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The Effect of Bank Financing on the Economic and Non-economic Performance of SMEs in Bangladesh

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Abstract

Small and medium-sized enterprises (SMEs) are often regarded as the key drivers of a country's economic growth. The lack of adequate financial resources will have an influence on the contributions of SMEs to economic progress. Bank financing can help SMEs get additional funds to help with business expansion. Nonetheless, numerous SMEs have reservations about the effectiveness of this type of finance in improving their business operations. As a result, the purpose of this research is to examine the impact of bank financing on the performance of SMEs in Bangladesh. This study employed a quantitative technique to attain its goals, delivering 403 questionnaires to SMEs in Bangladesh. The research reveals that bank financing improves both the economic and non-economic performance of Bangladesh's SMEs.

Keywords: SMEs, Bangladesh, Bank Financing, Performance

Introduction

Small and medium-sized enterprises (SMEs) are the backbone of sustainable economic progress in both developed and developing countries. All over the world, SMEs have been playing an essential role in defending economic development and increasing industrial production. It serves as a significant source of input for large industrial enterprises, contributing to increased revenue and job opportunities in the country (Sultan et al., 2021). Globally, more than 90% percent of businesses in a country are SMEs (World Bank Data, 2022). For example, among the industrialized countries, Japan has about 99% SMEs out of total firms. Meanwhile, the developing countries like Malaysia and Bangladesh have around 97% and 90% respectively (OECD, 2021).

Since the global economic crisis of 2008, SMEs have been critically affected in developing countries. Although some SMEs have consistently struggled with revenues, a lack of financial access, and increased credit costs, others have recovered quickly (D'imperio, 2015). The Covid-19 pandemic has exacerbated the problem by restricting SMEs' access to external finance. In turn, many SMEs are forced to shut down their businesses. Financial constraints continue to play a major role in SMEs' competitive performance to compete and gain

sustainable performance Chilembo (2021) and Iwara et al. (2021). Around 52% of SMEs have shut down the operation based on survey done by LightCastle Partners in 2020. This is more prevalent in Bangladesh, where SMEs contribute up to 20% to 25% of the GDP (Bangladesh Bank, 2021). However, a lack of external financing may cause the contribution to be sluggish. Figure 1 exhibits the type of financing of SMEs. About 70% of Bangladeshi SMEs are looking for external financing for a concessional and working capital loan due to the widespread impact of Covid-19.

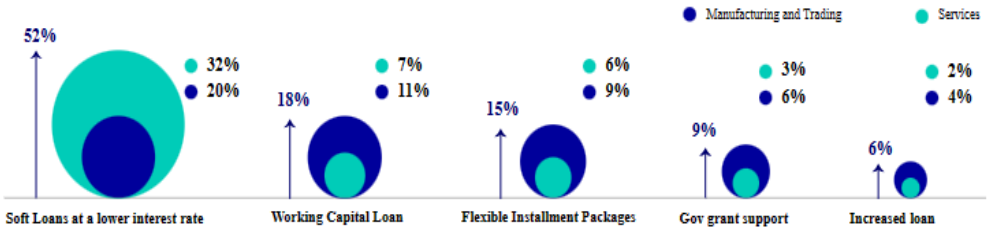

Figure 1: Types of SMEs Financing
Source: Light Castle & Partner Survey on April, 2020

If SMEs face restricted financial resources for their businesses, this might result in a shortened cash cycle due to disruptions in the supply chain and decreased sales. This can adversely affect their performance. As a result, SMEs will halt their business operations. Moreover, various worldwide economic crises have significantly limited the ability of SMEs to obtain financial support from banks, mostly due to the credit rating of these SMEs (Muriithi, 2017). Hence, SMEs must seek external funding, not only from banks but also from non-bank financial institutions (OECD, 2009). However, SMEs are less interested in obtaining financing from banks than from financial institutions, as financial institutions charge a lower interest rate (Chowdhury et al., 2015). Approximately 80% of SMEs are more dependent on financial institutions, NGOs, and internal funds than on banks due to the high-interest rates charged by the banks. For instance, SMEs are charged a minimum of 11% to 16% annually by non-bank financial institutions (NBFIs), and a minimum of 15% to 20% annually by banks (The Daily Star, 2017).

Nevertheless, most SMEs are uninterested in obtaining funding from banks and financial institutions due to their financing procedures and requirements. SMEs typically have a greater understanding of their own business's potential, but they may struggle to effectively communicate and provide comprehensive information about their organization to satisfy funders (Sung *et al*, 2019). For example, to fulfill the loan requirement (prepare documents and provide proof of evidence) when applying for financing. In addition, banks and financial institutions provide loans to SMEs with a restricted duration. In Bangladesh, SMEs are obligate to repay financing granted to them for a period of six months up to two years (Rahmatullah *et al.,* 2014). In contrast, SMEs necessitate an extended duration for loan repayment due to their frequent insufficient cash flow caused by changing profits.

However, the banks' limited funding duration is a result of their reduced resources caused by asset decreases (Shikumo & Mirie, 2020). Recently, some banks in Bangladesh have been affected by financial corruption. Notable victims of financial corruption include BASIC Banks, Jonota Bank, Sonali Bank, Krishi Bank, and Bangladesh Bank (the country's central bank).

Furthermore, political instability exerts an influence on the decline of a bank's assets (Bangladesh Bank, 2020) by impeding the timely turnover of loans to SMEs.

Moreover, the high demand for collateral and the inability to obtain the required amount of funding are significant barriers between banks and SMEs in Bangladesh. For instance, to obtain a $1 million loan, SMEs must prove that they have an asset worth more than $1 million as collateral. Further, bank funding is also less appealing to most small and medium-sized businesses since the application procedure takes so long. Banks take more than 10 months to approve and grant financing to SMEs, even though the duration of the credit is limited to six months to two years (Chowdhury et al., 2015).

Nonetheless, banks are the only sources capable of providing large sums of money to SMEs, notwithstanding their reluctance to deal with the time and hassle of bank financing. Therefore, bank financing is critical for SMEs to expand their businesses and improve their performance (Saidi, Uchenna, & Ayodele, 2019). Hence, it is relevant to investigate how bank financing affects the performance of SMEs in Bangladesh. Therefore, this study will examine the impact of bank financing on SMEs in Bangladesh particularly their impact on the economic and non-economic performance of SMEs.

Literature Review

Small and medium-sized enterprises (SMEs) are vital for economic development (Rodríguez-Serrano & Martín-Armario, 2019). According to the Asian Developmet Bank (2016), SME's account for 25% of the Gross Domestic Product (GDP), 45% of manufacturing value addition, approximately 90% of industrial units, and 30% of the labor force in Bangladesh. Notwithstanding this, SMEs face significant obstacles when it comes to acquiring the capital necessary for business operation and expansion (Madrid-Guijarro et al., 2016). Several factors, both internal and external, influence the funding of small and medium-sized enterprises.

Internal factors such as the need for collateral, paperwork, and internal capital requirements can make it hard for small businesses to get the money they need. SMEs are highly prone to collateral requirements on a loan contract because SMEs are less transparent about their creditworthiness (Moses, Njaya, & Mazhambe, 2023). Typically, banks limit the amount of loans they provide to SMEs since these businesses have fewer assets that can be used as collateral. For this reason, SMEs feel discouraged from applying for formal financing (Hanedar *et al.,* 2014). Secondly, SMEs are more interested in financing from relatives Chowdhury & Alam (2017) because it does not involve any costs and procedures.

SMEs in Bangladesh are indifferent towards bank loans due to the high-interest rates charged by banks. Research on Bangladeshi SMEs showed that most SMEs get financing at an interest rate of 14%, which is high for SME entrepreneurs (Chowdhury et al., 2015). Furthermore, banks and financial institutions usually provide limited tenure financing to SMEs (Sitharam & Hoque, 2016). However, SMEs need finance with a long repayment period because sometimes they have limited cash flow due to fluctuations of profit.

Financing is critical for SMEs to establish, extend, and grow their businesses. Exclusively relying on internal funding is insufficient for the expansion of SMEs. SMEs require large,

dependable, and multiple-access sources of finance, such as bank financing. The contribution of SMEs to economic development has been harmed by a lack of institutional funding Chien et al (2021), specifically bank financing. Agbozo and Yeboah (2012) found that bank lending played a crucial role as a capital source by facilitating firms in reducing transaction costs, mitigating risk, capitalizing on discounts, and addressing market imperfections in emerging economies and during financial crises in industrialized nations.

Few studies have been done on how external finance can help SMEs economic and non-economic performances. When SMEs have easy access to external financing, they will become more productive by using the fund, and their profits will increase as well. A Study show that 80% of SMEs from Uganda failed to operate their business in more than five years due to the lack of access to external finance and this is the most common phase of many developing countries' SMEs (Okello et al., 2017). Correspondingly, Eniola et al (2015) reported that a lack of access to financing has been identified as one of the greatest challenges to SMEs growth and performance in Africa. According to the authors, access to financing enables business to maintain a high level of motivation when it comes to developing their area of work. Additionally, it will assure an individual's ability to succeed as an entrepreneur.

Recent study by Arun et.al (2023) found that bank credit does influence small business performance. For small businesses to use bank financing efficiently and on schedule, they need to have a strong financial management system in place. Banks should create suitable guidelines to enable small businesses to obtain bank financing without any difficulties. Hence, SMEs can use the fund to expand their business when they easily can access the fund channel by bank. Bank credit has substantially influenced business performance in developing a capacity to conduct multiple events simultaneously, business growth, ROI, profitability, competitive advantage, purchase of new equipment, and adoption of recent technology.

On the other hand, according to Pecking Order Theory Myers and Majluf (1984), companies prefer internal financing to external financing. This is in line with the study by Yazdanfar & Öhman (2015), who confirmed that trade credit, short-term loans and long-term loans all have a negative impact on a company's profitability. Further, SMEs would seek short-term bank financing more frequently if there are more opportunities for business growth. The authors also found that SMEs benefit greatly from short-term debt since it lowers the nominal interest rate, making loans more affordable. This is because SMEs have limited access to long-term financing and the capital markets.

However, it should not be challenging for SMEs to acquire bank financing. This is because SMEs operations increase employment in a country's economy. Consequently, the economic and non-economic contributions of SMEs extend beyond developed to developing nations. This is why numerous people rely on SMEs for their source of income (Endris & Kassegn, 2022). SMEs create job opportunities across developing countries by employing low-skilled workers and skilled workers (Vadra, 2022). SMEs also support the employees' health care services and other value-added needs for living. Therefore, SMEs are critical for inclusion and poverty reduction, particularly in emerging and low-income economies. In this regard, external financing, such as bank financing facilities, can help low-income SMEs with funding to expand their businesses. Hence, they can create more jobs for unemployed people. Bank financing for SMEs not only stimulates job creation but also guarantees people's essential

requirements, thus enhancing their non-economic outcomes. Bank financing impacts the economic performance of SMEs, such as SMEs sales and profits and their market penetration nationally and internationally. Hassan & Mollah (2018); Islam & Miajee (2018) stated that a more accessible bank financing scheme could positively impact SMEs' economic performance like; increase their profits and business growth. Hence, according to the studies objective the following hypothesis is developed.

H1*: There are significant impacts of bank financing on the economic performance of SMEs.*

According to Herrera & de las Heras-Rosas (2020), non-economic performance refers to the SME's in-house socio-economic development, such as food and health, education, and contribution to reducing unemployment. The literature of this study finds that in developing countries like Bangladesh, SMEs are still struggling to overcome their poverty line, which can be alleviated by proper formal financing like; bank to improve their performance (Hassan & Mollah, 2018; Hasan et al., 2017). However, the bank financing impact on the non-economic performance of SMEs in Bangladesh has not been extensively studied. Thus, as the second study objective of this study aims to examine the impact of bank financing on the non-economic performance of SMEs in Bangladesh. The following hypothesis has been developed.

H2: *There are significant impacts of bank financing on the non-economic performance of SMEs.*

Meothodology

The current study adopts a quantitative research method to examine the determinant factors of SMEs bank financing in Bangladesh and the impact of bank financing on the SMEs' economic and non-economic performance. This study collected the primary data through a survey by using a questionnaire. The questionnaire was first translated from English into the Bengali language. At the beginning of the data collection, a pilot test was conducted using 30 SMEs' owners' data. The pilot test was conducted to determine the questions' reliability and validity for further data collection. After the pilot test, we distributed the questionnaires to collect the rest of the data. Respondents consist of the owner or top management of SMEs.

The population of this study consists of 866,424 SMEs establishments all over Bangladesh. Hence, the required sample size is n = 384, referring to (Krejcie & Morgan, 1970). Sample size determination and dealing with non-response bias are essential in quantitative research. The use of convenience sampling technique to perform survey on selected SMEs in Dhaka due to more than 80% of SMEs in Bangladesh held the business in this area. However, we managed to get 403 samples. Therefore, we used all the questionnaires for this study. The motivation behind this is that many social research studies often use surveys and voluntary participation data collection methods where the response rate usually falls below a hundred percent. Additionally, if researchers distribute questionnaires more than the survey's sample size, they are employing an oversampling technique to account for missing data or uncooperative subjects (Salkind & Rainwater, 2003).

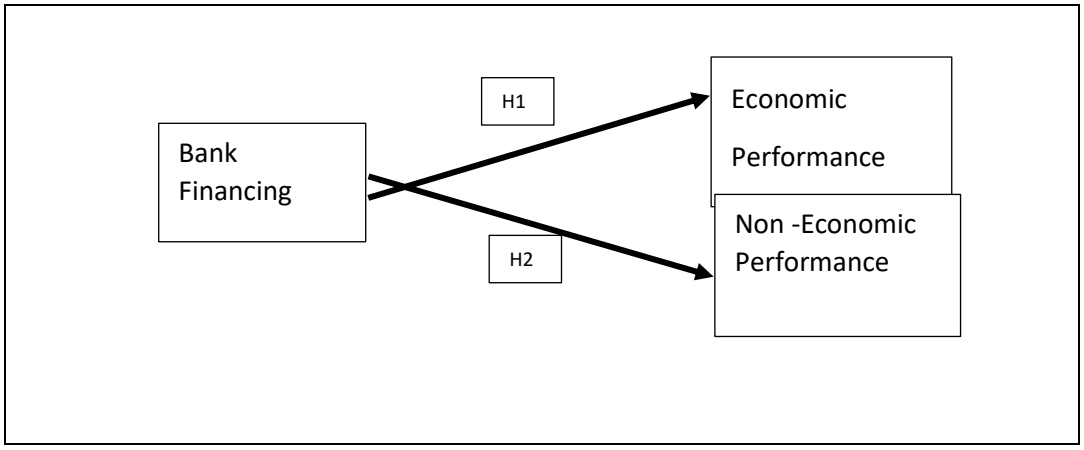

Figure 1: Conceptual Framework of the Study

The conceptual framework shows the relationship between the bank financing and SMEs performance. Referring to the Pecking Order Theory, SMEs should choose bank financing then equity financing as their source of funds to open their business or invest in their business. Though banks have a higher cost than internal finance, bank financing is still more secure and the biggest option to get higher financings for expanding their business. Also, bank financing is the multiple-accessible option for SMEs if they can repay their finance properly. On the other hand, based on the agency theory, when the SME will choose the bank financing, and bank will approve the financings for SMEs with less difficulty, the conflict between the agent (SMEs) and principle (bank) will reduce, which will increase the ultimate economic and non-economic performance of SMEs remarkably.

Bank financing is a form of lending money to any business activities with the agreement of repaying the money along with interest. The measure focuses on the SME's attraction and willingness to borrow financing from the banks and the amount of finance they get from the banks. The items of this measure are "Which of the following sources of financing system do you prefer to get the finance for your business?" adapted from (Islam & Miajee, 2018). The respondents were given five options to choose their answer, labeled as: (1) Family and friends (2) Grameen Banks (3) NGOs (4) Non-bank financial institutions, and (5) Banks. This item was selected to measure and observe the percentage of SMEs' interest in borrowing from banks. The other item was chosen to identify the financing amount that SMEs get from financial institutions like banks. The item is "What is your total amount of finance?" adapted from (Chowdhury, & Alam, 2017). For this measure also, the respondents were given five options to choose their answer labelled as: 0-100,000 (2) 100,001 – 500,000 (3) 500,001 – 2,000,000 (4) 2,000,001 – 5,000,000 and (5) 5,000,001 – 10 million.

SMEs' economic performance is defined by the economic growth of SMEs, such as their annual sales and profits and their ability to penetrate national and international markets (Rusu & Roman, 2017). Meanwhile, Non-economic performance refers to socio-emotional-wealth, corporate social responsibility, or human resource practices. The non-economic performances define the socio-economic wellbeing of a SMEs, such as education, food and health care, and contribution to unemployment reduction (Herrera, & de las Heras-Rosas, 2020).

Results and Discussions

The study used simple linear regression analysis is used to investigate the impact of bank financing on the economic and non-economic performance of SMEs in Bangladesh.

Reliability and Validity

To ensure the accurate result generated in this study, the reliability test was conducted on a sample item of each variable of the questionnaire. Therefore, Cronbach Coefficient Alpha was used to determine the internal consistency and reliability of this study. According to Nunnally (1978), an alpha value that equal to or greater than 0.70 is a sufficient condition and it means that these questions in the questionnaire possess sufficient reliability. Reliability test results in Table 1 that each item Cronbach's Alpha of 0.7 and above Hence, no item needs to be deleted.

Table 1
Reliability Test

Construct	No. of Items	Cronbach's Alpha
Bank Financing (BF)	2	0.785
Economic Performance (EP)	11	0.740
Non-Economic Performance (NEP)	12	0.730

For the normality test, it is important to have the results of skewness in between -1 and +1 and Kurtosis in between -2 and +2. Table 2 indicates all data was normally distributed as skewness of each variable are within the acceptable range of -1 and +1 also Kurtosis of each variable are within the acceptable range of -2 and +2.

Table 2
Data Normality

Variables	**Skewness**	**Kurtosis**	**Shapiro- Wilk df. sig.**	
Bank Financing	-0.108	-0.682	403	0.000
Economic Performance	-0.414	-0.021	403	0.000
Non-economic Performance	-0.437	0.207	403	0.000

Descriptive Statistics

Table 3 shows that the maximum respondent response for bank financing (BF) is 5.00, while the minimum response is 3.00. The minimum and maximum values of the Economic Performance (Min = 1.82, Max = 5.00) and Non-Economic Performance (Min = 2.33, Max = 5.00) also indicate that there are no outlier issues with the entered data set of economic and non-economic performances.

Table 3
Descriptive Statistics

Construct	N	Minimum	Maximum	Mean	Std. Deviation
Bank Financing (BF)	403	3.00	5.00	4.30	0.442
Economic Performance (EP)	403	1.82	5.00	4.05	0.591
Non-Economic Performance (NEP)	403	2.33	5.00	4.10	0.533
Valid N (list wise)	403				

Note: Likert Scale 1-5, N=403

Table 3 also depicts a very high acceptance level of the BF at the mean value level (M = 4.30, SD = 0.442). The respondents' high degree of acceptance for non-economic performance (NEP) is demonstrated by the mean value of (M = 4.10, SD = 0.533). On the other hand, the respondent acceptance level for the economic performance (EP) was high at the mean value (M = 4.05, SD = 0.591). Subsequently, the standard deviation value for all constructs is less than 1, indicating little variance in respondents' opinions and a low probability of data errors.

Results of Simple linear Regression Analysis (H1)
Hypothesis 1(H1): There are significant impacts of bank financing on the economic performance of SMEs.

Table 4 shows the result of the R-value signifies a robust relationship between bank financing and economic performance. The results of R square show that the independent variable, bank financing has an impact of about 31.4% on the economic performance of SMEs. However, the result of adjusted R square = 0.312. It means that 31.2% of the variation in bank financing is attributed to the combined variation in the economic performance, which is also significantly reliable.

Table 4
Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.560	0.314	0.312	0.49086

a. **Predictors (X):** Bank financings
b. **Dependent variable (Y):** Economic Performance

The significance value (p-value) for the overall regression model as indicated in Table 5 is 0.000 and the F-value is 183.60. This implies that this model is significant at 5% because the p-value is less than 0.05. Thus, the equation is a good fit for the data and can be used to reliably predict economic performance. So, this can be concluded that independent variables (bank financing) statistically significantly predict economic performance.

Table 5
ANOVA

Model	F	Significance /P-value
Regression	183.601	0.000

The results in Table 6 indicate that the independent variable predicts the dependent variable (economic performance). The independent variable (Bank financing) is positively related (0.749) and significant at the level of P <0.05 with economic performance. The result reveals that bank financing has a significant impact on the economic performance of SMEs. When SMEs get more funds from bank financing, SMEs can increase their economic performance. Bank financing has encouraged SMEs to grow their business. The sale will increase, and SMEs can get lower cost of inventory because buying in bulk. Employees of SMEs more motivated because get pay on time. Researcher further access multicollinearity issue by examining Variance Inflation Factor (VIF). VIF is reciprocal of tolerance, it is always greater than or equal to 1. VIF values that exceed 10 are considered as multicollinearity. Referring to Table 6, there are no multicollinearity between variables had VIF value is 1.00.

Table 6
Coefficient

Factors	Unstandardized Coefficient Beta	Standardized Coefficient Beta	T Value	P value Sig.	VIF
(Constant)	0.832		3.484	0.000	
Bank Financings	0.749	0.560	3.550	0.000	1.00

a. Dependent Variable (Y): Economic Performance

Results of Simple linear Regression Analysis (H2)

Hypothesis 2 (H2): There are significant impacts of bank financing on the non-economic performance of SMEs.

As claimed by Cohen in 1988, R value of 0.651 denoted a robust relationship between non-economic performance and independent variables of bank financing. Furthermore, the coefficient of determination in Table 7, R^2=0.423 stipulated that 42.30% variance in behavioral intention of non-economic performance was being explained by bank financing. The other 45.55% of the variance that remains unexplained means that there were other potential constructs that would affect non-economic performance in this study.

Table 7
Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.651	0.423	0.422	0.40545

c. **Predictors (X):** Bank Financings
d. **Dependent variable (Y):** Non-Economic Performance

The significance value (p-value) for the overall regression model as indicated in Table 8 is 0.000 and the F-value is 294.32. This implies that this model is significant at 5% because the p-value is less than 0.05. Thus, the equation is a good fit for the data and can be used to reliably predict economic performance. So, this can be concluded that independent variables (bank financing) statistically significantly predict non-economic performance.

Table 8
ANOVA

Model	F	Significance /P-value
Regression	294.321	0.000

The results in Table 9 indicate that the independent variable predicts the dependent variable (non-economic performance). The independent variable (bank financing) is positively related (0.732) and significant at the level of P <0.05 with non-economic performance. The result reveals that bank financing has a significant impact on the non-economic performance of SMEs. The more financing SMEs get from the bank, the higher of non-economic performance. SMEs in Bangladesh that receive fund form bank financing can improve and expand their operation which further improve their non-economic performance. For example, SMEs are more motivated to expand their business, improve the education of their family, better wellbeing, and belief they play their role in reducing poverty in Bangladesh. Table 9 also reveals that there is no multicollinearity between variables since VIF value is 1.00.

Table 9
Coefficient

Factors	Unstandardized Coefficient Beta	Standardized Coefficient Beta (β)	T Value	P value Sig.	Tolerance	VIF
(Constant)	0.783		3.709	0.000		
Bank Financing	0.732	0.651	17.156	0.000	1.00	1.00

a. Dependent Variable (Y): Non-Economic Performance

Conclusion

Small and medium enterprises (SMEs) are the backbone of the Bangladesh economy. SMEs face development constraints due to a lack of financial access. SMEs have difficulty getting external financing, specifically from banks. There is also potential growth SMEs are refused to get bank financing due to bank requirement. However, SMEs need adequate funds to

maintain and expand business. With adequate funds, SMEs can sustain the operation with no worries about short of cash flow for day-to-day operation. Hence, this will improve the performance of SMEs.

Bank financing is relatively incompetent at contributing more effectively to the economic and non-economic performance of SMEs. Nevertheless, this study has shown that bank financing has a significant impact on economic performance, such as increased profits, increased assets, and increased business expansion nationally and internationally. Additionally, this research found that bank financing has a significant impact on non-economic performance. This enhances the social lives of SME owners and employees by providing access to better food and health care, as well as improved education. Moreover, SMEs' owners believe that when their businesses expand, they will need to hire additional people, which will contribute to the reduction of society's unemployment. Therefore, if the factors can be reviewed properly, the SME's accessibility to bank financing will increase. Consequently, it will improve their economic and non-economic performance.

Nonetheless, the findings of this study are potentially beneficial for both practitioners and scholars. The current study provides empirical evidence on how SMEs' bank financing effects economic and non-economic performance. Hence, SMEs in Bangladesh should consider bank financing as a source of fund for their business operation. The models used in this study can be helpful for future researchers to develop a better understanding of Bangladesh bank financing. In addition, banks should review and restructure their collateral requirement and tenure of funding to attract SMEs for getting finance from banks. In this regard, the central bank can take the initiative to improve the relationship between banks and SMEs by providing special treatment for SMEs financing.

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