



Report and Recommendation of the President to the Board of Directors

Project Number: 36200-023
December 2015

Proposed Loan and Administration of Technical Assistance Grant People's Republic of Bangladesh: Second Small and Medium-Sized Enterprise Development Project

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 9 November 2015)

Currency unit	–	taka (Tk)
Tk1.00	=	\$0.0128
\$1.00	=	Tk78.250

ABBREVIATIONS

ADB	–	Asian Development Bank
BSCIC	–	Bangladesh Small and Cottage Industries Corporation
CIB	–	Credit Information Bureau
FIL	–	financial intermediary loan
INSPIRED	–	Integrated Support to Poverty and Inequality Reduction through Enterprise Development
JFPR	–	Japan Fund for Poverty Reduction
NPL	–	nonperforming loan
PFI	–	participating financial institution
SMEs	–	small and medium-sized enterprises
SMEF	–	SME Foundation
SMEDP1	–	Small and Medium-Sized Enterprise Development Project
SMEDP2	–	Second Small and Medium-Sized Enterprise Development Project
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government of Bangladesh ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2015 ends on 30 June 2015.
- (ii) In this report, "\$" refers to US dollars.

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 36200-023	
Project Name	Second Small and Medium-Sized Enterprise Development Project	Department /Division	SARD/SAPF
Country Borrower	Bangladesh Government of Bangladesh	Executing Agency	Bank and Financial Institutions Division-MOF
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Small and medium enterprise finance and leasing		200.00
		Total	200.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Partnerships (PAR)	Civil society organizations Implementation Private Sector	Effective gender mainstreaming (EGM)	✓
Private sector development (PSD)	Promotion of private sector investment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Rural	High
6. Risk Categorization:	Complex		
7. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI Indigenous Peoples: FI		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		200.00	
Sovereign Project loan: Ordinary capital resources		200.00	
Cofinancing		2.00	
Japan Fund for Poverty Reduction		2.00	
Counterpart		133.30	
Government		50.00	
Others		50.00	
Beneficiaries		33.30	
Total		335.30	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed loan to the People's Republic of Bangladesh for the Second Small and Medium-Sized Enterprise Development Project (SMEDP2), and (ii) the proposed administration of technical assistance (TA) to be provided by the Japan Fund for Poverty Reduction for SMEDP2.¹

2. SMEDP2 comprises a financial intermediary loan (FIL) of \$200 million to enable participating financial institutions (PFIs) to provide local-currency loans to small and medium-sized enterprises (SMEs) outside the metropolitan areas of Dhaka and Chittagong.² An amount of \$20 million under the FIL is earmarked for women SMEs.³

II. THE PROJECT

A. Rationale

3. Accelerating growth and reducing poverty, income inequality, and regional disparity are the overarching goals of the current development paradigm in Bangladesh. The development of SMEs is seen as a key element in this development strategy, as noted in the Government of Bangladesh's Sixth Five-Year Plan for fiscal year (FY) 2011–FY2015.⁴ To achieve double-digit economic growth as outlined by the government's Vision 2021 to attain middle-income status by 2021,⁵ promoting the SME sector is considered critical.

4. **Small and medium-sized enterprises—overview and constraints.** The SME sector in Bangladesh plays a vital role in the growth of the country. According to the most recent economic census of the country carried out by the Bangladesh Bureau of Statistics during March–May 2013, it is estimated that the SME sector comprises 7.2 million firms, which account for 90% of all private enterprises in the country, or even 99% of all firms when micro enterprises are included.⁶ SMEs employ about 70%–80% of the nonagricultural workforce and contributed 25% of Bangladesh's gross domestic product and 40% of the manufacturing output in 2014.⁷

5. Enhanced SME activities in the rural and backward regions constitute a key component of the government's strategy for rural development, and reduction of poverty and regional disparity, since most firms outside the metropolitan areas of Bangladesh are SMEs. However, the major development challenge in Bangladesh is a sharp metropolitan–nonmetropolitan divide in terms of employment and economic growth.⁸

¹ The design and monitoring framework is in Appendix 1.

² For the Bangladesh Industrial Policy 2010, see the Detailed Small and Medium-Sized Enterprise Sector Analysis accessible from the list of linked documents in Appendix 2.

³ Women SMEs are defined as being one of the following: (i) women are the owners or proprietors of a privately run organization, or own at least a 51% share in case of a joint-venture vehicle or a company listed with the Office of the Registrar of Joint Stock Companies and Firms; or (ii) at least 60% of the managerial staff are women.

⁴ Government of the People's Republic of Bangladesh, Planning Commission, Ministry of Planning. 2011. *Sixth Five-Year Plan FY2011–2015: Accelerating Growth and Reducing Poverty*. Dhaka. <http://www.plancomm.gov.bd/sixth-five-year-plan>

⁵ Government of Bangladesh, Ministry of Planning, Planning Commission. 2010. *Outline Perspective Plan of Bangladesh—Making Vision 2021 a Reality: FY2010–FY2021*. Dhaka.

⁶ Government of Bangladesh, Bureau of Statistics. 2013. *Economic Census*. Dhaka. <http://www.bbs.gov.bd/PageWebMenuContent.aspx?MenuKey=347>

⁷ Sector Assessment (Summary): Finance (Small and Medium-Sized Enterprise Finance and Leasing (accessible from the list of linked documents in Appendix 2).

⁸ As per the provisional figures of the economic census conducted by the Bangladesh Bureau of Statistics, 5.81 million enterprises were located in rural areas and 2.25 million enterprises in urban areas.

6. A survey carried out by the Bangladesh Integrated Support to Poverty and Inequality Reduction through Enterprise Development (INSPIRED) identified the following main constraints on SME growth: (i) inadequate access to finance, especially long-term funding; (ii) inadequate supplies of utilities (mainly electricity) and infrastructure (especially poor transportation); and (iii) increasing costs of labor and lack of skilled labor, particularly in manufacturing.⁹ These constraints are also reflected in the 2015 Doing Business Survey of the World Bank, which ranks Bangladesh 173rd out of 189 economies.¹⁰

7. The backward and forward links of SMEs to the formal sector, particularly the larger export-driven industries, are severely underdeveloped in Bangladesh. Backward links are essential to reduce the production cost of products to make them more competitive in both the domestic and foreign markets. Forward links are also missing: SMEs in Bangladesh, especially small ones, do not have enough capital resources and know-how to market their products to a wider market base. For industries to succeed in the current globalized economic environment, forming horizontal and vertical links is crucial. This can be done by forming alliances, clustering, and networking among SMEs to compete effectively domestically and internationally.

8. **Access to finance.** The banking sector in Bangladesh continues to be the largest provider of credit to the SME sector. Bank lending to SMEs amounted to Tk834 billion (about \$10.7 billion) or 97.8% of total SME loans in 2013. The remaining 2.2% came from nonbank financial institutions. The banking sector has been burdened by high levels of nonperforming loans, which were accumulated over many years primarily because of weak management of the state-owned banks. Although the ratio of nonperforming loans to total loans has declined from 13.2% in March 2008 to 9.7% at the end of December 2014, it is still high.¹¹ Although private sector credit among banks grew by 13.6% in the third quarter of FY2015, this was a decline from FY2010 and FY2011, when banks expanded their credit portfolio by 24.2% and 25.8%.

9. The actual delivery of institutional credit to SMEs has been grossly inadequate in Bangladesh. This is re-emphasized by the findings from the INSPIRED survey, which highlighted that 68.6% of small enterprises and 44.7% of medium-sized enterprises identified access to finance as a major constraint.¹² Based on analysis by the Asian Development Bank (ADB), the overall demand–supply gap for SME credit is estimated to exceed Tk529 billion (\$6.8 billion). This gap is even more pronounced for nonmetropolitan SMEs—SME lending is concentrated in urban areas, thereby limiting the potential of rural development.

10. Women in Bangladesh are not reaching their economic potential. Most engage in small, subsistence-based activities in trade and retail, but they are less educated and have significantly less access to SME finance than men.¹³ Women often lack the business skills, knowledge, and access to networks to increase their entrepreneurial capacity. The rates of women entrepreneurship are lower among rural nonfarm enterprises than metropolitan firms. Nonmetropolitan enterprises owned by women are smaller, younger, and more likely to be informal and home-based.

⁹ J. Vila and M. MacDonald. 2013. *Draft Working Paper 3: The State of the SME Sector—the Manufacturing SME Sector in Bangladesh (2013): An Overview*.

http://euinspired.org.bd/images/INSPIRED%20SME_Survey_Report_130930.pdf

¹⁰ World Bank Group. 2015. *Ease of Doing Business in Bangladesh*.

<http://www.doingbusiness.org/data/exploreeconomies/bangladesh>

¹¹ Bangladesh Bank. 2014. *Financial Stability Report 2014*.

https://www.bb.org.bd/pub/annual/fsr/final_stability_report2014.pdf

¹² Bangladesh INSPIRED. <http://euinspired.org.bd/index.php/en/>

¹³ According to recent statistics of Bangladesh Bank, women-led companies accounted for only 3.9% of all loans provided to SMEs in Bangladesh in 2014. This ratio has remained stable over the last 5 years.

11. **Enabling environment.** Lessons from previous FILs suggest that successful projects need to build on operationalizing three basic institutional pillars: (i) a credit information bureau, (ii) registration of movable and immovable property, and (iii) business development services.¹⁴

12. The government facilitated the automation of the Credit Information Bureau (CIB) at Bangladesh Bank to ensure the availability of a credit history for SMEs. Bangladesh Bank launched CIB online services in July 2011 to provide quick reports to banks and nonbank financial institutions. In addition, most credit rating agencies operating in Bangladesh assign credit ratings to some of the larger SMEs. These efforts broaden the coverage of SME borrowers and help banks shift from purely collateral-based lending to cash-flow-based lending. Efforts are also ongoing—supported by the World Bank—to expand the coverage of the CIB services to include the cottage industry and micro segment of the SME sector.¹⁵

13. While the registration of immovable property operates well in Bangladesh, a structured and modern secured transaction system is still absent because the legal and institutional frameworks for taking security in movable property are fragmented, incomplete, and opaque. As a result, lenders lack the confidence to extend credit secured only by movable property, which limits the availability of crucial secured financing alternatives for SMEs. The World Bank Group's International Finance Corporation is currently providing TA to support secured lending and to establish a movable collateral policy, which is expected to help the under-banked segment of Bangladesh's population to access bank financing.

14. The government provides business support and capacity development TA to SMEs, mainly through the Bangladesh Small and Cottage Industries Corporation (BSCIC), SME Foundation (SMEF), and Bangladesh Bank. Among the development partners in Bangladesh, one of the largest projects in the field of SME business development services is KATALYST (developing business service markets), funded by several bilateral development agencies.¹⁶

15. **ADB support for small and medium-sized enterprise development in Bangladesh.** Since the early 1970s, the Government of Bangladesh and ADB have engaged in extensive policy dialogue on SME sector development.¹⁷ Recent interventions include the SME Sector Development Program, which created a policy and regulatory framework conducive to SME growth.¹⁸ This was followed by the first SME Development Project (SMEDP1), which accelerated SME development in rural areas by boosting their access to medium- and long-term credit with an emphasis on women-led SMEs.¹⁹ Lessons from SMEDP1 were incorporated in

¹⁴ A special evaluation study prepared by ADB's Independent Evaluation Department in 2012 on ADB's Microfinance Development Strategy 2000 highlighted, in particular, the need for strengthening financial literacy among micro and small borrowers in ADB's developing member countries. This recommendation was incorporated into the design of SMEDP2 by using part of the attached technical assistance to establish incubation facilities at educational institutions and thereby promote entrepreneurship and access to finance.

¹⁵ The finance sector support project of the World Bank—approved in May 2015—will help broaden the CIB's scope to include credit information pertaining to the microfinance segment. World Bank. 2015. Financial Sector Support Project. <http://www.worldbank.org/projects/P150938?lang=en>

¹⁶ KATALYST. <http://katalyst.com.bd/>

¹⁷ Since 1973, ADB has approved 10 major projects, 17 TA projects, and one equity investment in the area of SME development. These interventions enabled ADB to gain an in-depth understanding of Bangladesh's SME sector and built the fundamentals that led to the proposed project.

¹⁸ ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant to the People's Republic of Bangladesh for the Small and Medium Enterprise Sector Development Program*. Manila.

¹⁹ ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the People's Republic of Bangladesh for the Small and Medium-Sized Enterprise Development Project*. Manila. The credit assistance loan of \$76 million under SMEDP1 was fully disbursed by December 2013—1 year before the end of the utilization period.

the design of SMEDP2.²⁰ The proposed intervention is designed primarily as a credit line to the SME sector.²¹ It is backed up by measures to strengthen access to credit and support the backward and forward links of SMEs to the formal sectors through a capacity development TA, all of which supports the government's development agenda. SMEDP2 is a continuation of the successful collaboration between ADB and the government under SMEDP1.²²

B. Impact and Outcome

16. The impact will be continued economic growth and poverty reduction through the development of the SME sector outside the metropolitan areas of Dhaka and Chittagong, aligned with the SME Strategy Paper for the government's forthcoming Seventh Five-Year Plan.²³ The outcome is increased in the number and size of commercially viable SMEs, as well as employment in the SME sector.

C. Outputs

17. **Output 1: Increased medium- and long-term credit, especially to SMEs, SME clusters, and BSCIC estates in rural areas.** SMEDP2 will comprise a credit line of \$200 million for boosting access to medium- and long-term financing through PFIs for eligible SMEs (and eligible SMEs organized as SME clusters and BSCIC estates) outside the metropolitan areas of Dhaka and Chittagong.²⁴ The credit line will enhance credit delivery, in particular to priority sectors, consistent with the national industrial strategy for promoting exports and high value-added industries. The strategy targets SMEs in the rural areas and will have two components:

- (i) **Component A**—comprising two-thirds of the credit line (\$133.3 million) and catering to the smaller firms of the sector, e.g., cottage industries and micro enterprises. Under this component, 15% (i.e., \$20 million) will be earmarked for lending to women-led SMEs.
- (ii) **Component B**—comprising the balance (\$66.7 million), the proceeds of which will be onlent by the PFIs to medium-sized enterprises.

18. **Output 2: Strengthened capacity of SME entrepreneurs to access bank financing.** This output under the capacity development TA will support the establishment of incubation facilities at educational institutions to promote entrepreneurship by (i) identifying areas (industry and/or sector) for support from incubation facilities, (ii) developing a country strategy with detailed action plans (and cost estimates) for incubation facilities, (iii) designing guidelines for the selection and graduation of entrepreneurs applying for business incubation services, and (iv) establishing a sex-disaggregated performance monitoring system for incubation facilities.

19. **Output 3: Strengthened managerial and technical capacity of small and medium-sized enterprise support institutions (Bangladesh Bank, SME Foundation, BSCIC) and**

²⁰ ADB. 2015. *Completion Report: Small and Medium-Sized Enterprise Development Project*. Bangladesh. SMEDP1 was evaluated as a successful operation by the project completion report.

²¹ The most recent SME operation by ADB was a nonsovereign loan of \$30 million to BRAC Bank Limited in July 2015 under the Sustainable Projects (Bangladesh) intervention. <http://www.adb.org/projects/49074-001/main>.

²² The project was not included in the country partnership strategy, 2011–2015 or country operations business plan, 2015–2017. At the government's request, ADB Management approved the concept paper of SMEDP2 on 29 July 2015.

²³ Government of Bangladesh, Planning Commission. 2015. *Seventh Five-Year Plan (FY2016–FY2020)*. Dhaka. <http://www.plancomm.gov.bd/7th-five-year-plan>

²⁴ BSCIC has developed 74 industrial estates throughout the country to foster the growth of small and cottage industries in a balanced manner.

participating financial institutions for small and medium-sized enterprise cluster financing. This output of the TA will help develop SME clusters and BSCIC estates by bolstering the backward and forward links of SMEs to the larger, more formal sectors such as the export industry. Capacity development of SME support institutions will facilitate cluster financing by building up SMEs ability to form alliances and clustering, so that small firms will grow and cooperate with larger firms, and by sensitizing PFI officials to promote loans to SME clusters and BSCIC estates.

20. **Output 4: Enhanced women-led small and medium-sized enterprises' access to bank finance and financial services.** This output of the TA will boost the capacity of women entrepreneurs' development units at Bangladesh Bank head office and nine branches, and dedicated women's desks at PFIs by (i) standardizing PFI procedures, (ii) facilitating dialogue and cross-fertilization of practices among PFIs, and (iii) monitoring of progress in women's access to and use of financial resources and services. The output will build the capacity of women entrepreneurs by supporting the development of an informal network of PFIs, women entrepreneurs' development units, and women's business associations with a focus on access to finance and good practices.

D. Investment and Financing Plans

21. The project is estimated to cost \$333.3 million (Table 1). The government has requested a loan of \$200 million from ADB's ordinary capital resources to help finance the project. The loan will have a 20-year term, including a grace period of 5 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions as are set forth in the draft loan and project agreement.²⁵ The government and the eligible PFIs are expected to contribute the taka equivalent of \$50 million each, while the participating SMEs are assumed to contribute 10% of individual subproject costs in the form of equity.²⁶

Table 1: Project Investment and Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank (ordinary capital resources)	200.0	60.0
Government (Bangladesh Bank)	50.0	15.0
Participating financial institutions	50.0	15.0
Small and medium-sized enterprises	33.3 ^a	10.0
Total	333.3	100.0

^a The small and medium-sized enterprise contribution of 10% is based on the assumption that SMEs will contribute 10% of the individual subproject cost in the form of equity.

Source: Asian Development Bank.

22. The Ministry of Finance, through its Bank and Financial Institutions Division, will relend to Bangladesh Bank the ADB loan in local currency under a subsidiary loan agreement on terms and conditions satisfactory to ADB. The government will bear the foreign exchange risks. Bangladesh Bank will onlend the ADB funds, along with its own share, to eligible PFIs for making subloans to eligible subborrowers to finance eligible subprojects under a standard form participation agreement acceptable to ADB.²⁷

²⁵ The interest will not include any maturity premium. This is based on the above loan terms and the government's choice of repayment options and dates.

²⁶ Eligibility Criteria for Participating Financial Institutions, Subprojects, and Subborrowers (accessible from the list of linked documents in Appendix 2).

²⁷ The Bangladesh Bank rate is currently about 5% and can be considered a proxy for cost of funds in Bangladesh.

23. Eligible PFIs will further lend the Bangladesh Bank funds under subloan agreements to eligible subborrowers at interest rates that reflect their cost of funds plus a spread to cover transaction costs and risks, reflecting full commercial and competitive terms at the PFIs' discretion.²⁸ The maximum size for subloans under component A of the credit line will be Tk10 million, and Tk30 million under component B. Each subproject will be financed with a subborrower equity contribution of 10%, a PFI debt contribution of 15%, a government debt contribution of 15%, and a contribution from ADB funds of 60%, to maximize leveraging of resources through this project.²⁹ Correspondingly, 16.7% of each subloan is financed by the PFI's funds, 16.7% of such subloan is financed by the Bangladesh Bank contribution, and 66.6% of such subloan is financed by ADB. While the minimum term of each subloan will be set at 2 years, a maximum of 30% of such a subloan may be used for working capital expenditures of the same subborrower and must be repaid at a minimum term of 1 year.³⁰ The minimum term of subloans to women entrepreneurs is 1 year.³¹ Subloans will only be provided to finance activities not listed in ADB's Prohibited Investment Activities List and will be subject to post-lending monitoring and review by ADB.

24. **Challenge fund.** Following a request from Bangladesh Bank, SMEDP2 will introduce, on a pilot basis, a challenge fund of up to \$20 million, to better align PFIs' comparative advantage as lenders and to catalyze funds from the finance sector into target areas.³² This will result in a wider range of financial products, new channels for the delivery of financial services, and opportunities for the most disadvantaged groups, with the ultimate goal of stimulating long-term inclusive, pro-poor economic growth. Potential focal areas that could be targeted under this concept are (i) disadvantaged geographical regions of Bangladesh with high incidences of poverty, (ii) SME segments that lack access to finance, or (iii) new financial products and services tailored to the needs of the target SME groups. A fund manager will oversee the implementation and operationalization of the challenge fund. It is expected that a maximum of five PFIs will be selected to participate. Funds not utilized by the winning PFIs within a period of 2 years will be transferred back to the main corpus under SMEDP2. The introduction of such a challenge fund would be complementary to the normal disbursement process under SMEDP2.

E. Implementation Arrangements

25. The Ministry of Finance, acting through its Bank and Financial Institutions Division, will be the executing agency, and Bangladesh Bank will be the implementing agency.³³ Bangladesh Bank's project management unit will be the SME and Special Programs Department established under SMEDP2.

26. The implementation arrangements are summarized in Table 2 and described in detail in the project administration manual.³⁴

²⁸ ADB requires such loans to have market-based rates. ADB. 2003. Financial Intermediation Loans. *Operations Manual*. OM Section D6/BP, para. 18. Manila (15 December).

²⁹ Each SME will be required to submit a business plan indicating that it will be able to contribute its 10% equity share.

³⁰ The maximum term of any subloan is 5 years.

³¹ As per Bangladesh Bank's policy, women entrepreneurs will receive ADB funds at interest rates of not more than 10%.

³² Challenge funds are not new. They made their entrance into the development landscape in the late 1990s, in early experiments of providing direct support to the private sector. At least 15 challenge funds have been established by various donors in the past 15 years.

³³ SMEF will be the IA for Output B of the capacity development TA.

³⁴ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

Table 2: Implementation Arrangements

Aspects	Arrangements
Implementation period	April 2016–April 2020
Estimated completion date	30 April 2020
Management	
(i) Oversight body	Steering Committee Secretary, Bank and Financial Institutions Division, Ministry of Finance (chair)
(ii) Executing agency	Ministry of Finance's Bank and Financial Institutions Division
(iii) Key implementing agencies	Bangladesh Bank (for the credit line); SME Foundation (for output B under the proposed capacity development technical assistance)
(iv) Implementation unit	Bangladesh Bank's SME and Special Programs Department
Disbursement	The loan and grant proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed upon between the government and ADB.

ADB = Asian Development Bank, SMEs = small and medium-sized enterprises.

Note: The introduction of a recycling mechanism with a period of 10 years starting from the end of the utilization period is proposed under the Second Small and Medium-Sized Enterprise Development Project. Once funds have been fully disbursed after 4 years, any reflows from SME subloans can be used again by the participating financial institutions for making fresh subloans to the SME sector for a total period of 10 years.

Sources: Asian Development Bank.

27. Bangladesh Bank has been deemed appropriate to administer the project because of its substantial experience in administering donor projects, its ready access to information in determining the financial soundness and capabilities of PFIs for providing credit to the SME sector, and its function as administrator of the CIB, which gathers information regarding borrowers.³⁵ Bangladesh Bank's SME and Special Programs Department, which has also managed ADB's SMEDP1, will monitor (i) the day-to-day implementation of the loans; (ii) exposure limits; (iii) administration of eligible disbursements against estimated PFI targets to SMEs at market interest rates consistent with ADB's FIL policy; and (iv) compliance with national policies and Bangladesh Bank's environmental and social safeguard framework, which ensures compliance with ADB safeguard policies and national norms.

III. TECHNICAL ASSISTANCE

28. A \$2 million capacity development TA, to be financed by the Japan Fund for Poverty Reduction on a grant basis and implemented over a period of 3 years, will complement the project outputs. The major outputs and activities of the TA include (i) facilitating the establishment of incubation centers to promote entrepreneurship; (ii) providing assistance in the development of SME clusters and BSCIC estates to boost their capacity to access bank financing and strengthen the backward and forward links of SMEs to the formal sector, particularly the larger export-driven industries; (iii) capacity building at Bangladesh Bank and the PFIs to ensure the effective functioning of the women entrepreneurs' development units at Bangladesh Bank branches and dedicated women's desks at PFIs, and to educate women

³⁵ A possible alternative candidate for project administration—or at least part of it—is SMEF, which was established by the Government of Bangladesh in November 2006 as part of ADB's SME Sector Development Program as an independent apex body for SME promotion under the Companies Act, 1994. ADB met with SMEF on several occasions to discuss its credit wholesaling program, which channels funds through PFIs to SMEs and SME clusters in Bangladesh. SMEF is being considered as a second implementing agency for the credit line of the project, for an SME cluster subcomponent of maximum \$20 million under SMEDP2—subject to SMEF's meeting ADB's due diligence requirement and demonstrating its ability to implement the ADB project. If SMEF fails to meet ADB's due diligence requirements or demonstrate its ability to implement the ADB project, then the funds provisionally allocated to SMEF will be utilized under the credit line administered by Bangladesh Bank.

entrepreneurs in selected districts on financial and legal literacy; and (iv) providing support to Bangladesh Bank to establish an administration unit for the implementation of the proposed challenge fund under the SMEDP2.³⁶ This output will also include the strengthening of Bangladesh Bank's information technology systems, so that it can carry out its monitoring and reporting functions under SMEDP2. Consultants will be engaged for the implementation activities under the capacity development TA subproject in accordance with ADB's Guidelines on the Use of Consultants (2013, as amended from time to time). The disbursements under the capacity development TA subproject will be made directly by ADB in accordance with its *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).³⁷ The Bank and Financial Institutions Division of the Ministry of Finance will be the executing agency. The TA will be implemented over a period of 3 years starting from March 2016.

IV. DUE DILIGENCE

A. Economic and Financial

29. Significant economic benefits are expected to arise from the project since all subprojects financed under SMEDP2 will have to be economically viable. The project will help (i) improve the efficiency of the medium- and long-term credit market; (ii) step up the capacity and capability of PFIs to provide profitable loans to viable SMEs in the country's rural areas, including some women-led companies; and (iii) help strengthen the backward and forward links of SMEs to the larger, more formal sectors such as the export industry. The project is expected to have positive impacts on growth, development, and employment creation, thus benefiting the private sector of Bangladesh. Due diligence confirmed the demand for local-currency-denominated, medium- and long-term subloans to the targeted SMEs. PFI eligibility criteria were defined, and potential PFIs identified.³⁸ Financial and integrity due diligence was completed for the top four PFIs, and brief financial due diligence was carried out for the next 15 PFIs involved in SMEDP1.³⁹

B. Governance

30. ADB's requirements and policies on financial management and procurement measures, and environmental and social safeguards were discussed and agreed with the Government of Bangladesh and Bangladesh Bank and incorporated in the project design. The specific requirements are described in the project administration manual.⁴⁰ Procurement by the subborrowers will be in accordance with established private sector or commercial practices acceptable to ADB, as required under ADB's Procurement Guidelines (2015, as amended from time to time).

31. The overall financial management risk is assessed as moderate. Based on the financial due diligence conducted, Bangladesh Bank needs to further strengthen its capacity and staff strength, particularly in the area of project administration and supervision. The financial management assessment, including a financial analysis of the potential PFIs, indicated that (i) internal audit units with an independent reporting structure exist at each bank; (ii) the financial statements are audited by reputable, internationally affiliated audit firms; (iii) formal risk management units exist; (iv) capital adequacy ratios are above regulatory requirements; (v) the

³⁶ Output and activity (ii) will be provided by SMEF.

³⁷ Attached Technical Assistance (accessible from the list of linked documents in Appendix 2).

³⁸ Detailed due diligence has been carried out for four candidate PFIs: IDLC Finance Limited, Eastern Bank Limited, Micro Industries Development Assistance and Services, and Mercantile Bank Limited.

³⁹ Economic and Financial Analysis (accessible from the list of linked documents in Appendix 2). Such due diligence will be completed before selection of PFIs is finalized.

⁴⁰ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

profitability ratios are reasonable; and (vi) net interest margins are adequate.

32. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and the Bank and Financial Institutions Division of the Ministry of Finance. The specific policy requirements and supplementary measures are described in the project administration manual (footnote 37).

C. Poverty and Social

33. **Poverty impact, gender, and social dimensions.** Recognizing that high incidence of poverty and lack of gainful employment fuel discontent and unrest, the project's rural development impact contributes to stability in Bangladesh's less developed areas. The project's poverty impact is discussed in the summary poverty reduction and social strategy.⁴¹ Potential gender and social impacts were reviewed. A gender assessment is reflected in the project documents and is an integral part of the project design, which is categorized thematically as effective gender mainstreaming.⁴² SMEDP2 contributes to women's empowerment by narrowing gender disparities through access to financial resources.

D. Safeguards

34. In accordance with ADB's Safeguard Policy Statement (2009), the project is classified as FI treated as C for impacts on the environment, involuntary resettlement, and indigenous peoples, and complies with ADB information disclosure and consultation requirements. The project is expected to have minimal environmental impact since the subloans to SMEs will be mainly for light manufacturing, trade, and service activities. Similarly, the subloans will be for activities that will not trigger any involuntary resettlements, nor have any impact on indigenous people. An environmental and social management system is not required because the subproject investments carry minimal or no environmental or social risks. Bangladesh Bank has developed environmental risk management guidelines for banks and financial institutions. These were endorsed by the government on behalf of the PFIs and are mandatory regulations under the Financial Institutions Act, 1993.⁴³ To ensure that subprojects comply with applicable government regulations and that loan proceeds will not be used to finance activities that are on ADB's prohibited investment activity list and are categorized as FI-C for environment, involuntary resettlement, and indigenous peoples, a subproject screening checklist will be made mandatory for implementation by all PFIs under SMEDP2.⁴⁴ The PFIs will report on the status of implementing this screening checklist to ADB through Bangladesh Bank.

E. Risks and Mitigating Measures

35. The project's risks and all measures identified to reduce them were carefully analyzed during preparation and appraisal. The overall project risk has been rated low because of the strong record of the implementing agency in managing similar projects in the SME sector using ADB's guidelines, the strong preparatory effort of Bangladesh Bank, and the tested design of the project in successful operations under SMEDP1. The integrated benefits and impacts are expected to outweigh the costs. The major risks and mitigating measures are summarized (Table 3) and described in detail in the risk assessment and risk management plan.⁴⁵

⁴¹ Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

⁴² Gender Action Plan (accessible from the list of linked documents in Appendix 2).

⁴³ Available at Bangladesh Bank. <https://www.bb.org.bd/aboutus/regulationguideline/guidelist.php>.

⁴⁴ Financial Intermediary: Environmental and Social Management Arrangement (accessible from the list of linked documents in Appendix 2).

⁴⁵ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
The creditworthiness of SMEs in some locations could affect utilization of the project's credit line.	ADB's assessment indicates that PFIs have significant opportunities for lending to viable SMEs outside the metropolitan areas of Dhaka and Chittagong. Furthermore, the anticipated improvement of the borrowing capacity of SMEs through the attached capacity development technical assistance will indirectly help strengthen their creditworthiness.
Weak operational and/or financial strength of PFIs	A significant number of experienced PFIs have indicated strong demand for funding from the credit line. Operational weaknesses of some PFIs are being dealt with through (i) improved access to credit information, (ii) strengthened business development services and financial literacy, (iii) strengthened governance structures and risk management practices, (iv) risk-based pricing, and (v) Bangladesh Bank oversight.
Implementation delays if the PFIs fail to sustain performance standards	These risks have been dealt with by assessing PFI eligibility and commitment upfront. In addition, PFIs with performance shortcomings or other material issues may be excluded from the credit line under SMEDP2.

ADB = Asian Development Bank, PFI = participating financial institution, SMEs = small and medium-sized enterprises, SMEDP2 = Second Small and Medium-Sized Enterprise Development Project.

Note: The proposed ADB PFI eligibility criteria go beyond Bangladesh Bank's prudential standards and include additional requirements such as limits on a minimum credit rating of BBB-, a CAMEL rating of 3 or better, and no involvement in any major scam.

Source: Asian Development Bank.

V. ASSURANCES

36. The government and Bangladesh Bank have assured ADB that implementation of the project shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the project administration manual and loan documents.

37. The government and Bangladesh Bank have agreed with ADB on certain covenants for the project, which are set forth in the loan agreement and project agreement.

VI. RECOMMENDATION

38. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve

- (i) the loan of \$200,000,000 to the People's Republic of Bangladesh for the Second Small and Medium-Sized Enterprise Development Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 20 years, including a grace period of 5 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and project agreements presented to the Board; and
- (ii) the administration by ADB of technical assistance not exceeding the equivalent of \$2,000,000 to the Government of Bangladesh for the Strengthening Capacities of Small and Medium-Sized Enterprise Stakeholders to Access Bank Financing and Services to be provided by the Japan Fund for Poverty Reduction on a grant basis.

Takehiko Nakao
President

8 December 2015

DESIGN AND MONITORING FRAMEWORK

Impact the Project is Aligned with			
Continued economic growth and poverty reduction through the development of the SME sector outside the metropolitan areas of Dhaka and Chittagong (aligned with the SME Strategy Paper for the government's forthcoming Seventh Five-Year Plan, FY2016–FY2020) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Increase in the number and size of commercially viable SMEs, as well as employment in the SME sector	By end of 2019: a. Ratio of SME credit to total loans of the banking sector increased to 25% over the next 4 years (2014 baseline: 20.2%) ^b b. SME sector employment increased by 5% over the next 4 years (2014 baseline: 38.1 million people employed) ^c	For all indicators: a. MOF and PFI annual reports b. Bangladesh Bank annual reports	Downturn in economic activity increases the risk that SMEs will not be able to repay the loans taken out under SMEDP2. Implementation delays if the PFIs fail to sustain performance standards.
Outputs 1. Increased medium- and long-term credit, especially to SMEs, SME clusters, and BSCIC estates in rural areas	By end of 2019: 1a. PFIs have fully disbursed the \$200 million credit line to SMEs, SME clusters, and BSCIC estates outside the metropolitan areas of Dhaka and Chittagong (2015 baseline: 0) 1b. A minimum of 15% of component A under the credit line (\$20 million) disbursed to women entrepreneurs in 2015–2019 (2015 baseline: 0) 1c. Challenge fund operationalized and \$20 million disbursed through the PFIs to the SMEs by end of December 2016 (2015 baseline: 0)	1a–1b. Annual progress report submitted by MOF, Bangladesh Bank, and PFIs 1c. Quarterly progress report submitted by Bangladesh Bank	Inadequate demand for medium- and long-term credit at market rates by viable SMEs.
2. Strengthened capacity of SME entrepreneurs to access bank financing	By end of 2018: 2a. At least 15 new incubation facilities at educational institutions established (2015 baseline: 0) 2b. Women entrepreneurs' needs incorporated in the design and development of incubation centers	2a–b. Bangladesh Bank annual report and consultants' report	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
3. Strengthened managerial and technical capacity of SME support institutions (Bangladesh Bank, SMEF, BSCIC) and PFIs for SME cluster financing	<p>3a. At least 200 SME entrepreneurs trained on how to form alliances in clustering and networking to help small firms to compete, grow, and cooperate with larger firms; and 50 staff from PFIs trained in SME cluster financing (2015 baseline: 0)</p> <p>3b. Gender-related elements and/or elements addressing needs of women entrepreneurs incorporated in the needs assessment and training programs on SME, BSCIC, and SME cluster financing</p>	3a–b. Quarterly consultants' monitoring report	
4. Enhanced women-led SMEs' access to bank finance and financial services	<p>4a. Trainers' training program for at least 50 staff of Bangladesh Bank's WEDUs on access to financial services conducted (2015 baseline: 0)</p> <p>4b. At least 100 staff of PFIs oriented on gender-sensitive approaches to assisting women entrepreneurs (2015 baseline: 0)</p> <p>4c. At least 400 women entrepreneurs trained in accessing financial services (2015 baseline: 0)</p>	<p>4a. Bangladesh Bank annual report</p> <p>4b–c. Bangladesh Bank and PFI annual reports</p>	

Key Activities with Milestones

1. **Increased medium- and long-term credit for SMEs, SME clusters, and BSCIC estates in rural areas** (continuous, beginning no later than Q1 2016)
 - 1.1 Establish an administration unit for the challenge fund.
 - 1.2 Establish operational rules for the challenge fund.
 - 1.3 Pilot fund allocation through the challenge fund.
 - 1.4 Disburse funds to PFIs.
 - 1.5 Lend from PFIs to SMEs, SME clusters, and BSCIC estates.
2. **Strengthened capacity of SME entrepreneurs to access bank financing** (continuous, beginning no later than Q1 2016)
 - 2.1 Undertake feasibility study establishing incubation facilities.
 - 2.2 Finalize proposals for the incubation facilities.
 - 2.3 Identify training modules for incubation facilities.
 - 2.4 Conduct training for SME entrepreneurs.
3. **Strengthened managerial and technical capacity of SME support institutions (Bangladesh Bank, SMEF, BSCIC) and PFIs for SME cluster financing** (continuous, beginning no later than Q3

Key Activities with Milestones

2016)

- 3.1 Conduct needs assessment for SME entrepreneurs on how to form alliances in clustering and networking.
 - 3.2 Assess the need for capacity development of PFIs for financing to SME clusters and BSCIC estates.
 - 3.3 Establish an administration unit at SMEF for capacity development support to SME entrepreneurs and PFI staff in SME cluster and BSCIC estate financing.
 - 3.4 Design training programs for SME entrepreneurs and PFIs for SME cluster and BSCIC estate financing and conduct seminars and/or training for trainers.
4. **Enhanced women-led SMEs' access to bank finance and financial services** (continuous, beginning no later than Q2 2016)
 - 4.1 Recruit national organization to implement gender components.
 - 4.2 Prepare a manual on Bangladesh Bank circulars and directives relating to women entrepreneurs, and on PFI standard lending procedures for small women entrepreneurs.
 - 4.3 Train Bangladesh Bank WEDU officials and staff at head office and branches, and key officials and women-dedicated desk staff.
 - 4.4 Monitor PFIs' application of the standard procedures for assisting women entrepreneurs.
 - 4.5 Conduct sharing events among Bangladesh Bank WEDUs and PFIs on challenges and lessons of lending to women entrepreneurs.
 - 4.6 Identify small women entrepreneurs interested in financial and legal literacy.
 - 4.7 Train identified small women entrepreneurs.
 - 4.8 Conduct multisector sharing events on lessons, challenges, and prospects of women entrepreneurship.

Project Management Activities

Establish a project management unit at the SME Special Programs Department of Bangladesh Bank with a project director, a deputy project director, and two full-time project managers

Conduct project reviews

Government, ADB, and Bangladesh Bank meetings (once every 6 months)

ADB review missions (once every 6 months)

Prepare and submit:

Project monitoring reports (quarterly)

Project review reports (annual and midterm)

Project completion report (Q4 2019)

Inputs:

ADB:	\$200.0	million (loan)
Government:	\$50.0	million
PFIs:	\$50.0	million (others)
SMEs:	\$33.3	million (beneficiaries)
Total:	\$333.3	million

Technical Assistance

JFPR: \$2.0 million

Assumptions for Partner Financing

Not applicable

ADB = Asian Development Bank, BSCIC = Bangladesh Small and Cottage Industries Corporation, FY = fiscal year, JFPR = Japan Fund for Poverty Reduction, MOF = Ministry of Finance, PFI = participating financial institution, Q = quarter, SMEs = small and medium-sized enterprises, SMEF = SME Foundation, TA = technical assistance, WEDU = women entrepreneurs' development unit.

^a UNDP. 2015. Government Approved the Five-Year Plan Aiming at Empowering People. 20 October. <http://www.bd.undp.org/content/bangladesh/en/home/presscenter/pressreleases/2015/10/19/the-7th-five-year-plan-like-to-be-approved-by-nec-in-october.html>

^b As per ADB SME Finance Monitoring Report 2014, the total amount of SME loans disbursed by banks was Tk980,330 million, which amounted to 20.2% of the total lending of the banking sector of Tk4,854,000 million as per Bangladesh Bank Annual Report 2013–2014.

^c As per data from the SME Foundation.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=36200-023-3>

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Finance (Small and Medium-Sized Enterprise Finance and Leasing)
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Economic and Financial Analysis
8. Attached Technical Assistance
9. Country Economic Indicators
10. Summary Poverty Reduction and Social Strategy
11. Gender Action Plan
12. Financial Intermediary: Environmental and Social Management System Arrangement
13. Risk Assessment and Risk Management Plan

Supplementary Documents

14. Detailed Small and Medium-Sized Enterprise Sector Analysis (including Demand–Supply Gap Analysis)
15. Eligibility Criteria for Participating Financial Institutions, Subborrowers, and Subprojects
16. Financial Due Diligence of Candidate Participating Financial Institutions
17. Financial Management Assessment