Required.

Number of years	Number of Financial Institutions
3	16
4	3
5	2

In the questionnaire the question '*What are the qualitative factors you would consider important for financing small firms?*' was put to the loan officials of the participating financial institutions. The question was a closed one having several answers to it. Table 10. 3. (5) contains a summary of the answers of the respondents.

Table 10. 3. (5).

Qualitative Factors Considered by Financial Institutions

Name of Qualitative Factors	Value label and Frequencies		
	<i>Yes</i>	<i>No</i>	<i>Rarely</i>
-Compliance with Government policy for financing Small Firms	19	2	-
-The borrower already owns a business or firm and/or has a reputation as a borrower and existing businessman	20	1	-
-The borrower is ready to put property as security, even though appraisal does not show potentiality in financing the firm	1	19	1
-Assessment of quality of management of applicant	20	1	-
-Nature of business opportunity	21	-	-
-Personal knowledge of the applicant	19	2	-
-Business experience of applicant	20	1	-

From table no 10. 3. (5) it can be observed that financiers consider multiple types of qualitative factors in dealing with loan applications and in deciding whether to grant a loan. The factor- 'Nature of Business Opportunity' received the highest positive responses (i.e., twenty one), which implies the financiers attention to and analysis of the firm's product or service market. Three different types of qualitative information relating directly to the applicant viz., the borrower is an existing businessman/reputation of the borrower, quality of management, and business experience received the second highest positive responses (i.e., twenty). The strong response in respect of 'existing businessman or a borrower who is an existing customer to the financier' suggest that first-time borrowers or new borrowers may get less favourable attention in assessing loan applications. The responses may also reveal an important aspect of lending behaviour which can be termed as 'unofficial relationship' or 'personal contact' between the financier and the borrower. This relationship or contact is not unusual or unexpected, but

use of this sort of contact has both advantages and disadvantages. Consideration of a characteristic like 'existing businessman or reputation of the borrower' without considering factors such as ability to generate new ventures and entrepreneurial abilities. Again, this attitude may lead to financiers' reduced involvement in formal loan evaluation with the eventual development of a lending culture involving little commitment and accountability by financial institutions.

Nineteen financial institutions consider compliance with government policy towards development of small firms as a qualitative factor in lending decisions. This is encouraging since out of the twenty one financial institutions only nine belongs to the public sector and the rest are from private sector. The government does not have any direct control over the functioning of private sector financing institutions excepting through general banking regulations applicable to them via the central bank or the banking division of the Ministry of Finance. However, statements regarding compliance with government policy for economic development through strategies like development of small firms by private sector financiers demonstrate, at least nominally, good will in this respect.

Reputation in running an existing firm suggest that a new venture may be successful and it may be rational for financiers to favour funding such an entrepreneur and existing borrower even though quantitative appraisal has not shown a similar potential. This research finds the possibility of frequent use of this practice by financiers, that is a project appraisal shows little potential but the project gets finance against a relatively higher security and based on an assumption on the financier's part that the borrower as an existing businessman and/or customer would be able to run it successfully. However, as it can be seen from table 10. 3. (5) only one financier agreed they might lending on a project on such a basis. While nineteen disagreed with this notion and one stated it might happen rarely. Nevertheless, this practice may be more common than is admitted and well be responsible for any failure or ineffective running of small firms. The general features pertaining to the small firms sector in

Bangladesh, such as low growth rates, high rate of failure, management inefficiencies, apparent absence of good relationships between suppliers of finance and the borrowers suggests that there exists a gap between theoretical approaches and the practical aspects of lending decisions. If it is truly the case as stated by loan officials in the questionnaire that they did not provide loans to projects which did not show acceptable prospects under loan appraisal should it be observed that there is a high rate of failure of small firms, inefficient running of projects, and a limited contribution of the small firm sector to the economy?

When the high officials of the financial institutions were interviewed regarding sources of qualitative factors they stated several sources. Table 10. 3. (6) shows these sources and their frequencies.

Table : 10. 3. (6)

Sources of Qualitative Information

Sources of Qualitative Factors	Value Label and Frequencies	
	<i>Yes</i>	<i>No</i>
-Loan application form	21	-
-Information collected by relevant loan officer/branch manager	11	10
-Credit information bureau	17	4
-First/Previous bank's/financier's report	16	5
-Detailed CV prepared and submitted by borrower	12	9
-Referee (name of which must be included in the application form)	15	6
-Interviews of proposed small firm owners by loan official	7	14
-Trade and Business Bodies	6	15

We can see from table 10. 3. (6) among the sources mainly three are used by most of the financiers. All the financial institutions use the loan application form as a source of qualitative information. The source ranked second by frequency of use is the Credit Information Bureau (CIB), using this source is of recent practice. This bureau was established in December 1992 under the direct supervision of the Central Bank of Bangladesh and collects information on the credit standing of firms through lenders to firms and projects. Seventeen financial institutions stated that they took help from

CIB in gathering information for loan appraisal purposes indicating general concern about the lending decisions in respect of small firms. Third main source for qualitative information 'Previous Financier's or Current Banker's Report' was cited by sixteen institutions. Under usual lending practices, the financial institution's Branch Managers are required to send loan proposals to the immediate higher level office (usually the Regional or Zonal Office) or if the loan amount is large the proposal is sent to Head Office. So, a Branch Manager has preliminary and important work to perform in connection with collecting information regarding a loan applicant using local contacts and knowledge. From the interviews with the high officials it may be inferred that using 'Information Collected by relevant Loan Official/Branch Manager as a source of qualitative information is not as widely welcomed or accepted by them. This is depicted in table 10. 3. (6) where only eleven out of twenty one high officials indicated this as a source of qualitative information.

'Referee' is another source used by financiers to gather information. Fifteen high officials agreed that their institutions used it as a source of qualitative information. In the course of using this source lenders usually contact a referee concerning the prospective borrower seeking information on a borrower's financial strengths in general, and attitude and behaviour. Interestingly, some financial institutions ask for a referee who is well established in society in general or at least in the financial arena or within that specific financial institution. Each situation, i.e., referee without any special knowledge or a referee with special knowledge may have implications for lending decisions. It may be argued that these implications may be more negative than positive as far as the evaluation of loan proposals and lending decisions are concerned. Honest, objective references taken from trustworthy individuals may assist in making correct loan evaluation decisions. However, references which hide or exaggerate information or which are accompanied by unwanted or undesirable pressure on the lender may bias decision and would not be conducive to a desirable lending culture in Bangladesh. There are suggestions that this reference system has been accompanied by systemised and crude pressure loan officers and this would engender problems in dealing with loan proposals using prescribed procedures on the part of financiers. When a financier ask for reference(s) from a proposed borrower, the

borrower is likely to choose a referee(s) in the light of expectations concerning the workings of the loan market and this might lead that borrower to choose persons of renown, influence or with contacts with the loan provider. A proposed borrower may feel that the chances of successfully obtaining a loan are greater with references of high social or political or bureaucratic status. The financiers reported, through both interviews and questionnaire, that undue or unwanted influence on the part of named referees and other influential persons hampered the normal lending system, making it difficult for loan officials to undertake comprehensive analysis of loan proposals to judge a project's viability. When similar questions⁵⁵ were asked of the owners of small firms about using influential persons in getting loans it was argued by forty two (out of seventy six, i.e., 55%) that financiers were responsible in this regard. Several issues were raised by the small firm owners regarding the role of the financial institutions and referees and influence. They felt that these arguments were used defensively by bankers to justify their delayed lending decisions. According to them, because of sheer complexity of bureaucracy in the lending system, loan officials' rigid attitudes and sometimes uncompromising behaviour lead to a very long time for financing decisions to be taken in respect of small firms. Sixty four small firm owners reported, through answering to the question "*Are there any additional points of interest that you would like to make*" that bureaucratic complexity and long time for lending decisions was one of the root causes of small firm's sickness or early failure, which occurred due to time over-run and cost over-run factors. The small firms' owners stated that delayed decisions or absence of prompt and spontaneous action relating to loan proposals had become an integral part of the lending by almost every financial institution. So, it was felt, that either to get started the process towards loan appraisal or a lending decision, or to give some momentum to the pace of the lending process there was a requirement to use agents or catalysts which would push the loan case towards satisfactory end. So, with this mind borrowers sought influential assistance. The high officials of the lending institutions were asked about any factors like 'personal contact' influencing lending decisions, while they answered to the

⁵⁵ See question 16 of appendix 3. During interviews with owners when discussions relating to qualitative factors, referees and so on came issue like using contacts and influence for sanctioning loan was also raised by the researcher to obtain their views in this regard.

question "*What type of qualitative information you require for credit appraisal?*"⁵⁶ only five of them agreed that they faced such pressure from personal contacts. However, given the strength of opinion expressed by the small firm owners and given that loan officials of the financial institutions either gave no direct reply or avoided questions on personal influence, it may well be that the rate of such personal contact/influence affecting loan appraisal and loan sanctioning is more than it was stated by the officials of the financial institutions.

Another source of qualitative information that only seven officials out of twenty one at the policy level of the financial institutions indicated as used was 'Interview with the Proposed Borrower'. In principle, this may be a good source of information for financiers who can communicate with the proposed borrower face to face and explore different issues from which a financier can make an initial opinion regarding a proposed borrower, including judgments as to the borrower's entrepreneurial ability or relationship with his existing banker if that person is an existing businessman. Although ten of the financiers argued that such interviews would be time consuming method, considering the average time taken by the financiers for initial scrutiny from three months to twelve months,⁵⁷ an hour or so for interviewing would be nothing but might produce benefits for both the parties.

Qualitative information on an existing small firm owner who applies for loan might be sought from trade and business bodies. Several such bodies exist in Bangladesh, some of are based on regions or area e.g., Dhaka Chamber of Commerce and Industries, others are based on individual industries e.g., Bangladesh Plastic Goods Manufacturers Association. There is one central organisation representing all businesses and firms Federation of Bangladesh Chamber of Commerce and Industries. Only six out of twenty one high officials of financial institutions reported that they used business and trade bodies as a source of qualitative information. The remaining fifteen argued, in favour of their practice (i.e., not to refer to such bodies), that these bodies might not give impartial views or comments on their fellow businessman since

⁵⁶ Question 13(a), appendix 2.

⁵⁷ See table 10.2.(3).

these organisations represented them. However, those that used these organisations as a source of qualitative information mentioned firmly that they received, at least seventy percent reliable information. They argued that it was not a problem for them to obtain reliable information from these types of bodies once they had explained to the trade association the purpose of their inquiry such as their wish to consider broad economic criteria and their intention of choosing a deserving small firm owner. They also felt that trade associations could be made to feel a sense of 'psychological participation' in lending decision, creating a sense of belonging in the financial system's decision making for funding allocations to small firms. Above approaches to trade associations were felt to create responsibility on their part for managing funds and the successful management of firms.

Other qualitative information, apart from the factors as mentioned in table 10. 3. (5) which financiers considered as relevant by high officials in the course of the interviews included business track record, educational background, knowledge of business by the borrower and managerial capacity. Table 10. 3. (7) shows the frequencies of use of these items.

Table No: 10. 3. (7)

Qualitative Information Used by Lenders

Qualitative Information	Value Label and Frequencies	
	Yes	No
Business Track Record	13	8
Educational Background	10	11
Managerial Capacity	16	5
Knowledge of Business of Borrower	17	4

During the interviews with the policy level high officials of the financial institutions, it seemed at different times that they wanted almost all possible expertise from

borrowers, and an impression was created that they inclined strongly to existing firm owners at the expense of newcomers since it would be difficult to expect a sound knowledge of business by a person having limited practical experience. From table 10. 3. (7) it can be seen that seventeen out of twenty one interviewed officials stated that they put strong importance on borrowers' knowledge of business aspect, and from their comments it was revealed that they not only consider the borrower's ideas and theoretical perceptions on this matter but expected a practical knowledge. This might discourage persons having ideas, equity capital, commitment and drive but no such practical experience, consequently handicapping potential new entrepreneurs. The relative popularity of managerial capacity and business track record also expresses a similar attitude since it would be difficult to meet these two criteria without potential borrowers with an organisation either in the capacity of an employee or as an owner. So, these types of criteria become preconditions for getting funds for establishing new firms. Preventing financial institutions from lending to existing small firm owners is not being advocated here, rather its aim is to locate hindrances in the development of small firms and the creation of more entrepreneurial potentialities.

In the questionnaire seven items of information were included and loan officials were asked to rank them in order of importance (from first to seventh) in their decision to grant a loan to a small firm, other things being equal. Table 10. 3. (8) shows the items of information and how they were ranked by the loan officers.

Table 10. 3. (8).

Aspects for Assessing Loan Applications

Items	Rank and Frequencies of Ranking						
	1st	2nd	3rd	4th	5th	6th	7th
-Security of Bank Loan	9	3	2	5	1	Nil	1
-Financial Stability	3	7	5	4	Nil	2	Nil
-Profitability	8	5	4	1	2	Nil	1
-Liquidity	Nil	3	7	6	5	Nil	Nil
-Consistency of Trends	Nil	Nil	2	3	6	5	5
-Generation of Employment	1	Nil	1	1	3	9	6
-Generation of Export Earnings	Nil	4	Nil	1	3	6	7

Ranking of these items may reflect the financier's lending culture, policy and attitude towards the government's policy programmes pertaining to the small firm sector.

Nine financiers ranked Security of Bank Loan as the first and one financing body ranked it seventh. Out of nine financing bodies that ranked it first, there were three commercial banks from each of the public and the private sectors; two DFIs and one specialised financial institution (these latter three also belong to the public sector). Thus six financing bodies are from public sector and three from private sector. The commitment to security by the public sector institutions may reflect an institutional view that they are the holders of public money (provided by tax payers). However, the financial institution which ranked 'Security of Bank Loan' seventh is a state owned commercial bank. The contradictory views of the public sector owned financing bodies, especially between the nationalised commercial banks implies their freedom in discharging their professional function as far as their individual corporate structures are concerned. It may also imply differences in respect of the application of lending methods. The largest grouping of private sector institutions, four, ranked 'Security of Bank Loan' as fourth. This suggests that private sector financial institutions may differ in respect of some important issues concerning lending decisions. It may be seen from table 10. 3. (8) that altogether fourteen financial institutions ranked 'Security of Bank's Loan' as at least third in importance, constituting two thirds of the total number of financial institutions, from which it may be inferred that lending is highly security based. This conclusion has support from the owners of small firms too. A comment during interviews was that for a very minimal amount of loan they needed to pledge very large security in the form of almost all their movable and immovable properties and assets in addition to the proposed project itself and its assets. Sixty four small firm owners stated that funding of their projects was highly security based and they had to pledge security from double to four times more than the loan amount given to them. Thirty seven of them stated that the lending agencies did not value their assets and properties in a true manner, but in most cases they undervalued the properties and assets. They also stated that when valuing their assets and properties, especially land, financial institutions did not consider the market or current value of the land but considered intrinsic value contained in the ownership deed. In this connection the following statement made by a small firm owner may be quoted:⁵⁸

⁵⁸ Views in this aspect was reported by owners in answering to questions 20(b) and 28 (in the appendix 3)

“ the land which I intended to place as a pledge for the loan had market value of four lacs taka, but our lender valued that land at two and a half lacs taka. We requested them to survey the price if they would want to do that,...they did not.....and finalised the said value for the land”.

The small firm owners were strongly of the view that financiers considered security of their loan as the first aspect in respect of business lending and felt that this was a way of ensuring the owners attention and involvement in the project by providing the incentive to protect the owner's own assets and property.

‘Financial Stability’ was ranked second by seven financing bodies including two from the public sector and five from the private sector, and first by three (all of them belong to private sector), and altogether fifteen financing bodies ranked it from first, second and third. Out of the fifteen, eleven belong to the private sector. The modal number of public sector financial institutions ranking this item (four) placed it fourth. From the above it may be concluded that financial stability has significance in lending decisions and that private financing institutions appear to put more weight than public financing institutions on this item.

‘Project profitability’ was ranked first through third by the highest number seventeen, of financing institutions. Eight ranked this item first, of which five belong to private sector, including one specialised financing institution for financing small business and three to the public sector, including one DFI. Of the five ranked this item second, three belong to the public sector including a specialised financing institution and two to the private sector. The four institutions ranking profitability third contained three public sector financial institutions. Thus, of the seventeen institutions, nine represent public and eight represent the private sector. These results suggest a strong concern with regard to profitability, as only three financing institutions ranked it below fourth. The institution which ranked it seventh is government owned. It cannot be said that only financing bodies of a particular sector value it more than those of the other.

Liquidity's ranking is centred between second and fifth, with no financial institutions ranking it at the extremes. It was ranked third by highest number of financing

institutions i.e., seven. Only three, one from private sector and two from public sector including one DFI, ranked it second; but it is interesting that no financial institutions ranked it first and why they did eleven institutions rank it as fourth or fifth. It is surprising that Liquidity is not considered significant. It might have been expected that the number of financing institutions ranking Liquidity more highly given its importance in models of loan sanctioning.

‘Consistency of trends’ was ranked between third and seventh, with first and second at nil. The highest number of financing institutions, six, ranked it fifth representing three each from public and private sectors with only two ranking it second. Ten financing institutions ranked it sixth and seventh having five from each sector. This suggest that financiers give relatively less importance to this item.

One of the main aims set for small firms by government is to generate more employment opportunities in line with the strategy for economic development. The item ‘Generation of Employment’ was ranked sixth by highest number of financing bodies i.e., nine, of which six were from the private and three from the public sector. Only three institutions ranked this issue at fourth or above and all were from the public sector. Eighteen financial institutions ranked it from fifth through seventh. So, it may be concluded that this item is not important for the financial institutions as a whole but has a certain amount of influence on the public sector financing institutions as they cannot easily ignore government policies.

Similarly ‘Export Earnings’ was not considered important by the financial institutions since most of them ranked it sixth and seventh (thirteen). Only four ranked it second (three from the public and one from the private sector). Therefore, it may be inferred that financing bodies give relatively less importance to this item but like employment, it is given some importance by state owned financing institutions who seek to accommodate or implement government macroeconomic policies.

If the seven items are taken together to consider their relative positions, it may be observed that Security of financial institution’s loan has been placed first with nine frequencies at rank number one, with Profitability second with a frequency of eight at one, Financial Stability third with seven at rank number two, Liquidity fourth place with seven at three, and Consistency of Trends in fifth position with six at rank five.

Generation of Employment and Export Earnings have been placed sixth and seventh respectively having nine frequencies at six and seven frequencies at seven.

In addition to the above the loan officials were asked to state what they considered to be the most important informational item which is financial and economic and non-financial group which they consider in evaluating credit proposals. Their answers are summarised in table 10. 3. (9).

Table No: 10. 3. (9).

Types of Information Used in Credit Evaluation

Informational Items	Value Label and Frequencies	
	YES	NO
Financial and Economic Information:		
Profitability	17	4
Security	14	7
Gearing	2	19
Return on Capital	14	7
Creation of Employment	7	14
Foreign Exchange Earnings	9	12
Non-Financial:		
Repaying Ability	16	5
Managerial Ability	12	9
Reputation of the Borrower	13	8
Personal Contact	3	18
Business Track Record	12	9
Borrower is an Existing Customer of the Financier	8	13

The information included in table 10. 3. (9) provides an opportunity to analyse the basis of lenders decisions and to provide a cross-check on the items included in table 10. 3. (8). These two tables consider two related questions. Table 10. 3. (8) addresses the question '*How would you rank the following Informational Items in respect of a firm to be financed?*' whilst table 10. 3. (9) considers the question - '*What is/are the information you consider of most important in evaluating credit proposal?*', This latter question gave respondents the opportunity to mention multiple sources of information.

From analysing information in these two tables several inferences can be drawn. Firstly, two items of quantitative/Financial information appear significant to the lending model used namely profitability and security. Financiers also consider the concept of return on the capital invested into the project as important with fourteen financing institutions stating that they used it in evaluating credit proposals. This may tend to reinforce views on the importance of profitability. Secondly, only one third of the financing institutions reported that creation of employment opportunities and earning foreign exchange were used in credit evaluation [supporting the result of table 10. 3. (8)] . Thirdly, the popular types of non-financial information indicated in table 10. 3. (9) indicate that loan officers seemed to be inclined towards existing customers, small firm owners or existing business in general. A great deal of the non-financial information upon which they reported that they relied normally could not be obtained except an existing small firm owner or an existing customer (of that specific financing institution or another). Fourthly, financiers, [see table 10. 3. (9)] appear not to give much importance to gearing. Two possible explanations are suggested. First lenders may have a broad range of acceptable ratios for debt-equity so that most applications are acceptable on this criterion and consequently they do not consider it as an important information in the way of evaluating credit proposals. Second, since gearing attempts to measure riskiness lenders may use other criteria or variables to assess risk (and which thus proxy for gearing) e.g., the variables relating to the personal characteristics of the borrower, security or general economic feasibility. However, the financiers' interviews, review of specimen copies of loan application forms and the interviews with small firms' owners it has been observed that the flexibility and openness in dealing with the debt-equity is not really to be expected. These data sources, especially interviews with small firm owners, suggest that normally the debt portion of project or firm financing would not be expected to go beyond sixty percent of total capital required. Responses to the question "*What are the sources of your capital in percentage?*"⁵⁹ by small firm owners are summarised as follows:

⁵⁹ Question 3(a), appendix 3.

Table. 10. 3. (10)

Debt Portion and Firms

Debt Portion	60%	70%	75%
Firms	47	17	12

Personal Contact was indicated by only three financial institutions as used in credit evaluation, supporting the results regarding this variable in table 10. 3. (9) Financing institutions in general do not appear to consider it important information in dealing with loan proposals. However, this contradicts the views expressed by small firms owners, where fifty eight (seventy six percent) of them stated that they felt that personal contact did play a significant role in lending decisions, and that financing institutions were not free from bias arising out of this. This may indicate a fundamental misconception by each side of the lending decision of the other's behaviour, or an easy focus for frustration by small firm owners, or a wish to appear objective by lenders.

From the detailed analysis above we may infer that financial institutions follow credit evaluation processes, which according to the field work, involve certain formalities i.e., submission of application and business plan together with analyses of various aspects of the business and credit application e.g., financial and marketing by using forecast and historical accounting reports and other related information. This suggests partial acceptance of the hypothesis: "Credit evaluation of loan applications for small firms is not based on established standards of best practice which involve formality, the submission of business plans including forecasted accounting information, (where necessary) historical accounting reports, and an appropriate consideration of qualitative factors." The length of time taken to follow the established formal practices, together with the highly bureaucratic nature of credit evaluation processes, suggests that, though formal, the procedures fall short of best practice.

Taking into consideration the above discussion, which contains an elaborate examination of lenders uses of qualitative information, we may infer that they place reliance on inappropriate qualitative factors in lending decisions for small firms. This

suggests acceptance of the hypothesis: “there is a reliance placed by the lenders on inappropriate qualitative factors in loan granting decisions for small firm”.

10. 4. Review of the Contracting and Monitoring Culture of Lending to Small Firms.

In previous chapters we emphasised the need for effective and appropriate loan contracting and monitoring as an integral part of lending to business in general. These features are also important for lending to small firms. In general lending practice, these contracting and monitoring are common in many countries irrespective of a country's development status i.e., developed or developing. In Bangladesh however it is suspected that there exists only a weak culture of monitoring and contracting practice.

The questionnaire and interviews were used to attempt to identify the policies of the financial institutions in these two matters. The data obtained from the financial institutions was supplemented by interviews with representatives of small firms.

From the data collected from the financial institutions through interviews and questionnaire it is clear that the financiers recognise the importance of a good contracting culture as well as effective monitoring. Out of the twenty one financing bodies eighteen reported that they used a single loan document or facility letter as the legal contract between the financier and the borrower. The other three reported that they used both a loan document and loan facility letter separately. For these three the loan document states the major features of loan contracting and this is used as the legal contract between borrower and lender and this is usually done in the non-judicial stamps, and the loan facility letter used to inform borrower about sanctioning of loan and other related information such as, total amount, maturity, interest rate and so on. They reported that they did so to make the whole documentation a more formal, on one hand they by facility letter inform borrower about the sanctioned loan with relevant information e.g. total amount of loan, and on the other hand they used loan agreement by inserting all information and clauses including those in the facility letter to make it a strong document in order to ensure interest of their financial institutions. The financial

institutions were asked about the source(s) of their documentation⁶⁰ (i.e., loan agreement/contract). According to the senior executives (who were answering at the policy level) all twenty one financing bodies reported that documentation originated from within the institution. However, in the case of four private commercial banks the policy makers said that their institutions took some guidance from a leading DFI and some Nationalised Commercial Banks (NCBs) in preparing the model loan contract which they used. In the questionnaire supplied to loan officers, (those are directly involved in loan appraisal) a question was asked concerning whether their institutions used a legal contract to govern a loan twenty of them answered Always and one Frequently.

Table 10. 4. (1)

Frequency of Using Legal Contract.

*Is a legal contract used:*⁶¹

Always	20
Frequently	1
Sometimes	-
Rarely	-

In the questionnaire there were questions relating to the formation and modification of loan contracts by the financiers. Sixteen institutions answered positively to the question like- "*Do you have standard forms of contract that cover every loan?*", and the remaining five said 'No'. Which means, these five financiers can be expected to prepare unique contracts for each loan. It is noteworthy here that, the term 'every loan' refers to loan for large, medium, or small firms. Out of the sixteen financiers answering 'yes' to the question on the use of standard contracts, twelve qualified their answer by saying that they would be likely to modify the standard contract for special circumstances i.e., loan for small firms or medium sized firms when necessary. This would be done either by retyping or manually. The remaining institutions stated that they would simply cross

⁶⁰ Question no. 16 of appendix 2.

⁶¹ Question no. 14(a) of appendix 1.

off/out in applicable options in relation to the respective borrower as mentioned in the loan contract. This suggests a high degree of standardisation for contracts. However we may note here that contracting is costly and the use of standard contracts may be efficient if the benefits of preparing unique contracts for each loan (or of using different types of contract for broadly different types of loan) e.g., reduced costs of default or credit loss or improved monitoring are less than the costs. There was an open-ended question in the interview schedule for the top executives of the financing bodies which stated: "*What are the main characteristics of the document or contract items?*" Answers to this question are summarised in the next page in table 10. 4. (2).

Table 10. 4. (2)

Items in Loan Contract (as per Senior Officials of Financial Institutions)

Feature/Item of Loan Contract	Value label/Frequency	
	Yes	No
Cross Default Clause	5	16
Expiry Date of Loan	16	5
Loan Limit	19	2
Machinery Specification ⁶²	5	16
Nature of Loan Limit	15	6
Penalty Clause	7	14
Personal Guarantee of Borrower	18	3
Rate of Interest	21	-
Repayment Schedule	19	2
Security Clause	19	2
Supervision of Loan Clause	6	15

From the table above we may see that the rate of interest used by all lending institutions. Nineteen institutions used loan limit, repayment schedule and security clause in the contract, eighteen financial institutions used personal guarantee clause, sixteen and fifteen financial institutions used expiry date of loan and nature of loan limit respectively. Whereas, five financial institutions used cross default and machinery specification clauses, seven used penalty clause and six used loan supervision clause. These have implications of diversified nature. For example, penalty and cross default clauses received less importance and used by only five to seven financial institutions, but inclusion and implementation of such clauses might have reduced lenders' risk of losing invested money in the firms. In the case of machinery specification, since less importance was given to its inclusion in loan contract there would likely be situations such as, manoeuvring prices (e.g., overinvoicing) and/or model of machine or equipment to receive illegal financial benefits by the sponsors.

⁶² Machinery specification refers to information such as model of required machinery, country of origin/manufactured, and other technical matters if any.

The questionnaire supplied to the loan officers of the twenty one financing bodies contained similar but closed questions were put, for example whether the financier include a statement of the details of the loan viz., minimum or maximum values for financial variables such as the debt-equity ratio. Table 10. 4. (3) below shows the responses of the participants in this regard:

Table 10. 4. (3)

Lending Contract and its Features of Loan Contract (as per Loan Officers)

Features/Items of loan Contract	Value Label/Frequency	
	Yes	No
1. A Statement of Details of the		
Loan:-		
Interest Rate	21	-
Repayment Terms/Schedule	21	-
2. A Statement of Conditions		
which the borrower must meet:		
Minimum or Maximum Values		
for Financial Variables:-		
Debt Equity Ratio	17	4
Total Borrowing	16	5
Asset Values	13	8
Net Asset Values	14	7
Interest Cover	14	7
3. A Statement of Events of		
Default:-		
Not Paying the Principal and Interest	19	2
Not Meeting the Terms and Conditions of Loan	18	3
Default of Another Loan/Cross Default	10	11

The information of above table 10. 4. (3) indicate that all twenty one financial institutions used two items i.e., interest rate and repayment schedule in the loan contract. This indicate the financial institutions objective in respect of controlling loan or repayment (by giving emphasis on the applicable interest rate and repayment date),

which contrast the general purpose of putting clauses in the loan agreement. According to Day and Taylor (1996) the purpose of covenants is to place a restriction on the shape of the company. Where the shape was set in the context of the expectations of the lender as derived from the credit assessment undertaken prior to granting a loan. Thus the lenders intended to see that the business is going in accordance with financial expectations. For observing financial consistency cashflow position may be a signal to it, so covenants pertaining to cashflow is likely to be present and practised, but this was not the case with the participating financial institutions. Apart from these two items, all financial institutions reported different views in respect of other items. In the case of number 2 group of items, the highest number of financial institutions was seventeen and reported that they used, in the contract, debt-equity ratio's minimum or maximum value to be maintained by borrower. In the contract, item like total borrowing was not used by all twenty one financial institutions; sixteen financial institutions reported that they used it in the contract; whereas ten loan officials reported that their institutions used cross default clause. Practices of uses of items, such as above, may likely to demonstrate financial institutions' lacking in clear perception in understanding the importance of such items in securing their invested fund's return and make borrowers to involve in firm for establishing it as a successful project. The general rationale for insertion and uses of financial variables is to control risk, for example total borrowing clause used to avoid bankruptcy risk by controlling the total amount (through keeping the limit at the agreed amount). Interest cover and assets values are also used to have a control over the lender's money by ensuring its security through repayment with the specified interest, and if the borrower fails, the lender may go to recover money by means of assets which value must satisfy the lender's requirement i.e., loan owed by the borrower.

We may now contrast senior officials answers to the open question regarding items used in loan contract and responses of loan officers to the closed question referred to the same issue. Senior officials did not mention anything about financial variables such as, debt-equity ratio, asset values, interest cover; but these items were in the questionnaire and responded by loan officials and as we can see from table 10. 4. (3) minimum thirteen and maximum seventeen financial institutions used financial variables in loan contract. This may imply that senior officials do not keep them up to date about possible items of loan contract or they may know about these items but do not feel that these items can be

such important to state while they were stating other items. According to answers from senior officials it may not be said that cross default might work in reducing risk of losing lent finance to firms, when only five of such officials reported their financial institutions used it in contract. However, loan officials were likely to be further optimistic, as far as their answer to the question regarding items in loan contract; ten of them (out of twenty one) reported that their organisations used this item. This also contradicted with high officials' views. Loan officials were those, who dealt loan proposal directly in assessing potentials for lending to small firms. It may be seemed that they might be well known about possible and practiced items in the loan contract in compare to high officials. Despite contradiction which existed among high officials and loan officials we may conclude generally that the financing bodies have formal lending contract and there are a number of common features of the contract which financial institutions use in loan contract. A further discussion on contracting practices will be followed later.

Loan monitoring, during under construction or establishment/pre-commercial operation and after the full commissioning of a project is a vital factor for subsequent sustenance and growth of a project, and literature review on this aspects has also provided such evidences that it does exist as a very strong catalyst for effective and efficient growth of small firms. A majority (sixteen, out of twenty one) of officials from financial institutions agreed to the point that monitoring loan on their part is an essential element for the development of small firms and when asked the question "*Do you Monitor the Loan?*"⁶³ the high ranking officials (at policy level in the different financing bodies) all responded in the positive. But while asked the question in the questionnaire "*Does the lending contract include any clause relating to ensure monitoring of loan operation by the borrower?*"⁶⁴ only six loan officials representing six financial institutions answered positively and the remaining fifteen answered negatively. Which was appeared to be indicative that monitoring of loan by the lending institutions was not built on the firm lending policy and practice. In the next two sub chapters hypotheses relating to contracting and monitoring will be examined.

⁶³ Question no. 17 of appendix 2.

⁶⁴ Question no. 15(a) of appendix 1.

10. 5. Review of Hypotheses Relating to Loan Contracting.

The use of contracts or other agreements between the supplier and borrower of finance in the small firms lending arena has been strongly prevalent in Bangladesh. This is not an exceptional as far as lending is concerned in any financial system. The financial institutions were asked whether lending to any small firms was based on any legal contract, all of the twenty one answered positively meaning each of the lending institution put a high importance on this aspect of financing small firms. In the questionnaire supplied to these financial institutions questions relating to some of the essential items in a loan contract were inserted and loan officials were asked to put their comments on these by agreeing or not agreeing to their use and by indicating the frequency of insertion of the described items in loan contracts. In the previous section, 10. 4, a general review of contracting culture has been provided. However, we may mention briefly here the items of the loan contract that are typically included. Questions were included on the inclusion of chargeable interest rate, repayment terms/schedule, any statement of events of default, minimum or maximum values for financial variables (e.g., debt-equity ratio, total borrowing etc.), any clause relating to monitoring and mechanisms of monitoring, any clause relating to counselling and advice to be provided by the financier. Apart from the questionnaire to loan officers on contracting practices the high officials of the participating institutions were interviewed about loan contracting practices. In the interview schedule an open-ended question was put in this regard about the main features of the loan agreement. The questionnaire and interviews were both used on this issue with two main purposes; firstly, to make a cross check between the answers of the loan officers and the policy level high officials, and secondly, to gather as much information as possible regarding the items of the loan contract. Besides these two sources of information attempts were made during the field work to collect specimen contracts papers from the financiers. Five of such specimen contract were collected. Thus, we will attempt to explain contracting practices in the light of these primary and secondary sources of information.

Referring to tables 10. 4.(2), and 10. 4.(3) that depict practices in this regard, and by taking into account the secondary sources of information it could be inferred that

various expected items are included in the loan contract. It may be noted that not all items are given the same importance by lenders in preparing loan documents. Two thirds of the financiers include some of these items as total loan amount, chargeable interest rate, last disbursement or loan expiry date, repayment schedule, security clause and personal guarantee clause. These might be the minimum items expected to be necessary in a loan contract to a small firm. Among these items loan limit, the security clause and the personal guarantee clause are usually given top priority. Of the twenty one financiers eighteen stated that they included clauses like these three. The prominence of these clauses emphasises the financiers' utmost concern about their lending to small firms borrowers. The examination of the five specimen loan contracts confirmed these and other features. The volume of a loan contract i.e., number of pages, ranges from three pages to fifty pages depending on the types of loan viz., small manufacturing firm, small service oriented firm (for example, a loan for commercial transport). A loan agreement of 'X' bank in respect of a sanctioned loan for a small firm contained five pages, of which almost three pages were occupied by clauses relating to security for the project. One loan contract of 'Y' bank contained fifteen pages, and eleven pages of which described aspects of security for the loan. On the other hand financiers do not appear to place importance in inserting clauses in the loan contract pertaining to special issues relating to a project or firm, for example cross default clauses, penalty clauses, monitoring clauses, counselling/advice clauses and machinery specification clause etc. The practical implications of these clauses need to be emphasised in the context of the situation that prevails in the small firms sector of Bangladesh. The insertion of a cross default clause gives the financier the opportunity to protect its money if the borrower already has a loan from another financier for the same or a different project and fails to repay that loan partially or fully. Should a borrower fail several times to repay a loan or become a defaulter there should be some penalties to discourage this and to make the borrower alert to the consequences of such action. This may reduce the rate of non-recovery of loans and the total bad debt provision position of financiers. Only a few financiers insert a penalty clause, as can be seen from the table 10. 4. (2).

The policies and practices of the lenders relating to monitoring, counselling and advice discussed in an earlier sub chapter of this chapter was again observed in the specimen loan contracts. In the specimen loan contracts no covenants or clauses were found in relation to monitoring or counselling services on the part of the financiers. A potentially important feature of a loan contract may be a 'Machinery Specification'. This received little attention from lenders. Only five of the twenty one stated that they inserted a clause relevant to this in the loan contract. The importance of this covenant emerges in situation where borrowers may use borrowed funds to import equipment and machineries which either was not required by the project nor was agreed for it. Anecdotal evidence suggests that such practices may be common with corresponding problems for the economy in general and the basis of the lending. Insertion of such a covenant in loan contracts may well protect the money of financiers and assist in directing finance to genuine small firms promoters and away from speculators by preventing possibilities of diversion of funds earmarked for designated machinery. We may compare the contents of loan contracts as determined from the field work with what might be expected in general from loan contracts. The following is a list of the standard items found in loan contracts

1. Name of the Project/firm
2. Loan Limit
3. Type of Loan (Long term/medium term/short term, based on the pay-back period)
4. Description of the Project
5. Period/Last Disbursement Date
6. Security:
 - a. Hypothecation
 - b. Pledge
 - c. Mortgage
 - d. Personal Guarantee
 - e. Third Party Guarantee
7. Documents to be taken by the lender (viz., copies of deeds on mortgaged properties)
8. Margin (i.e., the percentage of total loanable amount to be disbursed at the initial stage)

9. Rate of Interest

10. Mode of Disbursement/Payment Schedule (a detailed chart is prepared indicating relevant information, like date of disbursement, amount, balance remaining etc.)

11. Mode Repayment/Repayment Schedule (some loan contracts contain a chart stating- number of instalments, amount of principal loan out of the total loan to be repaid in each instalment, amount of interest to be repaid in each instalment etc.; some loan contracts describe all these features in a paragraph or so; some loan contracts state every single feature giving number)

12. Service charge

13. Payment of Interest During Construction Period (if appropriate)

14. Financier's Right to make any change in respect of any terms and conditions at any time without reference to the borrower.

15. Financial covenants (e.g., maximum debt equity ratio, minimum interest cover, or maximum total borrowing)

16. Cancellation/Suspension or Recalling of Loan Clause

17. Insurance Clause

18. Events of default (including non-payment of interest or repayment of principal, technical defaults and cross-defaults).

19. Applicable law (indicating the legal jurisdiction under which the contract terms are valid)

We may conclude that loan contracting for small firm lending in Bangladesh emphasises a narrow range of items when compared with the above list and the issues raised in the discussion of contracting earlier in this thesis. We hypothesised that loan contracts would not be efficient in the sense of ensuring adequate credit protection for the lender. The emphasis observed by this research on a small number of terms relating directly or indirectly to security aspects of documentation suggests that lenders are narrowly viewing credit protection. Moreover, by placing limited emphasis on formal monitoring (and correspondingly neglecting contract terms which would assist this such as financial covenants) lenders are taking a 'gone concern' approach to security rather than a 'going concern approach'⁶⁵ whether or not this is efficient for the lenders depends upon the relative costs of contracting (and monitoring

⁶⁵ That is ensuring their position if the small firm fails rather than seeking to ensure its continuation.

and counselling) of 'gone concern' versus 'going concern' contracting. It may be efficient for lenders to adopt this approach if it is less costly than engaging in relatively expensive documentation and monitoring. However, given the social and economic costs to the economy as a whole of small firm failure (implied as more likely as a result of existing practices) what is privately efficient for the lenders may socially inefficient.

10. 6. Review of Hypothesis Relating to Loan Monitoring.

Monitoring of loans by lenders and compliance in this practice by timely and regular adherence to the set rules or procedures in loan documentation on the part of the borrowers and other parties to a loan is likely to play a significant role in the effective operation and success of small firms (and their development in the economy). Monitoring practice can also bring about a change in the total scenario of lending, which may be very much needed for a country like Bangladesh. In Bangladesh, lenders to small firms and their clientele group recognise the significance of effective execution of monitoring along with a complementary advice and counselling process for small firms following lending. However, it has been observed through the research that in reality, despite contradictory claims, there is an absence of such an effective and supportive monitoring culture.

In the questionnaire, supplied to the loan officials a question⁶⁶ was put asking whether they included any clause in the loan contract relating to monitoring of loans. Out of twenty one financing institutions only six answered positively, meaning a substantial majority of them do not make official arrangements for monitoring. However, when policy level high officials of these financing institutions were asked about loan monitoring three of them stated that they included such clause, and the rest, eighteen, stated they did monitor as and when they felt necessary but they did not feel it had to be a binding arrangement through a contract. Fourteen of the above mentioned eighteen high officials stated that borrowers did not welcome a contract of having

⁶⁶ Question 15(a), appendix 1.

binding monitoring arrangements when by virtue of this the lender might be in a position to interfere with the functions of borrowers. In contrast, the borrowers' general view as expressed in the interviews with small firm owners was to have a consistent and continuous monitoring and counselling services from their lenders. Sixty five of seventy six small firm owners expressed their criticism on financial institutions attitude towards monitoring and counselling, and lack of their responsibility in respect of ensuring projects' effective running.⁶⁷ All of the seventy six owners of small firms mentioned their positive intention in this regard i.e., monitoring and counselling; and they stated during interview that they sought it in real terms and as good practice not only in a mere written form. Despite not in practice having formal contractually binding monitoring requirements, the fifteen financial institutions so reporting indicated that some monitoring did actually occur and that they had several ways of doing it. These were reported to include, periodic or occasional visits to the site/office of the small firms and verification of related documents; and requests for periodic or regular submission of certain documents requested by the financier. Occasional and periodic visits are made by the financiers depending on characteristics related to the project and the owner. If the financier believes that the borrower's attitude is positive towards the financed project and is expected to undertake all possible steps in this respect, then the periodicity of visits and rigorousness of checking of documents becomes relatively liberal and flexible. Regarding occasional visits the loan officers reported⁶⁸ that they did it either before disbursement of each instalment of a loan, before disbursement of the final instalment, before disbursement of working capital, or after the disbursement of the first instalment. Some of the loan officers reported that they did it in other ways, e.g., after completion of certain amount of construction work and/or on completion of full construction work, or prior to and/or after commencement of business by a new firm. Periodic visits are made by the financiers on either a monthly or quarterly basis. One of the financiers stated that they would conduct a visit, at least for a certain time, on weekly basis if that firm desires it. During the visit to the firm the financiers would seek to verify documents depending on the type and nature of the firm and the

⁶⁷ Views from owners were gathered in response to their answers to the question, 22(a) appendix 3, and subsequent discussions relating to issues like counselling and monitoring.

⁶⁸ Answers to the question 1(i) of 15(a), appendix 1.

lending. Among these are inventory record (raw material level, finished goods level etc.) sales records, profit and loss account, delivery schedules, memo of buying machinery and required materials for production, production book, cash flow statement, papers showing repayment of principal and interest, papers related to payment of rents and rates, movement of stocks, and security arrangements in the production area. The practices of these non-obligatory visits by some of the financiers are indications of their concern and perhaps (good motives) in the effective running of small firms by their owners as well as being conducive to the protection of the loan.

It should be emphasised that the basis of what is likely to be the great majority of this monitoring and these visits is the initiative or concern of an individual loan officer. Without this, monitoring seems unlikely to occur except in a crisis. In the absence of formal requirements for monitoring it is perhaps to be expected that small firm owners see the unpredictable visits of loan officers (with no obligatory right of access to information) as intrusive.

Adopting clauses in loan agreements requiring formal submission and verification of reports and documents might produce better results in the small firm financing arena. Undertaking a monitoring function of loan operations by the lenders has not yet been unanimously accepted as an essential part of the loan agreement at least at the level of day-to-day practice. This can be argued to contradict the views and interest of both borrowers and owners of small firms.

One important aspect of this has been revealed by this study, based on the opinions and comments of the main two respondent groups financiers and small firm owners, that lenders to the small firms do not want to consider themselves as 'participants' in financed projects or firms. Rather they prefer to act and to feel as the 'loan giver' against which they want their return viz., capital and interest. A majority of the financiers showed their reluctance to be recognised as 'participants' and did not want to accept such a contractual obligation to carry out other functions in addition to a narrow view of lending. Many of the owners of small firms, owing to this behaviour by financiers, expressed their views through interviews that sometimes they did not find any difference between a 'Mahajan' (a traditional private money lender who

provides loan to villagers) and a modern financier. The Mahajans provide loans to villagers against some sort of security and earn interest on it, and apart from repayment of principal do not consider any other aspect that may cause them delayed or irregular payment of their return. Sixty two small firm stated that their financiers role was not participatory and did not feel that the lenders displayed any sense of belongingness to the small firms they finance. By these two words, 'participatory' and 'belongingness' the owners appeared to highlight the financiers lack of concern about the projects they financed, and according to them the role of the financiers is confined to a very limited scale that is :

"we (lenders) are giving this loan with such an interest rate, repay the loan with the specified interest by such and such time period".

Excepting a very few financiers, this view, is largely substantiated by the views of the high level financing officials through the interviews.

This opinion of the owners may also be supported by taking another aspects of loan operations- counselling and advice. All of the twenty one financing institutions agreed that these two actions could result in a substantial development of small firms in the economy by responding to the question '*Do you consider counselling and advise by the financier can play an effective role in the development of small firms?*' in the questionnaire. But only five financing institutions reported that they included any provision in the loan agreement which requires them to tender counselling and advice to owners in need of it. Thus, a majority of the financiers do not appear to want to make themselves obligated to do this job despite acknowledging that it may have an effective role in the development of small firms (and protect the security of their lending).

The above discussion suggests qualified acceptance the hypothesis that lenders do not practice loan monitoring procedures either in the context of formal loan contracts or informally. However, some financing institutions do follow some sort of monitoring system based on certain clauses inserted into the loan contract, which reflects a very weak contractual phenomenon as far as loan monitoring and counselling are

concerned. In addition there was evidence of non-obligatory monitoring based on the initiative of loan officers need perceived by them.

This discussion raises important issues for small firm lending in Bangladesh. Based on these results there must be doubts that there exists effective support for the small firm borrower to ensure a reasonable chance of economic success for the loan. It is obvious to state that merely providing a loan to a small firm does not ensure its success unless it is given proper and timely care encompassing all its needs. This research suggests that the lending culture in the small firm sector of Bangladesh is characterised by a culture of 'lend and forget'.

Chapter Eleven

Lending Procedures and Entrepreneurs: Demand Side Issues.

In this chapter we will review entrepreneurship culture, lenders-borrowers relationships and the first two sub chapters below offer such discussion. Finally, in the sub chapter 11. 3 discussion on entrepreneurs role in lending decisions and the examination of the hypothesis related to it is made.

11. 1. Evidence on Entrepreneurship Culture in Bangladesh.

It has been argued that the pivot on which everything connected with economic growth turns is the entrepreneur (Schumpeter, 1936). In everyday parlance 'entrepreneur' has wide ranging connotations. Certain individuals, both contemporary and historical, might by common consent be described as entrepreneurs. J. Pierpont Morgan, J.D. Rockefeller, A. Carnegie and the other personalities associated with the development of banking and finance, the railroad, oil and steel in nineteenth-century America would seem each to warrant the label 'entrepreneur'. Yet the pure scale of person's activity, the opening up of whole continents, the development of entirely new industries, does not seem to be crucial. We might as easily apply the term to a person often engaged in conventional, long established, local trades, who nevertheless appears to possess those characteristics of energy, drive, inquisitiveness, acquisitiveness, shrewdness and perhaps even deviousness in the proportions required (Ricketts, 1994).

Energy and drive alone are insufficient to produce an entrepreneur: an entrepreneur must have the energy to act and the drive not to be discouraged by obstacles, but the blinkered determination of the fanatic is not an entrepreneurial quality. The entrepreneur requires not the momentum of the bulldozer to demolish all before him, but rather the agility and

the flexibility of the Land Rover to circumvent the difficulties. Clearly such a strategy requires that the entrepreneur should look about, and the acquisitive and inquisitive aspects of the entrepreneurial character relate to this process. Both words derive from the Latin *quaero*, to seek, and the modern theory of the entrepreneur is concerned primarily with elaborating on this primary characteristic-the search for, or discovery of, new knowledge. The entrepreneur uses the knowledge he has acquired to his own advantage by reallocating resources. This process of reallocation involves forming agreements with others, and it is here that the qualities of shrewdness and deviousness enter: shrewdness to judge the character and reliability of the people with whom agreements are formed, and deviousness to get the best of the bargains struck (ibid, pp. 49-50). Although the classical views on entrepreneurship do not accept the notion that entrepreneurship is a factor of production, the modern economists like Schumpeter has described entrepreneurship as an important factor of production and an accelerator for economic development. So, considering the facts associated with entrepreneurial it might be opined that an entrepreneur is the person who sees that possibilities for profitable collaboration exist, who puts together the necessary set of contracts between himself and the collaborating agents, and thus establishes a new enterprise or firm. Therefore entrepreneurship is central to the establishment of new enterprises. As Knight (1921) recognised,

‘a considerable and increasing number of individual promoters and corporations give their exclusive attention to the launching of new enterprises, withdrawing entirely as soon as the prospects of the business become fairly determinate’.

The literature on entrepreneurship development shows there is a close relationship between the development of small firms and entrepreneurship development. A study conducted by Storey and Johnson (1987) on entrepreneurship in the U.K argued that the development of small firms and entrepreneurial ability are dependent on each other. Thus, if small firms are created that will lead to the birth of new entrepreneurs at least in the small scale businesses area at the initial stage, however it will also ultimately flourish in other areas of businesses viz., medium and large businesses. But for effective

development of both entrepreneurship and small firms there is a need for appropriate supporting institutions like those of the financial system since small firms rely heavily on institutions for the provision of finance.

A country like Bangladesh cannot ignore the importance of the creation and growth of entrepreneurship for the sake of economic development via small firms. A firm is a coalition of an entrepreneur which agrees a production policy, an organisational structure, and a rule for sharing the residual profits (Wu, 1989). So, for the sake of the growth of small firms and economic progress a great deal of responsibility automatically comes to the promoters and entrepreneurs of a country such as Bangladesh. At present, in Bangladesh the economy has been experiencing a second generation of businesses promoters and industrialists since its independence. The entrepreneurship culture and the role of entrepreneurs in the economy depends on several factors, from which Bangladesh's entrepreneurs cannot be isolated and it can be inferred that entrepreneurial attitude and culture may be dictated by these factors. These factors may be separated in three categories: Stimulatory, Supportive, and Sustenance (BIBM, 1987). The stimulatory factors are those which refer to all such activities that stimulate entrepreneurship in any society. These factors ensure the evolution and birth of entrepreneurial abilities in an economy. The stimulatory factors are availability of necessary resources viz., material, non-materials and human. The supportive factors are those which contribute towards entrepreneurship development, such as availability of finance, land, factory buildings, power and other utilities. A firm may become sick or may turn into a losing concern caused by many unforeseen and uncontrollable variables, even a well managed firm may encounter closure problems due to lack of raw materials, introduction of substitutes, lack of skilled manpower and so on. Sustaining factors are those factors that help in ensuring efficient and profitable running of a firm upon its establishment and commercial operation, as for example, provision for advice and counselling, provision for helping balancing modernisation and renovation of firms, helping diversification, providing additional funding for expansion of firm or providing taxes holiday. In addition to the above mentioned factors there are others that factors have a direct and influential role over the entrepreneurs and their actions, attitude and

culture. These are socio-cultural variables like, family background, religion, family and entrepreneurial's expectations and pressures from acceptance in society, independence, free choice; individual's education, inclination and capacity in business.

The interviews with the seventy six small firms owners provided information on the variables influencing entrepreneurship in Bangladesh and its potential role in economic development. Seventy two small firm owners answered to a question the *'To whom, if any one, did you first go for advice and help in starting your firm?'*⁶⁹ answered that they themselves stimulated the idea for the project on which their business was based. They reported that several factors like the potentiality demand for the product in the future, availability of required resources (human resources and materials) were important considerations. All seventy six small firm owners expressed dissatisfaction over the services provided by the utilities departments⁷⁰, at both pre and post operation stages of their business. From the following statement of a small firm owner the gravity of such problem may be observed:

“ Ours is a garments sub-contracting firm. We had to wait for about one and a half month to get the electricity supply connected from the PDB⁷¹ despite our valid and formally accepted application. After submission of application when we met the person in-charge, we were told that the transformer and the cable for carrying electricity in the area where our factory is located were not capable enough in supplying electricity to our firm.however, we had to manage it by adopting unwanted means.... very simply, through using bribe...”

Forty eight firms (63% of the total surveyed) reported that they had been able to expand their business but only four of the forty eight (i.e., about 8%) did not face any constraints in getting additional loans from financial institutions for expansion purposes. In answer to the question *'What would you say are the advantages of being a relatively small firm?'* all seventy six of the interviewed owners stated that they did not in the past nor presently have received any special advantages from any agencies because of their

⁶⁹ Question no. 9 of appendix 3.

⁷⁰ While owners were asked to mention any additional points of interest relating to their firm and its establishment [question no. 28('anything else') of appendix 3], they mentioned about this problem.

⁷¹ PDB: Power Development Board, which generates and distribute electricity in Bangladesh, a state owned corporation.

smallness except for benefits directly due to nature of the firm's business i.e., export oriented or import substitution. From the above it might be opined that entrepreneurs in Bangladesh are responsive to certain factors like stimulatory, supportive and sustenance but that other factors, e.g., easily available public utilities and bank finance may be constraints.

One of the important features of entrepreneurial culture that emerged from the interviews with the small firm sponsors was that there is an absence of 'openness' among the entrepreneurs of Bangladesh. All the small firm owners were asked a question regarding the turnover⁷² of their business in the immediate preceding year. Only a very few owners gave the figure straight-away and a majority of them took a long time before disclosing the figure after elaborating and bringing irrelevant matters into the interviews rather than directly answering to that very simple question. This was despite full assurances of confidentiality and reassurances that the purpose of the question was for research purpose only. Despite this, it appeared to the researcher that the small firm owners were still sceptical about making this disclosure. A statement below, from a small firm owner, may illustrate this type of situation:

".... we never evaded taxes nor we tried to avoid any custom duties in the course of our business. Our firm has an experienced accountant who deals with accounts, financial and taxes matters, however every firm may have some confidential matters. My accountant may leave the firm, and can disclose that confidential matters, but I do not afraid of that; moreover I can get hold of him if I want to.....; yes, xxxx is my firm's annual turnover for the last year".

However, finally all the interviewees gave a figure for the specific question on turnover. The high officials of the financial institutions were asked for their general views on small firm borrowers during the interviews. The majority (thirteen out of twenty one institutions) said that they felt that it was usual for small firm owners to maintain more than one set of financial reports of each type, i.e., two Balance Sheets, two Income Statement/Profit and Loss Accounts; and that there might be instances where some firms maintain three sets of accounts in order to cater for the perceived specific needs of

⁷² Question no. 6, appendix 3.

different bodies which are involved in their business and for the satisfaction of the owners themselves. The lending officials felt that multiple copies of accounts would be amended and modified where necessary to satisfy the needs of entrepreneurs in relation to financial institutions and taxation purposes. This high level of suspicion, not just about accounting information (although this is clearly of potentially great significance in the context of bank lending) may also indicate a general suspicion about the nature of entrepreneurs in Bangladesh. It may also offer support to the emphasis reported in the earlier chapters which financial institutions place on the non-financial aspects of loan evaluation as well as the initial scrutiny of loan proposals made on qualitative grounds.

During the interviews with the small firm's sponsors there was discussion about the socio-cultural variables that had pushed them to small business.⁷³ Typical answers referred to factors like:

-“No boss-I (we) am (are) the boss(es)”,

-“I (we) am (are) independent”,

-“My/our family desires to see the family business”,

-“Business means more and more money with more social acceptance”,

-“I had an inclination to go for such a project with such a motive that if I could have succeeded in the play ground why not in a small firming”,

-“Previously most of the businessmen had no educational background and also at present not only in the small firms' sector but also in other sectors like large and medium a lot of small firms owners do not have any formal educational qualification but they have been successful although there are examples of severe failures as well; so why not me”.

These factors go some way to demonstrate the culture of entrepreneurs in Bangladesh. An interesting and hopeful aspect that came out of the interviews conducted among the

⁷³ Such discussions came at the time of asking the question: “To whom, if any one, did you first go for advice and help in starting your firm?”.

entrepreneurs was that they, at least in theory, considered themselves as pivotal agents in economic progress in Bangladesh. This was revealed while they were answering to the question: *"To whom, if any, did you first go for advice and help in starting your firm"* and were trying to justify their starting of business as profession (noted above). It was impressive that they appeared to understand very well the 'linkage' effect of small firms development, apart from feeling satisfied (and sometimes proud) of creating employment opportunities and earning valuable hard currency for the country by exporting products. At least twenty eight small firm owners stated about the role of entrepreneurs in economic development.

However, it is noteworthy that a very large number viz., sixty nine out of seventy six, were very critical and outspoken about the role of financier, utilities/services providers, government agencies and other related bodies for their non-effectiveness in dealing with matters pertaining to the growth and development of small firms in the country.⁷⁴ This appears to be a combined effect of factors which can be classified as stimulatory, supportive and sustenance and are very much prevalent in Bangladesh's entrepreneurs as a whole.

11. 2. Borrower Lender Relationships in Lending.

The term 'relationship' itself is a qualitative factor, which in fact has enormous importance in the entire lending arena. Lending models put forward by different researchers and scholars in this area consider this as an important item in decision making as far as loan proposals are concerned. Presently there is a popular term which is very often used by financial institutions namely 'Relationship Banking'. A banking relationship between a financial institution and a corporate borrower depends on certain factors as stated by Fair (1987) thus:

- making credit available.
- knowing a company's needs.

⁷⁴ Views of small firm owners in these aspects were gathered from their answers to the questions: "What would you say are the disadvantages of being a relatively small firm?", and "Are there any additional points of interest that you would like to make?". See question no. 27(b) and 28 in the appendix 3.

- knowing a company's business.
- calls frequently with quick response.
- quality of calling officers.
- making good use of time.
- competitive pricing.
- high quality operational service.
- providing service in more than one location.
- size of lending capacity.
- providing innovative, creative and flexible financing.
- involving senior management.
- providing good advice.
- sharing corporate business and financing strategy.

The above list is not an exhaustive one and there are other items which could be identified that might be felt essential in order to evolve good borrower-lender relationship.

Interviews and questionnaire were used to obtain views on the nature of banking relationships in Bangladesh from both lenders and borrowers. The owners of small firms were asked the question "*How would you describe your relationships with your financier?*" during interviews. They were given four options very good, good, satisfactory and not satisfactory. The results are summarised in table number 11. 2. (1) below. Out of seventy six small firm owners twelve (or 15.8 %) stated that they had a 'very good' relationships with their financier, nineteen (or 25%) stated that they had a 'good' relationships with their financiers, thirty eight (or 50%) stated that they had a 'satisfactory' relationship with their financiers and seven (or 9.2%) stated that they had a 'not satisfactory' relationship with their financiers.

Table 11.2. (1)

Relationships with financier (views expressed by borrowers)

Value Label	Frequency	Percent
Very Good	12	15.8
Good	19	25.0
Satisfactory	38	50.0
Not Satisfactory	7	9.2
<i>Total</i>	<i>76</i>	<i>100</i>

In case of lending to small firms in Bangladesh the relationship between a borrower and a financier begins at the time of initial contact concerning financing a firm. In reality the relationship is necessarily two-way and depends both on the lenders as well as the borrowers attitudes with regard to financing activities. The high officials of the financial institutions were asked about what they considered the essential factors which play a significant role in determining the relationship between them and small firms owners.

They indicated factors like repayment habit or attitude of borrowers, freedom from default risk, compliance by borrowers with the terms and requirements of loan contracts (e.g., submission of reports when required) and maintaining regular contact as the important determinants in this respect. One of the high officials stated:

“Many of the owners are uneducated and lacking minimum level of managerial skills, and do not employ skilled accounts personnel due to which they cannot prepare accounting reports properly and as required by lenders. Since owners cannot develop an enterprise culture in firms they lack in responding and complying with conditions of agreement, and this may have influence on the relationships between us and borrowers”.

Interestingly, of the four factors stated as important to banking relationships by the senior officials of financial institutions three relate exclusively to acceptable behaviour by borrowers and only one (regular contact) relates to lenders behaviour. Moreover, they suggest that the bankers' views are dictated by short-term transaction

factors rather than a wish to develop long term relationships. The owners of small firms mentioned other factors as important to relationship banking, namely: prompt decision regarding acceptance or rejection of funding a project, quick and uninterrupted disbursement of a loan (payment of loan instalments), listening to the problems of their running of their business (if not in all matters at least in financial matters), assistance in calculating the actual requirement for finance, quick response in easing any problems relating to financial matters, provision of some counselling and monitoring services to cater for their urgent needs. The statement below, made by an owner of small firm, may give an impression on relationship banking as understood by borrowers:

“Lenders take too long time in making lending decisions. Once loan is sanctioned, it again takes a long time for disbursement. When they complete disbursement of the loan they think they have finished their job. They only want return for their invested money, principal and interest on the principal, and do not intend to listen to the problems we face with such wishes to resolve those. Sometimes we find the financier just like a *mahajan*⁷⁵”

In contrast, these points all relate to the behaviour of lenders and are closer to the list of criteria identified by Fair above for good relationship banking. On the basis of this evidence Bangladeshi financial institutions do not recognise relationship-banking in the sense of service to small firm borrowers and since the notion of relationship banking depends on mutual interaction between lenders and borrowers it appears to be some way off being achieved, at least in the sense in which it is recognised in banking in developed countries such as the UK and USA, in the Bangladesh market for small firm finance.

Apart from the above mentioned factors relating to relationships outlined by the borrowers and the financing bodies there are other factors, more cultural and psychological than components of the formal lending procedure which also dictate the level and nature of relationship. One of these which was mentioned by the majority of

⁷⁵ Mahajans are typical money lenders found in the villages of Bangladesh, who lend money to villagers against security with high interest and do not listen to problems of borrower, and require the borrower to pay accrued interests and principal when due or confiscate the property given as security.

the owners of small firms in a negative sense was 'undermining' of the owners judgement and business intelligence by the officials of the financial institutions. They reported that this came in different forms like, not listening to the borrower's demand for actual need of finance (including working capital requirements), non-adherence to the proposed funding requirement in the loan proposal, giving insufficient importance to the opinions of small firm owners in respect of certain matters relating to projects and financing proposals while loan officers or other financial institution's personnel frequently gave the impression that they as a group which knew all aspects relating to an area of small firm business, although borrowers might have previous or existing practical expertise in that field. The other main issue that the borrowers pointed out about financiers was that they did not show what the borrowers considered to be proper (and desired) levels of concern in dealing with loan matters for small firms. An important matter that the owners opined that loan officers frequently gave the impression that they considered small firm owners to be investors of money and nothing else in their businesses. A strong feeling among the small firm owners was also that their educational background was dismissed by loan officers despite any qualifications which the owners might have. In this connection a statement made by a small firm owner may be quoted :

"I myself am a mechanical engineer having substantial experience in the business with which I am involved; and I am confident of providing required advice and guidance in that line of business in relation to establishment or expansion of such small business firm. Yet, the officials that were involved in loan evaluation process did not show their minimum recognition towards my educational background and business experience while I was explaining the reasons for inclusion of certain machineries or making some provision for using certain raw material or making some provision of finance on some specific matter in order to arrive at the actual requirement of finance (as far as possible) in the loan proposal..... which is very much unexpected; seemingly they (financing officials) were never ready to accept any sponsor's verdict or expertise although that must be true and justified....which is painful. It gave me much shock when I was sanctioned the loan about 40% less than the required amount after almost two years; while I had to put my reasons repeatedly, during the appraisal of my loan proposal, for the total amount of loan I asked towards my project...which they did not rely or believe me".

A majority of the owners of small firms (sixty three out of seventy six) stated that hypocritical behaviour and favouritism are other possible reasons for the absence of a desired level of relationship between them and financial institutions. By this they mean that corporate borrowers other than small firms and a certain group of small firms owner get preferential treatment compared with small firms in general. The following quotation made by a small firm owner may be cited in this respect.

“I had submitted loan application form, with all required papers and documents and also provided more required papers with lender when I was asked for leaving no such situation which might further caused to submission of additional papers, for a loan about eight nine months before another applicant for establishing same type of firm. In the end, I was sanctioned the loan after about nine months of that applicant's receipt of loan.”

Also, it was a widely held view that although there are government policies for growth of small firms when they (small firm promoters) enter the premises of financial institution it is different story. There were claims that they did not receive the same type of treatment from the financial institutions as borrowers of other firms. Moreover, as they stated, they very often did not receive same treatment like other of their fellow borrowers of finance for small firms, which eventually led to the undesired type of relationship between them and their financiers. Which factors determined this relationship may be obtained from the following statement of a borrower:

“..... these were the connections and influence with high officials in lending institutions and undesirable transaction costs (i.e., bribe) which act as an important determinant in receiving good dealings in respect of the applicant and application, and positive and prompt disposal of loan application”.

Sixty two entrepreneurs held that complex and bureaucratic red-tapism was the source of the poor relationships between them and their financiers. This bureaucracy was

reflected in long time scales for evaluation of loan proposals requiring submission of too many papers and documents which they argued created pressure on them with an eventual detrimental effect on relationships.

“We had to fill-in an application form of about 40 pages and required to furnish different papers and documents (excluding feasibility report, which contained 118 pages) of about 100 pages that made 258 pages, which lenders needed to go through, if they wanted to do so...”

From the discussion above it cannot be inferred that either lenders or borrowers singly or any individual factor is responsible for the existence of a poor relationship between financial institutions and borrowers rather there appears to be an involvement of all the related parties and some external factors as well in dictating the degree of relationship. This will be further elaborated and analysed with a discussion of suitable recommendations for easing the relationship gap between the sponsors of small firms and the financiers in a later chapter.

11. 3. Review of Hypothesis Relating to Owner/Manager.

This study has six broad hypotheses, and five of them relate to the loan capital market for small firms and the financial institutions that provide loan capital to borrowers for establishing small firms. While these hypotheses are designed to examine major aspects of lending practices, like appraisal of loan proposals and monitoring and contracting for loans, the implications and role of small firms' owners cannot be ignored in the total lending scenario and the effective development of small firms in the economy. So, a relatively broad hypothesis was framed to judge aspects of small firm owners in this regard. This introduces variables such as management skill and capacity, attitude towards accounting practices and financial management in their firms, ability and attitude towards the preparation of business plans which are subject to credit evaluation.

In the questionnaire supplied to the loan officials of the twenty one financial institutions, there were four questions regarding borrowers' behaviour, activities and attitude that might have contributed to the failure or non-effective running of small firms. The question '*Do you ask for a business plan from the borrowers as a precondition for assessing loan application?*' in the questionnaire was answered by loan officials as follows: fourteen, out of twenty one, stated that they asked for a business plan 'always'; four of them answered that they asked for it 'frequently'; while two and one of them stated that they asked for business plan 'never' and 'sometimes' respectively. These statistics show that majority of financiers are of the policy of requiring borrowers to submit a business plan, which is surely a good attribute of lending practice since the contents and presentation of a business plan by a prospective borrower is a prime input in the lending decision. According to twelve loan officers (out of nineteen, those asked for business plan) borrowers do not want to give proper attention to the preparation of a business plan. This may be detrimental to their chances of obtaining a loan and in the long run may lead the firm to financial problems. The gravity of this may better be understood from the following quotation from a loan official in the questionnaire:

"The small entrepreneurs do not appreciate the necessity of preparing a good business plan/feasibility study by either themselves or by a consultant or consulting firm. They come up with dubious business plans. The concept of business plan as an instrument of project implementation is yet to be understood by the entrepreneurs. As a result, project preparation becomes poor thereby leading to failure".

Twelve financial institutions stated that borrowers were not keen to submit a formal business plan encompassing all necessary information required to evaluate a loan proposal. In addition, a majority (sixteen) of the financial institutions' high officials agreed during interview that a relatively lengthy form of application was needed because of this situation, so that required data and information may be obtained in the absence of the business plan or missing information from it. In interviews with high officials (and informal discussions with loan officials) of the financial institutions it was argued that intending borrowers sometimes submitted a business plan or project

proposal which was a duplicate of another project by changing items of information where necessary, and this was done without underlying market analyses or similar background research. If true, this sort of behaviour by borrowers has certain implications for lending practice pursued by financial institutions. In this context, when the owners of small firms were asked about this view expressed by the lenders, none of the seventy six owners interviewed agreed that they did submit duplicate business plans by copying another one; nonetheless they did not disagree with the other views of the financiers on the issue of the submission of business plans.

The interviews and questionnaires supplied to lenders and borrowers produced conflicting views on the significance and level of managerial expertise amongst small firm managers. All of the small firm owners said that they had required managerial expertise to run their business affairs⁷⁶, and not surprisingly, considered themselves to be competent managers. Since the sample of firms included profit making and loss making firms this implied that losses and reducing profits were not thought to be the responsibility of the managers themselves but were implicitly the result of factors beyond effective managerial expertise in their respective firms. On the contrary out of twenty one questionnaire completed by the loan officers, sixteen indicated agreement that borrowers' lack of managerial expertise was the likely cause of a firm suffering financial problems. The same views were also expressed by eighteen of the twenty one high officials interviewed. The high officials were asked about their institutions responsibility at least, at the initial stage of loan sanctioning, of looking into matters relating to the quality of management in applying firms. They were unanimously of the view that they could not be fully responsible for assessing management quality since the borrowers did not always furnish all the information required (and requested) for this with the business plan or with the project proposal, or, where information was provided on management it was for firm's sake only in loan sanctioning but would in reality not be related to how management was practised. For instance, as described by a high official, loan proposals or business plans might make statements about the personnel that would be responsible for running the business but after the firm starts its operation commercially it would be found that the persons

⁷⁶ During interview with the owners they were asked to state their feelings about competence in running business when they were answering to the question "To whom, if any one, did you first go for advice and help in starting your firm?"

mentioned in the project proposal do not work in the business and their places are occupied by the owner's family members (in addition to directorships). Bank officials felt that in majority of cases the managers of small firms do not have sufficient education and training in running a firm, a result of what the bankers regularly described as 'first generation entrepreneurship'.⁷⁷ However, all of the loan officers claimed not to disfavour loan proposals from first generation entrepreneurs, although it should be mentioned that they commented that they preferred such borrowers to invest their own funds in other small firms that are already in business, that is with existing small firm owners.

Another factor that was regularly mentioned as crucial in running a small firm effectively by the representatives of the financial institutions was owners' attitude and practice in accounting in their organisations. The financiers were strongly of the view that employing or using a qualified accountant, or if not possible due to expense, an accounting or finance literate and experienced person would ensure financial discipline and proper management. In practice the situation is different. Almost all of the loan officers stated⁷⁸ that in their experience a very small number of small firm owners placed attention on this aspect of management. Here the view of a loan officer in this regard may be quoted:

"Accounting skill is absent from almost all small firms. Neither the owners/managers possess good accounting base nor they feel to employ persons having accounting knowledge or experience.....they want to keep this area aloof from outsiders".

The general view of the lenders was that even where owners claimed to employ, if not qualified, experienced and accounting and finance literate staff in practice it was frequent to entrust this function to a person without any accounting knowledge or background, resulting in improper keeping of books of account, failure to submit reports, and difficulties in financial appraisal. In addition, it was felt by the lenders that this would in turn produce problems in the effective running of the small firms. Of the seventy six small firm owners interviewed it was observed that only ten to

⁷⁷ Views expressed by loan officials in responding to the question 18, especially iii, iv, and vi. See appendix 1.

⁷⁸ Loan officers expressed their views in answering to the question 18(iv), see appendix 1.

twelve firms employed persons having accounting knowledge and background at the Masters degree level.⁷⁹ Such persons were not qualified (chartered or cost) accountants, although some were qualified to the Intermediate level of the Chartered Accountant of Bangladesh qualification. In the case of the rest, this particular job was done either by the owner (who might not have accounting knowledge) or by graduates with non-accounting degree (although they might be commerce graduates). A main reason for the owner keeping accounts was described as personal secrecy for reasons of taxation, satisfying the banker and more personal factors. This idea was also supported by the financiers when the high officials were interviewed. As one high official put it:

“The core philosophy of dealing with accounting matters, especially, by the owners is to make such endeavour to keep the firm’s actual financial position in secret”.

This view summarises the opinion of the financiers. There was a view, expressed by the lenders that small firm owners might attempt to use their control over the accounting function to manoeuvre the accounting and financial information in their favour. Due to this practice actual financial awareness may not evolve among the small firm entrepreneurs, which is essential for running a firm competently. Bank managers, in a study conducted by the NEDC (1986) in the UK, described financial awareness as one of the important requirements for small firms owners to run business in a competent manner and expected this quality from prospective small firm borrower in the interest of both the parties.

It is noteworthy here that although some small firms employ outsiders to advise on their financial affairs, the independence of that person is not ensured and there remains the full possibility of the owner’s influence being exercised. During the interviews with the high officials of the financing institutions an important issue came up, which is related to the groups of persons engaged in professional accounting and auditing practice including advice to small firms i.e., the chartered accounting (CA) firms. The bankers stated that it was not unusual for CA firms to produce reports or audits on the accounts of firms which contradict its previous report on the same firm.

⁷⁹ Compiled from answers to the question 23, see appendix 3.

The bankers argued that this type of report might be prepared by an accounting firm on request from its client i.e., small firm's owner, to seek certain advantages from the financier or through the financier from the government. A high official of a financing institution stated that his organisation had received two completely opposite reports on a small firm in a period of only 3/4 months, and these two reports were prepared by the same accounting and auditing firm. The first report submitted by the firm showed it was gaining profit and it would like to expand and asked for additional funding. In the mean time the government announced a policy of waiving accrued interest for those firms making losses or not earning profit at a level enabling them to repay loans or interest to financiers. In order to take this advantage, the same firm had submitted an accounting report showing it was a losing concern and appealed for a waive from paying accrued interest on its existing loan. This type of practice has strong implications for lending behaviour, and the ultimate consequences to the financial markets and to the economy as a whole are not likely to be beneficial. The impact of lack of accounting skill or knowledge and/or the misuse of accounting information is not necessarily limited to a firm or a group of firms. Rather it has a wider influence which might have an effect on macro economic issues such as the effective growth of the small firm sector.

From this discussion it can be argued that the pursuit of a best practice credit evaluation process by financiers for small firms namely finding suitable firms to receive loaned funds and to be effectively run depends not just on lenders. The role of borrowers in small firms cannot be ignored. It is, inter alia, small firm owners lack of management capacity and accounting and financial skills or integrity in these matters which may contribute to the non-effective running of small firms and the miss-allocation of lending. Thus there may be grounds for considering the acceptance of the last hypothesis i.e., "Owners/managers of small firms lack the skilled management, and particularly the accounting skills, to prepare loan applications which could be subjected to best practice credit evaluation".

Chapter Twelve

Conclusion and Recommendations.

12.1. Introduction.

This part of the thesis will seek to draw conclusions about the loan capital market for small firms, especially in loan evaluation, monitoring and contracting practices, and make recommendations in the light of standard lending practices pursued in different countries as obtained from the literature review and by taking into consideration factors common in a developing country like Bangladesh. For these purposes we shall consider the literature review chapters (from chapters 2 through 6) along with the contents of chapter 1 regarding financial structure in Bangladesh. Side by side we need to consider the empirical chapters 8, 9, 10 and 11. The framework used for examining the economic development programme and lending procedures has been evolved from both macro and micro concepts. The models of economic development illustrated in the literature review represent a macro framework, and the lending standards for firms, and small firms in particular, in countries where the well developed procedures are expected to be practiced represents the micro framework.

Recommendations will be put forward based on the standard lending procedures, evolved from the lending procedures identified in the literature review, as normative procedures and what is actually practiced by financial institutions in Bangladesh as identified in the empirical part of this research.

12. 2. General Conclusions.

The formal loan capital for small firms in Bangladesh is comprised of several types of financing bodies viz., commercial banks, development financial institutions, and specialised financing institutions. However, in the total process of lending to small

firms not only the members of the financial market and small firm borrowers are involved but also other groups and persons whose association is less direct. Even if, the financing institutions are primarily responsible for important and integral parts of lending decision making, i.e., credit evaluation, loan monitoring and loan contracting, this is inseparable from the responsibility of borrowers for establishing small firms, the responsibility of organisations for providing essential services to small firms, trade and business bodies and above all the state policy formulators and bodies responsible for implementing these policies cannot be ignored.

This research work is 'evaluatory' research whereby issues have been evaluated in the light of certain theories, models and literature. These issues have been drawn up in the form of hypotheses concerned with the involved parties, especially lenders and small firms borrowers. However, the roles of agencies like the state, and business and trade representative bodies have also been evaluated in line with the contemporary requirements of the two groups that are most closely linked with the loan capital market for small firms in Bangladesh, lenders and borrowers.

The heterogeneous nature of financial systems, often termed financial dualism, is present in Bangladesh. However, in this study only the formal financial sector's members, financing institutions, have been considered. Essentially, like other developing countries, the formal financial sector in Bangladesh is frequently a legacy of colonial times or the result of imported systems. There exists a considerable degree of control over the formal financial system on the part of the public authorities. The function like control is pursued by the central bank, the Bangladesh Bank and the Banking Division of the Ministry of Finance, and this function is directed, *prima facie* to ensure fair and committed financing and banking services in the country. In Bangladesh, like other countries both developing and developed, banks are the main sources of financing for small firms. Therefore, their role and activities have the prime impact on this sector's funding, its subsequent sustenance and growth. As has been stressed, this is a sector for Bangladesh whose effective financing and development is very important to the economic development

of the country. The vital role of financing institutions is well accepted and agreed by all concerned, including policy officials of various strata of government and high officials of the financing institutions. However, other parties involved in small firm lending, the small firm owners and borrowers particularly are sharply critical about the prevalent nature of financiers behaviour in respect of lending decisions and post lending activities. Additionally, policy officials and others stated a wish to see the financiers positioned on a relatively wider spectrum, that is not mere lenders of money but organisations showing timely and effectively responsiveness to the crucial clientele group of small firms. In spite of some of the financiers not agreeing with the argument to pursue relatively wider objectives related to the performance and financing of small firms, the reality of the need to accelerate the attainment of economic development in Bangladesh suggests that steps should be taken to change the behaviour of lenders.

We shall now discuss the hypotheses that were developed for testing in line with the objectives of this research.

12. 3. Conclusions Regarding the Hypotheses.

There were two broad hypotheses concerning two identical groups of units in the financial system of Bangladesh which have implications for the financing and development of small firms. The first hypothesis is related to the loan capital market for small firms and financing institutions namely: *Imperfections in the market for loan capital have contributed significantly to the failure of small firms to meet the development objectives set for them.* The second hypothesis is related to the entrepreneur/owner group: *Owners/managers of small firms lack the skilled management, and particularly the accounting skills, to prepare loan applications which could be subjected to best practice credit evaluation.*

The first hypothesis leads to four specific hypotheses concerning financing institutions' role in lending and developing small firms. These hypotheses and their status of acceptance or rejection are discussed below:

(1). *Credit evaluation of loan applications for small firms is not based on established standards of best practice which involve formality, the submission of business plans including forecasted accounting information, (where necessary) historical accounting reports, and an appropriate consideration of qualitative factors.*

The suggested status of this hypothesis is *Partial Acceptance*. The field work produced evidence which indicated that the financial institutions follow some formal procedures for lending to small firms i.e., submission of loan applications forms consideration of information of diversified types e.g., financial and qualitative/non financial information. The detailed analysis of these factors has been discussed in the earlier analyses chapters (10, 11) of the thesis. Although, a high level of formality might be said to be present in some respects, this could be fairly characterised as 'highly bureaucratic' and fall short of best practice. A number of information sources, procedures and criteria which are recognised as part of best practice were present significant doubts remain about how far they are applied in practice and how far they contribute to effective lending.

(2). *There is a reliance place by the lenders on inappropriate qualitative factors in loan granting decisions for small firms.*

The suggested status of the hypothesis is *Acceptance*. Which indicates that qualitative factors that are not appropriate, as far as the loan desirability on the part of potential borrower is concerned, are recognised to have played a significant role in loan granting decisions. Such a factor is, for example, the reference which a prospective borrower puts in a loan application form. The role of other qualitative information may also be questioned.

(3). *Lenders do not make use of loan contracting procedures which are efficient for ensuring:*

(i). *Adequate credit protection for the lender.*

The suggested status of the hypothesis is qualified *Rejection*. The field work results suggest that lenders make written arrangements in the contract which concentrate on

credit protection by incorporating clauses relating to security over a firm's assets and the property of sponsors of small firms. The effectiveness of this approach depends upon the value of assets in liquidation or the firm's ability to avoid failure and the lender's money. It is not helpful in assisting the small firm owner/manager in avoiding failure except by providing strong personal financial incentives to avoid failure. It remains unclear whether this is a more efficient approach than one which emphasises contract terms relating to the going concern condition of small firms.

(ii). *Effective support for the borrower to ensure a reasonable chance of economic success for the loan.*

The status of this hypothesis is qualified *Acceptance*. Following from the above discussion there is evidence that lenders do not make use of loan contracting procedures which are efficient in giving effective support for the borrower to ensure a reasonable chance of economic success for the loan. For economic success of small firms effective support may come in the form of counselling and advice in areas such as financial and marketing or through the use of financial covenants and monitoring to identify problems early. Reference to these issues may be made from discussions in chapter 9 and sub-chapter 10.6.

(4). *Lenders do not practice loan monitoring procedures either in the context of formal loan contracts or informally.*

The status of this hypothesis is qualified *Acceptance*. The field work indicates that monitoring by lenders is not much practised as a formal part of the contractual agreement between the borrower and the lender. There is evidence of some informal monitoring provided by loan officers but overall the level of monitoring is much less than expected by borrowers as a prerequisite for their effective running and development of their firms. Similarly, with reference to discussions in the literature review monitoring practices in the small firm lending sector of Bangladesh is relatively undeveloped (see chapters four to six). The relative absence of monitoring practices may be observed by looking at the discussions in the sub-chapters 10.4 and 10.6.

(5). *Owners/managers of small firms lack the skilled management, and particularly the accounting skills, to prepare loan applications which could be subjected to best practice credit evaluation.*

The status of this hypothesis is *Acceptance*. The field work indicates that not only supply side market imperfections are responsible for reduced effectiveness in lending decisions to small firms, but this problem is compounded by difficulties from the demand side too. Owners/managers have to play their part during the process of loan evaluation and after the loan is sanctioned by responding to appropriate and timely requests from the lender, to supply adequate and proper information with the loan proposal and subsequently for any assessment purposes. The detailed discussion in this respect is in chapters 11.1 and 11.3

12. 4. Synopsis of Content Analysis.

The following is a synopsis of content analysis based on the interviews and questionnaire surveys conducted during the fieldwork. The fieldwork was directed at several groups and types of organisations, policy makers, planners, small firm owners (entrepreneurs) and lending institutions, represented by senior officials at the policy level and loan officials at the operating level.

The content analyses are offered in four ways. Firstly, by bringing together issues relating to financing institutions that based on the opinions expressed by small firm owners and policy makers (indicated as Type A below). Secondly, by stating the views of the financing institutions about the borrowers/small firm owners (indicated as Type B). Thirdly, views expressed by financing institutions' and borrowers/small firm owners in relation to government and the agencies responsible for implementing different state policies (indicated as Type C). Fourthly, issues mentioned by all of the three main participants in the research for which none of them agreed that they were responsible, named as 'social' factors (indicated as Type D).

These various views may be used as a series of conclusions on the functioning of the loan market as perceived by the main participants in it. They extent to which they can

all be viewed as equally valid is obviously questionable but the views offer insights into the research issues, provide the basis of recommendations and issues for further research.

Type A: *Views on financial institutions.*

Views expressed by small firm owners and policy makers during the fieldwork relating to financing institutions are summarised below and relate chiefly attributable to effective growth or failure of small firms:

1. There is a lack of accountability among the loan officials.
2. The very long and time consuming procedure typically involved in is a problem in itself and one which loan sanctioning leads to cost over run.
3. Financial institutions lack procedures which are effective in choosing projects to lend to and entrepreneurs having business potential.
4. The attitude of financing institutions' officials was widely questions and there were frequent accusations of corruption.
5. There is an absence of cohesion and consensus among all the officials in an institution who are concerned with lending decisions.
6. Loan officials display a lack of uniformity on judgmental issues pertaining to lending decisions for the same or similar types of project or firm.
7. A relatively heavy reliance is placed by loan officers on borrowers' data for issues like market research when financial institutions may be better placed to assess this.
8. Lending policies are conceptually underdeveloped, which leads to defective lending practice in the long run.
9. Lenders are subject to pressure by different groups in lending decisions.
10. A participatory role in business on the part of the lenders is absent; rather they act as a financial transactor only interested in the return of the funds lent. Financiers think of themselves just as 'lender' and although they typically provide 60 to 70 per cent of total capital required by many small firm they do not seem them as participants in projects.

11. The personal contacts and image of the borrower are valued most in lending decisions and in a majority of cases other aspects of a project are ignored in funding decisions.
12. Loan evaluation and sanctioning is highly complex. Bureaucratic complexity in dealing with loan proposals is typical.
13. Loan evaluation is not pragmatic, and based on unrealistic assessments.
14. Lenders/financing institutions consistently underestimate the small firm promoters'/borrowers' views or suggestions in determining amounts to be granted in loans.
15. Financing institutions do not comply with some government directives, for example, the credit guarantee scheme is often not implemented under which small firm promoters can receive loans with government guarantee.
16. There is a generally unrealistic approach of assessing the total needs of finance for firms and this applies also to the calculation of working capital needs.
17. There are defective or incomplete lending contracts used which do not work properly to control defaulters and recover lender's money and this means that the good borrower is treated in the same way as the bad.
18. Financial institutions failure to identify deserving promoters who should be provided with finance to create successful small firms.
19. Financial institutions regularly practice over or under valuation of assets for security neither of which desirable for effective lending decisions.

These views indicate important areas of concern, especially on the part of small firm owners/promoters despite inconsistencies in the views and the admittedly partisan nature of some of the views (e.g. 18 and 19).

Type B: Views on small firm owners or promoters.

The following are the views expressed by financing institutions' regarding small firm owners:

1. Small firm entrepreneurs often reduce the level of their personal investment by over-invoicing the cost of the machineries and equipment.

2. Borrowers are driven, in many cases by 'demonstration effects' in their business dealings without sufficient care for the substance of business practices.
3. Bad practices are typically pursued by borrowers in diverting funds from projects which have been financed to others which have not been sanctioned.
4. Small firms display a lack of planning in all major aspects of business due to managerial inexperience. The absence of consistent and regular business planning creates problems by not foreseeing market developments (e.g., availability of substitute products at a cheaper price).
5. Project proposals are rarely submitted in a complete way by prospective borrower. Often the prospective borrower submits a weak business plan, for example submission of project proposal without a realistic market study.
6. There is a common attitude of not repaying loan amounts and interest amongst borrowers which causes lending institutions to reduce or stop their lending to new projects. This eventually creates a 'default culture' among small firm owners.
7. Integrity of owners is not unquestionable. Which might be observed through their practicing diversion of funds.
8. Lack of understanding of the importance of accounting, and lack of accounting skills in small firms means that owners are not careful about keeping accounts, product costing, and pricing which leads to poor financial management, an inability to make effective decisions, loss of marketability of products all of which leads to high rates of failure of small firms. Most of the small firms do not maintain their accounts in a structured way and do not employ professional or experienced accounts personnel. Instead they maintain what is commonly called a 'balance book' in which all sales and receipts are posted on one side and all purchases and expenses are posted on the other side. According to the financiers this is often the only information available to a small business and hence it is difficult to take any decisions or infer any conclusions/recommendations relating to it.
Lack of accounting skills engender problems like poor cash management and inaccurate forecasting of possible funding requirement.
9. Frequent disputes and misunderstandings among the partners of small firms lead to severe management disorder and the failure of many firms.

10. The ownership of small firms is often vested in family members who are reluctant to demonstrate openness as far as important aspects of a business are concerned, especially in financial matters. This helps explain reluctance to employ qualified or professional accountants since family owners wish to maintain secrecy about financial matters.

11. There is an absence of 'enterprise culture' in small firms. Owners, often first generation entrepreneurs lack of adequate business knowledge and experience and do not want to develop a systematic and well organised business structure. Accordingly a typical small firm owner becomes the focal point of all decisions irrespective of his or her level of knowledge or experience.

12. It is common practice to manipulate accounting reports and thus evolve ways of deferring or escaping from repayment of loans or interest. For example, firms earning adequate profits sufficient for repaying loans often manoeuvre their income statements to show a loss in order to take advantage out of deferred repayment.

13. It is common practice to over invoice for machinery and equipment which provides scope for a borrower to reduce the amount of investment in equity to a level which is negligible and which cannot make the borrower committed to the firm. Over invoicing allows a borrower to show the prices of machinery and equipment at a level which is two or three times higher than the actual price. Borrowers frequently submit project proposals showing those prices and when the project receives the sanctioned loan it is more than the actual amount required. As the debt-equity proportion is determined between the lender and the borrower on the basis of the proposal, the latter is able to invest less from his/her side as equity by taking advantage of 'over invoicing'. The borrower can use the finance that he/she would have invested in the project for other purposes.

14. Short termism on the part of the borrower is typical in fixing a project's goals and in profit planning. The intended profit may be at the cost of product or service quality which may lead to problems in the longer term for the firm.

The above shows a disturbing level of distrust by officials of financial institutions of small firm borrowers which, if justified may explain many of the attitudes complained of under 'A' above by small firm owners in particular.

Type C:

Views expressed by financing institutions' and their small firm owner borrowers in relation to the government and those of agencies responsible for implementing policies in relation to firms are now considered:

1. The implementation of government policies is delayed.
2. Inappropriate or faulty taxation policies are pursued.
3. Inappropriate and inconsistent tariff policies are pursued.
4. There is a high degree of corruption among customs personnel. There exists interpretational problems regarding customs rules by customs personnel which cause cost to small firm promoters both financially and socially.
5. Over taxation and duties which seem too high for local market based small firms.
6. Short-sightedness in preparing policies on the part of government.
7. Lack of cooperation on the part of the providers of physical infrastructural facilities and utility services (electricity, water, gas and telephones) which are essential requirements to establish and promote small firms. There do not exist any clear initiatives and rigorous policies from the government to ease and eliminate these problems.
8. There is wide spread corruption and absence of control over state organisations involved in the system of small firm development which produces lack of accountability as far as their performance is concerned.
9. There is no state-managed body in charge of market research which might work on bankers and financiers.
10. Despite statements otherwise there is an absence of government sincerity in reviewing the activities of financing institutions which provide loans to small firm in order to evaluate their functions in the light of the given targets in terms of loans disbursed, number of projects financed and the performance of financed small firms.

As with 'A' and 'B' the above indicates a high level of dissatisfaction by groups of loan market participants with other participants in the market. The above concerns, if justified, are very important since they relate to important structural features of the loan market and the general business environment.

Type D: Views on general social issues.

Factors that were mentioned by all of the three main participants to the field work for which none of them felt responsible, which they named as 'social' factors were as follows:

1. Labour unrest backed by political parties.
2. Uncongenial atmosphere to businesses due to restrictive practices of trade unionism.
3. Absence of commitment, drive and leadership from politicians and political parties in power.
4. Macro economic policies formulated by government serves, mostly, traders' and importers' interests, and the policy formulation process is not representative of all interested bodies.

12. 5. Recommendations.

12. 5. (i). Relating to Policy Bodies in Bangladesh with Special Responsibility for Small Firms Financing.

The institutional framework and organisational set up for extending support to develop small firms in Bangladesh is below standard when compared to other countries, especially developed countries which have adopted small firm growth as an important economic development strategy.

In Bangladesh the Planning Commission of Bangladesh is responsible for formulation of macro economic policies and adoption of economic development programmes and strategies. There is a division of this commission to deal with policy matters concerning industry including small firms and industries. Other related bodies have got their own policies and programmes which may have direct and/or indirect impacts on small firms. However, implementation of policies is not up to the expected level as indicated by this research.

The body called the Bangladesh Small and Cottage Industries Corporation (BSCIC) was established to create, promote and extend assistance, including infrastructural and financial assistance to ensure effective growth of small firms. It has a key duty to promulgate sustainable growth of small firms for economic development because it is the apex organisation set up by the government for this purpose. This organisation takes help from the Ministry of Industries, Planning Commission, and the Central Bank along with other financial institutions of the financial market and also from business and trade bodies which adopt supplementary programmes to boost small firms in the country.

The two relevant government ministries namely, Ministry of Finance and Ministry of Industries are not directly involved in the establishment of small firms, but their policies, i.e., financing policies and industrial policy obviously have a strong impact on the whole industrialisation process in the country from which the small firms sector cannot isolate. The industrial policy of the Ministry of Industries obviously reflects the attitude, philosophy and macro-economic policy of the policy makers in the government and is derived from the plans and programmes of the Planning Commission. The Banking Division of the Ministry of Finance deals with financial institutions. In general this division deals with banking policies and supplements and complements the functions of the Central Bank, the Bangladesh Bank.

The creation of an indigenous-owned, small firm sector is a basic development activity; which requires a number of supportive and infrastructural activities without whose existence a small firm sector cannot play its proper role in the economic development process. The achievement of economic development using small firms needs policies and programmes of a long-term nature. The influence of government is of paramount importance in respect of creating and sustaining an efficient climate for small firms, inter alia, in three main ways. Firstly, the choice of any economic activity will be encouraged by the strategies for economic development. The general attitude of the government regarding the small firm sector determines if the economic climate will be favourable or unfavourable to its modernisation. Government through its

policies must ensure that the appropriate climate is created for small firm development.

Secondly, the government through its spending and taxing authority can directly or indirectly change the relationships between cost and price, and eliminate many inefficient and wasteful aspects of traditional trading and business systems. It is very likely that success or failure of any government policy in this regard depends on a number of factors, for example, the motivation of individuals responsible for interpreting and implementing of government policies. Nonetheless, by substituting or formulating appropriate regulations, and by the motivating persons involved in different government agencies government can have a positive effect on the fashion and style of work pursued by people in the management. Thirdly, it may be likely that in many developing countries, government is the sole means of extending financial, technical and other types of assistance which are essential for the creation and expansion of small firms. However, countries that have additional or alternative sources of assistance of all types from government owned or private financing institutions can contribute more effectively to the creation and growth of small firms. Alert and imaginative government change agents are needed to extend essential services in adjusting both production and consumption to the widening possibilities created by the dynamics of the development process. In all these respects, the marginal productivity of governmental activities (which include both policy frameworks and supportive services) should be higher than the marginal productivity of any improvement introduced in the private sector (Petrof, 1987). It is not clear that in the case of Bangladesh the productivity of these government support and change agents, e.g., BSCIC, commercial banks, utilities suppliers, and DFIs, is as yet sufficiently high to contribute up to the expected level for effective development of small firm sector.

The discussion in this chapter of the content analysis identified many problems related to financial institutions, small firm owners, government or its associated agencies and social factors. Of these, type 'C' is directly associated with government organisations, and the role of government in certain cases cannot be ignored in respect of issues of concern of type 'A' related to financing institutions and 'B' related to small firm

owners. Possible recommendations to counter these problems are illustrated below. Nevertheless, in the case of concerns of type D, the government in association with other responsible persons from different professions and services especially politicians and legislators, trade and business bodies, bankers, planners and policy formulators, and small firm owners may take initiatives which might resolve these problems.

Some recommendations for the government:

General Policy related:

1. Revise macro policies in line with the contemporary needs of financial markets and the parties to it, especially the borrowers for small firms. This could involve altering the regulatory role of government to a more supportive role. Some structural adjustment work could be done in areas like foreign exchange rates and trade policy where matters have worked against small firms. Policies have resulted in an overvalued currency with high levels of effective protection within the large firms sector, in particular relatively capital intensive firms, in comparison to the small firm sector, which demonstrates discrimination against small firms. Foreign exchange policy and trade policy could be liberalised in such a way that small firms can import required raw materials by using foreign exchange which should be allotted in accordance with their actual requirements.
2. Formulation of consistent and appropriate policies for at least a period of five years, for example tariff policy, trade policy, and fiscal policy should be four to five year instead of a one year policy.
3. Eradication or reduction of corruption from agencies engaged in discharging functions relating to providing supportive services e. g., customs and electricity supply.
4. Service Sectors should be directed to provide essential services without hindrances to business.
5. Import duties on raw materials should to be reduced.

6. Anomalies in duties have to be eliminated. For example (stated by a small firm owner during interview), in the case of imported medicine foil import duty is 7.5%. If any firm seeks to produce that product locally, which may contribute positively to the economy, it has to pay four different duties for four raw material required to produce it; these rates are 7.5% on aluminum foil, 45% on polythene, 30% on printing ink, and 30% on chemicals; so the cost of production becomes much more higher than an imported product.

7. There should be one umbrella organisation to provide services to set up small firms on a priority basis.

8. A real and firm commitment from political leaders, policy planners, and the organisations under their control to implement of development programmes for small firms.

9. With the pursuit of a free economy, the 'infant industry' concept needs acknowledged and implemented through some sort of conducive state intervention.

10. Withdrawal or reduction of the Performance Guarantee Rate on imported machinery. Due to this high rate (i.e., 15% on buying price) the total cost of machinery is increased which in turn increases the cost of production and reduces competitiveness and may contribute to project failure.

Related to the financing of small firms and financing institutions.

(1). Policy to be formulated and undertaken to ensure establishing specialised small firm sections or branches in lending institutions that provide loans to small firms. If necessary government may extend technical and management and financial support in this regard by engaging agencies like BSCIC, the Planning Commission, the Banking Division, trade and business associations, and the Central Bank (Bangladesh Bank) in the policy.

(2). Government should improve the dissemination of information relating to the availability of finance so that potential borrowers can be aware of the opportunities for loans in the financial market.

(3). Government should initiate a comprehensive programme to impart effective training for lending institutions' officials responsible for dealing with small firms.

Small firm owners related.

(1). Necessary policies and programmes have to be undertaken to identify potential entrepreneurs to invest in small firms. In addition government should develop training and support facilities. With in the development programmes many types of services are already available including financial, technical, managerial and other related services. Government by engaging BSCIC, trade and business association e. g., FBCCI and representatives from financing institutions could formulate selection, training and support programmes to identify and make entrepreneurs aware and adequately trained about financial, technical, managerial and marketing matters to run business to higher levels of competence.

(2). Government should not only take steps to improve new small firms but should also seek to modernise existing small firms in the country. Government sponsored management educational activities would lead to the creation of modern firms whose growth and efficiency would be improved thus fostering economic development.

12. 5. (ii). Recommendations Relating to Financing Institutions

Organisational and Policy Related Matters.

(1). Separate divisions for small firms at head offices and separate sections in branches should be established to deal with funding of small firms. This is required to give proper attention in respect of loan evaluation and sanctioning procedures.

(2). Lending procedures in particular, loan contracting by making loan monitoring and counselling an integral part. Emphasis should be applied to this area not simple the loan evaluation standard lending procedures themselves.

(3). Financial institutions should establish liaison arrangements which will ensure coordination (and necessary support as and when required) among all the parties to lending i.e., borrower, infrastructural support services providers (e.g., electricity supply department), BSCIC and representatives of the trade and business community (e.g., chambers of commerce and industries) in order to improve the effective running of small firms when a loan is sanctioned and to reduce the rates of small firm failure.

(4). Institutional arrangements have to be established to tender assistance in the form of monitoring and counselling, once a loan is granted to a small firm.

(5). The financial institutions should consider making organisational arrangements to evolve effective methods of choosing entrepreneurs in order to encourage new entrepreneurs who would invest in small firms. Financing institutions may seek assistance from government and especially organisations like BSCIC and chambers of trades and businesses to do this. One important benefit of such an organisational activity by the financial institutions would be that they would be more likely to be lending to real entrepreneurs committed to small firms, thereby reducing their credit risks.

(6). There should be established certain maximum time periods for dealing with a loan proposal starting from receiving an application or lodging a request for a loan until the sanctioning of that loan. There should be specified time frame for each of the stages needed to be passed for final approval and sanction of loan. Hence, unnecessary tiers and bureaucracy have to be eased. This could be done by the institutions themselves or by a government agency such as the Central Bank.

(7). Proper training and career programmes should be established for loan officers of financing institutions dealing with small firms. Financing institutions lack expertise

and commitment from their work force and the situations is more crucial in case of lending activities relating to small firms. If small firm lending were valued and made a career track better lending practices might emerge.

(8). Financing institutions should develop their lending standards and models to accommodate and apply in practice two important aspects of lending i.e., a culture of 'customer focused quality (CFQ)' and a culture of maintaining 'a code of conduct'. These two factors, we hope, may improve the service quality of financing institutions by establishing another culture, 'relationships banking and lending' which basically may evolve due to practicing the first two cultures.

Under the CFQ culture of lending the financing institutions should look in to the matters which customers really want to receive from them. Financing institutions by analysing answering to questions like the followings may be able to establish a CFQ culture:

- what do customers expect when a loan request is made?
- what turnaround time do customers expect for a loan approval?
- what do customers like most and what do they like least about the bank's loan approval process?
- if a customer is given a chance to change one thing about the lending process, what possibly would it be?

Answers to these questions may be obtained if financing institutions give importance to comments and views of borrowers. Therefore, financing institutions should make arrangements for taking views and observations from customers either by way of regular communications through asking customers to write with their views to the financiers, or financiers may ask them to come and report their observations in respect of services the customers receive.

To avoid conflict between small firm borrowers and to hasten the process of lending decisions financing institutions should establish and follow a code of conduct. In

formulating the code of conduct financing institutions should consider certain basic ideas perhaps as follows:

--*Conflicts of Interest*: For example, 'loan officers should ensure that their personal interests do not conflict with the duties which they owe to the institution or the duties which the institution owes to its customers'.

--*Disclosure*: For example, the 'loan officer should support good internal governance by full and fair disclosure within the institution'.

--*Confidentiality*: For example, 'loan officers should keep certain information confidential'

--*Good Faith and Fair Dealing*: For example, 'loan officers should help the institutions act fairly and in good faith toward its customers while protecting the legitimate interests of the institution'

--*Nondiscrimination*: For example, 'loan officers should provide services to customers on the basis of rational business criteria rather than inappropriate factors like references from influential persons, race, sex or religion'.

--*Compliance with Law*: For example, 'loan officers should conduct themselves in full compliance with applicable laws and regulations'.

--*Institutional Standards and Practices*: For example, 'loan officers should uphold the standards, policies, and goals of the institution and protect its interests, challenging, within the institutions, any values or policies which are inconsistent with this code'.

(9). There should be a commitment to the timely sanction and disbursement of adequate working capital to small firms.

(10). Arrangement should be made to improve judgemental powers in lending decisions of loan officials of financing institutions by training programmes.

(11). Personal influence on lending decisions must be reduced, and steps should be taken to eliminate this eventually.

Matters Related to Loan Evaluation:

(1). An effective framework and procedures for appraisal of loan proposals for small firm financing should be established. These should have uniformity and consistency

in line with policies regarding adoption of small firm financing strategy as a development objective.

(2). Loan Appraisal should be more dynamic, realistic and effective. For example, realistic and appropriate methods should be used in valuation of 'security' items, estimating working capital requirements and hence calculating the total requirements of loans for a borrower.

(3). What sources of information are used and the sources of this information have to be clear and unambiguous, so that situations where sources of information are stated as being required by lender according to their standard procedures but in actual fact are not used for any decisions can be avoided and time and expense can be saved.

(4). Confidential reports on entrepreneurs should be gathered from other banks and credit rating agencies where entrepreneurs should be encouraged to keep accurate and reliable accounts.

(5). Over-invoicing by small firm promoters has to be contained and eliminated by ensuring effective valuation of machinery and equipment required by them.

(6). Assets and properties rendered by borrowers as security have to be valued realistically.

(7). Financiers need to be more practically oriented in lending decisions, by considering possible problems that might have to be faced by a borrower for small firm financing.

(8). Reliance on inappropriate qualitative factors e.g., reference or personal contact, in the loan evaluation process should be reduced when the feasibility of the proposed project is not judged good enough to accept it for lending without these qualitative considerations.

Monitoring.

(1). The views expressed by small firm owners that standard procedures should be adopted by the lenders in ensuring proper monitoring and counselling for their clients, without which effective running and growth of small firms is not likely to materialise.

(2). Monitoring and counselling services may require some reforms. For example, easier access to loan officers by their small business clients and their attention in listening to problems that might arise in firms. Monitoring systems should be devised in order to accommodate such prerequisites.

(3). Monitoring, advice and counselling, (as already mentioned in 'organisational and policy matters' above) should not be separated from other considerations in financing small firms. Instead these are functions that ought to be incorporated in the broad based functions of financing institutions. These responsibilities should be borne by lending institutions not only on grounds that they lend to small firms but also on the assumption that lenders are 'participants' in firms. The term 'participant' does not merely mean loan provider/supplier but rather 'participation' requires functions that might assist a firm in its effective running.

(4). Advice on financial matters e.g., requirement for working capital and marketing of products should be provided by financing institutions from especially set up units in relation to small firms. Our discussions in the literature review on lending models observed that advice from the financier is an essential element for improving the condition of small firms. In the empirical chapters, (9, 10, and 11) discussion was made of findings regarding the absence of effective monitoring and advice services for small firms, which the owners of small firms felt very important for their firms' growth and financing institutions also agreed on this. Provision for advice and counselling should be made an obligatory function for financial institutions lending to small firms.

Contracting.

As already mentioned loan contracting should also be a part of the lending model like evaluation and monitoring. Therefore, it should be the focus both borrowers and lenders. In the analysis chapters we discussed about contracting pattern and its covenants. The loan agreement, used by borrowers and lenders, contained clauses which basically emphasise on lender's funds security i.e., interest cover, asset cover and total borrowing, but the views of lenders regarding loan contract should not be such short-sighted. The contracting practices should be directed to achieve longer term benefits i.e., effective growth of small firms for both the lenders and borrowers. However, in preparing and practising loan contract both the parties should consider the costs and benefits of it. Since it include, for example, costs of brokerage and legal advice incurred by the lender, and cost of providing financial reports (Day and Taylor, 1997).

Financing institutions should develop and execute loan contracting systems encompassing loan utilisation and subsequent follow up functions. Clearly a suitable contract between a borrower in a small firm and a financing institution in Bangladesh should contain such clauses, based on agreement, which can give effect to practical implementation of loan monitoring, counselling and advice, and which are consistent with the capabilities of both lender and borrower.

12. 5. (iii). Recommendations Relating to Small Firm Owners.

Matters relating to Internal establishment

(1). Under this area are such matters be considered by borrowers before approaching a financing institution for a loan which may play a crucial role in the ultimate loan approval process. The following checklist may be a guide to prospective borrowers as to what to consider:

- What is the business strategy? Can the strategy delineate its key components?
- What is the market and where is that market? Who are the customers?

- Who are the prospective firm's competitors? Where are they? How do they compete? What are their positions e.g., strengths or weaknesses?
- What are the prospective firm's comparative advantages or disadvantages?
- What forces are driving the market or industry?
- What is the overall track record and experience?
- What is the collateral position?
- What is the level of self confidence and drive?
- What is the level of managerial skills.
- What is the level of willingness and readiness to learn from others and respond to market place?

(2). As an essential requirement for effective and efficient management of small firm, entrepreneurs should have characteristics as mentioned below, for which they should certainly get assistance from financiers and government agencies such as BSCIC:

- Initiative.
- Ability to see and act on any available opportunities.
- Persistence.
- Intuition in seeking information relevant to business plans and loan appraisal.
- Develop an attitude of concern for high quality of work.
- Develop an attitude of commitment to work, and contracts and agreements.
- Develop ideas in making systematic planning.
- Grow self confidence.
- Strive for developing expertise.
- Develop an attitude of recognising one's own limitations.
- Develop a quality of persuasion and assertiveness.
- Self motivation in accepting a situation under which an owner will be monitored for loan utilization and develop procedures to ensure monitoring works internally.
- Develop concern for the image of products and services, and also for the concept of relationship banking where owners have an important role to play.

(3). Entrepreneurs should motivate themselves in preparing for challenges during the course of building and running a business. This may be attained by arranging and participating in training on different important aspects of business i.e., general

management, financial management and accounting and marketing. An owner/manager of a small firm should have these skills in a form commensurate with its size.

External Establishment.

(1). As soon as a loan application is placed for sanctioning the practical work on it get begins. In that situation cooperation and mutual understanding between lender and borrower become inevitable for facilitating the lending. A borrower's attitude and motivation have implications for loan evaluation, contracting and monitoring. These may be made more effective by observing the followings:

- Submit a business plan with all necessary reports and data.
- Supply documents required by the lender .
- Reduce time lags in submission of papers or documents required for scrutiny of loan applications.
- Provide realistic and actual facts and figures in respect of a loan.

(2). Effort and commitment has to be made to create an enterprise culture in the small firm sector, rather than assuming a firm is an extension of the family.

(3). Entrepreneurs should try to develop and maintain professional ethics based on important factors like integrity, commitment, flexibility and attitude towards accepting the reasonable views of lenders. When these qualities are demonstrated the pattern of lending and its quality will likely be improved by reducing practices like diversion of funds, over invoicing, reducing investment through equity participation, manipulating financial information and accounts, tendency not to repay a financier's loan despite earning sufficient profits, short termism and dishonesty.

(4). Entrepreneurs should be open as far as financial aspects are concerned, and develop a culture of adherence to standard accounting practices by creating an appropriate atmosphere in their firm through employing experienced or professional persons in the accountancy function and establishing suitable organisational

frameworks. It may then be likely that the practices of preparing accounting reports to serve the purposes of different agencies by manipulating facts and figures will reduce and sound accounting practices will evolve eventually.

(5). It was discussed in the analysis chapters that small firm owners sought monitoring and advice from their financiers and felt that this was very important in the effective running of firms. However, this cannot work without small firm owners support and coordination by means of providing relevant data, reports or even the physical presence of themselves or of financiers at the firm's site. Therefore they should act on this themselves as and when required for the benefits of both entrepreneurs and lenders.

(6). Owners should pay attention to the issue of a 'manoeuvred' default culture (which means despite their ability to repay a loan they may not intend to do so, as argued by the financial institutions) and avoid or abandon such practices. This should improve lenders ability to recycle funds for further use and increase the scope of financing of small firm.

12. 6. Areas for Further Research.

There is scope for further research based on the data collected and reported in this thesis. The questionnaire and interviews were the first systematic attempts at research on this topic in Bangladesh. They represent a potentially rich source of further analysis. In addition, issues addressed by this research, e.g., relationship banking is a relatively new concept for a developing country such as Bangladesh, despite being recognised by researchers in commercial lending for small firms as especially crucial for developing and practising an effective financing culture in financial markets. In this research we have already reviewed and discussed issues concerning the important aspect of borrower and lender relationships but more needs to be done to investigate its usefulness in developing countries.

In addition further research on monitoring patterns and their development, and improvements of loan contracting systems may also be pursued in a more detailed and

systematic manner because these two areas are in need of further development to give them a realistic and practical form lending.

The style and presentation of the questions used in the questionnaire and interview schedules, may be altered or replaced by other methodologies by later researchers who may have been assisted by this research in identifying research issues to be addressed.

It is hoped that this research can make two contributions: firstly to furthering understanding on practices in loan markets and secondly to furthering the economic development of Bangladesh.

Appendix A

Table no. 8. 3. 1. (1).

List of interviewees other than Small Firm Owners

Some necessary abbreviations:

DFI: Development Financial Institution

CB: Commercial Bank

SB: Specialised Bank (other than DFI and CB; i.e, BASIC, MIDAS)

Policy: Organisations not for lending finance, but for policy making.

Business Community: Representative institution of businessmen.

BSB: Bangladesh Shilpa Bank

BSRS: Bangladesh Shilpa Rin Sangstha

EBL: Eastern Bank Ltd.

IFIC: International Finance Investment and Commerce Bank Ltd.

AB: Arab Bangladesh Bank Ltd.

IBBL: Islami Bank Bangladesh Ltd.

UCBL: United Commercial Bank Ltd.

BASIC: Bank for Small Industries and Commerce.

BSCIC: Bangladesh Small and Cottage Industries Corporation.

FBCCI: Federation of Bangladesh Chamber of Commerce and Industries.

BOI: Board of Investment.

ICD: Industrial Credit Division

RCD: Rural Credit Division.

MIDAS: Micro Industries Development Assistance Society.

BPC: Bangladesh Planning Commission.

MD: Managing Director

DMD: Deputy MD

GM: General Manager

DGM: Deputy GM

AGM: Assistant GM

SVP: Senior Vice President

Sr. AVP: Senior Assistant Vice President

AVP: Assistant Vice President.

d: contacted directly (PPC) by the researcher.

e: contacted via third party.

Table no. 8. 3. 1 (1).

Organisation's Name	Title interviewee	of Number interviewed	Type of organisation	Source of contact
BSB	DGM	1	DFI	d
BSRS	GM	1	DFI	d
EBL	MD	1	CB	e
IBBL	SVP	1	CB	e
AB Bank	AVP	1	CB	d
IFIC Bank	Sr. AVP	1	CB	d
UCBL	SVP	1	CB	e
National Bank	DMD	1	CB	d
Uttara Bank	SVP	1	CB	e
Al Baraka Bank	SVP	1	CB	d
Pubali Bank	AVP	1	CB	e
Rupali Bank	AGM	1	CB	d
Sonali Bank	DGM	1	CB	d
Agrani Bank-ICD	DGM	1	CB	d
Agrani Bank-RCD	AGM	1	CB	d
BKB	DGM	1	DFI	d
Janata Bank-ICD	DGM	1	CB	d
Janata Bank-RCD	DGM	1	CB	e
Bangladesh Bank	GM	1	Policy	e
MIDAS	DMD	1	SB	e
BASIC	Secretary	1	SB	e
BPC	Division Chief	1	Policy	d
Banking Division	Joint Secretary	1	Policy	d
BPC	Deputy Chief	1	Policy	d
BOI	Director	1	Policy	d
BSCIC	GM	1	Policy	e
FBCCI	Executive	1	Business	d
	Member		Community	

Table No. 8. 3. 2. (1)

List of Small Firm Owners interviewed

The table below shows some statistics of survey-participating small firms':

Necessary abbreviations:

SIS: Sources of identifying sample.

A: Contact provided by financial institutions.

B: Recommendation from owners of small firms.

C: Direct contact by speculative visit.

D: Instant financier's floor contact.

EO: Economic orientation.

x: export oriented.

y: import substituting.

z: local market oriented.

NOE: Number of employees.

AAT: Approximate annual turnover.

RWF: Relation with the financier.

1= very good

2=good

3=satisfactory

4= unsatisfactory

YOB: Years in business.

SOLC: Source of loan capital.

CB=commercial bank

DFI=development financial institution

SB=specialised bank (i.e., BASIC, IPDC, MIDAS etc)

TOF: Type of firm.

1=Public company

2= Private limited company

3= Partnership

4=Sole proprietorship

BDTk: Bangladesh Taka.

Sector: M= Manufacturing; S=Service

Table: 8. 3. 2. (1)

No. of Firm.	SIS	Sector	EO	NOE	AAT in BDTk.	RWF	YOB	SOLC	TOF
1	A	M	z	105	4 cr.	1	5	CB	2
2	A	S	z	120	4 cr.	1	7	DFI	2
3	D	M	x	400	2 cr.	2	22	DFI	1
4	A	M	x	40	70 lacs	1	2	DFI	2
5	A	M	x	700	24 cr.	1	7	SB	2
6	A	M	x	375	12 cr.	1	4	SB	2
7	B	S	z	20	4 lacs.	3	3	CB	2
8	C	M	x	180	16 cr.	1	19	CB	2
9	A	S	z	25	45 lacs	3	9	DFI	2
10	A	M	x	300	3 cr.	3	3	DFI	2
11	B	M	x	407	9 cr.	2	3	SB	2
12	A	M	y	19	32 lacs	3	2	CB	2
13	A	M	z	40	5 cr.	4	11	CB	2
14	B	M	z	25	85 lacs	2	10	CB	2
15	B	M	z	105	6 cr.	1	9	CB	2
16	C	M	z	40	20 lacs	3	5	SB	2
17	C	M	z	59	6 cr.	1	8	CB	2
18	A	M	x	300	3 cr.	1	4	SB	2
19	A	M	z	20	7 lacs	3	6	SB	2
20	C	M	x	150	24 cr.	3	17	CB	2
21	B	M	x	300	5 cr.	2	4	DFI	2
22	B	M	x	150	1.5 cr.	2	3	DFI	2
23	A	M	z	135	5 lacs.	3	6	CB	2
24	A	M	z	17	1.2 cr.	3	12	CB	4
25	A	M	z	33	60 lacs	3	3	DFI	2
26	A	M	z	130	6 cr.	3	10	CB	2
27	A	M	y	100	7 cr.	3	15	DFI	1
28	A	M	z	60	3 cr	1	29	CB	2
29	A	M	x	300	50 lacs	3	2	CB	2
30	A	S	z	40	6 lacs	3	2	CB	4
31	A	M	x	450	12 cr.	3	16	CB	2
32	A	M	x	250	6 cr.	3	2	CB	2
33	A	M	x	25	8 lacs	4	2	DFI	2

No. of Firm.	SIS	Sector	EO	NOE	AAT in BDTk.	RWF	YOB	SOLC	TOF
34	A	M	y	50	1.8 cr.	3	5	CB	1
35	A	M	z	134	6.5 cr.	3	7	DFI	2
36	A	M	x	350	5 cr.	3	4	CB	2
37	D	S	z	33	60 lacs	2	12	DFI	4
38	A	M	x	225	2.3 cr.	4	4	CB	2
39	A	M	y	145	10 cr.	2	3	CB	2
40	A	M	x	50	60 lacs	2	5	CB	3
41	A	M	z	100	1.5 cr.	3	8	CB	2
42	A	S	z	40	20 lacs	4	6	CB	3
43	A	M	y	48	80 lacs	4	7	CB	4
44	A	M	x	80	2.5 cr.	3	8	CB	2
45	A	M	x	70	1.5 cr.	2	6	CB	2
46	B	S	z	85	80 lacs	3	10	CB	3
47	A	S	z	25	20 lacs	3	5	CB	3
48	A	M	z	68	70 lacs	2	9	CB	3
49	A	M	z	83	2 cr.	3	7	CB	2
50	A	M	y	56	1 cr.	3	5	CB	2
51	A	M	x	120	2.5 cr.	2	6	CB	2
52	A	M	z	58	30 lacs	3	5	CB	3
53	C	S	z	28	18 lacs	3	6	CB	4
54	A	M	z	88	50 lacs	3	5	CB	3
55	A	M	x	76	1.5 cr.	2	7	CB	2
56	A	M	z	38	40 lacs	3	5	CB	3
57	A	M	y	55	80 lacs	3	8	CB	3
58	A	S	z	23	35 lacs	4	4	CB	4
59	B	M	x	80	1.5 cr.	2	7	CB	3
60	A	M	x	90	2 cr.	3	8	CB	2
61	A	M	x	160	7 cr.	3	10	CB	2
62	A	S	z	28	10 lacs	3	6	CB	3
63	A	M	y	75	45 lacs	2	9	CB	2
64	A	M	z	35	15 lacs	3	5	CB	3
65	A	M	x	80	2 cr.	2	8	CB	2
66	A	M	x	100	4 cr.	3	11	CB	2
67	B	M	x	180	6 cr.	2	10	DFI	2

No. of Firm.	SIS	Sector	EO	NOE	AAT in BDTk.	RWF	YOB	SOLC	TOF
68	A	M	x	130	5 cr.	3	8	CB	2
69	A	M	x	155	6 cr.	2	9	CB	3
70	A	M	z	105	1.5 cr	4	10	DFI	2
71	A	M	x	140	4.5 cr.	3	7	CB	2
72	A	S	y	60	1 cr.	2	6	CB	3
73	B	M	z	86	90 lacs	1	5	CB	3
74	A	M	x	125	4 cr.	3	9	CB	2
75	A	M	y	145	2.5 cr.	2	5	CB	2
76	C	M	z	80	75 lacs	1	4	CB	3

Appendix B.

Table 9. 2. (1)

Some data on surveyed Financing Bodies (Amounts are in million Taka)

Name of the FI ¹	Authorised and (Subscribed) capital ²	Total Loan Disbursed ³	No. of branches ⁴	of Estb. Date	Type of FI	Ownership ⁵
Sonali Bank	10,000(3, 272)	74, 939	1308 (1301+7)	1972	CB	Public
Rupali Bank	7,000(1, 250)	17, 250	518 (517+1)	1972	CB	Public
Agrani Bank ⁶	8,000(2, 484)	48, 500	902	1972	CB	Public
Janata Bank ⁷	8,000(2, 594)	48, 000	896 (892+4)	1972	CB	Public
Pubali Bank	160(160)	13, 195	353	1972(1984) ⁸	CB	Private
Uttara Bank	200(100)	8, 715	198	1972(1983) ⁹	CB	Private
UCBL	1, 000(177)	5, 900	77	1983	CB	Private
NBL	500(264)	9, 000	61(60+1)	1983	CB	Private
EBL	1, 000(600)	2, 202	11	1992	CB	Private
IBBL	500(160)	10, 597	83	1983	CB	Private
AB Bank	800(257)	7, 800	53	1982	CB	Private
Al-Baraka Bank	600(260)	5, 814	31	1987	CB	Private
MIDAS ¹⁰	200	50	3	1982	SFI	Private
IFIC Bank	500(221)	10, 797	52(50+2)	1983	CB	Private
BSB	2, 000(1, 020)	9, 315	14	1972	DFI	Public
BSRS	2, 000(700)	8, 887	4	1972	DFI	Public
BASIC	100(80)	1, 400	18	1989	SB	Public
BKB	2, 000(1, 000)	28, 961	834	(1992) ¹¹ 1973	DFI	Public
City Bank	400(160)	5, 500	75	1983	CB	Private

Source: Resume of the Activities of Financial Institutions in Bangladesh (1988, 1995, 1996)

¹ FI: Financing Institutions.

² Figures in million taka. 1 Great Britain Pound = 68 Taka; 1 US Dollar =42 Taka (at current rates in Dec. 1996)

³ Figures in million taka.

⁴ Numbers show in the bracket are branches in Bangladesh and abroad respectively.

⁵ Ownership is being considered on base year 1995.

⁶ In the survey two separate credit divisions i.e., Industrial and Rural were treated as two financing bodies as their lending policy differs depending on the sectors e.g., agricultural and industrial types of small firms.

⁷ In the survey two separate credit divisions i.e., Industrial and Rural were treated as two financing bodies as their lending policy differs depending on the sectors e.g., agricultural and industrial types of small firms.

⁸ Established in 1972 as a state owned bank, it was denationalised in 1984.

⁹ Established in 1972 as a state owned bank, it was denationalised in 1983.

¹⁰ Privately owned specialised financing institution.

¹¹ Established as a private specialised bank later it was taken by the government in 1992.

Table 9. 2. (2)

Applications received annually for financing small firms. (Questionnaire filled in by loan officials).

Value Label	Frequency
Less than 50	4
50-99	4
100-149	3
150-199	1
200-249	4
other numbers	5

Table 9. 2. (3).

Applications received annually for financing small firms. (Data from interviews with senior officials of financing institutions)

Value label	Frequency
Less than 50	2
50-99	4
100-149	2
150-199	4
200-249	3
Other	6

Appendix 1. (Questionnaire Completed by Loan Officials)

1. How does your Bank define Small Firms ? Please state in brief in the space below.

2. Does the above definition apply for:(Please tick as appropriate).

	Yes	No
i. both manufacturing and non-manufacturing firms.		
ii. only manufacturing firms.		
iii. only non-manufacturing firms.		

3. Does the definition of small manufacturing firms (i.e. small scale industry) in your bank differ from government one as described in the New Industrial Policy?

Yes	
No	

If 'Yes', please state the differences:

4. How many applications do you receive in every year for financing small firms.
(Please tick the appropriate box)

Less than 50	
50 --- 99	
150 --- 199	
100 --- 149	
200 --- 249	

Other(none of the above): Please state in number: _____

5. What percentage of small firms are financed annually by your bank out of the total applications received?(Please tick the appropriate box).

Less than 20%	
21%---40%	
41%---60%	
61%---80%	
80% & above	

6. Does the bank have a lending policy which favours lending to any particular type of Small Firms ?
(Please tick as appropriate).

i. Existing firms in :

	Yes	No
Manufacturing sector		
Non-manufacturing sector		

ii. New firms in:

	Yes	No
Manufacturing sector		
Non-manufacturing sector		

iii. Both Existing and New firms in:

	Yes	No
Manufacturing sector		
Non-manufacturing sector		

iv. Existing firms in manufacturing sector and New firms in non- manufacturing sector.

Yes	
No	

v. Existing firms in non-manufacturing sector and New firms in manufacturing sector.

Yes	
No	

vi. Other (Please specify):

7(a). Do your bank have its own standard procedures which you are required to follow for appraising loan application by Small Firms ?

Yes	
No	

(b). If 'No', have your bank derived a standard procedure from other sources (viz., Central Bank, Ministry of Finance, Ministry of Industry, OECD etc) ? Please specify.

8(a). If your bank have the standard procedure does it include the appraisal of--

Quantitative and Qualitative information:

Yes	
No	

Quantitative only:

Yes	
No	

Qualitative only:

Yes	
No	

(b). If you consider both Quantitative and Qualitative information what could be the relative importance of this two types of information in percentage terms (e.g., Quantitative- 60% and Qualitative 40% etc.)? Please indicate:

Qualitative:

Quantitative:

(c) Do these weighting vary between different types of lending (i.e., existing firms or new firms) ?

Yes	
No	

If 'Yes', please indicate in the space below what loan characteristics cause this weighting to vary.

9. What are the sources of quantitative information?

a) suppliers of information for credit evaluation/ independent credit rating organisation.

Yes	
No	

b) for existing firms-

Balance Sheet:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years (please enter number of years) : _____

Profit and Loss Account:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

Cash flow Statement:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

Sources and Uses of Funds:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many year(please enter number of years): ____

c) For a new firm-

Projected Balance Sheet:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

Projected Profit & Loss Account:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

Projected cash flow statement:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

Sources & Uses of Funds:

Always	
Frequently	
Sometimes	
Rarely	
Never	

For how many years(please enter number of years): ____

10(a). How would you rank the following informational items(among themselves) in respect of a firm to be financed?

(Please rank by putting the numbers from 1 to 7)

-- Security of the Bank's loan	
-- Financial stability	
-- Profitability	
-- Liquidity	
-- Consistency of trends	
-- generation of employment	
-- Export earnings (if the firm is an export-oriented foreign exchange earnings' firm)	

(b). If ensuring security for the bank's loan is an important objective, how is this achieved ?

i. through the assets of the business:

always	
frequently	
sometimes	
rarely	
never	

ii. through the personal assets of the owner of the business:

always	
frequently	
sometimes	
rarely	
never	

iii. through the profits and cash flow of the business:

always	
frequently	
sometimes	
rarely	
never	

11(a). What are the qualitative factors you would consider important for financing small firms?

i. Compliance with the government policy for financing small firms.

Yes	
No	

ii. The entrepreneur already owns some business or firms or/ reputation of the applicant as an existing businessman.

Yes	
No	

iii. The entrepreneur is ready to put his/her properties as security, even though appraisal does not show potentiality in financing the firm.

Yes	
No	

iv. Quality of the Management.

Yes	
No	

v. Nature of Business Opportunity.

Yes	
No	

vi. Personal knowledge of the owners.

Yes	
No	

vii. Business experience of the owner.

Yes	
No	

11(b). What is/are the information you consider of most important in evaluating credit proposals?

Financial and Economic information	Non-financial
Profitability []	Repaying ability []
Security []	Managerial ability []
Gearing []	Reputation of the borrower []
Return on capital []	Personal contact []
Creation of employment []	Business track record []
Foreign exchange earnings []	Borrower is an existing customer of the bank []
Other(please specify)	Other(please specify)

12. Do you ask for a business plan from the borrowers as a precondition for assessing loan application?

Yes	
No	

If 'Yes', is it required :

always	
frequently	
sometimes	
rarely	

13(a). Do you provide equity finance in addition to loan capital to fill-in the equity gap of the small firms ?

Yes	
No	

If 'Yes', is it provided :

always	
frequently	
sometimes	
rarely	

13(b). Do you provide working capital to the small firms ?

Yes	
No	

If 'Yes', is it provided :

always	
frequently	
sometimes	
rarely	

14. When the bank grants loan to Small Firms does it base the lending on any legal contract with the borrower?

Yes	
No	

If 'Yes':

a). is a legal contract used:

always	
frequently	
sometimes	
rarely	

b).i. Do you have standard forms of contract that cover every loan ?

Yes	
No	

ii. Do you prepare a unique contract for each loan ?

Yes	
No	

iii. Do you modify standard contracts for the special circumstances for each loan e.g., loan for small firms/medium firms etc.?

Yes	
No	

14(c). Does the lending contract contain:

(i). A statement of the details of the loan(for example)-

Interest rate:-

Yes	
No	

Repayment terms/ schedule:-

Yes	
No	

(ii). A statement of conditions which the borrower must meet(for example)-

Minimum or maximum values for financial variables:

(Please tick as appropriate).

	Yes	No
-Debt to Equity ratio		
-Total borrowing		
-Assets values		
-Net asset values		
-Interest cover		

-Other(please specify): _____

(iii). A statement of events of default:

	Yes	No
-Not paying the principal and interest		
-Not meeting the terms and conditions of loan		
-Default on another loan/ cross default		

15(a). Does the lending contract include any clause relating to ensure monitoring of loan operation by the borrowers?

Yes	
No	

(b). If 'Yes', in which form does this monitoring apply to the firms?

1 (i).. visit to the site of the firm:

Yes	
No	

If 'Yes', is it :

Occasional:

Yes: () [Please specify, as for instance- 'before disbursing final instalment of loan' etc.]

No : ()

Periodic:

Yes : () [Please state the periodicity, for example- 'quarterly'/ 'monthly' etc.]

No : ()

1(ii). Does this visit include:

Checking/ inspecting/ verifying of any documents, reports etc?

Yes	
No	

If 'Yes', what are the types of documents/ reports you verify(for example P/L Accounts etc.)? Please state.

2. No visit to the site but requires submission of certain documents.

Yes	
No	

If 'Yes', what are types of documents you ask for? Please state.

16(a). Do you consider counselling and advice by the bank can play an effective role in the development of small firms?

Yes	
No	

16(b). If yes, does the lending contract include any clause which requires the borrower to be counselled and advised by the bank.

Yes	
No	

If yes, in what form does this counselling come?

(i). Financial matters:

Always	
Frequently	
Sometimes	
Rarely	
Never	

(ii). Technical:

Always	
Frequently	
Sometimes	
Rarely	
Never	

(iii). Marketing:

Always	
Frequently	
Sometimes	
Rarely	
Never	

(iv). None of the above: []

(v). Others, (please specify):

17. What percentage of small firms financed by your bank are successfully running their business?

Less than 10%	
11%-20%	
21%-30%	
31%-40%	
41%-50%	
51%-60%	
61%-70%	
71%-80%	
81% and above	

18. What factors, if any, contribute to the failure of Small Firms?

(i). Government policy?

Please specify:

and

(ii). Lending policy of the banker/financier?

Please specify:

and

(iii). Lack of owners'/managers' managerial expertise.
Please State in brief:

(iv).Lack of accounting skills:
Please state in brief:

(v). Poorly prepared loan applications/business plans.
Please state in brief:

and
(vi).Other(Please specify).

Appendix 2: (Interview Schedule used for Senior Officials of Financial Institutions)

1. The position of the Interviewee:

2. Does your bank have got an identifiable banking and lending culture?

(N.B: Marketing/Product and Standard Procedures)

Yes	
No	

If 'Yes', in what ways is it different? Would you please state in brief:

If 'No', how do you differentiate your service from the competition?

3. How would you (according to your bank) define a small firm-both in manufacturing and non-manufacturing sector?

4. Does the bank have formal lending procedures? If so, what are they?

5(a). Do you have any formal qualification in Accounting and/or Finance/training on Accounting and Finance?

(b) What is your level of knowledge of accounting and financial reporting?

Low:

Yes: (), Do you see this as a problem? Yes: (); No: ().

No: ()

High:

Yes: (), Do you think you make better lending decisions? Yes: (); No: ()

No: ()

6. How many loan applications do you receive in every year for financing small firms?

Is it?

Less than 50	
50-99	
100-149	
150-199	
200-249	
Other(none of the above)	

7. What percentage of small firms are financed annually by your bank out of the total applications received?

Less than 20%	
21%-40%	
41%-60%	
61%-80%	
80% and above	

8. Does your bank favour financing of any particular type of small firm? For example manufacturing, non-manufacturing, existing or new etc.

Yes	
No	

If 'Yes':

Is this a long-standing policy?

Yes	
No	

If 'Yes':

Why this policy?

9. How do you seek business- what is your bank's marketing strategy?

It comes to you: Yes: (), how do you screen out risky loan proposals?

No: ()

You seek it out: Yes: (), how do you do that?

No: ()

Both of the two above: Yes: (). No: ()

10. What are you looking for in the potential loan commitment?

Contractual Income: ()

Return of principal amount with adequate return for risk i.e. interest: ()

Other(Please specify):

11. What information do you require in a loan proposal from a potential borrower?

	<u>Existing firms</u>	<u>New firms</u>
--	-----------------------	------------------

Financial accounts(please state types):	[]	[]
---	-----	-----

Management accounts(please state types):	[]	[]
--	-----	-----

Forecasts(please state types):	[]	[]
--------------------------------	-----	-----

Other(please state):		
----------------------	--	--

12(a). Do you consider both qualitative and quantitative information in the standard procedure of loan appraisal? If so, what could be relative importance of these two types of information in percentage(e.g. quantitative 40%, qualitative 60% etc.) in a typical case?

(b). Do these percentages vary in particular circumstances?

13(a). What type of Qualitative information you require for credit appraisal?

(b). What are the sources of qualitative information?

14. How would you rank the importance of the following informational items (among themselves) in respect of a firm to be financed? (i.e., from 1 to 7).

-- Security of the Bank's loan	
-- Financial stability	
-- Profitability	
-- Liquidity	
-- Consistency of trends	
-- generation of employment	
-- Export earnings (if the firm is an export-oriented foreign exchange earnings' firm)	

15(a). Do you consider the management of a company as factor in granting a loan?

Yes	
No	

If 'Yes':

(b) What are you looking for in the management of a company to which you grant a loan?

--technical skills: please give a list

--financial skills: please give a list

--conceptual skills: please give a list

16. Do you use a standard facility letter and/or loan document as the legal contract for a loan?

Yes: (), if 'Yes', what are main characteristics of the documents or contract items? Please specify,

--What is/are source(s) of the standard letter/document?

No: (), if 'No', how do you draw up the facility letter/agreement?

17. Do you monitor the loan?

Yes	
No	

If 'Yes', in what ways:-

--check compliance with covenants or other terms of the loan:

Yes: (), how often:

No: ()

--analyse financial statements of the borrower:

Yes: (), how often:

No: ()

--progress report:

Yes: (), how it is done:

No: ()

--appoint director:

Yes: (), in what circumstances ? What are the advantages in it:
Are there disadvantages?

No: ()

--other means of monitoring, please state:

18. Do you expect regular submission of financial and other information from the borrower?

Yes: (), how often?

No: (), what other information do you seek instead?

19. What is your opinion on the standard of accounting information provided by companies which borrow from your bank?

--Favourable:

Yes	
No	

If 'Yes'--

how they helped the job of the lender?

what role do they play in monitoring the loan?

what improvements can be made?

--Unfavourable:

Yes	
No	

If 'Yes'--

what are the problems?

how is the lender's job affected?

what improvements can be made?

20(a). What percentage of small firms financed by your bank are successfully running their business?

Less than 10%	
11%-20%	
21%-30%	
31%-40%	
41%-50%	
51%-60%	
61%-70%	
71%-80%	
81% and above.	

(b). What factors, if any, contribute to the failure of Small Firms(e.g. government policy, lending policy of your bank, lack of management skills of the owners/managers etc.)? Please state.

21. Are there any other issues relating to lending to small firms which you would like to raise?

Appendix 3 (Interview Schedule used for Small Firm Owners)

1. What is the exact nature of your business?

2. Which of these most closely describes your firm?

Public company	
Partnership	
Private company	
Sole proprietorship	

3. a) What are the sources of your capital:

Equity	
Loan capital	
Both Equity and loan capital	

In percentage:

Equity :

Loan capital :

b) If it is loan capital: what is the source-

Commercial banks	
Development Financial Institutions(i.e. BSB, BSRS, BKB etc.)	
Others (Please specify)	

5. How many people do you employ in total in total? (Please include both Part time and full time employees)

Full Time:

Part Time:

6. What was your turnover during the last full financial year?

In Tk.:

Other(i.e. \$ or £):

7. How old is your firm? (Approximation is acceptable, i.e. approximately 5 years):

8. How was the start of your firm financed?

Equity	
Loan from financial institutions	
Loan from personal sources	

9. To whom, if any one, did you first go for advice & help in starting your firm?

10. Have you expanded your firm after the establishment of your firm:

Yes	
No	

11. How was the expansion financed?

Equity capital	
Additional loan capital from the existing Financier	
Loan from other financial institution	
Loan from personal sources other than Equity capital	

12. What do you regard as the main constraint on expansion? Please indicate in the space below.

13. Which of the following would you say are, in your case, major constraint on expansion?

Lack of internal generated funds	
Obtaining funds from other sources	
The market for the goods/services sold by your firm	
The market for loan capital	
Taxation	

14(a). What, if any, security is required? Please specify.

(b). What would you estimate the value of the security to be ?

15(a). Do you have a Bank Overdraft (O/D) facility?

Yes	
No	

(b). What is your limit?

Tk. :

(c). What, if anything, are you required to show your bank every year?

Full accounts	
Balance Sheet only	
Profit and Loss Account only	
Cash Flow Statement	
Sources & Application of Funds	
Nothing	
Other(please specify): _____	

16.In your opinion what factor(s) your financier/banker considered most important at the time of evaluation of loan application?

(i). quantitative factor i.e. accounting information viz., profitability .

Yes	
No	

or

(ii). qualitative factor viz., 'existing customer'/ 'reputation' etc.

Yes	
No	

or

(iii). both

Yes	
No	

or

(iv). others (please specify):

17(a). Have you ever been refused by any financing institution for funding your firm?

Yes	
No	

(b). What were the reasons given by the Financial Institution for refusing funding?

(c). Did you think these reasons were justified?

Yes	
No	

If 'no', why? Please specify:

18. To what extent do you rely on trade credit from suppliers?

rely very much	
rely somewhat	
do not rely	

19. To what extent do you rely on giving credit to customers for their custom?

rely very much	
rely somewhat	
do not rely	

20(a). How would you describe your relationship with your financier?

Very good	
Good	
Satisfactory	
Not satisfactory	

(b). If relation with your loan supplier/ financier is 'not satisfactory', what improvements would you suggest? Please specify.

21. What are your main sources of advice and information regarding financial and technical matters etc.?

Accountants and Auditors	
Your Financier/ Loan supplier	
Your Bank	
Consultant	
None	
Others(please specify): _____ _____	

22(a). Have you ever wanted advice and been unable to get it?

Yes	
No	

(b). What this advice about?

Financial matters	
Technical matters	
Others(please specify): _____ _____	

23. Is your accountant:

On the staff	
Outside the firm	
On the board	

24. Does your accountant produce necessary reports for your financier as and when required?

Yes	
No	

25(a). Does your supplier of loan capital require the submission of annual accounting reports?

Yes	
No	

If 'yes', does it require:

Balance Sheet	
Profit and Loss Account	
Sources and uses of funds	
Cash flow statement	
None of the above	
Others(Please specify): _____	

(b). Does your supplier of loan capital require the submission of accounting information at any other times(e.g. quarterly/monthly etc)?

Yes	
No	

If 'Yes', please specify: _____

26. Do you belong to :

	Yes	No
Federation of Bangladesh Chamber of Commerce and Industry		
Metropolitan Chamber of Commerce and Industry		
Dhaka/CTG./Khulna/----- Chamber of Commerce and Industry		
Bangladesh Chamber of Commerce and Industry		
Others(please specify): _____		

If 'Yes', do you find them:

useful	
useful at times	
useless	

27(a). What would you say are the advantages of being a relatively small firm?

(b). And the disadvantages?

28. Are there any additional points of interest that you would like to make regarding e.g.,

Finance:

Employment:

Anything else:

Appendix 4 (Interview Schedule used for Policy Makers)

1. What are the major macro-economic policies of the government of Bangladesh for economic development.

2. Is industrialisation programme has been undertaken as a major strategy for economic development?
(if answer to the Q.1 comes with certain policies including 'industrialisation').

Yes	
No	

3. Do you think that economic development could be ensured via small firm development in Bangladesh?

Yes	
No	

4. Would you please state the background behind the inclusion of small firms development as an approach for economic development?

5. What philosophy played dominantly in choosing small firms development as a developmental strategy for Bangladesh.

6. Do you think that small firms have been successful in attaining their objectives pertaining to the economic development?

Yes	
No	

If yes-

a) What are the features of such attainment in general terms viz. employment generation, contribution to GDP, etc.

b) Are there contributions, you think, up to the envisaged level.

If no,

a) Why not successful? In your opinion, what are the constraints in general in respect of effective development of small firms?

b) (If answer comes with the responsibility of financier in financing small firms, this question will not to be asked)

Do you think that suppliers of loan capital have got implications on the development of small firms?

Yes	
No	

If answer comes yes, then-

--What are the policies/ issues those causes failure to small firms?

--Do you think financial institutions / credit suppliers' lending policy/procedure, monitoring & lending contract are responsible for this failure?

(If the answer to the previous question covers these, then there is no need to ask this question)

Yes	
No	

If answer comes positive, then the respondent will be requested to explain further.

c) What could be other reasons behind the failure of small firms?

Do you held government policy itself defective in this regard?

Yes	
No	

Or
small firms owners

Yes	
No	

Or

Others (Please specify)

7. What are the broad programme for development of small firms in existence at present?

8(a). Is your role confined only with programmes or you contribute to the execution of policies regarding development of small firms?

9. As a part of government Machinery, you have role to attain economic development in Bangladesh. Do you have any role at macro-policy level in respect of development of small firms as an approach to economic development as the supply of finance for industrialisation is concerned.

10. Are you sure that prospective entrepreneurs know enough about the facilities that are available for financing small firms?

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