Financing the Micro, Small and Medium Enterprises (MSMEs) Sector in Jamaica: Constraints and Prospects for Leasing, Factoring and Microfinance

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Abstract

The Micro, Small and Medium Enterprises (MSMEs) sector is increasingly being recognized as having an important role to play in accelerating economic growth in the Jamaican economy. However, access to financing has been a major constraint to expanding job creation in the sector as credit providers have a preference for traditional collateral-based lending as well as the provision of business plans and audited financial statements given the need to minimize their exposure to credit risk. In recognition of this obstacle, the Government has granted licenses for the operation of two credit bureaus and work is in progress on the development of a secured transaction framework (STF). These initiatives will allow borrowers to pledge moveable collateral and will also reduce information asymmetry which paves the way for widening the menu of financing options that can be offered to MSMEs. This paper reviews the literature on the use of STFs in other countries and recommends microfinance, leasing and reverse factoring as additional types of financing for MSMEs. These supply side initiatives, which are currently being used in other developing economies, have been successful complementary financing products which place greater emphasis on relationship lending, cash flow coverage of lease obligations and the credit worthiness of large international buyers. Increased use of these non-traditional lending arrangements by financial institutions which are supervised by the Central Bank is expected to increase the number of MSMEs which access credit from the formal banking sector thereby strengthening the efficacy of the credit channel of monetary policy transmission in Jamaica. The provision of these types of financing in Jamaica will, however, hinge on inter alia, the credit providers being in compliance with the Electronic Transactions Act and the passing of the appropriate legislative and regulatory framework for the leasing of equipment.

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[1] The views expressed are those of the author and do not necessarily reflect those of The Bank of Jamaica.

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Introduction

Since the mid-1990s, real GDP growth in Jamaica has averaged less than 1 per cent a year, which has contributed to sustained high unemployment rates. Both the Government of Jamaica and the private sector share the view that any strategy geared towards accelerating economic activity within the economy must include improving access to credit, especially for micro, small and medium-size enterprises (MSMEs). While there is no single definition of MSMEs globally, given differences in economic structures and stages of development, countries have developed their own definitions in an effort to construct effective and appropriate policies and programmes for the sector. A single national definition for Jamaica was created in July 2011. Micro-enterprises in Jamaica are defined as enterprises that employ 5 persons or less and have an annual turnover not exceeding $10 million. Small enterprises employ between 6 and 20 persons and have an annual turnover of between $10 million and $50 million. Medium-sized enterprises employ between 21 and 50 persons and have an annual turnover of between $50 million and $150 million (Ministry of Industry, Investment and Commerce, 2012).

Commercial banks are the dominant providers of credit within the Jamaican financial system. However, as is the case in many other countries, the take-up on commercial bank-mediated credit remains constrained by a number of factors. These factors include relatively tight lending standards enforced by high collateral requirements, poor credit information which makes it difficult to conduct credit risk assessment, high interest rates as well as legal systems that favour large businesses and those with property. It is also worthy of note that although there are a number of specialized institutions geared towards providing financing to MSMEs, these entities are also constrained by information asymmetries and the high costs of repossession of non-traditional collateral.

In recognition of these and other constraints, the GOJ, in its Vision 2030 Development Plan has articulated its commitment to developing a MSME and Entrepreneurship Policy framework. The policy document outlines plans to inter alia promote the on-lending of funds to micro entrepreneurs who do not possess traditional collateral. Towards this end, work is in progress on the development of a Secured Transactions framework which will allow borrowers to pledge moveable property in a manner that establishes and preserves property rights.

In addition to the secured transactions framework, the GOJ has granted licenses for the operation of two credit bureaus in an effort to increase the supply of credit. Both initiatives are necessary but not sufficient for sustainable credit expansion. In order to fully exploit the benefits of the improved lending infrastructure, it is necessary to fully develop non-traditional lending arrangements. A wide scale use of these non-traditional lending arrangements by the formal banking sector should serve to improve the efficacy of the credit channel of monetary policy transmission.

This paper provides a review of the literature on the use of a secured transactions framework in other countries and explores the development in Jamaica of microfinance, leasing and reverse factoring, as three types of non-traditional financing or lending technologies to MSMEs.

Microfinance is typically a form of relationship lending in which underwriting primarily depends on soft (non-quantifiable) information about the borrower. This type of financing is suitable for micro enterprises that are informationally opaque and lack significant amounts of assets that can be pledged as collateral. Reverse factoring, an asset-based lending technology provides working capital to riskier small businesses. Since, reverse factoring is the sale of accounts receivables; the level of firm transparency is inconsequential. Leasing involves the rental of fixed assets and is also well-suited for informationally opaque small businesses because loans are primarily underwritten based on the value of the leased asset. In Jamaica the market for these methods of financing are largely unregulated and underdeveloped. The further development of these lending technologies in Jamaica will depend largely on several legal and regulatory reforms including the secured transactions framework.

This paper is presented in four sections. Section I highlights the experiences of other developing countries with non-collateral based lending. Section II introduces best practices within international counterparts in addressing the issue of MSME financing. Section III presents stylized facts about the MSME sector in Jamaica, traditional sources of financing and the constraints within the lending market in Jamaica. Section IV proposes a framework for the development of these lending technologies in Jamaica through the application of international best practices.

Section I: Public Policy on Lending

There has been evidence from the experiences of other countries that in many cases public policies or government expenditure on a country's lending infrastructure, yields more result than direct support for business development, including MSMEs (Tambunan, 2008).

The lending infrastructure of a country includes:

i. commercial laws that affect secured transactions,
ii. creditor rights and their judicial enforcement,
iii. regulation of financial institutions,
iv. restrictions on lending,
v. barriers to entry and state ownership of financial institutions,
vi. information infrastructure including the accounting standards to which potential borrowers must comply; organizations and rules for sharing information, taxes that directly affect credit extension
vii. other factors that affects the economic environment that financial institutions lend (Kyaw, 2008).

Over the years, governments across the globe have invested in the development of the lending infrastructure of their countries in order to facilitate the widening and deepening of the financial markets. In this section, this paper will highlight the benefits of formulating a secured transaction framework and establishing credit bureaus.

A secured transactions framework

A secured transactions framework allows borrowers to use movable property for collateral purposes. This framework removes ambiguity related to the property that has been pledged and to whom it has been pledged. The secured transactions framework gives the lender the right to repossess the assets in a speedy manner if there is a default in payment. Countries that have implemented this framework have experienced a lowering of interest rates and increased access to finance by MSMEs.

Critical Features of a Secured Transactions Framework

There are four main features of a well-functioning secured transactions framework. These are creation, priority, publicity and enforcement.

Creation

A Secured Transactions Act, (hereafter referred to as, the “The law”) must define the assets that are being pledged in order for a property right to be created. It must permit clear and low cost methods for creating “security interest” on the part of the lender. The contract may state that the debtor will remain in the possession of the asset and may not dispose of the collateral without the consent of the creditor. However, in the case where inventory is used as collateral, the debtor will need to sell the inventory and restock during the term of the loan. The contract should allow the newly purchased goods to become collateral without the drafting of a new contract. This procedure is known as “floating charge”.

Priority

The law should set clear and logical priorities among the different property rights and set a time of publicity from which a right will prevail against other claimants to the same property.

Publicity

The law must provide a practical, effective and sustainable system for publicizing rights so that other potential lenders can determine whether an asset has already been pledged to another lender. An easily searchable database is therefore necessary to indicate that security interest in a particular asset exists.

Enforcement

The law should support a practical system for enforcing lenders’ rights, which includes repossession and sale of the property if there is a default. There should be no need for judicial intervention when a secured creditor disposes of collateral that is in the creditor’s control or possession (Holden, 2011).

Secured Transactions Framework – Other Country Experiences

Romania

A best practice secured transactions reform was undertaken in 2001, which resulted in an increase in the filing of security interests from below 10 000 to 600 000 in four years of operation. Romania has more secured transactions filings (measured in proportion to population or GDP) than any other country, and the improved access to credit that these measures have supported has led to strong economic growth. Lending increased in both rural and urban areas. Non-bank lending also increased as a broader range of movable collateral was accepted by lenders (Holden, 2011).

In Romania, taking security on movable assets is governed by the 'Legal Treatment of Security Interests in Personal Property' (Law on Security Interests). The Law on Security Interests allows for the creation of possessory and non-possessory charges, subject to registration in the Archive. The Electronic Archive is centrally managed by the Ministry of Justice and a number of organizations such as Chamber of Notaries and Chamber of Commerce serve as licensed registrars.

Cambodia

According to The World Bank (2008), Cambodia's new secured transactions law led to that country being the top performer in getting credit in 2007/08. Before the reform, Cambodia's business owners could use only immovable property as collateral. This significantly limited access to credit by small businesses in Cambodia. A general description of collateral is acceptable in loan agreements, permitting words such as "all assets" or "all movable property" of the borrower. This provision which allows for the use of a general collateral description facilitates the use of revolving assets such as inventory and accounts receivable as well as intangibles as collateral (The World Bank, 2008).

Rwanda

Rwanda's new secured transactions law now allows the use of moveable property as security for loans while the debtor maintains possession of the property. The law also permits future assets to be used as collateral. A collateral registry was also established in order to protect secured creditors against third parties (The World Bank, 2009).

China

A national online registry for security interest in receivables was created in China, subsequent to the enactment of the Property Law in October 2007. An evaluation of the impact of the reform showed that:

- There have been in excess of 385,000 registrations representing loans with a value estimated at over US$3.5 trillion. More than 490,000 searches have been performed in the registry.

- Of the US$3.5 trillion in new financing facilitated, approximately US$1.1 trillion corresponds to SME financing.

- SMEs that have benefited by being able to access credit amount to approximately 68,500 companies.

- The percentage of moveable-based lending in China increased to in excess of 20% from 12% during the pre-reform period.

- The use of factoring as a method of financing for the MSME sector increased from a volume of US$2.6 billion in 2003 to around US$70 billion in 2009.

- Approximately 5,400 people have participated in workshops, training, and awareness raising events.

- Among the registry’s 3,000 plus customers, we can find users such as banks, guarantee companies, law firms, finance companies, and pawn shops. The user experience with the registration system has been overwhelmingly positive.

Credit Bureaus

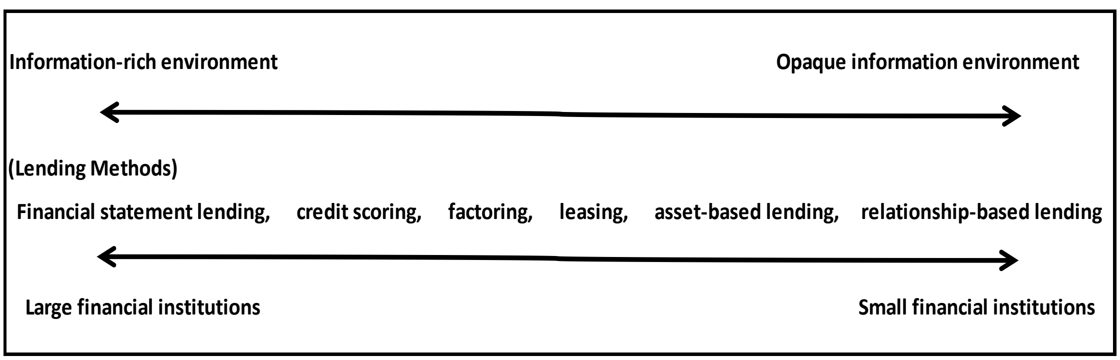
Credit bureaus help to protect creditors against unnecessary credit risk exposure, assist in reducing application fraud by authenticating application particulars, protect consumers against financial mismanagement and improve efficiency and turnaround time of credit evaluation. The establishment of credit bureaus should lead to lower interest rates as suppliers of credit are better able to assess credit risk.

Research shows that the existence of credit registries leads to increased overall lending and improved access to financing. Results of a study based on information from more than 100 developed and developing countries show that, on a macro level, the existence of credit registries is associated with a higher private credit to GDP ratio, after controlling for other country-level measures of development (Miller, 2003). Another study on credit reporting firms in more than 40 countries shows greater information sharing not only increases lending as a percentage of GNP but lowers default rates as well (Jappelli & Pagano, 2002).

Section II: Non-Traditional Sources of External Financing - Other Country Experiences

The improvement of the credit infrastructure with the introduction of a secured transactions framework and credit bureaus, allows for the development of financing arrangements which can complement traditional collateral-based and financial statement lending (see **Figure 1**).

Figure 1: Spectrum of MSME Lending Models



Source : Kyaw, 2008

Given the imminent passing of the Secured Transactions Act and operation of credit bureaus, the three non-traditional lending arrangements that will be explored are leasing, relationship-based lending (microfinance) and reverse factoring.

Lease Financing

Lease financing grants the entrepreneur (the lessee) the use of the equipment while the lessor retains ownership. The lessee makes specific and regular payments to the lessor in order to retain the use of the equipment. The leased equipment serves as collateral since the lessor retains ownership. In terms of information requirements, the leasing company needs to ensure that the lessor can generate sufficient cash from the use of the equipment (Deleen, 2003). Lease financing benefits both the lessee and the lessor as the lessee generates additional income from the economic use of the asset while the lessor receives income while retaining ownership.

There are two main types of leasing arrangements: a financial lease and an operating lease. A financial lease is a method of acquiring an asset for long term use. The duration of the agreement is set in line with the expected economic life of the asset. The lease payments are set so that the present value of the payments cover the cost of the asset and profit. The lessee usually has the option to purchase the equipment at the end of the contract.

In contrast to a finance lease, an operating lease is a short-term contract for the use of equipment. The lessor makes profits by renting the equipment to different users. The lessor bears the risk related to the value of the equipment, as well as the risk of obsolescence (Deleen, 2003).

Leasing in Russia

Many MSMEs in Russia struggle with inadequate access to the medium or long- term financing to invest in newer, better technologies and improved equipment as well as to finance agricultural production. The development of finance leasing as a complementary tool to bank loans has provided an additional solution for financing major capital investments and has significantly expanded the available pool of medium and long-term capital to MSMEs. The leasing market has also benefited from technical assistance and investment provided by international donor agencies in the late 1990s.

The main tax advantages of leasing in Russia are the flexibility to record an asset on either the balance sheet of the lessor or lessee, accelerated depreciation of the asset up to a factor of 3 (not exceeding 3 times the relevant depreciation rate), which reduces property taxes, as well as the ability of lessees to record the full lease payment as an expense item, thereby lowering the taxable profit.

Arrears and write-offs have generally been smaller in Russia's leasing industry than those of traditional lenders since productive equipment is too important to client operations to risk losing it by defaulting on lease payments. Leasing companies retain the titles to the equipment during the lease period. Further, leasing companies employ a range of risk mitigation techniques and policies to limit risk exposure and protect against default. These policies include portfolio diversification, tailored repayment schedules, thorough client risk analysis which can be done through credit scoring, buy-back and re-marketing agreements as well as insurance. Higher than usual down payments for leases are common in Russia, putting additional pressure on the client to repay. The legal and regulatory framework for leasing in Russia is relatively developed and as a result, leasing companies rarely cite legal and regulatory issues as a major hindrance to operations (Sposeep & Sedova, 2006).

Leasing in Ghana

The leasing industry in Ghana has experienced significant growth, primarily driven by bank lessors. In 2007, the value of new leases was $93.13 million relative to $31.46 million in 2006, representing an increase of 196.6 per cent. At the end of 2007, there were 14 leasing companies in Ghana which included 5 non-bank lessors and 9 bank lessors. This is in comparison to 7 leasing companies in 2004 (5 non-bank lessors and 2 bank lessors). An adjustment to the banking regulations which permits banks to engage in leasing without acquiring a special license has contributed to the increase in the number of banks with leasing operations. However, non-bank lessors reach a larger segment of the market and focus on smaller lease arrangements (Leasing in Ghana: A survey of the leasing market, 2008).

The benefits of leasing in Ghana include tax advantages. All rentals are offset against the lessee's taxable profit, while under traditional credit only interest charges can be written off against taxable profit. Leasing also enables the lessee to use the asset without increasing its asset base (off-balance sheet financing), thereby allowing the institution to record a higher return on assets.

Leasing in Serbia

The International Finance Corporation's (IFC) Southeast Europe Enterprise Development Facility (SEED) facilitated the development of financial leasing in Serbia. The programme consisted of legislation development and market development (Malhotra, 2007).

During the legislation development phase, SEED partnered with the government to introduce relevant leasing legislation. An assessment of all laws related to financial leasing was conducted in conjunction with government authorities, commercial banks, and SMEs to determine whether separate leasing legislation was required or whether amendments to various pieces of legislation would be sufficient. A market research study was conducted which involved the commercial banking sector and SMEs which indicated strong interest in leasing arrangements (Malhotra, 2007).

During the market development phase, SEED focused on capacity-building activities that promoted financial leasing to all relevant parties. These consisted mostly of technical assistance and training aimed at key local stakeholders, such as commercial banks and other financial institutions as potential lessors and local business service providers and SMEs as potential clients.

A leasing market assessment study showed rapid growth of the industry within the first 16 months of the passage of the Financial Leasing Law in May 2003. The Law allows only the leasing of durable, movable goods and does not cover immovable goods. Real estate leasing services are based on other laws and regulations. Statistics indicate that approximately 33 per cent of clients of leasing companies are manufacturing businesses with almost all of them being privately owned.

Microfinance

Relationship-based lending addresses the issue of the absence of hard information. The information that is used by lenders under this lending technology is based on soft information on the borrower which is generated through the close relationship between the lender and the borrower. This lending method tends to be labour-intensive and therefore more costly to administer. These costs can result in higher fees and higher interest rates for the borrower (Kyaw, 2008).

Microfinance is a relationship-based lending methodology geared specifically towards microenterprises. Microfinance lending methodologies are based on information rather than collateral and emphasize personal contact rather than detailed documentation. Loan officers visit the work site of potential borrowers and prepare documentation using expected cash flows and net worth to determine the terms of the loan. An assessment is also done of the borrower's character and willingness to repay. Given this approach, this type of financing has two distinctive features. First, higher administrative costs are usually associated with this labour intensive lending arrangement than that which is required for the supply of traditional credit. Second, the loans are typically small, short term and unsecured, with more frequent repayments and higher interest rates than conventional bank loans.

Some MFIs use the group lending methodology. Loans are offered to a small group of persons, with each member acting as a guarantor for the remaining members of the group. Therefore, peer pressure within the group is the mechanism that ensures repayment, as the default of one group member has an adverse impact on the availability of credit to the others.

Microfinance in Brazil

Schonberger (2001) in making reference to the four best known microfinance programmes in Brazil- Viva Credi, PortoSol, CrediAmigo and the FENAPE network- noted that all four programmes emphasized shorter-term (up to 6 months) working capital loans. Solidarity group lending is the dominant means of addressing the absence of "real guarantees" for micro-lending. The Brazilian programmes all offer or plan to offer individual loans for solidarity group customers and new customers who qualify for larger loans than those of typical group members. All programmes provide or plan to provide flexibility in repayment frequency to better match client cash flow. Interest rates are consistent with those charged by Brazilian banks for personal loans to individuals who, unlike micro entrepreneurs, can provide proof of adequate, salaried income.

Microfinance in Peru

Peru has chosen to support the entry of regulated, microfinance-focused institutions through creation of a distinct type of financial entity. This approach is consistent with "tiered banking" in which regulations are adapted to the requirements of the microfinance industry. In a tiered-banking approach, the Central Bank defines intermediate institutional forms that generally have lower minimum capital requirements, limitations on services that can be offered (in particular savings services), and more stringent prudential guidelines.

Mibanco, a leading microfinance bank in Peru was transformed from a nongovernment organization in 1998. Since then, Mibanco has expanded its outreach and the scope of its services, from urban to rural areas. During the period, 1999 – 2002, Mibanco's assets increased by 252 per cent; gross loan portfolio by about 379 per cent and total equity by 71 per cent.

Mibanco applies both individual and solidarity group lending methodology. Loan amounts range from US$100 to US$100,000 with loan terms from 3 to 60 months and interest rates within the range of 25 per cent to 50 per cent. These interest rates are higher than the market average in Peru. This is due to higher risk of lending to MSEs. Since, Mibanco's creditors also demand higher rates on funds lent to the company, these rates are passed down to the clients. Despite these higher interest rates, Mibanco has a lower debt ratio than the market average. This is attributed to the strong relationships between business advisors and clients (Franco, 2008).

Microfinance in Indonesia

Bank Rakyat Indonesia (BRI) is a profitable state bank that has been successful in developing a nationwide microfinance portfolio via its Unit Desa system (BRI-UD). BRI-UD is a rural banking network that aims to meet the financial needs of rural entrepreneurs in a flexible and financially viable way. BRI's risk management techniques takes a "carrot and stick" approach. This means denying nonperforming clients future access to finance, making site visits to clients that coincide with repayment schedules and providing incentive for timely repayment in the form of a refund of 25 per cent of the interest payment on the loan. Loan officers are also given incentives for initiating and maintaining quality portfolios. The Unit Desa system has clear efficiency benchmarks with respect to the loan officer to client ratio, teller to deposit account ratio and administrative costs to loan portfolio ratio (Malhotra, 2007).

Reverse factoring

Factoring is another additional type of financing arrangement which provides working capital for the supplier. Under a factoring contract the creditor assigns it receivables to a factor (financial institution). The financial institution pays the supplier on behalf of the creditor (a discounted amount). After an extended period of time, the financial institution then collects the amount owed by the creditor. In factoring transactions, hard information is necessary on the buyer in order to assess their creditworthiness.

The difference between ordinary factoring and reverse factoring is that reverse factoring requires the buy in of the buyer. It is usually the case that that the buyer provides the list of suppliers so that factoring can take place. Under this arrangement, the lender purchases the accounts receivable only from high-quality buyers (such as a large, internationally accredited firm). The main advantage of reverse factoring is that the credit risk is equal to the default risk of the high-quality customer, and not the risky SME. This allows lenders to provide low-risk loans to high-risk suppliers. This drives down the interest rate charged on these operations.

Reverse Factoring in Mexico

A successful example of reverse factoring in a developing country is the Nacional Financiera (Nafin) Development Bank Factoring Programme in Mexico. Between 2001 and 2004 Nafin's share of the factoring market increased from 2 per cent to 60 per cent. Nafin was created by the Mexican government in 1934 as a state-owned development bank with the goal of providing commercial financing.

The programme is called "Cadenas Productivas" or "Productive Chains" programme and works by creating "Chains" between "Big Buyers" and small suppliers. The Big Buyers are large credit worthy firms, while the suppliers are typically small, risky firms who generally cannot access any financing from the formal banking sector. The Nafin programme allows small suppliers to use their receivables from Big Buyers to receive working capital financing, effectively transferring their credit risk to their high-quality customers to access more and cheaper financing. All factoring is done on a non-recourse basis, which allows small firms to increase their cash holdings and improve their balance sheets[2].

[2] The factor that purchases the receivable s assumes the credit risk for the buyer's ability to pay.

Nafin has a “Multi-bank” approach, which allows lenders to compete to factor suppliers’ receivables. In addition, Nafin pays for the costs associated with their electronic factoring platform and all legal work, such as document transfers, preparing and signing documents, etc., so that banks charge only interest and not service fees. Nafin covers its own cost with the interest that lenders pay for Nafin’s refinancing capital or service fees.

The reverse factoring service is offered at a maximum interest rate of seven percentage points above the bank rate (five percentage point on average), which is about eight percentage points below commercial bank rates. Interest charges are tax deductible. Nafin operates an electronic platform that provides on-line factoring services, which reduces costs, improves security and allows for economies of scale.

On delivery of goods by the supplier and the provision of an invoice to the buyer, the buyer posts on the Nafin webpage a “negotiable document”, equal to the amount that Nafin should factor. In general this is 100 per cent of the value of the receivable. Next, the supplier uses the internet to access its buyer’s Nafin webpage and clicks its receivables. Any lender that has a relationship with the buyer and the supplier is willing to factor the receivable will appear on the next screen, along with a quote for the interest rate at which its willing to factor this specific receivable. To factor its receivable, the supplier clicks on a shown factor and the amount of its negotiable document less interest is transferred to its bank account.

Even though the buyers are high quality, one risk factor still remains, in the case of returns. If the buyer is unsatisfied with the quality of goods or services received, they generally have the right to return the goods for a full refund within a certain number of days. However, factors are responsible to pay Nafin on the day the invoice expires, regardless of whether the buyer pays the bank the full amount.

The success of the Nafin programme has been attributed to the use of an electronic platform and the existence of supporting electronic laws. For example, the “law of Conservation of Electronic Documents” gives data messages the same validity as written documents, and the “Electronic

Signature Law" confirms the legal validity of electronic signatures safeguarding the interest of the parties involved in these transactions (Klapper, 2005).

Table 1: Summary of Lease Financing in Selected Countries

Country	Initial Implementation	Institution Type	Lease Products	Taxation	Risk Mitigation
Jamaica		private banks	finance and operating leases, sale and lease back arrangements	off balance sheet financing, lease payments are a tax deductible expense	
Russia	donor intervention	private and government owned, also includes foreign banks	financial lease (lease term set close to the expected life of the asset)	the option of recording the asset on the balance sheet of the lessor or the lessee, accelerated depreciation of the asset up to a factor of 3	portfolio diversification, flexible repayment schedules, selective monitoring based on risk profile, buy-back and remarketing agreements, surety contracts, insurance
Ghana	private	private, bank and non-bank	operating lease, finance lease, outsourcing,	off balance sheet financing, lease rentals are offset against lessee's taxable profit	leases equipment that has maintenance facilities and secondary market in Ghana, diversified lease portfolio, careful client screening process,
Serbia	donor intervention	private	financial lease, "sale and lease back"		

Table 2: Summary of Microfinance in Selected Countries

Country	Initial Implementation	Institution Type	Description of Microfinance Products offered	Risk Mitigation
The Caribbean		NGOs, Credit Unions, private MFIs,	asset-based lending, group lending	retrieval of collateral, penalties for arrears, loans increased based on client repayment performance
Brazil	government,	microenterprise credit societies	short-term working capital loans: solidarity group loans, individual loans	provision of small loans that are only increased on a performance basis, close monitoring of microfinance portfolios, penalties for borrowers in arrears
Peru	NGO	microfinance bank	working capital loans, fixed asset loans, housing loans	
Indonesia	subsidized state-owned bank	rural banking network	small non-targeted loans, passbook savings accounts, time and demand deposits	provision of incentives to clients for timely repayments, incentives for loan officers, the use of financial technology to screen borrowers, adequate provisions for loan loss

Section III: Stylized facts about the MSME Sector in Jamaica

Performance

Statistical Institute of Jamaica's (STATIN) Labour Force Survey regarding Employment Status for 2011 showed that the Own Account Worker (sole traders) category, which constitutes the vast majority of MSEs, accounted for 35.9 per cent of the employed labour force with an average employment of 392 867 persons (see **Table 1**). This performance was lower than that which obtained in 2010 but higher than that which occurred in 2007. The lower contribution to national employment was influenced by weak global and domestic demand as well as rising production costs.

Table 1

Own Account Workers in Jamaica, 2007-2011					
	2007	**2008**	**2009**	**2010**	**2011**
Average employment	375 800	401 125	414 850	411 625	392 867
Male	243 450	257 950	270 200	268 650	257 867
Females	132 350	143 175	144 650	142 975	135 000
Percentage of total employment	33.1	34.5	36.9	37.6	35.9

Source: The Economic and Social Survey Jamaica, Various Issues

In relation to the number of MSMEs, in 2011, there were approximately 10 438 micro and small firms in Jamaica relative to 10 915 the previous year. Micro and small enterprises accounted for 87.2 per cent of all firms that filed GCT returns in 2011. These returns indicate that sales by MSEs amounted to $86.1 billion or 10.1 per cent of total sales of all the firms. For 2010, sales by MSEs were $89.6 billion and accounted for 9.8 per cent of total sales (Planning Institute of Jamaica, 2012) (see **Table 2**).

Table 2

Number of MSEs in Jamaica, 2009-2011 (Estimated from GCT Contributions)						
	2009^r		**2010^r**		**2011^p**	
Industries	**Micro**	**Small**	**Micro**	**Small**	**Micro**	**Small**
Agriculture	117	52	86	48	76	53
Mining	43	11	30	10	28	11
Manufacturing	736	369	498	348	478	334
Energy and Water	10	5	8	5	8	5
Construction	563	119	321	134	313	111
Wholesale and Retail Trade	4 024	1 958	2 795	2 046	2 663	1 988
Miscellaneous	634	144	419	147	358	153
Transport and Communication	776	183	440	185	387	178
Financial Services	214	85	141	92	139	104
Rent, State and Professional	2 449	522	1 641	562	1 593	561
Government Services	1205	269	693	266	622	275
TOTAL	**10 773**	**3 717**	**7 072**	**3 843**	**6 665**	**3 773**

r – revised

p – preliminary

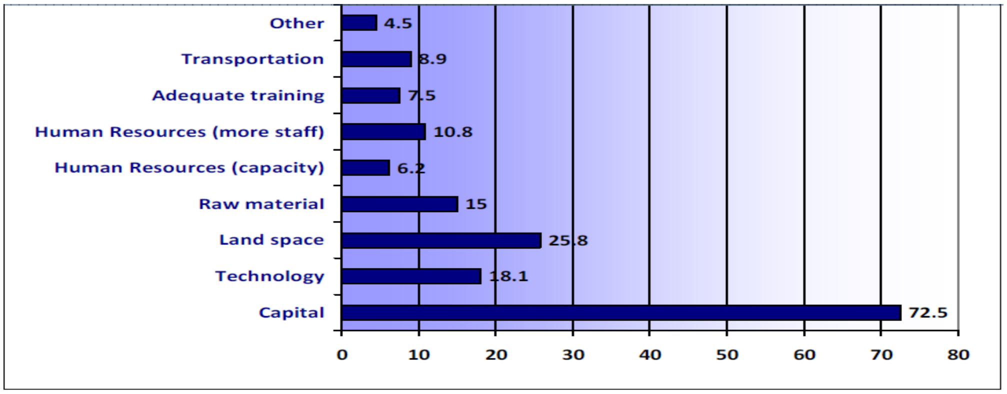
Source: The Economic and Social Survey Jamaica 2011

Sources of Financing

A survey of Jamaican MSMEs was conducted in 2008 in order to assess the profile, competitiveness and needs of the sector. Results of a survey of approximately 2000 MSMEs across the 14 parishes of Jamaica indicated that 73 per cent of respondents identified that capital was the most needed resource to expand their output (A Landscape Assessment of Jamaican Micro Small and Medium-Size Enterprises, 2008)(see **Figure 1**).

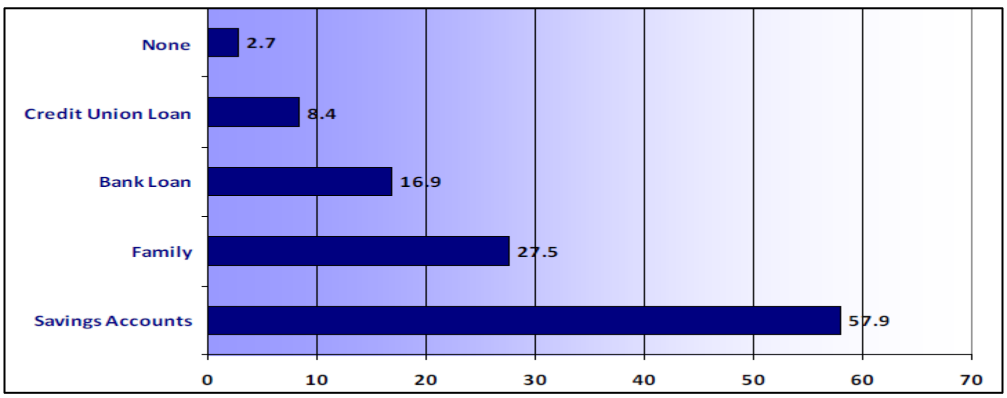
Figure 2 shows that approximately 60% of the entrepreneurs surveyed used their own funds to start their businesses; while another 30% received financing from family members. Less than 26% of the entrepreneurs surveyed, received financing from a formal source to start up their businesses. An even lesser proportion of the entrepreneurs surveyed accessed funding from formal sources within the previous 2 years.

Figure 1: Resources needed to expand Enterprise output



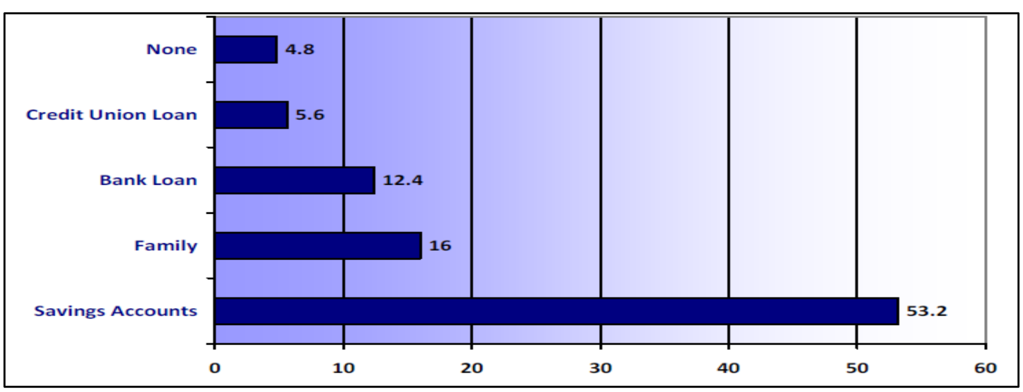
Source: A Landscape Assessment of Jamaican Micro Small and Medium-Size Enterprises

Figure 2: Sources of post Start-up Funds



Source: A Landscape Assessment of Jamaican Micro Small and Medium-Size Enterprises

Figure 3: Sources of finance in the last two years



Source: A Landscape Assessment of Jamaican Micro Small and Medium-Size Enterprises

An Overview of External Sources of Financing

There are two major categories of institutions that provide credit to the MSME sector. These are private sector credit providers and credit schemes established through the GOJ and/or donor agencies. However, many private sector providers also on-lend funds provided by the GOJ/donor schemes.

Credit provided by GOJ/Donor schemes

The GOJ and a number of donor agencies have provided funds for MSME financing, typically through wholesalers, such as the Development Bank of Jamaica (DBJ) and the EXIM Bank. In 2011, approximately $3.2 billion was disbursed by the GOJ to MSEs via wholesale lenders relative to $2.9 billion the previous year (see Appendix). Although wholesalers lend directly to small businesses in some instances, these funds are largely channeled to MSMEs through Approved Financial Institutions (AFI) and Microfinance Institutions (MFI). These retailing institutions provide initial credit evaluation and loan supervision.

According to Tennant (2008), these arrangements enable the Government to avoid the problems of loan delinquency and high administration costs associated with lending directly to MSMEs. However, given that AFIs use standard credit scoring criteria based largely on fixed collateral, the rate of loan disbursements is generally low. In addition, high interest rate spreads to cover default risk and administrative costs are critical barriers to the goal of providing low cost funds to the MSME sector.

Credit provided by selected private financial institutions (FI)

The main private sector institutions providing credit to MSMEs in Jamaica are commercial banks, building societies, and credit unions (Tennant, 2008). In addition, there are a number of specialized unregulated institutions geared towards providing financing to MSMEs.

Commercial Banks

Commercial banks are the dominant providers of credit within the Jamaican financial system. Currently, most of these commercial banks have an SME department targeted specifically to serve this sector. A review of the business banking websites of Jamaica's commercial banks showed that these institutions typically offer traditional collateral-based lending to the MSME sector. Asset-based lending involves the disbursement of a loan secured by collateral (assets). The loan or line of credit is typically secured by balance sheet assets such as land, equipment, motor vehicles and accounts receivables. The commercial banking sector deploys a range of asset based financing facilities for MSMEs such as term loans, revolving loans/trade financing as well as various supplementary financing instruments. In terms of non-traditional financing, one commercial bank offers factoring to MSMEs that supply goods and services to 30 reputable pre-approved institutions while another offers equipment leasing.

Scotia Group Jamaica entered the microfinance market in 2011 with the new subsidiary Scotia Jamaica Microfinance Company Limited (CrediScotia). CrediScotia targets micro entrepreneurs mainly in the trading and manufacturing sector as well as personal loans for educational purposes, with loan amounts ranging from J$60, 000 to J$850,000. These loans are priced on an individual basis, largely determined by available collateral, past history with other financial institutions and character. CrediScotia's aim is to service the unbanked and in so doing, assist them to transition into the formal sector (Gordon, 2011).

Building Societies

Jamaica National Small Business Limited (JNSBL), a member of the Jamaica National Group, employs an asset-based lending method. Micro loans ranging from J$60,000 to $400,000 are offered to entrepreneurs who have been in operation for at least six months by JNSBL. Appliances, household furniture, motor vehicles up to seven years old and third-party guarantees are accepted as collateral. JNSBL has experienced a significant growth in its portfolio over the last 12 years, partly due to their unconventional methods of offering loans. JNSBL's portfolio at risk was below 5 per cent as at September 2012.

Credit Unions

Members of the Credit Union League also offer asset-based financing for small businesses which includes loans for starting a new business or expanding an existing one, financing working capital and the purchase of capital equipment. Loan requirements include a business plan, experience and knowledge of managing a small business, maintenance of accounting records, security/collateral, and at least 1/3 equity in the business.

Other Financial Institutions

Financing is also made available to MSMEs through unregulated financial institutions. One of these institutions is Micro Credit Limited (MCL). MCL is an independent microfinance institution, which was established in 2003 in Jamaica with the mission of serving the lower end of the microfinance market, offers both solidarity group and individual loans. However, given that MCL is unregulated and not authorized to collect client deposits, their main source of funding is interest and loan funds from private and commercial entities. MCL listed the lack of a credit bureau as one of its major challenges.

At least three financial institutions offer lease financing in Jamaica. These institutions offer lease financing for capital investments such as machinery, office equipment and furniture, information technology equipment as well as commercial and industrial vehicles. One institution offers both finance and operating leases, while another offers sale and lease back arrangements. The institutions that offer leasing arrangements face a number of challenges which include repossession and resale of collateral.

Constraints to the Development of MSME financing in Jamaica

A number of constraints have resulted in MSMEs' being reliant on own-funds for the financing of their operations. These constraints are related to the present credit environment in Jamaica as well as the management of MSMEs.

Information asymmetries

Given the absence of a national database on MSMEs, financial institutions have been challenged to disburse sizeable loans to entities in the sector. In light of information asymmetries there is a paucity of information on MSME operations, including sales, cost of sales and expenses. A database for evaluating, categorizing and monitoring the performances of MSMEs would offer useful and relevant information that could improve MSMEs access to finance and serve as a catalyst for growth and job creation.

Managerial Inadequacies

Another critical issue relates to the quality of the manager and/or owner as demonstrated by the passion that he/she displays and his/her thorough understanding of the business, which is oftentimes found to be very limited in small business entrepreneurs (SME loans hard to disburse: information on operations missing, 2009).

Inadequate collateral

MSMEs have been characterized as being high risk and unreliable with limited capacity to provide collateral for financing.

Legal Restrictions on Lending

The Banking Act places limits on lending without collateral. The Banking Act states that a bank shall not lend to an individual in excess of 20 per cent of its capital base but not more than 5 per cent of its capital base on an unsecured basis. If a bank is lending to a group, it cannot lend in excess of 40 per cent of its capital base or more than 10 per cent on an unsecured basis. Connected persons are also restricted from borrowing on an unsecured basis. The capital base of a bank is therefore important in determining how much secured and unsecured lending it can do. Lenders also cited inadequate legal and regulatory framework as a hindrance to the process of lending money to small businesses (Robinson, 2012).

Lending Requirements & Standards

Often-times loan officers within commercial banks are trained to manage and evaluate large borrowers with proper accounting records and information. In this context, MSMEs are required to meet the lending criteria which are used in the assessment of large corporations; however, the MSMEs are unable to meet these lending criteria. In addition, MSME loans are generally viewed as being less attractive since a bank will incur substantial administrative costs in processing the loan, while the absolute dollar returns are much smaller than large corporate loans.

Official and Private Response

In recognition of these and other constraints, the GOJ, in its Vision 2030 Development Plan has articulated its commitment to developing a MSME and Entrepreneurship Policy framework. The policy document outlines plans to inter alia promote the on-lending of funds to micro entrepreneurs who do not possess traditional collateral. Towards this end, work is in progress on designing a Secured Transactions framework which will allow borrowers to pledge moveable property in a manner that establishes and preserves property rights.

In addition to the approval of a secured transactions framework, in 2011, the GOJ granted licenses for the operation of two credit bureaus in Jamaica in an effort to increase the supply of credit. Under Jamaica's Credit Reporting Act, the credit bureau can collect information on a consumer's financial means and credit worthiness, amount and nature of loans and advances, type of collateral provided by the consumer (includes leases and hire purchase), the nature of any guarantee or other non-fund based facility accessed by a consumer as well as the history of financial transactions involving the borrower.

With respect to the inability of some prospective investors to produce financial statements and the lack of managerial experience, the Government and a number of private institutions have begun to provide training in financial accounting and management to entrepreneurs in the small business sector. Some of the organizations which have developed training programmes for the sector include the Small Business Association of Jamaica, The Entrepreneurial Centre, University of Technology, Jamaica Business Development Center and Jamaica Promotions Corporation (JAMPRO).

The recent initiatives to develop the country's lending infrastructure are necessary but not sufficient for sustainable credit expansion. In order to exploit the benefits of the improved lending infrastructure, it is necessary to develop non-traditional lending arrangements in a stable macroeconomic environment.

Section IV: The Implementation of Non-Traditional Lending Arrangements in Jamaica

Non-traditional methods of financing MSMEs such as reverse factoring, leasing and relationship-based lending are currently available on a limited scale in Jamaica. The successful development of these methods of financing would assist MSMEs to meet long term funding needs as well as to establish an appropriate debt-equity ratio.

The Development of Lease Financing

Issues for Consideration

Lease financing would be best suited for MSMEs which operate in the transportation, manufacturing, construction, mining, agriculture and health sectors. MSMEs in these sectors are challenged with accessing medium or long-term financing to facilitate the replacement of old and obsolete equipment and adopt better technologies which could enhance the scale or productivity of their operations.

A prerequisite for developing this type of financing arrangement for entities in these sectors is a market research to inform the lessor about the types of equipment that have stable market values and will add value to the enterprises' production process. A leasing market would also benefit from partnerships between equipment suppliers and lessors. If equipment markets are distorted or uncompetitive, lessors will have difficulty negotiating favorable prices and conditions with suppliers. A second hand market for the resale of repossessed equipment is also important.

The institution offering leasing needs to have the necessary staff skills. Lease officers need to be able to assess the value of the equipment, its usefulness within the enterprise, the extra cash flow it will yield, the enterprise itself and the environment within which it operates. The lessor will also need to have good operational, internal control and accounting systems as well as the ability to monitor all leased equipment.

For significant development of a leasing industry in Jamaica, a public education initiative will be necessary, which should incorporate information on the benefits and associated risks. An enabling regulatory system is also necessary for leasing institutions to survive and make profit. This suggests that procedures for obtaining a leasing license must be transparent, capitalization requirements of the scheme should be less stringent than for deposit-taking financial intermediaries, procedures for lessors to repossess equipment in the case of default should be straightforward and the tax treatment of lessors and lessees should be consistent and favorable to leasing.

The legal framework governing lease financing should include a Leasing Act which covers issues such as, the rights and obligations of the parties, claims on residual value as well as licensing and prudential requirements.

The Development of Microfinancing

Issues for Consideration

In structuring a regulated microfinance sector, several factors will have to be considered. These include an appropriate legislative framework, loan-loss provisioning requirements, capital adequacy ratios, non-traditional collateral requirements, loan documentation requirements and staff skills.

The Basel Committee on Banking Supervision recommended that microfinance activities conducted by non-banks should be clearly defined in laws and regulations. This should include a clear definition of microcredit which may include loan amount, term, repayments frequency and underwriting methodology. The range of financial products that will be permitted such a micro-savings and micro-insurance should also be included (Bank of International Settlements, 2010). If the microfinance sector is to expand in Jamaica, it is very likely that microfinance institutions will need to diversify their sources of funds to include deposits. Supervisory oversight by the Central Bank may then become necessary.

The potential volatility of microfinance portfolios suggests the need for **higher capital adequacy requirements** – generally in the range of 15 to 20 percent of risk adjusted assets. Credit only microfinance companies, however, may only need non-prudential regulations which could include consumer protection and disclosure rules as well as provisions of the civil and criminal codes.

Standard loan-loss provisioning requirements generally do not reflect the value at risk in a microfinance loan portfolio. Given their rapid turnover and more frequent repayment periods, standard past-due provisioning requirements often exceed the terms of microfinance loans. Bank of Jamaica regulations require full provisioning for any loan with a payment more than 180 days overdue. Given that most micro loans are for between 90 and 180 days, micro finance lending requires **a more aggressive loan-loss provisioning policy** related both to the time overdue as well as the number of installments missed. However, any new classification system should take into account the variability in the terms and conditions of the loan as well as the potential implications for audits of loan classification of institutions with both micro and standard commercial portfolios.

Regulators and supervisors should set simple loan documentation standards that are efficient and feasible taking into consideration the nature of micro entrepreneurs and their businesses. Credit-scoring models based on the lending experience of microfinance institutions, can also help to reduce this reliance on documentation while providing more accurate information regarding the probability of repayment.

Loan officers employed by MFIs are generally given incentives for productivity and the management of high quality portfolios. This incentive structure holds loan officers accountable for their institution's relationship with clients throughout the life of the loan which includes analysis, disbursement, monitoring and repayment. The Bank of International Settlements (2010) also recommended that given the heavy reliance of MFIs on the knowledge, skills and credibility of the loan officer, licensing authorities should assess compensation packages and training policies for loan officers in order to discourage excessive risk taking behavior.

Lending Methodology

The implementation plan should include adopting the relationship lending model which is based on qualitative information with an emphasis on the character and reliability of micro entrepreneurs, including information gathered from informal sources such as suppliers and community leaders.

Loan analysis should look at prospective clients' ability to pay (cash flow) while placing less emphasis on collateral. And even when collateral is required, flexible definitions of what constitutes collateral should be used. Loan amounts should initially be small and short term, with clients gaining access to larger amounts and longer terms based on their repayment performance as they build a credit history with the financial institution. This would be supported by the recent implementation of the credit bureaus and the soon to be implemented secured transactions framework. Microfinance providers should schedule site visits that coincide with clients' repayment schedules while providing these clients with incentives for timely repayment.

The Development of Reverse Factoring

A technology platform is necessary to facilitate efficient processing of reverse factoring transactions. This platform should be tailored to the specific needs of the participants and should be easily accessible without heavy investment by the buyer and suppliers. It should also be user friendly so as to prevent inefficiency.

The development of reverse factoring is significantly strengthened by legislation that clarifies its nature as a transfer of credit, giving judicial strength to the bill sold. This measure can increase MSMEs access to factoring at a lower cost, given that factoring companies can rely more securely on the creditworthiness of the final client.

In order to give MSMEs the incentive to participate in the reverse factoring programme, interest charges paid by small suppliers to their factors should be tax deductible. For taxation, it is also important to clarify factoring as the sale of credit. That is, the sale of the receivable is separate from the sale of goods and therefore should not be subject to the double imposition of the value added tax or similar taxes, which can make the instrument unattractive (Cheikhrouhou, 2007).

Conclusion

There is general consensus within the public and private sectors that the MSME sector has a critical role to play in the achievement of higher economic growth and development in Jamaica. Given this recognition, finding solutions to the challenges which have constrained the development of the sector has been of critical importance. Among these challenges is the inability of many MSMEs to access credit from the formal financial market given the difficulty in meeting lending requirements including non-traditional collateral and a general weakness in managerial practices. Improving the competitiveness of MSMEs cannot be achieved without tackling these challenges.

In order to resolve these constraints, there is a need to deepen the financial market by revamping the legal and regulatory framework governing the country's lending infrastructure. Towards this end, it is necessary to fast track the operationalization of a secured transactions framework and the required collateral registry. These initiatives in conjunction with functioning credit bureaus will pave the way for developing non-traditional financing options such as leasing, microfinance and reverse factoring. A wider use of these types of financing and the implementation of strategies to strengthen entrepreneurial skills is expected to result in increased employment, competitiveness, an improvement in the trade balance, improved monetary policy transmission, all of which will auger well for higher economic growth.

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APPENDIX

Table A:1 - DISBURSEMENTS BY WHOLESALE AGENCIES, 2007 -2011 (J$ Million)					
AGENCIES	**2007**	**2008**	**2009**	**2010**	**2011**
Development Options	157.5	213.7	186.0	n/a	n/a
Pan Caribbean	89.9	51.2	50.7	64.5	96.7
Micro Investment Development Agency	242.1	164.5	153.4	95.8	146.1
National Insurance Fund	n/a	323.7	228.5	921.9	n/a
Development Bank of Jamaica	n/a	n/a	980.7	661.7	n/a
TOTAL	**489.5**	**753.1**	**1 599.3**	**1 743.9**	**242.8**

TABLE A:2 LEASE FINANCING IN JAMAICA, DECEMBER 2007-2011 (J$' 000)					
DEPOSIT-TAKING INSTITUTIONS	**2007**	**2008**	**2009**	**2010**	**2011**
Commercial Banks	78,532	158,025	104,361	127,553	103,015
Merchant Banks	649,479	627,892	683,180	632,449	499,266
TOTAL	**728,011**	**785,917**	**787,541**	**760,002**	**602,281**