FINANCIAL SECTOR ASSESSMENT PROGRAM
DEVELOPMENT MODULE

JAMAICA

SME FINANCE
TECHNICAL NOTE
APRIL 2015

This Technical Note was prepared in the context of a World Bank Financial Sector Assessment Program mission in Jamaica during April-May 2014 led by Alfonso Garcia Mora, and overseen by Finance & Markets Global Practice, World Bank and the Monetary and Capital Markets Department, IMF. The note contains technical analysis and detailed information underpinning the FSAP assessment's findings and recommendations. Further information on the FSAP program can be found at www.worldbank.org/fsap.

THE WORLD BANK GROUP
FINANCE & MARKETS GLOBAL PRACTICE

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GLOSSARY

AML	Anti-Money Laundering
ATM	Automated Teller Machine
BoJ	Bank of Jamaica
BOJ	Bank of Jamaica
CAR	Capital Adequacy Ratio
CFT	Combating the Financing of Terrorism
EFF	Extended Fund Facility
FI	Financial Inclusion
FSAP	Financial Sector Assessment Program
FSC	Financial Services Commission
FSSA	Financial System Stability Assessment
GDP	Gross Domestic Product
GOJ	Government of Jamaica
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
MFI	Microfinance Institution
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MSME	Micro, Small and Medium Sized Enterprise
MICC	Ministry of Industry, Investment, and Commerce
NBFI	Non-Bank Financial Institution
NPL	Non-Performing Loans
NPL	Non Preforming Loans
ROA	Return on Assets
ROE	Return on Equity
ROSC	Report on Observance of Standards and Codes

EXECUTIVE SUMMARY[1]

1. **Almost all formal SMEs in Jamaica have access to checking or saving accounts, but the financial sector is scarcely used to finance their investments.** Most SMEs in Jamaica have a bank account, but less than a third have a bank loan or line of credit (well below the 48 percent average in LAC).[2] As a result, investments are mostly financed with own funds, delaying decisions and eroding productivity, competitiveness and growth. The lack of funding for the SME sector, or its high cost, has a negative impact on entrepreneurship and business profitability and stability through the business life-cycle, having a particularly negative effect on employment.

2. **There are several factors that have constrained bank lending to MSMEs.** These factors include, *inter alia*: (i) traditionally banks have not saturated lending in the retail segment due to investment opportunities in low-risk Government securities and have not felt the need to diversify into other segments; (ii) lending to the MSME segment has been perceived as high risk due to significant information asymmetries that exist in the market (lack of credit reporting systems) and the high level of informality, especially of micro-entrepreneurs[3], resulting in higher interest rates for this segment or refusal of credit; (iii) lack of adequate traditional collateral owned by MSMEs as required by banks, focused mostly on real estate or motor vehicles; (iv) lack of bank strategies, processes, lending methodologies, and financial instruments to lend to this segment, although banks have started to develop such methodologies; and (v) lack of reliable financial statements for MSMEs that makes it difficult for banks to assess risks.

3. **In addition, the supply of formal nonbank sources of finance is limited, especially for micro-enterpreneurs, with credit unions providing mostly consumer finance and an underdeveloped microfinance sector.** Credit unions' assets represent less than 5 percent of GDP and they provide mostly consumer finance (9 percent of the loan portfolio is provided to micro-entrepreneurs).[4] The current regulatory framework for credit unions is being revised and supervision will be undertaken by Bank of Jamaica (BoJ). In addition, the microfinance sector is small and remains largely unregulated. The absence of a regulatory framework over the activities of microfinance may hinder the growth of the sector. The authorities aim to develop a Micro-Credit Act to make it mandatory for MIFs to register, and to create a regulatory authority to oversee MFIs. The regulatory environment for microfinance should provide a level playing field amongst financial institutions providing microfinance. The regulatory framework for credit unions should take into account the specific characteristics of the sector, and BoJ should have overall responsibility for supervising and regulating all the lenders in the market, including credit unions and MFIs (non-prudential supervision of MFIs), in order to avoid regulatory arbitrage and other market distortions.

4. **Beyond credit, the supply of alternative sources of finance for MSMEs is limited**. The absence of alternative products beyond credit lines or personal loans represents a hurdle for MSME activity. Factoring is not developed, and leasing is scarcely used due to lack of tax incentives. As

[1] This note was prepared by Bujana Perolli (Financial Sector Specialist, Finance & Markets Global Practice), team member of the Jamaica FSAP mission that took place during April 28 – May 9, 2014.
[2] Enterprise Survey, 2010.
[3] 43% of the economy is estimated to be informal.
[4] Bank of Jamaica (BoJ) data.

a result, working capital is funded exclusively with credit lines at high rates, representing a significant obstacle for the development of the private sector. Also in terms of equity, source of alternative finance are limited in the market. Venture capital is not developed, and there are only 22 companies listed in the Jamaican Stock Exchange for SMEs (Junior Stock Market) with low liquidity and turnover ratios. Alternative sources of finance that are particularly valuable for SMEs, such as factoring, leasing, and venture capital should be developed and promoted.[5] Similarly, specific instruments to facilitate access to finance for micro-entrepreneurs and farmers should be designed, such as micro-insurance.

5. **The authorities have taken significant initiatives to enhance the legal and regulatory environment and financial infrastructure, but further efforts are needed.** The Government has developed an ambitious package of legislative reforms to ease doing business for MSMEs and has improved regulation for deposit-taking institutions. In addition, several reforms have been undertaken to expand financial infrastructure, including the establishment of three credit bureaus[6] (although data fragmentation is a concern), the modernization of the secured transactions legal framework and establishment of the movable collateral registry (although improvements for the set-up of the registry are ongoing), and adoption of the insolvency law, which is expected to facilitate out-of-court restructurings. However, further efforts are needed in these areas, to: enhance the credit reporting oversight and consumer protection framework, further enhance the regulations of the movable collateral registry, and develop regulations for the insolvency law along with training of judges and insolvency administrators.

6. **The authorities have also put in place public programs for MSME finance, however they lack sufficient coordination, and the partial credit guarantee scheme needs to be revamped.** There are several public programs, such as the Micro Investment Development Agency (MIDA), the Self-Start Fund (SSF), Jamaica Business Development Corporation (JBDC), and others that lend and provide capacity building to SMEs. Consideration should be given to review and consolidate these programs, with a view to improve efficiency and effectiveness. The Development Bank of Jamaica (DBJ) is one of the main players for MSME finance, as it provides on-lending via financial institutions (about 2 percent of banks' lending to MSMEs). It also operates a partial credit guarantee scheme, which is not being utilized by lenders. Thus, its design should be reviewed and revamped to ensure adequate incentives for lenders to use it and its sustainability.

Table 1. Summary of Recommendations

Recommendations	Agency	Timeframe
Legal and regulatory framework		
Ensure an adequate regulatory and supervisory framework for different lenders to guarantee a level playing field for financial institutions providing the same services	MoF/BoJ	MT

[5] In recent years, the authorities have undertaken efforts to encourage the development of the venture capital eco-system.

[6] Two credit bureaus are operating, and a third one was licensed in 2014.

Recommendations	Agency	Timeframe
Simplify documentation requirements for MSMEs and consider adopting measures in prudential regulations to incentivize lending to MSMEs	BoJ	MT
Alternative sources of finance for SMEs		
Develop a factoring law, and review/revise the legal, regulatory, and tax framework for assignment of receivables	BoJ/MoF	ST
Consider the development of an electronic factoring platform	DBJ	MT
Review/revise the legislative framework to remove ambiguities for the development of leasing, develop leasing law	BoJ/MoF	ST
Conduct awareness raising for financial institutions and SMEs, on factoring and leasing as useful instruments	MoF/MICC/DBJ	MT
Develop the legal, regulatory framework, and infrastructure for the development of venture capital	MoF/BoJ	ST
Develop a specific regulatory framework for micro-insurance	FSC	ST
Secured transactions, insolvency framework		
Improve collateral registry regulations	Collateral registry/Companies Office	ST
Conduct capacity building of stakeholders to maximize the benefits of the new system (communications campaign, stakeholder trainings)	MoF/Collateral registry	ST
Develop insolvency regulations	MICC/MoJ	ST
Conduct trainings of judges and insolvency administrators	MoJ	MT
Public programs		
Review and revamp the PCG scheme to provide adequate incentives for lenders to participate	DBJ/MoF	ST
Consolidate public programs for MSME finance (through DBJ, Exim bank, Self-Start Fund, MIDA, and others) to improve efficiency and effectiveness	MoF, MICC	MT
Provide capacity building to SMEs to improve their bankability, through JMDC and business associations	MICC	MT
Other		
Collect comprehensive data on the MSME sector, and conduct a demand survey on business finance	MICC, Statistical Institute	MT
Evaluate measures to reduce informality	MoF/ MICC	MT
Include agriculture finance as a key area in the overall financial inclusion strategy, including specific financial instruments, public policies, and institutional framework	MoF/BoJ/MoA	ST

ST - up to 1 year; MT- 1-3 years

I. MACROECONOMIC ENVIRONMENT

1. **Over the past 30 years, Jamaica has experienced low economic growth and high fiscal deficits, with a significant impact on the development of the financial sector.** In the last 30 years, Jamaica's real GDP per capita has increased at an average of one per cent per annum. Natural disasters, financial shocks coupled with unstable and lax fiscal policies, resulted in persistent public deficits financed through significant public sector borrowings. High borrowings led to both high financing costs with crowding out of private sector investments, and macroeconomic uncertainty driven by unsustainable public debt ratios, at about 147 percent by 2013. Nevertheless, Jamaica's macroeconomic outcomes have recovered and are expected to improve. For fiscal year 2014, growth is estimated at 0.9 percent and for fiscal years 2015 and 2016, it is projected at 0.9 and 2.1 percent, respectively.[7]

2. **The Government of Jamaica (GoJ) has articulated a comprehensive program of reforms that includes fiscal consolidation and a strategy to promote private sector-led growth**. The Government's economic reforms will benefit from the signed GoJ-IMF Extended Fund Facility Arrangement (EFF) for SDR in the amount of 615.4 million (about US$932.3 million) for the period of April 2013 to March 2017, and support from the World Bank and the IDB, each having agreed to allocate US$510 million over the next four years.

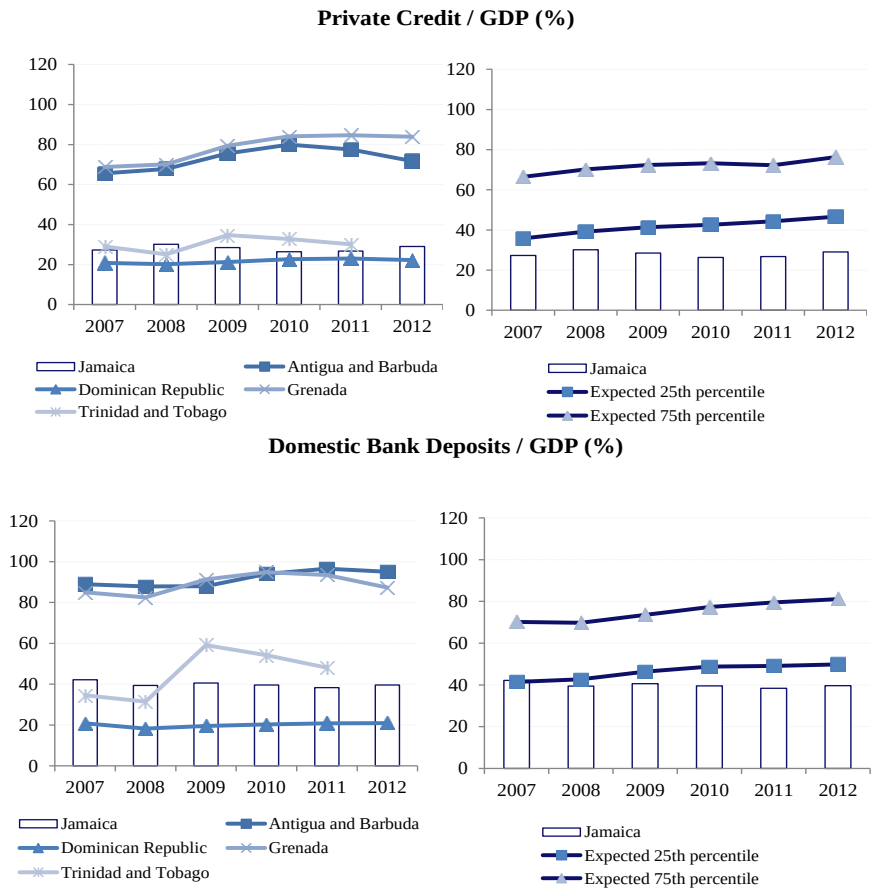
3. **The macroeconomic and fiscal context has determined the development of the financial sector, whose assets represent 129 percent of GDP but with a low credit penetration.** The combination of slow economic growth rates and high level of sovereign debt issuance has limited the evolution of the corporate and financial sectors. The high ratio of financial assets to GDP is due to the large proportion of sovereign debt on the financial sector's balance sheet, which has crowded out its primary function of lending to the economy. Government instruments accounted for about 20 percent of bank assets at end-2013.[8]

II. FINANCIAL SECTOR LANDSCAPE

4. **Financial intermediation in Jamaica remains low.** Notwithstanding the recent credit expansion, the stock of credit remains subdued. Credit has grown by an average of 11 percent in the last five years. Credit to private sector stands at J$450 billion (US$ 4 billion), representing 29 percent of GDP and 46 percent of the total assets of Deposit-Taking Institutions (DTIs), whereas bank deposits represent 40 percent of GDP. Both credit and deposit penetrations are well below their expected value based on the country's structural characteristics, such as income and demographic indicators, and below peer countries, such as Trinidad and Tobago, and Antigua and Barbuda.[9]

[7] World Bank estimates as of December 2014.
[8] BoJ data.
[9] World Bank FinStats database.

Figure 1. Credit and Deposit penetration

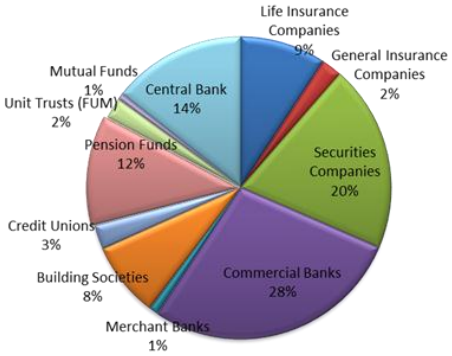


Source: World Bank FinStats

5. **The financial sector is fragmented.** DTIs supervised by Bank of Jamaica (BoJ), including six commercial banks, two merchant banks, and three building societies, represent only 52 percent of total financial sector assets[10]. Non-Bank Financial Institutions (NBFIs) include non-bank securities dealers (23 percent of assets), insurance companies (11 percent), credit unions (3 percent), and pension funds (12 percent). Despite credit unions' small share of total lending, their client base consists of a third of the population. In addition, there is a small microfinance sector (over 100 companies), which is largely unregulated.[11]

[10] Commercial banks represent 75 percent of DTIs' assets, building societies 21 percent, and merchant banks less than 3 percent.
[11] Microfinance Association, microfinance companies.

Figure 2. Market share in financial system assets, 2013



Source: BoJ

6. **The financial sector has been resilient with adequate profitability, capitalization, and provisioning**. Despite the two debt restructurings, financial sector soundness indicators remain adequate, with DTIs exceeding the 10 percent minimum capital adequacy ratio (15.1 percent as of end-2013). Non-performing loans have declined to 5.4 percent in December 2013, as a result of write-offs, payments and loan growth, with provisioning increasing to 96 percent of NPLs in December 2013. Banks are fairly profitable (with a 2 percent average ROA and a 14 percent ROE at end-2013) as a result of a high net interest margin (higher than 9 percent over total assets).[12] The stress test results from BoJ show that commercial banks would remain adequately capitalized even under reasonable additional stress, and could absorb losses associated with significant hypothetical depreciations of the Jamaican Dollar and increases in NPLs.

7. **The financial sector has a relatively comfortable liquidity position, despite short term liquidity pressures as a result of the national debt exchange and the transfer of government deposits from banks to the Central Treasury Management System at BoJ**. Liquid assets represent about 25 percent of total assets[13]. The liquidity situation of the financial sector was negatively affected by the implementation of the National Debt Exchange (NDX) in February 2013 and the subsequent illiquidity of GOJ debt instruments[14], and the movement of GoJ deposits from commercial banks to Central Treasury Management System accounts at the BoJ. However, the ratio of deposits to loans remains at 137 percent, and the ratio of short term assets to short term liabilities remains at 40 percent, showing a comfortable structural liquidity position.[15] In fact, lack

[12] BoJ data.
[13] Commercial banks and merchant banks are required to hold reserves amounting to 26 per cent of their average prescribed liabilities in the form of liquid assets.
[14] The NDX was characterized by a reduction in the interest rates on GOJ domestic bonds of between 1and 5 percentage points as well as an extension of the maturity profile. In an effort to alleviate the operational impact this tighter liquidity position could have in the banking sector, BoJ provided funds to DTIs through special repurchase agreements.
[15] BoJ data.

of significant pressure on liquidity can also be inferred by analyzing the cost of funding. Despite the short term liquidity concerns, the average cost of deposits has not increased, and remains at 2 percent, well below the inflation rate.

8. **There is an uneven regulatory and supervisory framework for lending institutions.** Parliament has passed the Banking Services Act, which consolidates existing pieces of legislation and regulations that govern DTIs. However, other lending institutions have significant presence in specific sectors (e.g. public agencies in the mortgage market), segments of the population (e.g. credit unions in low income households), and geographic areas (e.g. NPCB in rural areas), and have different regulatory and supervisory frameworks. The regulatory and supervisory heterogeneity in the market could be an impediment to sound and stronger growth.

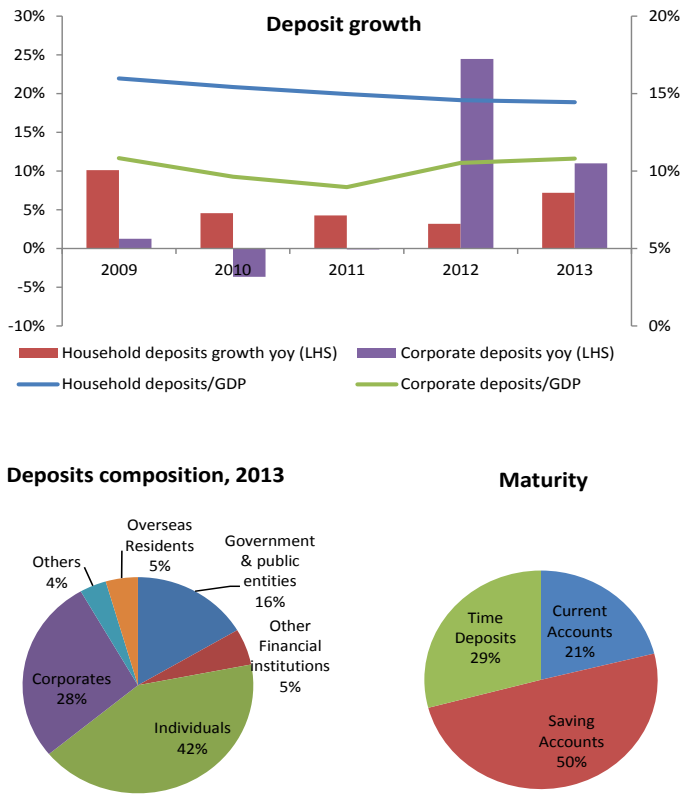
Financial Intermediation by DTIs

9. **Commercial banks are the main players in the credit market, but competition is low and the portfolio is concentrated in loans to households and large corporates.** Commercial banks represent 70 percent of the total loan portfolio of DTIs and credit unions, and credit unions 10 percent. Competition among banks is low with the two largest banks – National Commercial Bank and Bank of Nova Scotia Jamaica – holding about 75 percent of assets and deposits of the banking sector. As a result of the activity on the sovereign bond market (government securities accounted for 20 percent of bank assets at end-2013), banks' balance sheets still show a low ratio of loans to total assets, with a focus on household and corporate loans, and in urban areas. Lending to MSMEs represents about 20 percent of the total portfolio of commercial banks and merchant banks (building societies focus on mortgage lending).[16]

10. **Deposit-taking institutions (DTIs) activity is funded with short term deposits (80 percent of total liabilities) as long term funding is nonexistent**. Deposits are growing steadily at an average rate close to inflation and in the absence of other alternative saving instruments, and in a context in which DTIs will continue reducing their exposure to public debt (it has decreased by more than 5 percentage points in the last four years), the availability of funds for lending should remain at comfortable levels. Deposits have grown at an average of 8 percent in during 2009 - 2013, at a similar rate for households (5.9 percent) and corporates (6.6 percent). Individuals hold more than 40 percent of deposits, enterprises less than a third, and the public sector holds about 16 percent of total deposits, at end-2013. As a share of GDP, household deposits accounted for 14 percent and corporate deposits for 11 percent in 2013. Deposits are mostly short term demand and savings deposits (more than 70 percent). [17] See Figure 3.

[16] BoJ data.
[17] BoJ data.

Figure 3. Deposit growth, composition, and maturity

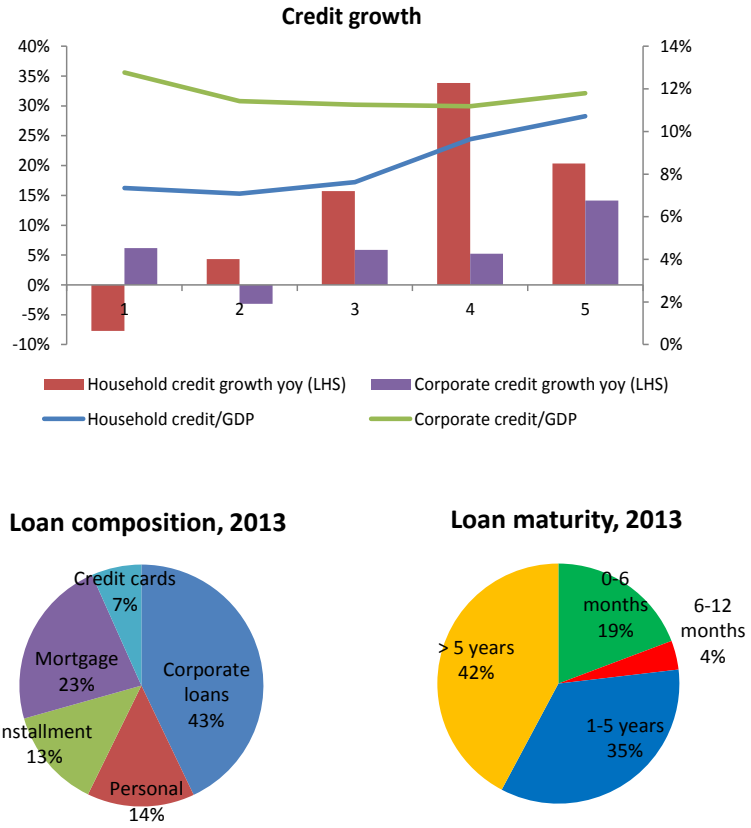


Source: BoJ

11. **Credit has grown by an average of 11 percent in the last five years**. Credit growth has been driven by lending to households, at an average of 13 percent during 2009-2013, compared to an average of less than 6 percent growth in lending to corporates. Corporate loans account for about 40 percent of lending to the private sector, and consumer lending consists of mortgage, installment, and personal loans. A significant share of loans (more than 40 percent) mature beyond 5 years, about 23 percent of loans have maturities of up to 1 year, and 25 percent of 1 -5 years (Figure 4).[18]

[18] BoJ data.

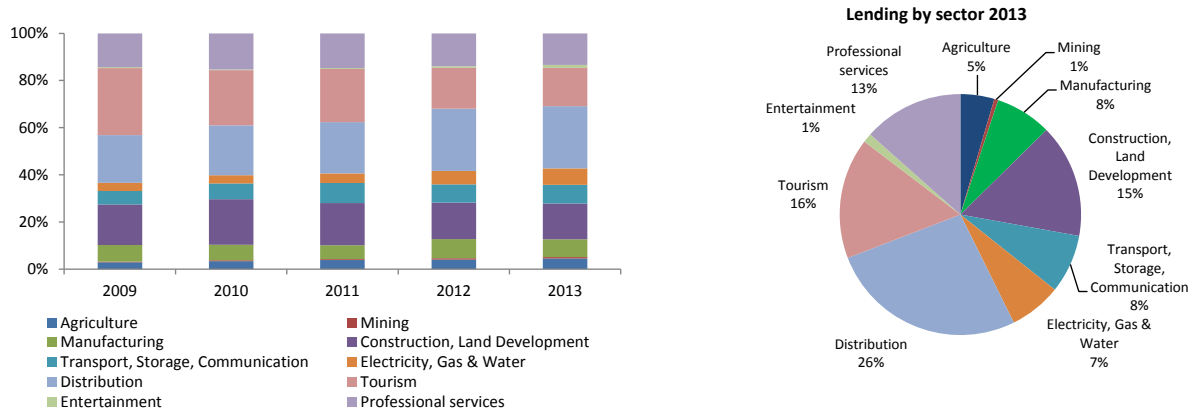
Figure 4. Credit composition, growth, maturities



Source: BoJ

12. **Loans are diversified across sectors of the economy.** At end-2013, distribution accounted for about a quarter of total loans, tourism for 16 percent, and construction for 15 percent. Manufacturing and the agriculture sector receive a low share of lending, 8 percent and 5 percent respectively. The agriculture sector's contribution to the economy is not high, as agriculture represents 6.5 percent of GDP, and 17 percent of the labor force. More than half of land is unregistered, making it difficult for banks to lend against this type of collateral. Most agriculture is done by small scale farmers.

Figure 5. Lending by sector of the economy



Source: BoJ

Financial Intermediation by Credit unions and MFIs

13. **Credit unions represent a small share of total lending, but have over 1 million members (a third of the total population), and provide mostly consumer finance.** There are 37 credit unions, with assets of less than 5 percent of GDP (J$ 76 billion or about US$ 685 million), representing 7 percent of DTIs' loan portfolio. About 9 percent of their total loan portfolio is provided to micro-entrepreneurs for productive purposes. Since 2009, their loan portfolio has grown by an average of 10 percent (yoy), while deposits have grown by 7 percent (yoy) in the same period. Credit unions only lend to their members, including to sole traders. About a third of members are in rural areas. They have 76 branches, the majority of which are located outside of Kingston and St. Andrew parish.[19] There is significant concentration among the largest credit unions, with the four largest representing about half of the sector's assets (CWJ, Jamaica Teachers' Association, COK Sodality, and First Heritage Cooperative). They are currently registered and regulated by the Department of Cooperatives and Friendly Societies in the Ministry of Industry, Investment, and Commerce, and will be supervised by BoJ under the upcoming Credit Unions regulations (see section on the legal framework).

Table 2. Indicators for Credit Unions

	2009	2010	2011	2012	2013
Credit Unions (#)	47	46	44	43	38
Total Assets (Net) (J$ billion)	56	61	67	71	76
Savings (J$ billion)	44	48	52	55	59
Gross Loans (J$ billion)	37	39	43	49	53
Membership (#)	986,412	976,012	948,869	971,177	1,003,201

Source: BoJ

[19] BoJ data, Credit Union League.

Table 3. Selected Financial Sector Indicators for Credit Unions

(in percent, unless otherwise indicated)	2009	2010	2011	2012	2013
Capital adequacy					
Capital/Assets	11	11	11	12	11
Asset quality					
NPLs (3 Mths &>) : Total Loans (gross)	2	4	3	3	3
NPLs (3 Mths &>) : (Total Assets + IFRS Provision for losses)	2	3	2	2	2
Profitability					
Pre - tax Profit Margin (for the Year End)	19	10	12	9	11
Return on Average Assets (for the Year End)	3	1	2	1	2
Net Interest Income to Gross Income	89	89	86	85	84
Non-Interest Expenses to Gross Income	75	86	85	89	87
Non-Interest Income to Total Income	8	8	11	12	13
Loans and deposits					
Loans/Savings	84	80	83	89	91

Source: BoJ

14. **In addition, there is a small microfinance sector, which is largely unregulated**. It is estimated that there are about 100 microfinance companies in Jamaica. A bank (Scotia bank) and a building society (Jamaica National) have set up microfinance companies. However, most of them are unaffiliated with the formal financial sector. These companies are non-deposit taking institutions and dependent on their capital base and borrowings to fund lending. The loan portfolio is estimated at about J$8 billion (US$ 80 million).[20] This represents about 25 percent of the total lending of credit unions. They also serve a small client base of approximately 30,000 – 40,000 borrowers. The largest MFIs are Access (with a loan portfolio of about US$ 12 million and 7,000 borrowers) and Jamaica National Small Business Loans (loan portfolio of US$ 10 million, and 13,000 borrowers).[21] They provide both consumer lending and loans to micro-entrepreneurs. There is a microfinance association with 11 members, but the largest ones do not form part of the association.

15. **Microfinance companies are charging a rate of 1% a week, or above 50 percent yearly**. The Money Lending Act caps the interest rate from microfinance companies at 40% yearly, but allows exemptions from this requirement), a process that seems rather simple, with microfinance companies applying to the Ministry of Finance yearly for such an exemption. The reported interest rates are high, but the cost of managing many small loans is expensive and micro-lenders charge higher interest rates than other financial institutions to account for that and cover their costs. Research analyzing the key determinants of microcredit interest rates (such as the cost of funds, loan-loss expense, operating expenses, profits) to understand what drives the high interest rates charged by microcredit providers, have shown that operating expenses are the largest determinant of the interest rate. From the perspective of the demand side, timely availability, easy accessibility of micro credit, and low collateral requirements are often the most important factors for micro-borrowers. The adoption of technology is the way forward to reach customers better and lower operating costs. In addition, given concerns with high microfinance rates, an interest rate

[20] Microfinance Association.
[21] Access and Jamaica National Small Business.

decomposition can be undertaken to determine the primary factors driving the high interest rates in microfinance in Jamaica.

16. **The absence of a regulatory framework and authority to oversee the activities of microfinance may hinder the growth of microfinance.** Instead of an interest rate cap, there are other ways to protect small borrowers, such as requiring transparent disclosure of loan costs and terms, prohibiting abusive lending and collection practices, establishing complaint resolution systems, and improving consumers' financial literacy. The Microcredit bill is expected to make it mandatory for MFIs to register, will establish the qualifying criteria for registration, and will make them subject to a regulatory authority

III. MSME FINANCE MARKET

Firms' demand for financial services

17. **MSMEs[22] are expected to contribute significantly to the country's employment and the economy.** It is estimated that there are about 200,000 formal SMEs in Jamaica, and between 200,000 – 400,000 micro-entrepreneurs, although there are no recent official estimations on the size and composition of the MSME sector. According to different sources and surveys, the Own Account Worker category (i.e. any person who operates a business but did not employ paid help) is estimated to account for 36 per cent of the employed labor force[23] and most MSMEs are involved in wholesale and retail trade (more than 50 percent) and community, social, and personal services sectors (23 percent). More than half of the micro and small businesses are located in the Kingston metropolitan and other urban areas (St. Andrew and St. Catherine).[24]

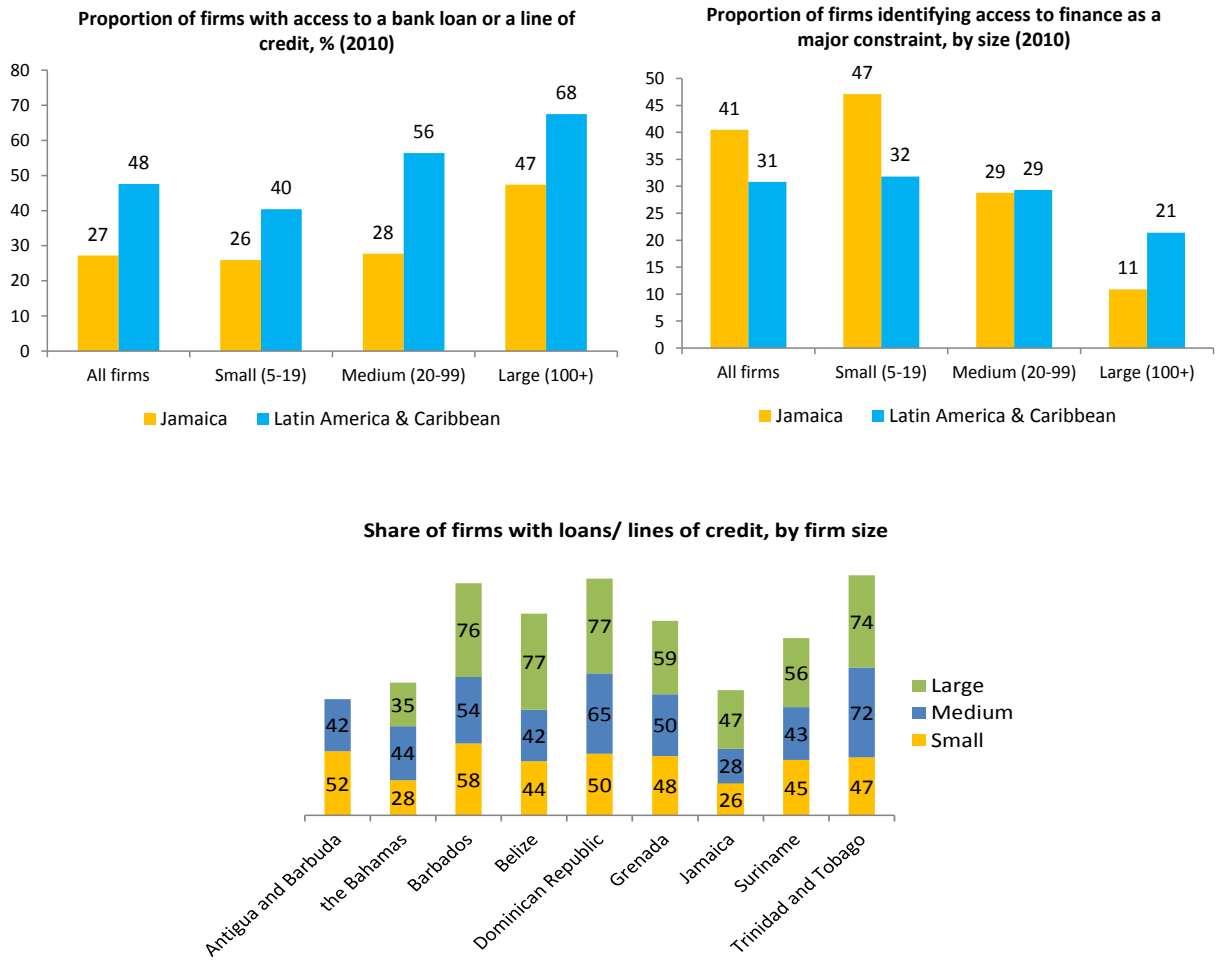
18. **However, MSMEs face access to finance constraints that limit their ability to invest, grow, create jobs, and contribute to the economy.** According to the 2010 World Bank Enterprise Surveys, almost all formal SMEs have access to checking or saving accounts, but only about 27 percent have a bank loan or line of credit, well below the average of 48 percent in LAC. More than 40 percent of firms in Jamaica consider access to finance as a major constraint, but especially small enterprises (47 percent, compared to the average of 32 percent in LAC). The top three business environment constraints in 2010 in Jamaica were tax rates, electricity, and access to finance.

[22] A national definition for MSMEs in Jamaica was established in 2011 under the Ministry of Industry, Investment and Commerce's "MSME & Entrepreneurship Policy". Microenterprises are defined as enterprises employing 5 persons or less and have an annual turnover not exceeding $10 million. Small enterprises employ between 6 and 20 people and have an annual turnover between $10 and $50 million. Medium-sized enterprises employ between 21 and 50 persons and have an annual turnover between $50 and $150 million.

[23] According to the 2011 Statistical Institute of Jamaica (STATIN) Labor Force Survey. In Latin America, formal SMEs account for over 90 percent of enterprises, with small firms accounting for over 60 percent of enterprises, Enterprise Surveys, 2010.

[24] MSME Entrepreneurship Policy (2013), 2008 survey "A Landscape Assessment of Jamaican Micro, Small and Medium-Size Enterprises (MSMEs)."

Figure 6. Enterprises and Access to Finance



Source: Enterprise Surveys, 2010

19. **Access to finance constraints result in investments being financed primarily with SMEs' own funds.** About 72 percent of investments are financed internally (above the average of 63 percent for LAC), while only 22 percent are financed by banks (similar to the average in LAC).[25] Due to such constraints, investments tend to be limited or delayed, resulting in lost productive capacity, eroding competitiveness, sales, and ultimately growth.

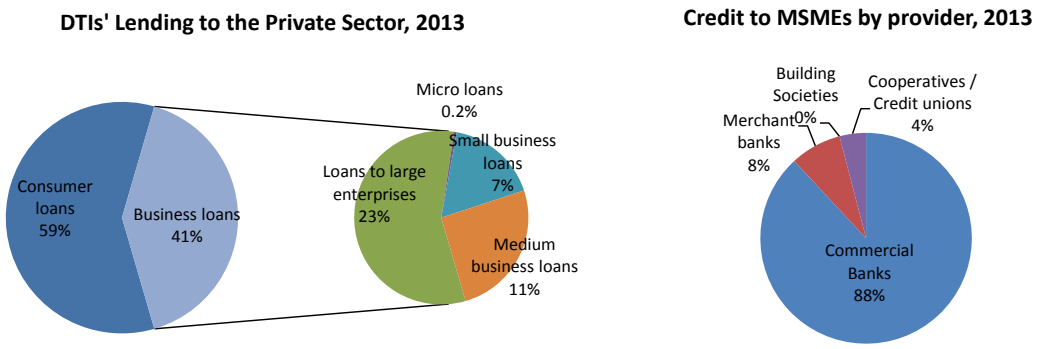
Lending to MSMEs

20. **Bank have been lending mostly to profitable sectors, such as loans to larger firms, avoiding riskier and more difficult segments to serve, like MSMEs**. According to BoJ's Credit Conditions survey of 2013, MSMEs received about 18 percent of DTIs' lending to the private sector in 2013, while large enterprises received 23 percent of lending to the private sector. [26] Banks are the main providers of credit for MSMEs, with credit unions providing 4 percent of total lending

[25] 3% financed with supplier credit. Enterprise Surveys, 2010.
[26] BoJ Credit Conditions survey.

to MSMEs. As a share of total lending to enterprises, MSMEs received a share of more than 40 percent of loans.

Figure 7. Credit to the private sector



Source: BoJ

21. **In terms of the enabling environment, banks perceive recent reforms in the credit information sharing environment and movable collateral registration as positive developments to encourage them to serve MSMEs**. Credit information sharing is nascent in Jamaica. The data submission process to credit bureaus, which started operation in 2013, is still ongoing. Although the credit bureaus are still receiving data and the process is ongoing, banks are requesting credit reports from their customers, already helping in identifying creditworthy customers. Equally, the establishment of the movable collateral registry is recognized by banks as a positive development, although registration is not being done in bulk yet, and banks report skepticism about enforcing movable collateral. Overall enforcement of collateral can be difficult.

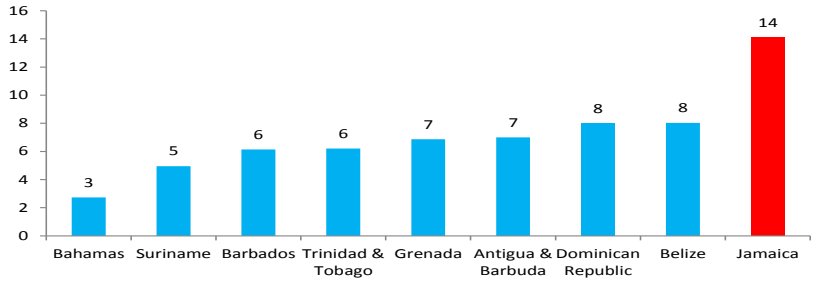
22. **There are several factors that have constrained lending to MSMEs.** These factors include: (i) traditionally banks have not saturated lending in the retail segment due to investment opportunities in low-risk instruments and have not felt the need to diversify into other segments; (ii) lending to the MSME segment has been perceived as high risk due to significant information asymmetries that exist in the market (earlier absence of credit reporting systems) and the high level of informality, especially of micro-entrepreneurs[27], resulting in higher interest rates for this segment or refusal of credit; (iii) lack of adequate traditional collateral by MSMEs as required by banks, focused mostly on real estate or motor vehicles; (iv) lack of bank strategies, processes, lending methodologies, and financial instruments to lend to this segment, although banks have started to develop such methodologies; and (v) lack of reliable financial statements for MSMEs that makes it difficult for banks to assess risks.

[27] 43% of the economy is estimated to be informal. Enterprises in the informal sector are concentrated in low-productivity, labor-intensive activities. Nearly 60% of Jamaicans in the informal sector work in the wholesale/retail trade or agriculture. In addition, a 2008 survey revealed that about half of MSMEs surveyed claimed to be registered with the Companies Office of Jamaica (COJ) (IDB, 2006. The Informal Sector in Jamaica).

- **Banks have had high return- low risk investment opportunities.** In the last five years, the banking sector has had limited incentives to increase lending due to the availability of investment opportunities in low risk GoJ securities.

- **Lack of a more developed financial infrastructure and insufficient competition in the banking sector, have contributed to higher credit risk, and higher interest rates**. Lending rates[28] averaged at about 18 percent in 2013, and are three times as high for micro-entrepreneurs as for medium-sized firms, while the cost of raising deposits averages at about 2 percent (a 16 percent spread). Interest rates are higher for MSMEs due to the higher risks and higher transaction costs. MSMEs make more extensive use of short-term credit that carry higher interest rates. Credit unions and MFIs charge rates of above 50 percent annually for microenterprise loans. The absence of a public credit registry and the incipient situation of the credit bureaus[29] have increased credit risk for financial institutions, by making it difficult for them to assess the level of indebtedness and borrowers' repayment capacity, and thus having high traditional collateral requirements. When compared to other peer countries, Jamaica has the highest interest rate spreads (Figure 8).

Figure 8. Jamaica and Peer Countries, Interest rate spreads, 2012



Source: WDI

- **MSMEs lack adequate traditional collateral required by banks, focused mostly on real estate or motor vehicles.** Banks offer mostly secured credit to SMEs. The main sources of collateral are real estate, as well as vehicles and equipment. In addition to other requirements, banks also require letters of references from MSMEs. On average, the value of collateral needed for an SME loan is more than 200 percent of the loan amount (compared to 140 percent of the loan amount for large enterprises), according to the Enterprise Surveys of 2010, higher than its peers (such as, Trinidad & Tobago, Antigua & Barbuda, Barbados, Belize).

- **Banks have limited strategies, processes, lending methodologies, and financial instruments to lend to this segment, although banks have started to develop such methodologies.** Banks serve SME clients primarily through their branch network, and the largest banks have started to develop processes and methodologies for lending to this segment. Most of the large banks have SME departments.

[28] As a result of high lending rates (18 percent, which compares to 8.25 percent for 180-day T-bill and a 9.5 percent inflation rate in December 2013) and low cost of funds (2 percent weighted average deposit in local currency rate), the Net Interest Margin for DTIs was 8.9 percent of average assets in 2013.
[29] See Technical Note on financial infrastructure.

- **Banks are cautious to lend to MSMEs because many are considered unbankable due to the lack of reliable financial statements.** Banks report that the financial statements of MSMEs are not reliable, and they consider this factor as one of the most significant obstacles for them to lend to MSMEs.

- **A large share of firms remains in the informal sector, especially microfirms, and thus do not enter the formal financial sector.** A significant part of the economy is informal (estimated at about 43 percent of GDP),[30] and does not have sufficient access to the formal financial sector (except from the credit unions and MFIs). Enterprises in the informal sector are concentrated in low-productivity, labor-intensive activities. Nearly 60% of Jamaicans in the informal sector work in the wholesale/retail trade or agriculture. In addition, a 2008 survey revealed that about half of MSMEs surveyed claimed to be registered with the Companies Office of Jamaica (COJ).[31] Informality affects negatively MSMEs' growth prospects and their ability to raise finance. Banks report that informality is a significant obstacle as they do not approach the financial sector.

23. **In addition, the supply of nonbank sources of finance especially for micro-entrepreneurs is limited, with credit unions providing mostly consumer finance and a an underdeveloped microfinance sector.** Credit unions provide mostly consumer finance to lower income households, with about 9 percent of their loan portfolio to micro-entrepreneurs for productive purposes. In addition, MFIs are small, largely unregulated, and for micro-enterprise lending they report annual interest rates of about 50 percent.[32] The high cost of funds and high administrative expenses for small loans contribute to the high interest rate. Given the high interest rate charged, the short term maturity, and the low value of such loans, they fill a gap for immediate liquidity for micro-entrepreneurs, but not for financing investments.

Alternative Sources of Finance for SMEs

24. **Financial instruments that can be especially valuable for SMEs are lacking in the market, such as factoring and leasing.** The recent modernization of the secured transactions reform should encourage the development of such movable asset based financing instruments.

25. **Factoring[33] does not exist in Jamaica and there is a general lack of awareness about this instrument.** Factoring and reverse factoring would help small businesses finance their production cycle, since they lack access to bank credit and most buyers usually take between 30 and 90 days to pay. Factoring schemes are widely used to provide SMEs with immediate working capital on the basis of their receivables from large firms, and become important instruments, especially in an environment with weak contract enforcement regimes Factoring provides many benefits to SMEs, both credit and a way to manage cash flow. In traditional factoring, the factor purchases many accounts receivables from SMEs, and needs to collect credit information and

[30] IDB, 2006. The Informal Sector in Jamaica.

[31] IDB, 2006. The Informal Sector in Jamaica.

[32] Credit Union League, Microfinance Association, microfinance companies.

[33] Factoring is a form of financing in which SMEs sell accounts receivables to a financial firm (the factor) at a discount (equal to interest plus service fees) and receive immediate cash. The title of the accounts receivables is transferred to the factor.

assess the credit risk for a large number of buyers. However, in an alternative way, reverse factoring, the factor purchases receivables only from high quality buyers. In this manner, reverse factoring mitigates the problem of information opacity as factors need assess the credit risk of a few large transparent firms, as well as the risk of fraudulent invoices.

26. **In Jamaica, factoring is not recognized as a financial service in the Banking Services Act, and there is no factoring law.** The development of factoring is affected by specific legal, regulatory, and tax issues, which need to be assessed, including the recognition of the sale and purchase of accounts receivables, the treatment of this instrument in the financial regulatory framework (or how factoring companies are regulated compared to other financial services firms), and tax considerations, as stamp duties on factored invoices and VAT might make factoring transactions too costly. Jamaica has an Electronic Transactions Law that should favor the development of factoring.

27. **In addition, there is very limited leasing conducted by commercial banks.** Financial leasing is defined in the Banking Services Act as a permissible activity for DTIs, but there is no leasing law. There appear to be ambiguities amongst market players as to whether they can undertake leasing as a financial service, whether a special license is needed, and what the benefits would be for offering such an instrument.[34] Leasing would enable SMEs to finance an investment without owning assets, and they would be able to lower taxes by recording the full lease payment as an expense. It would also enable lessors to reduce credit risk as it resolves the issue of lack of collateral and financial information/credit history from the SME, it provides a stronger legal position for seizing equipment since they own it, and would benefit from tax deduction for the depreciation. Preferential tax treatment for leasing transactions would encourage its development. A relevant issue is also the existence of second-hand market for certain equipment, in which to sell the equipment if an SME defaults and the equipment is seized. There is an indication that there would be difficulty in selling certain repossessed equipment in the second hand market in Jamaica.

28. **Beyond debt financing, there is limited equity financing for SMEs.** Venture capital investments in Jamaica have generally operated informally, through the entrepreneur's own funds or from friends and family. The development of venture capital presents an opportunity to finance high-growth firms, given an enabling legal and regulatory environment and policy commitment. In addition, the Junior Stock Market for SMEs is small and not liquid.[35] Only 22 SMEs are listed and since its establishment in 2009, SMEs have raised about J$3.5 billion (US$ 27 million) in the Junior Market (compared to J$ 10 billion or US$ 90 million raised in the overall market). As of end-2013, market capitalization was J$ 27 billion (US$ 270 million, about 10 percent of the overall market capitalization), with traded volumes of about 477 million for a value of J$1.4 billion (US$ 12 million). This constitutes on average 29 trades a day, with a daily value of less than J$5.5 million (US$ 45,000). [36]The limited number of firms that would qualify to be listed, lack of liquidity, lack of relevant institutional investors, and the risks presented by such investments for retail investors, do not encourage the development of this market.

[34] In developing countries on average about 15 percent of investments are financed via leasing.
[35] The Junior Market is designed for SMEs to raise between J$50 million and J$500 million. It has provided tax advantages for SMEs to list, and allows for reduced fees, and requires companies to appoint a mentor to assist them with corporate governance principles, financial reporting, etc.
[36] Junior market data.

29. **In addition, micro-insurance is an important financial service that would mitigate risks for micro-entrepreneurs and farmers, but is currently limited.** Micro-insurance would enable micro-entrepreneurs and farmers to mitigate risks in their daily lives and businesses. Currently, the offer of micro-insurance products is focused on funeral coverage, some specific loans, employer-based insurance products with low premiums paid by employees, and for simple accident coverage. A micro-insurance product (index based: wind speed or rain fall) has been developed and offered to farmers to protect their agriculture products. The authorities are working towards drafting a specific regulation for micro-insurance, which is currently treated in the same manner as regular insurance.

IV. LEGAL AND REGULATORY FRAMEWORK

30. **BoJ does not have in place a modified regulatory framework in terms of documentation requirements that could incentivize lending to MSMEs.** Documentation requirements and certain regulatory norms can limit banks' lending activity to SMEs. In Jamaica, as a result of AML regulations, banks require audited financial statements, proof of tax compliance, recommendation letters and other requirements from MSMEs.[37] Jamaica has adopted IFRS for all SMEs, but in many countries IFRS for SMEs has been considered excessively costly and complex for smaller firms.[38] A large share of the firms in Jamaica consists of small businesses and it is costly for such small borrowers to be required to submit audited financial statements.[39]

31. **BoJ will undertake official supervision of credit unions with the enactment of the Credit Unions' Regulation to be issued under the Bank of Jamaica Act.** Credit unions are currently registered and regulated by the Department of Cooperatives and Friendly Societies in the Ministry of Industry, Investment, and Commerce as per the Cooperative Societies Act. Credit unions have also been identified as "specified financial institutions" under the Bank of Jamaica Act by the MoF, which enabled BoJ to request financial and other information from credit unions as necessary. The Credit Union League is also involved in the voluntary regulation of credit unions and it maintains a stabilization fund for credit unions.

32. **The development of a clear regulatory framework[40] for credit unions and the transfer of supervisory oversight to BoJ is a positive development.** Lack of a clear regulatory framework for credit unions has created uncertainties amongst the industry in recent years. Following extensive consultations with the industry, BoJ is in the process of modifying the regulations. Initially, proposed provisions included requiring a cap on secured lending of 10 percent of total loans, when the microfinance business is mostly unsecured, or requiring full provisioning for all loans over 90 days (modified in the current revisions to require full provisioning for unsecured loans at 180 days, 50% provisioning for secured NPLs of over 360 days, and full provisioning for

[37] KYC requirements are currently under review in the context of supervision and AML oversight approach from a risk based perspective. There is a pending review/update of supervisory guidance on the requirement of audited financial statements, or alternative submissions that would be acceptable.

[38] The EU exempts firms with fewer than 50 employees from obligatory audits, to strike a balance between improving transparency and reducing the regulatory burden for small firms.

[39] The Enterprise Surveys of 2010 indicated that over 44 percent of formal firms in Jamaica were sole proprietors (compared to 31 percent in LAC). 14 percent of firms were LLCs (compared to above 40 percent in LAC), 12 percent partnerships, and 29 percent limited partnerships.

[40] For guidance on regulation and supervision of microfinance, see Basel Committee on Banking Supervision" Microfinance activities and the Core Principles for Banking Supervision" 2010, and CGAP's "A Guide to Regulation and Supervision of Microfinance", October 2012.

secured NPLs of over 18 months past due).[41] The draft CU regulations[42] also provide for a minimum capital requirement of J$ 5 million (compared to 60 million for commercial banks). The regulation should also take into account the implications of the SIPP law that broadened the range of personal property that can be taken as collateral.

Table 4. Provisioning Requirements under CUs' Regulations

	Credit Unions Voluntary Provisioning	
	%	
	0	
	0 10 30 60 100	

nder the Regulations will require the early full provisioning or write-off of non-performing facilities as follows:

100% write off at 180 days past due

% write off at 9 months after non-accrual (i.e. 12 months past due) and 100% at 15 months after non-accrual (i.e. 18 months past due)

upervisor may, after giving due consideration to attendant circumstances, allow for up to 24 months after non-accrual for 100% provisioning

*Source: BoJ, * Provisioning required regardless of the value of any collateral security held, all loans that do not attract a specific provision (including current loans) attract a 1% general provision.*

[41] Currently, CUs use a 30% provisioning for arrears up to 6 months, 60% provisioning for arrears up to 12 months, and 100% for over 360 days.

[42] The draft CU regulations refer to the regulations at the time of the assessment in May 2014.

Box 1. Good Practices in Prudential Regulation for Deposit-Taking Microfinance

A Guide to Regulation and Supervision of Microfinance, CGAP (2012)

• Minimum capital should, in principle at least, be set high enough to ensure that the institution can cover the infrastructure, MIS, and start-up losses to reach a viable scale. Minimum capital should also provide incentives for adequate performance and continued operation.

• Where possible, it is usually preferable to set minimum capital through regulation rather than legislation, but the regulator needs to be clear in its communications with the market to avoid a perception that the regulator is unpredictable. Primary among other advantages, setting the requirement through regulation makes it easier for supervisors who are new to microfinance to start with a manageable number of new licensees, reserving the option of reducing minimum capital and licensing more institutions as experience is gained.

• Regulation—including any proposed new regulation that provides for depository microfinance—should clearly define the types of permissible activities that a prudentially regulated institution may engage in.

• There are strong arguments (and recent experiences) that support the imposition of higher capital adequacy standards for specialized depository MFIs than for banks.

• A microloan portfolio should not be limited to a specified percentage of the lender's equity nor burdened with a high general provision requirement simply because the loans are not conventionally collateralized.

• Absent special circumstances, performing microloans should have the same provision requirement as other loan categories that are not particularly risky. However, the provisioning schedule for *delinquent* microloans that are uncollateralized should be more aggressive than the provisioning schedule for secured bank loans.

• Boards of deposit-taking MFIs should be independent of management and should include members with experience in finance and banking, as well as members who understand the clients well.

• Specialized MFIs may need higher, rather than lower, liquidity requirements.

• MFIs should not borrow or transact in foreign currency without having the capacity to assess and manage currency risk.

• Given the size of microloans and the nature of the borrowers, loan documentation requirements need to be lighter for microcredit than for conventional bank lending.

• Prohibitions against co-signers as borrowers may need to be relaxed.

• Branching requirements should be re-examined, but not necessarily eliminated, for microfinance.

• The content and frequency of reports should enable supervisors to conduct the analyses needed for effective supervision of a depository MFI. However, regulation must also consider the circumstances of its supervised institutions, which may not be able to comply with some requirements applicable to banks.

• With respect to MFIs that are not member-owned and that receive favorable regulatory treatment because of their focus on poor clients, it is hard to see a reason for any insider lending except perhaps small welfare loans to employees

• When creating new regimes for depository microfinance, regulators should take care that full-service banks and other financial institutions (not just MFIs) are enabled to provide microfinance services.

Basel Core Principles and Deposit-Taking Microfinance

The 2010 guidance paper on Basel Core Principles for Microfinance, applying the 25 principles to microfinance activities in depository institutions, highlight the importance of a proportionate (risk-based) approach as well as the key differences between a microloan portfolio and a commercial loan portfolio. The key differences include (a) the particularities of the labor-intensive microlending methodology, (b) the licensing requirements, which should reflect different risks than those of commercial banks, (c) the particular provisioning and reserve requirements that should be applied to microloans, and (d) the need for different liquidity requirements (BCBS 2010).

Source: CGAP, A guide to regulation and supervision of microfinance (2012), BCPs for Microfinance (2010)

33. **Microfinance companies remain largely unregulated, and the authorities are working to develop a Micro-Credit Act.** The absence of a regulatory framework over the activities of microfinance may hinder the growth of the sector. MFIs are governed under the Money Lending Act (MLA) of 2004, established to regulate money lending in Jamaica and to protect borrowers

from unscrupulous lending practices. While the Act precludes lending institutions from charging interest rates above a ceiling of 40 percent, some institutions are exempt, including banks, building societies and friendly societies, as well as MFIs that receive an exemption from the Ministry of Finance (to be renewed annually). The authorities are working on a current proposal for developing the Micro-credit Act that would make it mandatory for MFIs to register, would establish the qualifying criteria for registration, would create a regulatory authority to oversee the MFIs, and would remove the interest rate cap.

V. SECURED TRANSACTIONS AND INSOLVENCY FRAMEWORK

34. **The authorities have undertaken significant reforms to strengthen the enabling financial infrastructure, with improvements in the enabling environment for credit reporting systems[43], secured transactions, and insolvency and creditor rights framework.** According to Doing Business 2014, Jamaica ranked 109th on the ease of getting credit,[44] below the LAC average of 92nd. Doing Business ranks Jamaica fairly positively (8 out of 10) in the strength of legal rights index[45], but poorly in the depth of information index (0 out of 6).

Table 5. Doing Business 2014: Getting Credit Indicator

Indicator	Jamaica	LAC
Getting Credit ranking	109	92
Strength of legal rights index (0-10)	8	6
Depth of credit information index (0-6)	0	3
Public registry coverage (% of adults)	0.0	12.8
Private bureau coverage (% of adults)	0.0	37.5

35. **The establishment of the credit bureaus will reduce information asymmetries in the credit market over time.** Credit reporting is valuable to creditors for enhanced credit risk assessments, and thus can facilitate access to finance for individuals and MSMEs over time. However, the data submission process to the credit bureaus is taking place at a slower pace than anticipated. The credit reporting oversight framework and consumer protection framework are in the process of implementation.

36. **Recent secured transactions reforms, including legal reforms and the establishment of the movable collateral registry, would facilitate lending to MSMEs as they have mostly movable assets.** The modernization of the secured transactions reform is a positive development. Research indicates that the establishment of movable collateral registries increases firms' access to bank finance.[46]

37. **The Secured Interest in Personal Property (SIPP) Act was enacted at end-2013, and an electronic moveable collateral registry was launched in January 2014.** The Act enables

[43] For further details on financial infrastructure issues (payment systems and credit reporting) see the Financial Infrastructure Technical Note.
[44] The Getting Credit indicator measures the legal rights of borrowers and lenders with respect to secured transactions through one set of indicators and the sharing of credit information through another.
[45] The strength of legal rights index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending.
[46] Love, Peria, Singh, 2013. "Collateral Registries for Movable Assets: Does their introduction spur firms' access to bank finance?"

creditors to register a wide range of moveable assets, such as vehicles, equipment, agricultural products, livestock, inventory, accounts receivables, intellectual property, and security over present and future assets. Banks report that the electronic registry is easy to access and at a low-cost. It is expected that the registry will become fully operational by end-2014, and improvements are ongoing. It established a transition period of one year to register all the secured interests previously recorded in paper-based databases. Most banks have not yet uploaded their data on moveable collateral at the registry, are manually registering each security and cannot upload in batch. There have been more than 44,000 secured interests filed as of end-April 2014, most of which from retail firms selling home appliances.

38. **The law includes many positive features**. The positive features of the law[47] include: (i) creation of a uniform secured transactions system that covers all existing liens and other encumbrances; (ii) creation of a wide-ranging security interest in all types of tangible and intangible, present and future movables; (iii) registration is generally the preferred method of perfection, although the law provides alternate methods of publicity for specialized types of collateral or for specialized transactions; (iv) inclusion of comprehensive rights over proceeds and after-acquired property; and (v) creation of a modern electronic registry system and provision for effective enforcement remedies.

39. **However, potential difficulties in the regulation for the registry can be encountered.** These include: (i) the drafting style and terminology of the regulation is general and high-level, with several important rules including the methodology, logistics and process for registration not being specific enough); (ii) the registry process appears to give responsibilities to the registrar beyond those necessary for the normal operation of a modern commercial registry, including the qualification of registry information; (iii) the registry rules establish that it does not provide constructive notice of the existence of a security interest, which is the main role of any collateral registry; (iv) the registry rules are complex and incomplete in some sections, and generally require registry involvement in functions that can either cause delay, error or liability for the registry. More details on the specific issues with the regulation of the registry are presented in

[47] This analysis does not consider the law's interaction with other existing legislation or other registries. Contributions on the legal and regulatory framework for secured transactions by John Martin Wilson of the World Bank Group Access to Finance team.

40. Box **2** below.

41. **Beyond the regulation, further efforts are needed to maximize the benefits of the new system.** The use of movable assets would require a shift in the lending culture. These include challenges related to the lack of financial institutions' capacity to adopt innovating lending technologies and lack of awareness of the SME sector of the possibility of using nontraditional types of collateral (such as accounts receivables). In addition, enforcement mechanisms have not been tested yet, and there are concerns that the court system may not be prepared to enforce security interests. Data collection is also incomplete, which will hinder any efforts to monitor and evaluate the registry's usage and efficacy. For example, there is no data on the value of each secured interest filed, the type/size of company, or identification of the kind of movable assets being registered.

Box 2. Specific issues with regards to the regulations of the registry

- Registry rules frequently mention a unique identifier number, but do not provide details of the use and functionality of that number in many subsequent operations regarding the initial registration. If the registry rules attempt to follow a folio system, it may be necessary to change the rules whereby subsequent amendments follow the same number system.
- Registry rules establish an electronic system. However, the rules also preserve written authorizations and other paper-based operations. In some cases, the registrations require the creation of printable written statements to be effective. These rules should be amended to make this a purely electronic registry.
- Application of the Purchase Money Security Interest (PMSI) does not appear to be reserved exclusively for purchases and the manner in which it extends to proceeds, accounts and other types of property, does not seem to require the extension of new value. Both are necessary features of a PMSI.
- There are inconsistencies in the rules for the registration of motor vehicles, whereby in some cases registration by serial number is mandatory but in other cases it could be interpreted as optional.
- The registry rules appear to use description of land as a potential index search criterion for fixtures. However, there are no specific rules on how this search would operate or the manner in which it would be coordinated with real estate registrations.
- The rules require the involvement of the registrar in qualifying and verifying information. They also require that the registrar deny some registrations based on interpretations or rules and other legal criteria.
- The rules require authorization of registrations, which opens the door to registry errors and questions as to the reliability of information in the system.
- In case of registry error or omission, rules allow for the validity of a registration with errors against subsequent creditors, even though (due to the error) it is possible that they would be unable to locate the security interest to which they are subject.
- The verification process (to ensure that the creditor has authorization to file) requires a written contract. However, the contract can take place after the registration. Although this helps with some issues (i.e. pre-filing), there are uncertainties regarding the validity of the period in which the registration existed but was not authorized, which can be confusing and cause potential problems.
- Rules that require that a registration be terminated by the creditor within 21 days after the payment of the secured obligation add unnecessary complications to the system, given that a registrar would be unable to enforce the termination, unless the registry also had access to all loan documents and payment information. This requirement may also reduce the possibility of using secured lines of credit in which no obligation may exist at numerous points in the credit relationship.

Insolvency and Creditor Rights Framework

42. **The authorities are also reforming the insolvency and creditor rights framework, with the new Bankruptcy and Insolvency bill, which is expected to foster access to credit at lower costs.** Effective frameworks for creditor rights and insolvency systems reduce the risks for lenders and make the collateral execution process less time-consuming and less costly. Research has shown that countries with stronger creditor rights tend to have higher rates of private credit to GDP, and lower costs of debt.

43. **The Bankruptcy and Insolvency law aims to facilitate corporate rehabilitations in Jamaica and it introduces out-of-court work outs**. It also includes personal insolvency provisions, i.e. covering also non-corporate SMEs. While the new insolvency law has been adopted, implementing regulations would need to be developed. There need to be clear guidelines for the regulation and supervision of insolvency representatives, covering amongst other things,

professional qualification, independence requirement, etc. Significant training is also required for judges and insolvency administrators, as well as other legal professionals.

VI. GOVERNMENT PROGRAMS RELATED TO ACCESS TO FINANCE

44. **The authorities have put in place several government programs and institutions for MSME finance to address a market gap.** The Development Bank of Jamaica (DBJ), publicly owned, plays an important role for MSME finance. DBJ provides financing to MSMEs mostly through onlending via financial institutions (commercial and merchant banks, credit unions, the National People's Co-operative Bank, and microfinance companies) that undertake the credit evaluation and loan supervision.[48] Eligible companies must have assets of less than US$250,000, annual sales below US$ 4 million, and fewer than 250 employees.

45. **For MSMEs in 2012 DBJ facilitated the approval of over 8,000 loans, in the amount of J$ 1.4 billion.** Of this total, the vast majority was facilitated through MFIs (about 40 percent) and NCPB (about 38 percent), and the rest through other AFIs (17 percent). DBJ's lending to MSMEs constitutes almost half of credit unions portfolio to microenterprises and 2% of banks' lending to MSMEs. The funds are provided at attractive interest rates in the range of 10-13% to clients involved in the productive sectors, such as agriculture, agro-processing, manufacturing, tourism, mining and the service sectors. DBJ has also been designated as the lead agency for co-ordination of MFI industry interventions, playing a significant role to provide funds to these institutions.[49]

46. **In addition to DBJ, there are other banks and agencies that lend and provide capacity building to SMEs.** EXIM bank provides mostly direct lending to SMEs (a loan portfolio of around J$8 billion), the Micro Investment Development Agency (MIDA) provides wholesale lending to SMEs, and the Self-Start Fund provides direct lending to SMEs (expected at J$100 million in 2014/2015, in the past five years the SSF has disbursed over 600 loans valued at over J$200 million). In addition, JBDC also had a financing arm for SMEs, but it now focuses only on providing capacity building services to SMEs.

47. **Partial credit guarantee schemes have the potential to improve access to finance for SMEs, mitigating the credit risk that could generate the existence of asymmetric information.** Guarantees can enable lenders to learn about the creditworthiness of borrowers without incurring the initial risk involved. They not only enable SMEs to access formal credit, but also improve terms and conditions of the loans (longer terms, lower rates, higher loan amounts). However, credit guarantee schemes need to be well designed to work successfully, so that they do not increase moral hazard for borrowers and lenders. Governments' involvement in credit guarantee schemes can be to both provide funds to private guarantee schemes, or to set up public credit guarantee schemes. The majority of credit guarantee schemes in developing countries are public schemes. One of the main questions with regards to the impact of the scheme relates to additionally, whether they generate additional loans, or loans that would have been issued even in the absence of the PCG. Box 3 below outlines the features of FOGAPE, a good practice PCG scheme in Chile.

[48] Its asset base stood at about J$ 23 billion, with a loan portfolio of above J$9 billion. In 2012, it approved more than 8,000 loans in the amount of J$ 6 billion. Direct lending constituted above 40% (for large strategic sectors), and about 60% for onlending.

[49] DBJ data, DBJ has lent over $2 billion to MFIs since the Micro Finance Window was established in 2009.

Box 3. Public credit guarantee scheme in Chile - FOGAPE

FOGAPE is a credit guarantee fund managed by a large public bank, BancoEstado, which provides partial credit guarantees to financial institutions for investment or working capital loans to MSMEs, as well as partial reinsurance to SGRs. Loans guaranteed can be up to US$ 250,000, for a maximum maturity of up to 10 years. The fund does not have its own staff, it is managed by five staff of BancoEstado. The fund's current capital is about US$ 250 Mln. Leverage can be up to 11 times the size of the fund, and its current leverage is 8 times. The guaranteed products are loans, lines of credit, factoring, leasing, and credit cards. FOGAPE does not target its guarantees to any particular sector. It's supervised by the financial system regulator, and is externally audited.

Low operating costs - FOGAPE does not evaluate guaranteed loans, but rather sets broad eligibility criteria and lets participating financial intermediaries decide which loans to guarantee. This has allowed FOGAPE to maintain relatively low administrative costs.

Influencing incentives for lenders, partial guarantees - FOGAPE has put in place an incentive structure for lenders that has reduced some of the problems created by credit guarantee schemes, allowing it to keep a high portfolio performance. FOGAPE only provides partial credit guarantees, so that financial institutions bear part of the credit risk, discouraging them from selecting only the highest risk borrowers, and maintaining incentives for screening and monitoring loans that are covered. In a survey by Beck, Klapper, and Mendoza (2008), 29 out of 39 public guarantee schemes in the sample guaranteed on average up to 75 percent of the loan amount.

Auctioning of guarantees based on the coverage rate - FOGAPE allocates guarantees to financial institutions, or reinsurance to SGRs, through an auction in which these institutions bid on the total amount to be guaranteed and the coverage ratio, fostering competition amongst institutions and driving down the average coverage ratio (by law the maximum coverage ratio is 80 percent). Guarantees are allocated to those financial institutions offering the lowest coverage ratio until the total amount of guarantees auctioned equals the total amount bid. This bidding process encourages banks to take on more risk. SGRs also participate in the auctions for obtaining partial reinsurance for the guarantees (currently about 10 SGRs participate in the auctions).

Adequate fees – In Chile, the fee that financial institutions pay for the guarantees is tied to loan defaults. Fees can vary between 1-2% of the guaranteed amount annually. Most schemes in the world charge annual fees of about two percent of the guaranteed amount (Green 2003).

Simple claims procedures – FOGAPE has in place clear rules for paying out guarantees, which are paid out in full within 15 days of the claim being made, making the scheme more attractive for financial institutions.

Increased outreach - FOGAPE has also been successful in scaling up outreach, increasing the number of new loans guaranteed per year from 10,147 in 2000 to over 64,000 in 2012 (for micro and small enterprises only). In 2000-2012, it guaranteed more than 500,000 loans for more than 200,000 firms. In 2010, there was a peak in guarantees, since due to the financial crisis it was authorized to accept guarantees for larger size companies.

Source: De la Torre, Gozzi, and Schmukler (2007), authors

48. **The DBJ has been operating a partial Credit Enhancement Facility (CEF) since 2009, but it has not been sufficiently utilized by financial institutions**. DBJ set aside J$250 million capital with a 2x maximum leverage to provide partial credit guarantees to AFIs. Since DBJ provides all the capital, the scheme is consolidated on DBJ balance sheet. The maximum guarantee is established at J$ 10 million (US$ 100,000) or 50% of the loan. The scheme charges a fee of 2%, for covering 50% of the loss *par i passu* after financial institutions have exhausted their recovery efforts. Currently the scheme only offers one product and applies the same premium to all the sectors and originators. Since the coverage is *par i passu*, the conditionality and underwriting requirements are not very demanding. In 2012, the CEF approved 105 guarantees in the amount of J$155 million (US$ 1.4 million), supporting J$233 million (US$ 2 million) in loans through 8 AFIs. Since inception, the CEF has facilitated the issuance of J$309 million (US$ 2.8 million) in

loans to 115 SMEs with guarantees totaling J$ 178 million (US$ 1.6 million). To date, there have been no claims against the CEF. [50]

VII. POLICY RECOMMENDATIONS

Legal and regulatory framework

49. **The authorities can consider simplifying documentation requirements and modifying the existing prudential framework for banks to incentivize lending to small businesses.** The requirement to provide audited financial statements for small businesses is costly and time-consuming. BoJ could enable banks to treat business loans below a certain amount as consumer loans, for the purposes of information and provisioning requirements, thus, easing documentation requirements that banks ask from their clients for loans below the determined amount, and the required risk assessment. In addition, current prudential regulations for banks need to be adapted to take into account the range of movable assets introduced by the SIPP law.

50. **The regulatory environment for microfinance should provide a level playing field amongst financial institutions providing microfinance, in order to promote competition and reduce the risk of regulatory arbitrage.** The proposed Credit Unions regulations to be issued under the Bank of Jamaica Act, and the Micro-Credit Act are a welcome development. The authorities should ensure that the regulatory framework for credit unions takes into account their unique characteristics, in terms of liquidity and reserve requirements, provisioning, etc. Given BoJ's role as the supervisor of DTIs, and its new upcoming authority of supervising credit unions, consideration should be given for BoJ to also undertake non-prudential supervision of credit-only MFIs. Since these MFIs are non-deposit taking, non-prudential supervision would be appropriate, in terms of ensuring transparent lending practices, establishing complaint resolution systems, basic reporting, fit and proper criteria, etc. In addition, given concerns with high microfinance rates, an interest rate decomposition exercise can be undertaken to determine the primary factors driving the high interest rates in microfinance in Jamaica.

Expanding alternative and nonbank sources of finance for SMEs

51. **In order to encourage the development of non-traditional financial instruments such as leasing, factoring, and venture capital, the authorities should create an enabling legal and regulatory environment.** Consideration should be given to: (i) develop a factoring law and review and revise relevant provisions in other legislation; (ii) review of the legislative framework that may have contradictions that inhibit the development of leasing, and development of a leasing law to remove ambiguities amongst private sector players; (iii) awareness raising on the benefits of both factoring and leasing, since there is lack of know-how in the market on movable asset based lending; and (iv) develop the eco-system for venture capital.

52. **The authorities should also consider the development an electronic factoring platform.** Such a platform would link large creditworthy firms with their SME suppliers, allowing them to use their receivables from these large buyers to obtain working capital finance through factoring operations. Such a platform would facilitate efficient and low-cost processing of reverse factoring

[50] DBJ data.

transactions. As an example, Mexico's development bank NAFIN created an internet based infrastructure to facilitate factoring. The program created chains between big buyers and their suppliers. The buyers that participate in the program, large creditworthy firms, must invite suppliers (small opaque firms) to join their chain. The program allows small suppliers to use their receivables from these big buyers to obtain working capital finance through factoring operations with participating financial institutions. Transactions take place online, significantly reducing costs. NAFIN was responsible for the development, production, and marketing costs of the electronic system, and in charge of its operations.

53. **In order to encourage the development of micro-insurance, the authorities should draft a specific regulation for micro-insurance.** This regulation should simplify the approval process for micro-insurance products and enable the environment for market players to develop such products.

Strengthening the secured transactions, and insolvency framework

54. **The regulation for the operation of the movable collateral registry should be revised, and beyond the regulation, further efforts are needed to maximize the benefits of the new system.** The use of movable assets would require a shift in the lending culture. These include challenges related to the lack of financial institutions' capacity to adopt innovating lending technologies and lack of awareness of the SME sector of the possibility of using nontraditional types of collateral (such as accounts receivables). Thus, a comprehensive and extensive communications and outreach campaign would be useful to increase awareness and usage of the registry, and stakeholder training that includes the dissemination of the new system to government officials, judges, enforcement officers, lawyers, business community, and financial institutions. The trainings would cover the following areas: (i) structure and content of the Secured Transactions law, including, creation of security interests, publicity of security interests and priority scheme vis-à-vis third party, enforcement of security interests, and other areas; (ii) organization and use of the electronic registry; (iii) overview of asset based lending practices, including accounts receivable financing, inventory financing, equipment financing, collateral management and valuation of collateral, and agribusiness financing taking movable property as collateral.

55. **The authorities should monitor closely ongoing developments in the set-up of the collateral registry, and evaluate and address any challenges.** The registry should enable the identification of the kind of movable assets being registered, specifying the share of accounts receivables, equipment, etc. in order to show impact of the reform over time, identification of the value of the security interest, or the type/size of company. A monitoring and evaluation framework would be useful to monitor and evaluate the registry's usage and efficacy.

56. **While the new insolvency law has been adopted, implementing regulations would need to be developed, and trainings for judges and insolvency administrators.** There need to be clear guidelines for the regulation and supervision of insolvency representatives, covering amongst other things, professional qualification, independence requirement, etc. Significant training is also required for judges and insolvency administrators, as well as other legal professionals.

Strengthening the credit guarantee scheme, and other programs

57. **The design and operational model of the PCG scheme should be reviewed and revamped to provide adequate incentives for lenders to participate.** Experience has shown that with an adequate financial and operational design and attractive products, PCGs can provide improve lending to MSMEs, especially in a context characterized by the lack of credit information. The PCG scheme should be established separate from DBJ to avoid financial consolidation that could reduce the incentives of its use. The capital structure could be either based on public funds, or with both public and private funds. A financial model based on expected loss needs to be established that allows the PCG to be profitable by charging a premium that is adequate for to the risk coverage provided. The instruments and services it provides to lenders should include different alternatives based on the sector, percentage to be covered and type of coverage (*par i passu*, first loss, or second loss). Premiums could vary according to the characteristics of the instrument and the coverage provided). Conditionality and underwriting criteria would also depend on the type of coverage, and this could be used in some cases to homogenize portfolios that could be securitized. In addition, there needs to be a simple and efficient claims procedure, with clear rules on when and how to pay out the guarantees, as well as paying claims without a long and costly verification process.

58. **Given the existence of many government-funded programs for MSME finance (through DBJ, Exim bank, Self-Start Fund, MIDA, and others), consideration should be given to review and consolidate such programs.** Such consolidation would result in improved efficiency and effectiveness of public finance programs for MSMEs.

Easing other constraining factors for MSME lending

59. **In addition, technical assistance to MSMEs is critical to improve their bankability.** Capacity building of SMEs in terms of preparing financial statements and business plans, as well as improving their financial literacy and management training, would have a positive impact on SMEs' bankability. The capacity of institutions that provide business training to SMEs such as JMDC should be enhanced with greater coordination and simplification among different institutions. There needs to be collaboration amongst various training agencies and other key stakeholders (Small Business Association of Jamaica, Jamaica Chamber of Commerce, and others) to set up a comprehensive platform for providing training and development services for SMEs, including through community organizations.

60. **The authorities should also evaluate measures of formalizing SME activity to improve their capacity to access credit.** MSMEs would likely gain more access to finance if levels of informality were reduced. While there are many differences amongst countries, there are common business environment reforms that can have an impact on the formalization of informal firms, including tax policy and administration, business practices regulations, and labor regulation. In addition, countries adopt policies that improve enforcement and undertake information campaigns that help firms understand their obligations and the increased benefits and reduced costs of becoming formal. An assessment of the causes of informality is first needed prior to designing reform programs. [51]

[51] See the report by the World Bank "Economic Informality: Causes, Costs, and Policies: A Literature Survey of International Experience", 2009. It presents country experiences that deserve further analysis, such as simplified taxation schemes (Brazil, Bulgaria, France, Hungary, Sweden), reducing barriers to entry (Mexico), allowing for more flexible hiring and firing of workers (Spain), informing firms about the benefits of formalization (Colombia), and others.

61. **In order to inform policy-making, there is also need for continuous and comprehensive data on SMEs.** Data collection on the size of the MSME sector, its composition, contribution to the economy and employment, would be valuable to adequately inform policy-making. In addition, a demand survey on business finance would be useful to better understand demand-side constraints.