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## financiamiento del desarrollo

# **A** new approach to development banking in Jamaica

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Santiago, Chile, May 2007



This document was prepared by Keith R. Collister, consultant of the Development Studies Unit of the Economic Development Division, at the Economic Commission for Latin America and the Caribbean (ECLAC), within the activities of the project “Strengthening the Role of Regional and National Financial Institutions for Sustainable Social Development” (GER/03/002)”, executed by ECLAC jointly with *Deutsche Gesellschaft für Technische Zusammenarbeit* (GTZ). The author would like to thank Daniel Titelman for his valuable comments on a previous version.

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United Nations Publication  
ISSN printed version 1564-4197 ISSN online version 1680-8819

ISBN: 978-92-1-121644-8  
LC/L.2732-P  
Sales No.: E.07.II.G.70  
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Printed in United Nations, Santiago, Chile

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## Abstract

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This document analyses development banking in Jamaica, identifying its weaknesses and proposes solutions to address its shortcomings. The first part of the document provides an overview of development banking in developing economies. The second part, “The Jamaican Experience of Development Banking” examines the modus operandi of all Jamaica’s post - Independence developmental institutions. The Jamaican experience substantiates the conclusions as to the desultory performance of development banking in the developing world. The third part “Financial Deepening in Jamaica”, seeks to address the question “how to rectify this situation” Accordingly, it considers first how Jamaica’s development banks might access the international capital markets and hence raise fresh capital in the same manner as their counterparts in developed countries. A condition precedent to such a step would be the need to “clean up their balance sheets”. However, it should be borne in mind that it would be impossible to keep their balance sheets clean, operating on the high risk/ low return principle. In making suggestions for the expansion of the range of financial products offered by the development banks, the document points out the need for legislation to make it easier to transfer financial ownership to creditors and for the establishment of a credit bureau to improve access to financial information. It also identifies new financial products. More importantly, to illustrate a proposal that Jamaica’s main development bank assume the role of a corporate financier, it likens the institution to a multi-story building, each of whose floors represents a particular level of appetite for risk. Thus, the top floors represent “secured debt” whilst, at the other end of the scale, the ground floor represents equity. The intervening floors represent “Mezzanine or Quasi Equity Financing” including commercial loans, preference shares etc. This illustration sets the stage for what the paper argues in “The Way Forward for Development Banks”. In short, the proposal is that the development bank should switch its modus operandi to that of a Venture Capital Corporation (VC).





# 1. Stylized facts of development banking

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## What is development banking?

Kane (1975) defines the Development Bank (DB) as “a financial intermediary supplying long- term funds to bankable economic development projects and providing related services”, while Panizza (2004) highlights considerations of externalities: DBs are “financial institutions primarily concerned with offering long-term capital finance to projects generating positive externalities and hence under financed by private creditors.” Clearly, Kane’s definition and that of the IDB’s Panizza, some 30 years later, are both insistent on the paramount importance of the long term lending role of the DB. However, it is submitted that the “real essence” of development banking was identified much earlier by Joseph Schumpeter in his book, “The Theory of Economic Development”, published in German in 1912 but only published in English in 1934. In vivid language, Schumpeter argues that banking and entrepreneurship are the two key agents in the process of economic development. He is one of the earliest to contend that financial development causes economic development, as financial markets promote growth by funding entrepreneurs and channelling capital to high return projects.

## The origin of development banking

Development banking began in Continental Europe, where universal (industrial or credit) banks were formed first in France, with the *Credit Mobilier* in 1852, and then more successfully in Germany and Italy, explicitly to support industrialization through providing large amounts of financing to growing industries. These precursors of the modern development bank were created by countries engaged in a catching up process, who held the view that gradual accumulation of capital over many years out of retained earnings i.e. the British model, would be inadequate. European enterprises were much younger, but were faced with larger, more sudden capital requirements, such as building a modern steel or textile mill. Moreover, the large capital requirements to build utilities such as railways could have been raised only with difficulty in Continental Europe, as unlike Britain, they lacked a large prosperous middle class and developed stock markets.

## The German experience

In his seminal work “Economic Backwardness in Historical Perspective: A Book of Essays” published in 1962, the economic historian, Alexander Gershenkron, argued that the banking system had played a key role at certain stages of the European industrialization process, pointing out that, when Britain industrialized, technology was small scale and, hence, institutionally not very demanding. These conditions were radically altered in the nineteenth century when Germany, his favourite example, started to catch up. This was due to what Gershenkron described as the seemingly inbuilt tendency of modern technology to require ever larger and more complex plants (static and dynamic economies of scale) with similarly changing requirements with respect to the physical, financial and institutional infrastructure. He argued that, because of the high potential rewards from successful entry, and the heavy modernization pressure it helped to generate in the rest of the economy, it was of paramount importance for the latecomer to target such progressive, dynamic industries, and compete globally through investing in the most modern equipment and plants. He attributed Germany’s success in achieving rapid development to its banking system, which he viewed as the primary source of capital and entrepreneurship: “The focal role in capital provision in a country like Germany must be assigned not to any original capital accumulation but to the role of credit creation policies on the part of the banking system”.

Drawing from the German experience, Gershenkron drew the following conclusions:

- it is “largely by the application of the most modern and efficient techniques that backward countries could hope to achieve success, particularly if their industrialization proceeded in the face of competition from the advanced country.”(9).
- To succeed in catching-up, countries had to build up new “institutional instruments for which there was little or no counterpart in the established industrial country” (p. 7). The purpose of these institutional instruments would be to mobilize resources to undertake the necessary changes at the new and radically enlarged scale that modern technology required.
- The more backward the country, the greater the need for banking to supply both capital and entrepreneurship.

In his 1968 work “Continuity in History and Other Essays”; Gershenkron addressed the issue of the other essential ingredient of development banking i.e. entrepreneurship, when he argued that:

- The inadequacy in the number of available entrepreneurs could be remedied or substituted for by increasing the size of plant and enterprise above what would otherwise have been an optimal size. Once again using the German experience, he points out that the various shortcomings of individual entrepreneurs were offset by the device of splitting the entrepreneurial function. As suggested above, the German investment banks – a powerful invention, comparable in economic effect to that of the steam engine – were in their capital - supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of the entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major – and sometimes even not so major – decisions of the individual enterprises. **It was they who very often mapped out a firm's paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases.” In short, the German investment banks actively participated in the entrepreneurial ventures which they financed. This is a point to be noted by present day development banks.**

## Development banking in developing countries

The Gerschenkron hypothesis, extolling the virtues of the European model, received considerable academic attention in the late 1960s and 1970s, at the same time as many development banks were being set up by the newly independent countries, often with help from the World Bank. However, it should be borne in mind that the development of modern financial systems in the industrial countries took place in an environment vastly different from that in which developing countries' financial systems have developed. To be specific, prior to the Great Depression in 1929-1933, most governments intervened neither in macroeconomic management of the economy, nor in special regulation of the financial sector. This distinct trend towards universal banking was stopped by the regulations introduced everywhere in the 1930s. However, in the 1970s, when some of the regulation of the 1930s was relaxed, this trend re-emerged.

More recently the Gerschenkron hypothesis has been called into question by policy advisers, who have asserted that financial institutions under the control of industrial conglomerates worsen resource allocation. In his second edition of *Money, Banking and Development* 1995, Pg.301, the late Professor Maxwell Fry observed “The apparent conflict with the historical experience of Europe lies in the fact that conglomeration in the developing countries is often strongly motivated by the desire to avoid interest rate ceilings and other regulations on lending, such as credit ceilings.”

In addition, according to Fry, Pg 302 “Four key differences should be borne in mind when comparing the financial systems of most developing countries with industrialized countries' financial systems. First, financial markets are oligopolistic in most developing countries, whereas they are competitive in most industrialized countries, particularly so in the United States. Second, although detailed regulations concerning financial transactions exist in all countries, they are generally enforced much more consistently and effectively in the developed than in the developing countries. The same regulations on paper may be quite different in practice. Third, dis-intermediation in the developed countries implies substitution from indirect to direct financial claims. In most developing countries, it implies substitution into tangible assets used as inflation hedges. Hence, national savings ratios may be unaffected by deposit ceilings in industrialized countries but be affected by them in developing countries. Finally, the driving force behind the recent wave of financial innovations and reforms in the industrialized countries may well have been market forces in the face of the worldwide inflationary surge of the 1970s, whereas the ideas of Ronald McKinnon (1973) and Shaw (1973) have had substantial impact on developing countries, perhaps most obviously in the policy recommendations of the IMF and the World Bank”.

Fry (Pg 303) continues by drawing a distinction between postwar financial development in developing countries and that of developed countries: “Postwar financial development in developing countries differs in several important respects from financial development in the industrialized countries. First, the pace has been forced in developing countries, with government intervention occurring with increasing frequency. There has been a strong tendency towards increasing government ownership of financial institutions in developing countries over the past two decades”. This leads inevitably to the question: Are state owned development banks a long term development finance solution? And further: Has over-concentration of development banking ownership in Government hands hindered financial development?

Fry does however acknowledge there are significant similarities between banking in developing and developed countries, when he continues “An important parallel between nineteenth-century Europe and many post-war developing countries lies in the banks’ involvement in government finance. Nineteenth century Austrian banks focused their attentions on financing the government’s perennial deficits. The same happened in Italy, Serbia and Spain. Banks in Austria, Italy and Spain took the easy path of lending to finance large government deficits. These examples from nineteenth century Europe bear more than a passing resemblance to many developing countries today. Government policy and government finance had as large an impact in molding the structure of financial systems in nineteenth – century Europe as they had in the postwar period in developing countries. Cameron’s comment on Serbia (1972, 21) drives home the point, when he argues “the privileged position of the government in the capital market, and its penchant for unproductive expenditures – just as that of Austria, Italy and Spain – made it difficult for the banking system to contribute to industrial development”. The parallels between these observations and the position in Jamaica and other developing countries today is self-evident.

## **Development finance institutions (DFI’s)**

From its creation in 1944, and for the first four decades of its existence, the World Bank was the leading supporter worldwide of development finance institutions (DFIs). Indeed, it should be noted that, although the first wave of World Bank reports on the financial sectors of developing countries, written in the late 1970s and early 1980s, concentrated mainly on microeconomic and sectoral issues, these reports often advocated the adoption of universal banks at the institutional level. It therefore seems appropriate to quote from the World Bank’s seminal World Development Report of 1989 (WDR 1989) to define DFIs. According to WDR 1989, pg 106:

“The most common type of non-bank intermediary in developing countries is the development finance institution (DFI). Most are public or quasi-public institutions that derive much of their funding from the government or from foreign assistance. Originally they were intended to provide small and medium – size enterprises with the long - term finance that the commercial banks would not supply. During the 1970s the mandate was broadened to include the promotion of priority sectors. Using government funds, DFIs extended subsidized credit to activities judged unprofitable or too risky by other lenders.”

After World War II, the lack of long - term funding for investment projects encouraged many countries to establish development finance institutions (DFIs) by using public funds to fill what was identified as a financing gap. The evolution of the terminology of development institutions has included “development finance companies” (DFCs) or corporations defined as public entities with non- banking activities, “development funds” (often funded through special accounts at the Central Bank) and “national development banks” (NDBs).

It is not entirely accurate to regard the term, NDB, as being roughly interchangeable with the term, DFC (which excludes key banking activities), particularly when quoting from earlier writers on development. The term DFI is more correctly used to include a greater number entities than only NDBs, and we shall use it specifically to include the relevant “special” funds targeted at financing development, such as those used to finance small and medium sized enterprises (SMEs) in Jamaica.

The most common form of DFI is the national development bank (NDB). The NDB typically provides long - term finance for development projects for the industrial or agricultural sectors. The central role in economic development assumed by most developing country governments for most of the post war period required them to set up institutions to identify, appraise, promote, finance and implement investment projects - in short, a national development bank, which became an instrument of government policy expected to act in the country’s long term developmental interests. Virtually every developing country has at least one DFI, most often a NDB, whilst many countries, like Jamaica, have several.

Another key role of DFIs is to fill “gaps” in the capital markets through mobilizing capital for investment. Kitchen (1986) observes “ In countries where financial institutions are limited in number and limited in vision regarding their lending policies, where entrepreneurial activity is largely concentrated on activities which provide quick returns, such as trading, and where security for loans may be limited, then DFCs are probably a necessity. The conditions described prevail in a large number of developing countries, of course”.

## **Why have so many countries set up development banks?**

Fry observes “ Invariably, these specialized financial institutions have been established to attract foreign resources, to mobilize domestic savings (in part by developing capital markets), and to allocate investable funds efficiently”.

Kitchen (1986) takes a broader view: “The raison d’etre of a Development Finance Corporation in a market (or mixed) economy is to provide long-term finance (debt or equity) which the capital market cannot, or will not provide.” He adds that among the broader aims to which governments expect development banks to subscribe are:

- The creation of employment
- The saving or earning of foreign exchange
- The distribution of income (between social classes, ethnic groups etc)
- The diversification of industry
- The modernization of the agricultural sector
- The development of small business
- The encouragement of entrepreneurial activity
- The development of the capital market

## **Have development banks been a success?**

To answer the above question, we need to evaluate how important and how effective a role development banks have played in financial sector development in emerging market economies?

Set out hereunder are the views of a number of economists, some with practical experience in the field:

### **Maxwell Fry (1995, pg 364)**

“The record of the past 30 years suggests that DFIs have attracted foreign resources effectively, have failed completely to mobilize domestic resources, and have a mixed (and deteriorating) record in allocating funds to productive investment projects. In general, DFI efforts at promoting capital markets have been disappointing.”

He adds “Very few DFIs have become self – supporting autonomous financial institutions capable of mobilizing resources entirely on commercial terms. This is partly because DFIs have often been required to make loans at low rates of interest, frequently negative in real terms.”

### **The development bank in practice**

An economist with considerable experience working in the development banking field opines that, although usually lending to projects that commercial lenders consider to be too risky, in practice, the development bank rarely addresses the twin problems of lending risk and access to finance. Hence, most development banks around the world are bankrupt, either because of the inherent risk of the projects to which they lend, or because political interference pushes development banks to lend to well connected borrowers who frequently feel no obligation to repay their loans. At the other extreme, the few development banks that are solvent lend only to the highest quality borrowers at subsidized interest rates, thus crowding out commercial lenders. In this economist’s experience hardly any development banks have been worthwhile and, in particular, have not made any meaningful contribution to financial market development. He identifies the usual problems from which such institutions suffer as including:

- Political interference, which results in loans being made to government supporters.
- Below market interest rates, which crowd out private sector lenders
- High default rates
- Poor collection records
- Government bail- outs on a regular basis.

However, he notes that Singapore is a special case, “There are 99 bad examples against this one good one, which exists in a country which “works” with an efficient bureaucracy, non-existent crime, an immigration service that is a model for the world, a telecoms sector that is very low cost, utilities that are efficient, and the best private airline in the world.

### **Kitchen (1986)**

Kitchen argues that “any government which aims to develop an expanding and competitive financial sector should appreciate also that the favoured position of the DFC is, in the long run, incompatible with that aim. Moreover, a protected DFC may even discourage the development of private sector financial institutions, because the latter will clearly be unable to compete with it, and the development of long - term lending by the private sector may be discouraged.” Kitchen’s comment is in line with the point just made above about solvent development banks crowding out commercial lenders.

## Other caribbean and latin american experience

The following comments from an economist who has worked on development bank reform in the Caribbean and Latin America explains the challenges currently faced by development banks very well. Apparently, his views reflect the current views on the subject of the major multi-laterals:

"I have worked on development bank reform in Barbados and Trinidad & Tobago (T&T), as well as several Latin American countries. In all cases **the only thing that has any chance of working is when the state owned development bank limits its operations to second tier (wholesale) lending, and channels the funds through the commercial first tier banking system.** Interest rates need to be market determined with the wholesale development bank lending at rates roughly at or above the deposit mobilization (savings) rate paid by commercial banks. This assures that the retail banks, S&Ls, microfinance institutions, etc. do not have the perverse incentive of borrowing from the development bank instead of mobilizing funds from their own depositors. Secondly the first tier institutions should be able freely to set their on-lending (retail) interest rates based on market considerations. (i.e. they should not be required to lend at predetermined, "preferential" below market rates).

In Barbados we made a policy based loan which resulted in the conversion of the Barbados National Bank from a de facto, highly insolvent development bank (which had been making uncollectable loans to unprofitable sugar growers and mills), into a privatized commercial bank. This is one of the few happy endings of a development bank story that I know of, and of course it ended well because the BNB got out of the development banking business. The loan also called for the closure of the Barbados Development Bank, which had required repeated recapitalizations from the Government. There was also an understanding that any successor "development bank or banks" in Barbados would be majority privately owned. The BDB was closed but unfortunately the goal of a viable niche development bank has not been achieved. Two successor institutions have been created and although their shares were offered for sale, there was insufficient private sector interest and the institutions are now floundering along, losing money, as government-owned first-tier development banks. One of these institutions has an equity window, with the problem that it is very difficult for a state-owned institution to be impartial and free from (albeit subtle) influence in its decisions as to where to make equity investments. Their main saving grace is that they are sufficiently small that they are not doing much damage.

In T&T we tried to reform the Agricultural Development Bank, but we were unsuccessful. There is essentially no justification for the ADB as T&T is a small homogeneous country with the commercial banks having more branches in the rural areas than the ADB. However, the ADB is a highly political institution serving some important constituencies. It loses money, but I guess the party in power feels that is a small price to pay. Fortunately it is essentially irrelevant and therefore is not distorting the financial markets of T&T.

Our experience in Peru was better, with COFIDE, the state owned development bank getting out of the retail lending business and channelling its funds at essentially market rates through the commercial banks and specialized private sector development lending institutions. We have also been pursuing more fundamental financial sector reforms in Peru, where the Congress recently approved one of the first secured transactions laws in Latin America."

### Colin Mayer

Mayer points out that, over the years, World Bank missions have recommended the establishment of development finance companies (DFCs) to provide long term financing for worthwhile (primarily industrial) projects. His review of DFC performance suggests that, in general, it has been disappointing. Few are self supporting; a third are in serious difficulties, and as far back as 1983

half of the banks had arrears on a quarter of their loans. In consequence, even by the early 1980s, the Bank's wisdom in establishing DFCs was being questioned. Moreover, from his recent experience in a group of developing countries, Mr. Mayer concludes that :

- an efficient banking system is central to the promotion of economic growth,
- the performance of financial markets is not necessarily furthered by artificially lengthening the maturity of bank lending,
- economic growth is not promoted through the financing of projects,
- corporate organization, not project activity, is what distinguishes developed from developing countries- in other words, economic growth relies on the structure and quality of financial institutions., and
- financial assistance is only part of what is needed to create an appropriate institutional structure -monitoring and rewarding individuals may often be more pertinent.

## **Is the concept of the development bank fatally flawed?**

Kitchen (1986) argued that DFIs frequently found themselves obliged to finance projects where:

- The financial structure would not meet normal commercial criteria. Generally this means the debt/equity ratio is too high, because of the inability of the sponsors to raise sufficient equity. The DFI may then supplement the equity by taking some itself; this, though, increases its total exposure, perhaps to levels that would not normally be considered prudent.
- The cash flow cannot meet the bank's normal repayment terms. The DFI is then required to extend its grace periods or normal maturities. This it may be able to do, but for a DFI which operates on a revolving fund basis such slow repayment circumscribes its ability to finance future (and perhaps more deserving) projects
- Little or no worthwhile security is available. This applies notably to small businesses, or businesses that already have a prior charge on their existing assets. In the event of failure of a business, the market for the assets may anyway be very limited, thus ensuring that little will be realized from their sale. The smaller and poorer a country is, the truer this is likely to be
- The entrepreneur has little track record, either in the line of business being financed, or in any other business. These risks apply a fortiori if the industry in question, or the technology, is new to the country, which is often the case.

Clearly, financing projects, subject to the deficiencies identified above by Kitchen, brings into sharp focus why DFIs often find themselves financing risky projects. Moreover, macroeconomic imbalances, in particular the debt burden, have resulted in governments, such as the Jamaican government, having to pay high interest rates on government debt. This has resulted in banks holding very high concentrations of government debt which, in Jamaica, constitute the equivalent of over 40 per cent of total deposit liabilities, one of the highest government debt/deposit ratios in the world. This results in high levels of real interest rates, whilst substantial spreads between borrowing and lending rates exacerbates the problem.

Basic capital market theory suggests higher risk sectors should have a higher discount rate. Thus, new projects ought to pay a significant risk premium over the rates paid by Government. However, the higher the rate of return demanded by the lender, the more likely it is that the company will fail. Hence, the riskier the project becomes.



The degree of risk assumed by DFCs is heightened when government objectives lead the DFC to concentrate its lending and investments in a few industries, thus depriving it of the possibility of holding a well – diversified portfolio of loans and equity stakes. Specialized institutions such as agricultural development banks have even less scope for risk diversification. Thus, the principle of diversification is a strong argument against establishing institutions that are too specialized.

Despite this high degree of risk, to meet Government’s national objectives, development banks have often been required to finance projects, whose rate of return is expected to be relatively low i.e. below what would be acceptable on commercial grounds. In short, development banks have been obliged to take high financial and commercial risks, which would normally require high expected returns, but at very low rates of return. Clearly, the twin problem of low rate of return is just as important as the risk factor.

This low rate of return also adversely affects the ability of the development bank to access finance. Kitchen (Pg 125) believes “that mobilization of funds is, probably rightly, a minor role of DFCs. They can, of course, tap the capital market with bond or equity issues (their own or their clients’), but they are not equipped to mobilize small savings on a national scale. Such functions are best left to post offices or specialized savings and loan banks. ” However, if DFCs are to tap the capital market with bond or equity issues to enable them to increase steadily their lending and investment, they need to be profitable.

One may conclude from the above that where a development bank is required to lend at relatively low, “below market” interest rates to acquire “riskier” loan portfolios than those of local commercial banks, this constitutes a fatal flaw in its modus operandi. Hence, its survival will depend on continued Government or institutional subventions.

## Conclusion of part 1

Kitchen refers to the above flaw as the “Danger of Social Credit” arguing that to expect DFCs “to act as social institutions may be altogether too much.” He acknowledges that the problem would be alleviated if there were in existence a sufficient number of projects that were simultaneously both financially acceptable i.e bankable and socially acceptable i.e. developmental. However, he points out that the number of projects with both high financial and social returns is likely to be limited. He therefore concludes that “There is a danger ... that DFCs may become financiers of last resort instead, lending on projects which are not acceptable to private sector financial institutions.”

The above conclusions call into question the continued relevance of development banks today. It is undeniable that long term finance is necessary for industry, agriculture, certain services, and infrastructure, and where this is not financed directly by government, it is not satisfactory that it be provided through rolling over short term loans whose continued availability is uncertain. Whilst DFI’s have provided long term finance, the question is whether this could have been better provided through better avenues.

The foregoing leads to the following further questions:

- Were the DFCs established in the right way so that the solutions match the problem:
- Whether new roles, strategies and instruments are now appropriate to justify their continued existence.

It is submitted that, in attempting to answer these questions, the Jamaican experience should be particularly helpful. However, it should be borne in mind the social credit issue may be less relevant to Jamaica than to many other developing countries because the Development Bank of Jamaica has, for the most part, stopped the practice of making loans directly, and has mainly lent through the major commercial banks and other institutional lenders.

## **2. The Jamaican experience of development banking**

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### **History of development banking in Jamaica**

The History of Development Banking in Jamaica reflects the underlying theme of Part I of this document. This is highlighted by the following analysis of the various development and quasi-development banks established in Jamaica since independence in 1962:

#### **The Jamaica development bank**

The Jamaica Development Bank (JDB) was established in 1969 to “provide the type of assistance required to facilitate the establishment and operation of “development enterprises” identified in the Jamaica Development Bank Act, 1969 specifically as “industrial, tourist, housing, and commercial agricultural enterprises.” In addition, a subsidiary, the Small Industry Development Finance Company (SIFCO), was set up specifically for the purpose of targeting small enterprise.

It was envisaged the services which JDB would provide would include “direct loans, loans with equity participation, the underwriting of securities, guarantees, and the provision of financial advice to potential as well as existing clients” (Central Planning Unit, 1969:113). From the start, the commitment to support the development of the financial sector was explicit. For example, the Act specifically charged the JDB with responsibility to “assist persons in establishing,

carrying on, or expanding development enterprises by participating in share capital, granting loans, and providing other forms of financial assistance,” and crucially to “foster the development of money and capital markets” (Jamaica Development Bank Act, 1969: s 4.1; Central Planning Unit, 1970:103). In short, the task of the JDB was not only to provide the entrepreneur with finance but also to follow the German model identified by Gerschenkron by offsetting the shortcomings of individual entrepreneurs by sharing the entrepreneurial function. Thus, the JDB was expected to **“furnish financial advice and provide or assist in obtaining managerial, technical, and administrative services for development enterprises in Jamaica.”** However, it should be noted that notwithstanding the presence of discretionary powers relating to these extension activities, these activities were not viewed as a mandate and were not given priority focus in the general scheme. This was at least partly because of the JDB’s limited capacity to perform these functions.

During the controversial 1970s period, both JDB and SIFCO became virtually insolvent. This was due to the fact that it had made large loans to a bankrupt Government, as well as well as suffering from a high number of non- performing direct loans. In consequence, the JDB lost the ability to raise finance on the international markets or from any other source.

### **National development bank (NDB)**

The JDB was replaced by The National Development Bank of Jamaica Limited (“NDB”), established in 1981 following the change in government in 1980. Its primary function was to foster the country’s economic development, and to increase the availability and access to medium and long term project – based financing. However, in the light of the JDB’s experience, with the goal of minimising credit risk, the lending mandate changed, so that all loans by the NDB were now made to borrowers through commercial banks, merchant banks and other financial institutions, recognized as Approved Financial Institutions (“AFIs”) by the NDB. **This of course is the second tier approach identified in Part I as being the only way to enable development banks to remain solvent.**

The idea was that commercial banks and other AFIs could reduce their interest rate spread, enabling them to lend to their customers with small increases in the interest rate charged to the borrower. Funding for the NDB was provided by lines of credit from the World Bank (secured through the Government), The Caribbean Development Bank (“CDB”) (Government guaranteed) and The European Investment Bank (“EIB”) as well as the Government of Jamaica.

### **National import – export bank of Jamaica**

The National Export – Import Bank of Jamaica was established in 1986 as a limited liability company jointly owned by the Bank of Jamaica and the Government of Jamaica to take over and execute the functions of the former Jamaica Export Credit Insurance Corporation. The Ex-Im Bank’s main objective is to provide financial support and export credit insurance to the productive sector, so as to facilitate the expansion of local industry and trade between Jamaica and foreign countries. Foreign currency funding is also provided to facilitate the importation of capital equipment and raw materials needed by public sector entities, engaged in infrastructural development projects, which have national impact and enhance the productive sector of the country.

### **The agricultural credit bank (ACB)**

The Agricultural Credit Bank (“ACB”) was also established in June 1981 to facilitate agricultural and agro – industrial development in Jamaica through the provision of loan financing. Financing was provided to all eligible agricultural and agro-industrial enterprises. Funding to the ACB was provided by multilateral and bilateral agencies, the Government and internally generated sources.

The AC Bank took over lending to agriculture from the pre-existing Agricultural Credit Board and was expected to “be run as a viable enterprise ... to provide credit to farmers on a timely, cost-effective and relevant basis.” The AC Bank was designed to “operate as a wholesaler of credit” and to “on-lend funds to commercial banks and approved institutions such as the People’s Cooperative Banks and Cooperatives” that in turn operated to provide “retail credit to farmers and ... bear the risk of the loans”-again a second tier approach.

## **National investment bank of Jamaica (NIBJ)**

The National Investment Bank of Jamaica (“NIBJ”) succeeded the Jamaica National Investment Company Limited by an act of Parliament in 1984. According to its website, NIBJ aims to play a pro-active role as an investor in the local capital market, to act as a catalyst for investors with new ideas and to assist in the expansion of medium to large-scale businesses.

Through **equity** and **quasi-equity financing**, NIBJ invests in development projects that are designed to improve and broaden the country’s economic base. The Bank makes investments, primarily to finance capital expenditure, in the seven key economic sectors of agriculture, manufacturing, mining & minerals, entertainment, infrastructure, information technology, and tourism, which are supported by the National Industrial Policy (NIP).

In recent years, the NIBJ’s mandate has been to act as the Government’s central privatization agency focusing on the divestment of public sector assets, responsible for, amongst many other privatizations, the divestment of Air Jamaica. The divestments were supposed to serve as catalysts for attracting incremental capital flows whilst simultaneously relieving the Government of any financial responsibility for the operations of these entities.

## **Merger of DBJ/NIBJ**

The Agricultural Credit Bank of Jamaica Limited (ACB) and the National Development Bank of Jamaica (NDB) were merged on April 1<sup>st</sup>, 2000 creating the Development Bank of Jamaica (DBJ). This was followed some years later by the merger of DBJ and NIBJ.

Minister of Finance, Omar Davis, in his 2004/2005 budget speech addressed the proposed merger of the Development Bank of Jamaica, and the National Investment Bank of Jamaica. His comments explain the issues involved well, and are quoted verbatim:

“The fact is that the previous merger - of the former ACB and NDB - was quickly effected because the institutions were very similar except for areas of focus. In this case, there is a difference in that NIBJ has significant equity stakes in a range of companies, unlike the DBJ which is essentially a bank with a loan portfolio. As such the analysis has demonstrated that, prior to effecting the merger, it is important that the various investments held by NIBJ be reviewed, so as not to affect the balance sheet of the DBJ which, as is generally accepted, is in excellent financial state. Put another way, there is need for us to separate those investments which have not been profitable, prior to proceeding with the merger of the two institutions. The timetable is that this will be done during this fiscal year. However, even when the merger takes place, gains will be in terms of increased efficiency levels and greater focus in terms of developmental initiatives”. Hence, “there are no significant” budgetary “savings to be reaped from this merger.”

From the Minister’s explanation, it is clear that the motive was not cost saving but the rather more intangible motives of “increased efficiency” and “greater focus in terms of developmental initiatives.” However, there appears to be lack of transparency to the merger process as the DBJ, a second tier institution, was owed some J\$1.7 billion by the NIBJ. Conversely, the NIBJ had been functioning as a first tier institution, investing in equity and direct loans, including functioning as an AFI for the DBJ. This leaves one to wonder as whether the real motive for the merger was to

channel more of DBJ's funds into NIBJ. In other words, was the NIBJ running out of funds because of non-performing loans or inadequate returns on its equity investments, whilst the DBJ remained fairly liquid due to operating on a second tier basis. If indeed this were the case, one might well speculate as to whether the root cause of NIBJ's problem was its failure participate directly in the management of the entrepreneurial activities in which it invested in accordance with the German model identified by Gerschenkron.

## **The development bank of Jamaica interview**

The Development Bank of Jamaica (DBJ) does very little direct "retail" lending to the ultimate customer, preferring to make most of its loans to Approved Financial Institutions (AFIs) at a standard interest rate, with a fixed spread at which the institution can on – lend the money. This lending preference is reflected in its loan portfolio, which is currently almost entirely made up of "wholesale" loans to financial and agricultural institutions, Government of Jamaica support programmes, and Government of Jamaica infrastructural loan programmes.

According to management, the DBJ adopts a fairly "hands off" approach to the approval of credit as their credit risk limited to that of the intermediary institution e.g. frequently a well capitalized commercial bank, rather than the underlying customer loan. Jamaica's AFIs include its six commercial banks, nine merchant banks and several "other" AFI s including the Jamaica Cooperative Credit Union League, the Jamaica Agricultural Development Foundation, National Development Foundation of Jamaica and the National People's Cooperative Bank's Offices, or so called PC Banks.

The DBJ's small and medium size enterprise lending is mainly to the agricultural sector, particularly small farmers, virtually all through the PC bank network (now that the Agricultural Credit Bank no longer exists). This has recently been consolidated into a National PC Bank of Jamaica with 30 individual branches. Often over a hundred years old, typically PC banks were set up by the pastor, teacher or other rural community leader in their local community. According to DBJ management, commercial banks regard farming and agriculture as high risk, and many of the PC bank loans would not be regarded as "bankable" by the mainstream commercial banks.

The PC banks, even after their recent consolidation, are thinly capitalised so with the PC banks, unlike the other AFI's, the DBJ takes what it calls a "hands on" approach in looking to the underlying loan "as if we are making that loan" for repayment. Moreover, the DBJ is required generally to take a more proactive role with the PC banks as they are typically relatively unsophisticated, but providing technical assistance for the development of the agricultural industry. Whilst most of their loans are to individual farmers, they are currently lending to a cooperative as a pilot project in St. Thomas, as part of a program to encourage greater farming linkages to tourism. In April 2004, the bank also earmarked a \$10 million dollar revolving fund for disbursement through the Jamaica Business Development Centre (JBDC), and has also earmarked money specifically for micro lending through Jamaica National Building Society.

### **An example of industry re-engineering - poultry farming**

According to DBJ management, significant loans have been made to the broiler industry, particularly for investments in "tunnel ventilation". Whilst the smallest PC banks loans can be as low as JA \$200,000, agricultural loans for tunnel ventilation can go as high as \$30 million or more.

According to the DBJ management, the re-engineering of the sector is being driven by the Jamaica Broilers group, who provide management and economies of scale and an assured market for the final product of chicken. Marketing is typically one of a small farmers biggest problems, although perhaps an even bigger problem for their farming clients was that the large hotels do not pay on time, creating such a squeeze on their small suppliers as to be almost criminal.

### **The size of the DBJ's lending**

The DBJ approved 129 local currency loans totaling \$1.24 billion during the year ended March 31<sup>st</sup>, 2005 (of which 94 or \$103 million of the total loans came from PC banks). Consequently, agriculture and agro industry together comprised 88% of total loans, although only a combined 43% of loans by value. There is a "guideline" of \$100 million for an individual tourist loan, but this is not a hard and fast limit. No foreign currency loans were approved. This compares with the 128 local currency loans that were approved in March 2004 totaling \$1.35 billion, with U.S. \$27.7 million in foreign loans approved. (Appendix 8 – Analysis of Development Bank of Jamaica Lending gives a comprehensive breakdown of the DBJ's loans, sources of funds etc.)

### **The DBJ's lending rates and terms**

The standard lending rate for Jamaican dollar loans is 10% plus a maximum banking spread of 3%, or a combined 13%, whilst the U.S. dollar lending rate is 7% plus 2%. The length of the loans can be up to 10 to 12 years, and the bank is willing to look at restructuring. The Bank of Nova Scotia Jamaica recently provided a one-off special line of \$350 million and \$250 million at lending rates of 8% and 7.875%, but allowed DBJ a spread of only 0% and 1/8% spread respectively.

### **The impact of the NIBJ merger and the trafilgar development bank takeover**

DBJ management agreed that the takeover of Trafalgar Development Bank had created a vacuum in the system for equity and venture capital. They were also concerned that, whilst the NIBJ's role in equity financing will continue as part of the new DBJ, due to the NIBJ's relative lack of success in this area, there was a critical question of how equity investments should be made going forward.

However, in their view, the merger of the NIBJ and DBJ would improve the DBJ's knowledge of the borrower, as formerly a project frequently went to NIBJ for equity finance, and then went to an AFI for a loan, delaying the process and creating bureaucratic complexity. The merger meant that the relevant information would now all be under one roof. The merged institution would also continue its lead role in privatizations of state owned enterprises.

### **Problems experienced by development banks with equity financing**

DBJ management appeared to believe there was a cultural problem of honouring commitments in Jamaica, stating as evidence that even some very large private companies refused to give audited financial statements. They agreed however that a credit bureau would improve compliance.

Whilst they also agreed the ideal was improved access to equity, in practice they were very cautious on equity financing as in their view many entrepreneurs needed the big stick provided by the receivership option in loan financing to encourage repayment. However, their own history of getting money back from putting companies into receivership was very poor, as receiverships in their view seemed mostly to benefit the receivers.

DBJ management suggested that the rules for successful equity investing for development banks should include the need for real board meetings, and the necessity for good information so

the bank knows what was going on in the company. All this boiled down to the need for a true culture of partnership between the bank and the entrepreneur. The problem in Jamaica was that most Jamaican entrepreneurs regarded equity as merely a loan, and therefore did not believe any financial reporting was required. As an investment instrument, preference shares required dividends to make a return but typically entrepreneurs reported that no profit had been made out of which to pay those dividends. Moreover, entrepreneurs knew that, as a development bank, the DBJ would be reluctant to take a decision to foreclose.

### **Why there is still a need for a DBJ?**

Unlike the commercial banks who are mainly financing consumer credit, the DBJ's management believes that Jamaica's development banks lend for development of industry. Another problem with the commercial banks is that they resist accessing DBJ funds due to the lower spread of DBJ lending. Commercial banks are not bullish about agriculture as they perceive it to be high risk. As a consequence, to get development going, the DBJ believes it is also forced to do non-core activities like adopting a school to assist it in moving agricultural projects towards best practices. The justification for this approach is that students need to see opportunity in agriculture, where the DBJ management believes there are very significant opportunities in resuscitating ginger, cocoa and financing sea island cotton on ex sugar land. They agreed however that the DBJ's performance in developing manufacturing industry in Jamaica had been disappointing. They attributed this to high security costs and energy costs, which made it very difficult for Jamaica to compete in this area.

### **Reflections on Trafalgar development bank**

Trafalgar Development Bank ("TDB") was established in May 1984 to provide development funds (through loans, leases and equity investments) to enterprises in manufacturing, tourism, agriculture and horticulture, mining and the services sectors. Funding was primarily provided by USAID, EIB, CDB etc. TDB was founded by a group of Jamaican business leaders, who headed up some of Jamaica's largest companies, such as Grace Kennedy, Geddes Grant, The Gleaner Company, Pan Jamaican Investment Trust etc. It was born out of the conviction that the Private Sector should be the engine of growth for the economy, not the government. Prior to the establishment of TDB, all development banking in Jamaica had been undertaken by the government, with the assistance of institutions such as USAID. In the past, it had been the policy of USAID, only to grant loans to Jamaican government institutions. Indeed, in the late Seventies, Jamaican businessmen had found it ironical that USAID would only lend to the Jamaican government, when that government was perceived as being bent on destroying the private sector. However, in the Eighties, with the changes in the administration in both the USA and Jamaica, USAID changed its policy and began to actively (and directly) support the private sector.

### **The start up phase**

As a consequence of this change in policy, USAID took on the role of sponsor of the TDB project, providing TDB with both technical and financial assistance. The German Development Bank (DEG) and the Dutch Development Bank (FMO) also provided TDB with technical and financial assistance, in addition to taking up significant stakes in TDB's equity. This equity participation entitled these institutions to board representation. On the other hand, although USAID did not participate in the equity of TDB, it did provide TDB with a significant amount of long-term loans to fund TDB's development banking activities. Initially, the quantum of these funds was determined on the basis that USAID would match, dollar for dollar, whatever funds TDB was able to raise itself. In recognition of the role played by USAID in the establishment of USAID, whilst USAID did not have formal board representation, it was nonetheless be entitled to have its representatives



attend TDB board meetings. The government also made its contribution to the successful launch of TDB by entering into an arrangement with TDB whereby, when the time came to repay the USAID loans, US dollars would be sold to TDB at the same rate as that prevailing at the time the US dollars were initially borrowed (J\$5:US\$1). In addition, TDB was granted tax free status by being classified as a venture capital corporation.

## Practical problems

As indicated above, TDB seemed to have everything – the finance on a “sweetheart deal” basis, the technical assistance, tax free status and strong local and foreign partners - everything that seemed to be needed to operate a highly successful development bank. Thus, TDB could be expected to succeed where the Jamaican government’s development banks had failed. However, from its inception, it began to encounter similar difficulties to those experienced by the Government entities. Specifically, those seeking to borrow from TDB tended to look upon TDB:

- simply as a source of cheaper funds than those obtainable from the commercial banks
- a source of funds to finance projects which the commercial banks considered too risky to finance.

Such projects were often the brainchild of the entrepreneur, who wanted to keep for himself all the potential gains of the project. On the other hand, he was either unwilling or unable to put up the capital needed to seed the project. Indeed, he wished TDB to substitute long-term development loans for his equity. In short, the entrepreneur’s goal was to get TDB to take all the risk which should have been borne by the company’s equity, without TDB having any of that equity. Thus, TDB’s its potential return would be limited to a low rate of interest on its development loans. Another motive for the entrepreneur wanting to retain 100% control of the project was his desire to keep his affairs away from the prying eyes of the income tax department and the exchange control authorities.

Another problem with which TDB was faced was the fact that, in addition to almost non-existent accounting records, the entrepreneur did not have the ability to put the details of his project together in a format, which could be presented to the TDB Finance and Credit Committee (F&C) as a “bankable proposition”. Moreover, he was usually either unable or unwilling to put up the finance required to hire a professional to undertake the task.

## TDB’s project analysis team

TDB had established a project analysis team, whose task was to assess the feasibility of projects submitted to TDB and to make recommendations as to whether such projects were “bankable”. Such assessments were to take into account not only feasibility but also whether the capital structure proposed to seed a project would provide TDB with a cushion adequate to protect the loan finance it was being asked to provide. In the event of the cushion being inadequate, the team would be expected to recommend what additional security should be obtained from the entrepreneur.

However, the project analysis team found itself in the position that it not only had to vet the entrepreneur’s feasibility study but also had to prepare the actual study. The net effect of this was that, in their anxiety to put development project loans on the books of TDB, the project analysis team was tempted to prepare feasibility studies which it felt it could “sell” to the F&C. Thus, the latter committee was likely to have feasibility studies placed before it, which looked at development projects through “rose coloured spectacles”. Indeed, the cash flow statements submitted to the F&C sometimes indicated such a tremendous positive project cash flow that it begged the question “with this level of cash flow, why does the entrepreneur need to borrow from TDB at all?”

Another issue was that of capital structure. Knowing that the F&C would be concerned at TDB taking virtually all the risk without any equity participation the project analysis team would

often arrange for a part of the development loan to be in the form of preference shares. This was portrayed to the F&C as “equity participation”. However, these preference shares were not convertible preference shares and, hence, could be considered the “worst of all worlds” in that they did not have the rights afforded to a creditor in the event of a liquidation, nor did they have the benefit of participating in the profits (other than a small preference dividend) were the company to be successful. The project analysis team defended these arrangements on the basis that this was as far as entrepreneurs were prepared to go in relation to equity participation.

Another assurance sometimes given to the F&C was that the TDB management had negotiated a seat on the board of the entrepreneur company. However, these seats were taken up by members of TDB’s management team not by independent members of the F&C. In fact, very few reports on the progress of these projects ever filtered back to the F&C as a result of such board representation.

From the above, one might draw the conclusion that the TDB management and the project analysis team were on the side of the entrepreneur rather than TDB. In other words they seemed to view their role as being that of getting the best possible deal for the entrepreneur, rather than getting the best possible deal for TDB. In such a scenario it was inevitable that many of the projects financed by TDB would either fail or become delinquent, requiring debt repayments to be rescheduled and, in some cases, requiring fresh loans to ensure the entrepreneur stayed in business – sometimes throwing good money after bad. Certainly, very few projects lived up to the glowing feasibility studies submitted to the F&C.

### **The phasing out of TDB’s development banking operations**

In these circumstances, TDB’s profit performance came under pressure although, with the continued sharp devaluation of the Jamaican dollar over the period of TDB’s existence, the sweetheart deal with the Jamaican Government in respect of the repayment of the initial USAID loan to some extent cushioned TDB against the adverse effects of these losses. Cash flow also came under pressure although, for a time, TDB was reasonably successful in raising new soft long term loans from international institutions. Eventually, sources of long terms loans started to dry up whilst, at the same time, and both DEG and FMO appeared to be losing interest in TDB. Accordingly the future prospects of TDB were discussed at board level. When the FMO director was asked what is the future of development banking his answer was succinct: “Development Banking is dead!”. Eventually DEG and FMO sold their stakes in TDB paving the way for Pan Jamaican Investment Trust Limited to acquire a controlling interest in TDB. TDB’s development banking operations were then phased out and its project analysis team and most of its management and staff were made redundant. TDB then became a financial services company, which has now been rebranded as Pan Caribbean Financial Services.

## **Conclusion**

The fact that TDB did not make it in the development banking field when it was set up with everything in its favour:

- Soft loans
- Exchange rate protection
- Technical & financial support from international institutions
- Strong partners both local and institutional
- Tax free status as a venture capital corporation

Suggests that the traditional development banking approach does not work. Thus, TDB failed because it operated in the same manner as governmental development banks had done in the past rather than as a venture capital corporation as its tax free status implied.

Venture Capital / Private Equity Organisations normally operate on the principle that they only expect to back 2 winners out of any 10 projects they finance. However, they do expect to make enough gains out of these two winners to cover, not only the losses they have sustained on the other eight projects, but also to produce a handsome return for their shareholders. Clearly, TDB (along with development banks in general) did not operate on this principle having neither real equity participation in the projects financed, nor any control over the actions of the entrepreneurs whose projects it was financing. In summary, one must conclude that development banking can only be successful if it is operated along the same lines as venture capital / private equity organizations.

## **The financing of small and medium sized businesses in Jamaica**

A brief review of their loan and investment portfolios over the past five years, including the number and size of loans and investments made, suggests that the focus of the Development Bank of Jamaica and the National Investment Bank of Jamaica has not been on financing small and medium sized enterprises (SME's) in Jamaica, and certainly not micro – enterprise lending. Possibly in response to this, a number of programmes targeting SMEs are planned. In addition to a plan to lend to the SMEs through the Development Bank of Jamaica, a number of other schemes are being set in motion. The details of these schemes are covered in the following numbered appendices:

- The Private Sector Development Programme (PSDP) – Appendix 1
- The Mutual Guarantee Company (MGC) Concept – Appendix 2
- The Credit Unions - Appendix 3
- The National Investment Fund Credit Facility – Appendix 4



### **3. Financial deepening in Jamaica**

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#### **Capital market access**

For most of their existence, Jamaica's development banks, like their developing country counterparts abroad, have been provided with long term finance mainly from Government budgets, aid from foreign Governments and loans from the major multi-laterals. By way of contrast, the multilateral development banks and the development banks of the major OECD countries appear to be successfully meeting almost all of their borrowing needs from the international capital markets. Their ability to tap international capital markets for financing seems to be linked to their high credit ratings, normally AAA, reflecting the fact that most nationally owned development banks' ratings are typically rated the same as their countries' ratings.

Jamaica's international rating of single B is a barrier to tapping international financing at rates attractive enough to on lend at their target U.S. dollar lending rate. Nevertheless, international capital market rates on Jamaica's 2017 Eurobonds of just under 8% are only a little bit above the 6-7% at which the DBJ borrows from international and regional development banks, and this includes their spread for administration costs etc. There would therefore appear to be a case for seeking to determine whether Jamaican development banks can access the capital markets, either through using an international rating agency such as an S&P to access international U.S. dollar financing, or a regional rating agency such as CariCRIS to access the regional capital market. Even absent the goal of raising money by way of a bond issue, a regional rating of the Jamaican development banks would be a good 'private diagnostic' of their operations.

The need for transparency arising from seeking a regional rating may lead to an earlier recognition of losses, on the principle that “first loss is best loss”, as opposed to waiting for things to get worse as typically occurs worldwide in these scenarios. In the case of the newly merged DBJ and NIBJ for example, it is likely that the NIBJ portfolio in particular has a number of poorly performing equity or quasi equity (as non quoted equity investments, these are automatically difficult to value) investments that should be hived off from the core operations and restructured by some kind of “work out” specialist. In the case of the newly merged DBJ and NIBJ for example, it is likely that the NIBJ portfolio in particular has a number of poorly performing equity or quasi equity (as non quoted equity investments, these are automatically difficult to value) investments that should be hived off from the core operations and restructured by some kind of “work out” specialist. In any case, there is an argument for splitting that portfolio into two pools, one for investments that are at market or near market prices and one that is marked down to reflect the element of subsidy granted at inception, either as a lower interest rate or reflecting the under-pricing of the risk.

According to their March 31<sup>st</sup> 2005 financial statements, the DBJ’s portfolio is almost all “wholesale” financial and agricultural institution loans, Government of Jamaica support programme loans (almost all to state owned agriculture, largely sugar), and Government of Jamaica infrastructural loan programmes (roads and highways). These should not present any valuation problems for their accountants, Price WaterhouseCoopers.

## **The product range of the development bank**

The range of financial products offered by development banks largely depends on their expertise, size and risk appetite. All three factors are in relatively short supply in Jamaica, implying a need for a new approach, preferably involving foreign expertise and capital, perhaps as part of a regional pooled arrangement. Concentrating the available local expertise and Government capital into a “one stop shop” for investments in Jamaica, using the DBJ as a catalyst, should allow Jamaica to expand its menu of financial products to better fit the needs of local entrepreneurs. Critical to the long-term success of any new approach will be the establishment of close links with the local private sector, preferably by means of a formalized public/ private sector partnership.

However, conditions precedent to the achievement of these goals are that the cost of credit be reduced by making it easier to transfer financial ownership to creditors, and that there be an improvement in the access to information with the use of a credit bureau. Finally, there needs to be further development of local and regional securities markets.

The first of these conditions was studied in detail by the IDB in their “IDB Private Sector Assessment of Jamaica”. This study is reproduced herein as Appendix 5.

The second of these conditions is covered in Appendix 6 by

- an abridged version of a newspaper article on a seminar/interview with Mr. Venkat Raman, the CEO and Chief Rating Officer of CariCRIS and
- an appreciation of the benefits of credit bureaus, particularly for small business. This is entitled “A credit bureau would increase access to credit.”

## The standard loan product

The standard loan product of the development bank is a long term loan which, because it increases the bank's liquidity and interest rate risk, requires long-term financing e.g. long term loans, equity, donor grants etc for the DB to avoid excessive mismatching. The Development Bank of Jamaica's standard lending rate for Jamaican dollar loans as a "wholesaler" is 10%, plus a maximum banking spread of 3% for its first tier "retail" lenders, or a combined 13%. The U.S. dollar lending rate is 7% plus a 2% spread. Although the length of the loans, at up to 10 to 12 years, is relatively long term, the DBJ management indicates it is willing to look at restructuring. This would extend the term of a loan still further.

In years gone by, when the risk free rate on short-term Government paper was at high multiples of these lending rates. The Jamaican dollar lending rate in particular represented a very significant subsidy. Even now, there is a significant opportunity cost between the rate at which the Government borrows, and the rate at which the DBJ lends to the commercial banks, although this "cost" has narrowed substantially from its previous highs. Whilst it would seem likely that this "second tier" lending has increased the maturity of loans to business by providing longer term loans to the banking system, it is not clear that this has increased the overall volume of bank lending. In any case, total development bank lending in Jamaica, as in most other Caribbean countries, is only a very small percentage of total bank lending. However, it should be borne in mind that, in many cases, in the absence of other mechanisms there may be good reason for shorter term lending, as a form of control over the borrower. Furthermore, it is likely that most Jamaican companies borrowing from Jamaican development banks simply do so as a cheaper source of funding than that obtainable from commercial banks or as a source of funds for projects, which the commercial banks considered too risky to finance. Thus, the subsidized lending model is a fundamental weakness of Jamaican development banking, which has led to continuing losses for the development banks requiring their repeated recapitalization. In short, they have been beset by the same problems as were identified in Part 1 as besetting development banks in general.

Whilst the change in policy making most lending wholesale through the commercial banks (who then bear the credit risk) has largely eliminated this type of loss, it has also meant that the development bank is not likely to be financing the risky projects required for future development. If anything, the restriction on the spread the commercial banks can charge makes it likely that the development bank is indirectly financing even lower risk projects than those the commercial banks are financing out of other funds. As a consequence, much of the development bank's wholesale funds have generated very little "investment additionality" as the borrowers have often included some of Jamaica's largest companies, which could procure financing without going through a development bank. Thus, some cash rich companies would appear to have been recipients of an interest rate subsidy from a cash strapped government!

Experience from developed countries suggests a change in product mix to providing relatively small subsidies to a larger number of borrowers might work better than the current approach. Moreover, combining this with technical or grant assistance to either high growth companies with potential to access new markets, or small and medium sized companies unable to get access to bank loans, due to poor technical capacity e.g. no financials, would appear a better way forward. It is therefore suggested that Jamaican development banks avoid subsidized lending, and focus instead on market rate loans (perhaps coupled with grants for technical assistance) in order to encourage a competitive environment for private sector lending and generate marketable loans for future securitization. In conclusion, the core loan product of development banks should complement rather than compete with the private banking and financial markets by providing tenors, amounts, currencies or interest rate structures not currently available. Thus, it would be "additional" to Jamaica's existing commercial lending, thereby creating "new" lending and investment.

## New financial products

Identified hereunder are a number of new (other?) financial products which, it is submitted, will not only make development banks more liquid and therefore more effective, but will also enhance the Financial Deepening of Jamaica's capital market:

- **Syndicated Lending or Co – Financing**

Involving other lenders is a good method of increasing the impact of small development banks with limited capital bases and sources of new funding, as is the case in Jamaica. Co-financing or syndication partners could include commercial banks, official co-financiers (such as government agencies and bilateral financial institutions providing grants, parallel loans and equity), export credit agencies and other international financial institutions such as the World Bank and the International Finance Corporation (loan syndications currently account for nearly 13% of their commitments or more than US\$1 billion dollars per year). The development bank would act as the sole lender of record, whereby commercial banks participate in the loan through separately funded participation agreements. Besides the role of lender of record, the development institution performs an “agent” role. This role includes activities such as billing and disbursements, collecting debt service payments, remittance of these payments to participants as well as supervision and monitoring. The participating banks have no direct contractual relationship to the borrower. The agency loan would be on terms and conditions that other financial institutions cannot match, usually in the form of a longer tenor rather than a lower rate. The commercial credit risk would be shared by the development bank and the participating banks. However, by using the development bank as lender of record, the participants may enjoy protection due to the agency's tax status (no withholding tax) as well as its de-facto preferred creditor status.

- **Securitisation and Structured Finance**

Securitisation is potentially a key way to develop the domestic medium to long-term debt market though offering “credit – enhanced” securities to domestic investors, typically by issuing debt against income generating assets. For example, a large infrastructure project could be financed through the sale to private investors of the securities of a special purpose vehicle (SPV), backed by the assets of the project.

- **Mortgage Securitisation**

As one of Jamaica's development banking institutions, the Jamaica Mortgage Bank (JMB) might benefit from considering mortgage securitisation. Its current model is the traditional model where one institution performs the major functions of loan origination, servicing, and funding and portfolio risk management. This would require it to look at the modern “unbundled” mortgage delivery system, where the key functions are handled by specialized entities. The key advantage of this “unbundled” model would be to access a wider range of investors, ranging from local mutual or pensions funds to overseas Jamaicans, comfortable with investing in an asset secured by land. There is in principle no reason for the JMB to keep the mortgage assets if they can be sold, perhaps as a securitized pool; allowing them to make new mortgages and thereby improving mortgage availability.



- Short Term Financing

Short-term lending markets are required for successful long-term lending markets, just as the ability of a stock exchange to raise capital depends on the liquidity of its secondary markets. However, despite short term loans being more readily available from commercial banks, there is still a potential role for Jamaican development banks to get more involved in short term lending products by the provision of working capital by means such as trade finance, factoring, personal loans and treasury services - all with the goal of achieving quite dramatic “quick wins”.

- Factoring

A particularly promising short term financing approach for the DBJ to consider is electronic factoring. Many small businesses in Jamaica are challenged to access bank financing. Small firms need to finance their production cycle but, after goods are delivered, most buyers demand 30 to 90 days to pay. Sellers issue an invoice – recorded for the buyer as an account payable and for the seller as an account receivable – which is an illiquid asset for the seller until payment is received. Such receivables fall into two categories:

- Government Receivables: Virtually every small businessperson can give numerous examples of Government paying very late for goods or services, with the consequence that he or she can be put out of business due to lack of cash. An institution such as the DBJ factoring these receivables may do as much for the financial health of small and medium sized businesses in Jamaica as any other conceivable single measure
- Private Sector Receivables: The case of the local agricultural industry supplying the large hotel chains deserves specific mention as another good example of small businessmen (sometimes even large distributors) being put under financial pressure by the late payment for goods supplied. The ability to get timely cash to invest in the agricultural cycle may be the best “linkage” to facilitate agricultural development.

Such financing vehicles would be extremely helpful to the SMEs due to the fact that the lending interest rates of commercial banks are still very high in Jamaica with rates charged to SMEs being as high 22%. This is a reflection of the very high spread (12%) between the deposit and lending rates in Jamaica. According to the report of the IMF’s last Financial Sector Assessment Programme, this was the highest spread of a comparable group of highly indebted countries, the majority being from the Caribbean region.

- Exim Bank Lending

The specific needs of exporting firms are being met satisfactorily through the Exim Bank, although its programme could be expanded.

## The DBJ as Jamaica’s corporate financier

### Creditor finance

To illustrate a proposal that Jamaica’s main development bank assume the role of a corporate financier, the institution has been likened to a multi - storey building, each of whose floors represents a capital structure, which reflects a particular level of appetite for risk. The top floor, or the debt financing just considered, normally requires specific collateral, with a fixed charge against a specific company asset. This debt is at the top of the building and is senior to all other payments at the time of liquidation. Beneath the top floor could be a secured lender with a floating charge over the assets. Below this level would be the unsecured lenders, who rank behind secured lenders if the

company goes into liquidation. Often this is done by “negative pledge”, referring to financial ratios (gearing, interest cover) which the company agrees not to breach.

## Mezzanine or quasi equity financing

Mezzanine financing, a hybrid or form of quasi equity, is a basic component of venture capital style financing, and includes subordinated loans (coming after secured debt in bankruptcy) such as convertible loans or loans with equity positions, participating loans/preference shares, subordinated debt and preference shares (usually with stock options or warrants), and convertible preference shares. The term mezzanine financing is best understood as the middle floor between the top floor of debt and the bottom floor of equity. The three most popular forms of mezzanine financing are:

- Convertible Loans

Typically unsecured, convertible loans are for a fixed period (at a fixed or floating rate of interest) with the right of conversion (at the option of the lenders) into ordinary shares (sometimes preference shares) at specified dates in the future. Otherwise the loan is paid off at maturity. Convertible loans are a good financing method for projects that might take several years to be profitable, but where the costs and time of development can be predicted with a reasonable degree of certainty, so that the lower cost during the development stage converts to a higher cost when the project is profitable.

- Subordinated loans plus options

In this case, a company issues debt with a “sweetener” to buy new shares from the company at a future date at a fixed price known as the exercise or strike price “the option”.

- Preference Shares

This most popular form of venture capital financing is a preference share, which rank above ordinary shares in terms of their claim on assets, earnings and dividends, but below creditors and lenders. Whilst preference shares normally pay a fixed dividend (usually cumulative) based on the nominal par value of the shares, “participating” preference shares can also participate in the ordinary dividend distributions. Preference shares may also be convertible into ordinary equity or redeemable like a debt instrument.

Although these and other mezzanine structures have been used by Jamaica’s government owned development banks and the former private sector owned Trafalgar Development Bank, most of the time the equity conversion rights have not been meaningful. In the case of TDB, preference shares were typically issued without equity conversion rights at a “heavily subsidized” standard interest rate of 15%, which, for most of the 1990s, would have been a fraction of the risk free rate payable on Government securities. As a riskier instrument, coming after standard loans in terms of priority in the case of a default, to have been priced correctly i.e. without subsidy, a further substantial risk premium on top of prime corporate lending rate should have been added to their coupon rate.

The issuance of preference shares through Jamaica’s financial markets has been very limited, to the point of being irrelevant in most instances, with a very small number of quoted issues. Clearly, this presents Jamaica’s local development finance institutions (DFIs) with an opportunity to help develop the local financial market, by seeking to make these products available to local investors, thereby stimulating their interest in more structured financial products. For example, the DFIs could sponsor and underwrite the issuance and listing of preference shares, or better yet convertible preference shares, on the Jamaica Stock Exchange, providing transparency and a “demonstration effect” to the local private financial markets. If the shares were attractive investments, as opposed to investments that require marking down from par on the day of issue to

reflect the subsidy element, they could even be sold to raise further capital for the development bank. An effective way to achieve this might be through pooling and securitisation of a number of similar assets with the goal of a subsequent sale, either through a private placement (limited to 50 investors under the Securities Act) or listing on the underutilized Jamaica Stock Exchange.

## Equity

On the bottom floor of the building are the ordinary shareholders, who have voting rights, plus the right to receive ordinary dividends. When our development banks take equity ownership positions, they should have clear guidelines as to the maximum investment size, both in absolute terms and in terms of invested amounts. It should be noted that, while some institutions actively attempt to influence project management, most appear (mistakenly we believe) to have adopted a passive approach. In any event, there should always be a clear exit strategy for equity investment. However, it is submitted that the most effective exit strategy is to have a formal venture capital fund, perhaps as a partnership between the state and the private sector.

## Venture capital – the way forward for development banks

Venture Capital (VC) or more properly private equity (venture capital is really a form of private equity generally applying to start-ups) is just another structure to pool other people's money (OPM) in the same fashion as occurred through the investment banks of Europe 150 years ago. Those investment banks provided both capital and crucially "entrepreneurship" for industrial latecomers (the equivalent of today's developing countries) to catch up through the creation of new industries. (See Part 1).

The emphasis on services in the Caribbean as industries in which we can be competitive means that, excluding tourism, there is much less in the way of collateral against which to lend. In the absence of the manufacturing plants prevalent in Germany's industrialization, venture capital/private equity structures should be better financing structures than bank loans to mobilize the resources required to target modern industries. Such structures need not only to provide funding but crucially compensate for the entrepreneurial deficiencies of individual entrepreneurs in the region (about which we need say no more). Typically, development banks, which go this route create separate subsidiaries, no doubt reflecting the different mindset required – that of the entrepreneur/industrialist and not a civil servant.

In addition to the correct mindset, the investment structure is extremely important. The investment bank of old made its real returns from equity (J.P. Morgan was no accident), and a VC fund is just another structure to link risk and reward properly, as opposed to the traditional regional development bank model of all risk and no reward. Without the big successes from new industry creation, the capital to fund further new industries is not accumulated, leaving these other potential new industries stillborn.

## What is venture capital?

A good definition of venture capital (VC) is "The investment in the illiquid equity securities of a privately held business by third-party investors (OPM) seeking high returns, which reflect the high risk profiles of the companies and the near-term illiquidity of these types of investment.

VC funds are typically managed by full time professionals, motivated mainly by the goal of producing capital gains, rather than current income. Venture capitalists expect the potential for a high rate of return in the businesses in which they invest – a minimum of 25% per annum compounded, whilst in fact targeting 100% per annum. This very high potential pay off is necessary because venture capital is a very high-risk business. Venture capitalists understand that, out of a portfolio of 8-10

investments, most are likely to lose all or nearly all the investment, some will perform in an average manner and only one to two investments will be the big winners that must pay for the other failures. This very high failure rate is the reason why banks do not do VC financing as, with their upside capped, they cannot charge enough in interest to compensate them for the risk of their lending to start up businesses. Bank lending is appropriate when a company is more established, with assets and cash flow to lend against rather than just an idea.

VC is a harsh business, functioning on the basis of The Golden Rule -“ he who has the gold, makes the rules” and, as a consequence, entrepreneurs should only seek VC financing if they are prepared to give up between 20-50% of their business in return for such an investment. They should bear in mind however that it is better to have a smaller percentage of a lot, than the whole of nothing. In addition, entrepreneurs should expect several rounds of financing rather than being given a single large capital sum. This increases the investor’s control over the project, and accommodates the reality that different investors are comfortable with the different levels of risk associated with the stages of the investment.

## **The venture capital cycle – an outline of the U.S. or U.K Model**

### **Pre- Seed Round**

In the “pre- seed” round where the entrepreneur just needs the money to start his business, entrepreneurs normally tap the traditional three F’s – friends, fools and family. This round can itself be further split into

- initiation (creation of company with nominal funding split between partners),
- commitment (founders invest more meaningful funds as they decide to commit themselves to the business possibly, although not necessarily, giving up their present jobs,
- extension (founders take on more partners to complement their skills),
- the aforementioned 3 F’s, and professional (professionals, such as lawyers and accountants, agree to work for slice of the equity).

The British Venture Capital Association (BVCA) has identified next four stages through which firms needing money to expand their business will go:

- Seed Round

The “seed” round will allow the business concept to be developed, perhaps through creating a well formulated business plan, the basic elements of which would include: the executive summary, management, company, product or service, market, marketing program, numbers and competition. This is essential as one is now trying to persuade professional investors to finance the market research, or create the prototype necessary to get the company to the start up stage, where it can qualify for the next round of financing.

- Start Up Round

The Start up Round is when the funding to develop a company’s products as well as fund their initial marketing is found. Companies may be in the process of being set up or may have been trading for a short time, but may not have sold their product commercially. Often the presence of an “angel investor”, defined as a wealthy private individual who invests in start ups, is of particular importance in this vital round of financing. This “smart money” can help the start up business to complete its management team, and finalise the business plan needed to get the company to the next stage of financing.

- Next Early Stage

The next Early Stage or so called” first round” of financing follows the start up phase. Funding is to initiate commercial manufacturing and sales where the company has completed the product development stage, but may not yet be generating profits. It is at this stage that the company should either have a product or service that is commercially viable or at least sufficiently far along in development to interest an institutional VC fund.

- Expansion

Funding to grow and expand an established company – this second and final round of financing is where the company is seeking to finance increased production capacity, product development, marketing and additional working capital for its initial and subsequent expansion e.g. increasing receivables and inventory. At this stage, the company would be expected to be moving from loss to profit.

Some authors (Plummer 1987) extend the number of stages before the real final “liquidity stage” of exit to a third round (profitable but poor cash flow), a fourth round (rapid growth towards liquidity point) and a bridge stage (requiring mezzanine investment).

- The IPO or other Exit

It is after the final round(s) that the company would typically do an IPO (initial public offering) on the stock market. An IPO normally requires profits although that requirement seemed to be waived during the “Dot Com” era. The other main exit route is another company already in or seeking to enter the industry. This provides an opportunity for the company to raise additional capital for expansion, and for the venture capitalist to turn his illiquid investment into cash, by converting it into a publicly traded equity security.

## How a venture capital company operates?

Venture capital can be broken down into a simple five stage process: deal origination (identifying investments), screening (analyzing), evaluation (valuing), structuring (investing) and post investment activities (adding value):

- Deal Origination

Identifying investments is a critical element of venture capital investing. The main sources of deals are unsolicited cold calls, referral and active search. Successful entrepreneurs who know the venture capital game are probably the best source of deals. In Jamaica, there are no formal entrepreneurial networks, so using an institution such as the Jamaica Chamber of Commerce would probably be a good substitute.

- Screening

Given good deal flow, one will need to have a screening process, including size of investment (there is an implicit lower limit on investment size as it takes time to monitor). Maximum size is determined by the overall size of the fund (no more than 10% of the portfolio in any one investment), industry specialization e.g. technology, geographic location of venture (usually nearby as there is a need to meet management regularly), and stage of financing e.g. expansion phase.

- Evaluation of Investment

This process is much more than just looking at the profit history, balance sheet and any security the company has. Whilst some less experienced VCs particularly emphasize the importance of management (they would rather have an A grade management team and B grade technology than the other way round), a U.S. study by Tyebjee and Bruno puts this factor only at number five in terms of priority. According to their telephone survey of 46 venture capitalists and a detailed analysis of 90 investments made by 41 different venture capitalists, the number one criterion is market size, the number two criterion is product differentiation, number three is cash out potential, whilst number four is environmental threat resistance (e.g. obsolescence, barriers to entry).

A more memorable way of defining points two and four is that the business should have an unfair and sustainable advantage in distinguishing its business plan from the 99 other business plans the VC receives e.g. making it the 1 in a hundred he funds.

- Structuring the Deal

For a start up, tranching the investment so as to focus entrepreneurs to reach the goals set out in the business plan is critical. Convertible preference share structures are good for later investments.

- Post Investment Activities

Venture capitalists can add value in a number of ways after the investment, including sourcing additional funds, acting as devil's advocate, fostering the correct internal company climate (usually a combination of marketing enthusiasm and attention to costs), fostering credibility for the big sales (higher status VC helping out), exit mechanisms (negotiating support IPO etc), recruitment of founders and management (staff recruitment) and advising on legal protection (e.g. of intellectual property rights) or avoiding other costly mistakes.

## Private equity must be adapted to emerging markets

More than 500 emerging market funds raised more than \$50 billion in new capital between 1992 and 1999. This new breed of international private equity funds were clones of their U.S. predecessors, with the same fund-raising, organization structure, investing, staffing, and exit strategies, usually planning to sell the investments at a profit through an IPO. However, this U.S. model has not worked well in most developing countries. One must therefore conclude that if private equity is the way forward then the model will have to be adapted if it is to work in emerging markets. The following Jamaican case study is worth looking at in some detail because of the lessons which can be learned from it, which may give an indication of the nature of the adaptation required:

### The caribbean investment fund (CIF)

There have been a number of attempts at Venture Capital in Jamaica, but they have not been particularly successful. The last and most high profile attempt was the Caribbean Investment Fund, nearly all of whose investors, of which a very limited number were private sector, were from outside the Caribbean. After a long gestation period, which began in 1992, it commenced operations in January 2000 at a time when the Jamaican stock market was very illiquid. Jamaica had just experienced one of the world's worst financial crises in terms of percentage of GDP and, in consequence, there had been no Initial Public Offerings for almost five years prior to its launch. In fact, this IPO drought would only be broken nearly three years later. On the other hand, around this time, increased cross listing reflected renewed interest in a Caribbean Stock Exchange. Moreover,

the following two years (2003 –2004) saw a very substantial increase in regional, particularly Trinidadian, investment in Jamaican shares. Since then, despite much talk, the concept of a Caribbean Stock Exchange has not been significantly advanced.(For an appreciation of the issues surrounding moves to establish a Caribbean Stock Exchange - see Appendix7 - A Caribbean Stock Exchange – Charting the Way Forward)) Furthermore, the recent regional bear market, primarily on the Trinidadian and Jamaican stock exchanges, has not helped matters in regard to Caribbean stock market liquidity. A recent interview with CIF’s managers revealed that they had learned the following lessons from their experience at the CIF:

- Liquidity

The financial market scenario portrayed above brought home to them the fact that, whilst always important, the exit strategy becomes critical in illiquid stockmarkets such as those in Caribbean which, in keeping with other small emerging markets, lack opportunities for exit by IPO. Accordingly, it was critical that they “ buy right” as they would usually be compelled to sell to a local “trade” buyer at a keen price. Hence, initial overpayment would severely depress return.

- The issue of control

All the CIF investments were minority positions, mostly in family owned businesses. Accordingly, detailed shareholder agreements and other performance triggers would be more important than in the U.S. In particular, this would be the case when dealing with private family companies, who may not have same objectives as the investor- for example, they may not even want to list!

- Region has small market size

As investments are in businesses almost all of which are serving the regional market, the businesses were seen as unattractive to overseas buyers due to the small market size of the region, thus reducing potential exit options. This problem was compounded by what investors perceived as high political and economic risk, particularly in Jamaica. Local investment money is therefore of critical importance.

- The early stages

The early stage venture capital investments in the CIF’s portfolio performed particularly poorly, leading to the conclusion that it is courting disaster to buy into businesses, which the investor does not fully understand, or which he has not subjected to detailed analysis. It is therefore essential advisers should be Caribbean based and have a full understanding of the region.

## **The promotion of emerging market private equity – the case of Jamaica**

In the light of the above, drawing in particular from the CIF experience, the following guidelines for the promotion of Private Equity are put forward:

- Investments must be export orientated (local markets too small)

At least in the Caribbean where the domestic market size is too small, any new venture capital fund should seek to provide capital mainly to exporters, including SMEs targeting exports. This should encourage the creation of innovative products that add value, whilst simultaneously generating employment, spreading risk and stimulating changes in the Jamaican business culture and types of business model – in short providing entrepreneurship.

- Local money and expertise

It is of critical importance to have a suitable mix of investors, including substantial local equity. The local equity is best achieved through a mix of domestic private and institutional funds. The managing partners, the ultimate representatives of the investors, should be a multidisciplinary team, able to negotiate investments and add value, whilst also being creative and able to tailor solutions to problems.

- Control and 24/7 information

U.S. style "Corporate Governance" requires a culture of profit sharing. In the absence of trust, control achieved through majority ownership may be a normal requirement. The ability to exercise shareholder rights is extremely important where the business is family owned.

Quality financial information as to the status of the investment is critical. Without information, the private equity model simply does not work in emerging markets. This implies the necessity for strong, in situ, real time financial controls, designed to ensure that financial information is neither inaccurate nor one sided. The managing partners should also be professionals resident in the country, who understand both the culture and the local market realities. Finally, investments should normally be in areas in which the managing partners have both expertise and experience.

- A public/private sector partnership

The need for a public / private sector partnership reflects the critical importance of having "smart money", meaning investors who would not only provide money but would also give advice, help to build the management team, and use their contacts to find business or additional financing - basically acting as a true partner. The planned expansion by the Jamaican government of business incubators across Jamaica is theoretically a good idea. These incubators are designed to provide business infrastructure for entrepreneurs with only an idea and little else. As such, they represent the ultimate in smart money. However, without proper partnerships with practising businessmen or so called business "angels", these initiatives attempts may not bear as much fruit as the Jamaican Government would like. A good way to proceed might be for the Government to partner with the Jamaica Chamber of Commerce, using its islandwide network of regional Chambers as joint venture partners in creating these island wide business incubators. The directors of the regional chambers could then, hopefully, act as mentors and even as "business angels" investing capital in some of the incubating companies.

## **New venture capital funds – a proposal**

It is submitted that it is an appropriate time to revisit the issue of creating one or more new venture capital funds for Jamaican business. Such funds should preferably be joint public/ private sector partnerships, hopefully with our local development banks leading the way as catalysts and sponsors. Indeed, the Development Bank of Jamaica would be a particularly good candidate to sponsor an exchange traded venture capital fund. These shares could be traded on the Jamaica Stock Exchange, which would allow different categories of investors to participate.

Such funds' investments would be of the "Mezzanine" type i.e. quasi -equity (loans that give the same benefits as equity capital, except that they have to be repaid) as well as preferred shares. These investments would be adapted to the cash flow and growth realities of the business, but would be paid back thereby providing competitive returns to investors.



## 4. Executive summary and recommendations

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### Lessons from history

In Part 1 of this paper, we traced the history of development banks with the aim of identifying what lessons modern day development banks could learn from it. It quickly became clear from this analysis that the 19<sup>th</sup> century European development banks were established with the aim of solving exactly the same industrial development problems as modern day development banks are seeking to address i.e. the raising of long term finance for investment. These early development banks would have been regarded as investors in ventures of a pioneering nature whereas today, as the name implies, development banks would be regarded as financing “development”. This rather obvious distinction highlights a fundamental difference between the early development banks and those of today – the early banks raised long term investment finance for projects which were very high risk but also seemed to have the potential to generate high returns. Conversely, modern day development banks, particularly those in developing countries, seem to be prepared to take high risks without the prospect of high reward. This is what Kitchen refers to as the “Danger of Social Credit”. This appetite for risk without reward is particularly prevalent where the development institution is Government owned. However, as the case study of Trafalgar Development Bank illustrates, private sector development banks are not immune.

Gerschenkron draws attention to another fundamental difference between the early European banks and the modern development banks when he points out that, in addition to supplying finance, the German development banks were also a substitute for entrepreneurial deficiencies. He continues “ From their central vantage point of control, the banks participated actively in shaping the major – and sometimes even not so major – decisions of individual enterprises. It was they who very often mapped out a firm’s path for growth, conceived far sighted plans, decided on major technological and locational innovations and arranged for mergers and capital increases”. In short, the German investment banks actively participated in the entrepreneurial ventures, which they financed, in two significant ways:

- they controlled the venture
- they were heavily involved in the planning process and other major decisions.

As the interview with the Development Bank of Jamaica makes clear, this is in sharp contrast to the “hands off” approach adopted by development banks today. Again, the section of the paper on Trafalgar Development Bank indicates that the “hands off” approach is not confined to the public sector owned development institutions. However, in TDB’s case, it is not entirely true to say that that it did not involve itself in the planning process. Indeed, as the study indicates, its Project Management team often actually put together the entrepreneur’s plans. Hence, TDB was in an excellent position to monitor and control- just like the 19<sup>th</sup> century German banks. That TDB failed to do so may be attributed to the fact that its management and staff were imbued with the same hands off mindset, as obtained at DBJ. It may also be due to the fact that, unlike the German banks, it did not enjoy voting control of the venture,. Of course, as the study suggests, very little if any effort was made to acquire such control.

## Have development banks been a success?

To answer the question “Have Development Banks been a Success?” the paper draws on not only the views of academics – Maxwell Fry and Kitchen – but also of several economists with years of practical experience in the field. In the view of one of the latter “hardly any development banks have been worthwhile and, in particular, have not made any meaningful contribution to financial market development”. He identifies the usual problems from which such institutions suffer as including :

- Political interference, which results in loans being made to government supporters.
- Below market interest rates, which crowd out private sector lenders.
- High default rates.
- Poor collection records.
- Government bail- outs on a regular basis.

The above views are in line with those of the other economists who have worked in the field. However, a point worth noting is the observation that “the only thing that has a chance of working is when the state owned development bank limits its operations to second tier (wholesale) lending, and channels the funds through the commercial “first tier” banking system.” Inevitably, the above views prompt the question “Is the concept of a Development Bank fatally flawed.” In answer to this question, the paper concludes that the development banking concept is indeed fatally flawed. In brief, it cites the reason for this as the impossibility of operating a successful financial institution on the principle of “high risk, low return”. Clearly, the principle is in sharp contrast to the “high risk, high return” principle adopted by the European banks. Less obvious is the other fatal flaw in the principles on which modern day development banks operate i.e. their “hands off” approach, rather

than following the German Banks principle of sharing the entrepreneurial role with the entrepreneur being financed.

## **The Jamaican experience of development banking**

Part 2 of the paper “The Jamaican Experience of Development Banking” examines the modus operandi of all Jamaica’s post - Independence developmental institutions. These analyses bring into sharp relief the fatal flaws in the principles adopted by these institutions. In other words, the Jamaican experience substantiates the conclusions as to the desultory performance of development banking in the developing world, which were arrived at in Part 1 of this paper.

## **Financial deepening in Jamaica**

In the light of this, Part 3 of the paper, entitled “Financial Deepening in Jamaica”, seeks to address the question “how to rectify this situation” Accordingly, it considers first how Jamaica’s development banks might access the international capital markets and hence raise fresh capital in the same manner as their counterparts in developed countries. A condition precedent to such a step would be the need to “clean up their balance sheets”. However, it should be borne in mind that it would be impossible to keep their balance sheets clean, operating on the high risk/ low return principle. In making suggestions for the expansion of the range of financial products offered by the development banks, the paper points out the need for legislation to make it easier to transfer financial ownership to creditors and for the establishment of a credit bureau to improve access to financial information.

The paper notes that, with the switch to “second tier” lending, the Jamaican development banks standard loan portfolio has been insulated against “borrower default”. However, it questions whether this policy will not simply result in commercial banks using the development banks funds to finance projects which they would have financed anyway- thus achieving no incremental lending. It therefore suggests that development banks focus on market rate loans, perhaps coupled with grants for technical assistance.

A number of new financial products are identified : Syndicated lending or Co- Financing, Securitisation and Structured Finance, Debt Securitisation, Factoring etc. Moreover, to illustrate a proposal that Jamaica’s main development bank assume the role of a corporate financier, it likens the institution to a multi-story building, each of whose floors represents a particular level of appetite for risk. Thus, the top floors represent “secured debt” whilst, at the other end of the scale, the ground floor represents equity. The intervening floors represent “Mezzanine or Quasi Equity Financing” including commercial loans, preference shares etc.

## **The way forward for development banks**

This illustration sets the stage for what the paper argues is “The Way Forward for Development Banks”. In short, the proposal is that the development bank should switch its modus operandi to that of a Venture Capital Corporation (VC). In effect, what is being proposed is that the development banks should “go back to their roots” and follow the principles adopted by the early European banks, namely:

- Only invest in high risk ventures when there is a prospect of high return.
- Seek to exercise control over such ventures.

- Share the entrepreneurial role with the entrepreneur by getting involved in the planning and deal making processes.

To be able to function in this manner, the VC itself would need to be managed by full time professionals, who are resident in the country, and who understand both the culture and local market realities. Such professionals would be motivated by the goal of capital gains as high as 100%. This very high potential pay off is necessary because, out of a portfolio of 8-10 investments, there will be only one or two of the big winners needed to compensate for the losses. Moreover, these professionals seek to control the businesses in which they invest, working on the principle of the Golden Rule i.e. “he who has the gold, makes the rules”. It is envisaged that such control would be exercised largely by means of a system of “24/7 Financial Information”. In adapting Venture Capital/Private Equity to Emerging markets, such as the Caribbean, such a control system is regarded as a pre-requisite. In addition, the mix of investors should include substantial local equity, which would best be achieved by a mix of domestic private and institutional funds. It is suggested that the DBJ would be a particularly good candidate to sponsor such funds. It is also noted that listings would constitute an added incentive to prospective investors because it would provide them with a ready made exit strategy.

In closing, it is perhaps appropriate to observe that the drafting of the paper has been driven by the conviction that what is needed to finance investment in developing countries is “not more loans, but more equity!”.

## **Appendices**

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## **Appendix 1: The private sector development programme (PSDP)**

The PSDP is a four-year €28.67 million technical assistance programme financed jointly by the European Commission via the 9<sup>th</sup> European Development Fund (EDF) and the Government of Jamaica (GOJ). The PSDP's objective is "to enhance the perspective of socio-economic development through strengthening of the private sector in the challenging context of globalisation and the liberalization of the economy."

The purpose of the programme is "to increase the private sector's contribution to GDP, and more specifically, the contribution of the Micro, Small and Medium Enterprise (MSME) sector." The programme intends to achieve this "by addressing competitiveness challenges and constraints at policy and regulatory levels; by enhancing MSME competitiveness via firm-level assistance; and by strengthening the support provided by MSME representative organizations. There are 12 PSDP components, those relevant to this paper being the Corporate Finance Brokerage and the proposed Mutual Guarantee Company (MGC) that are aimed at increasing MSME access to corporate finance.

### **Corporate finance brokerage - background**

It is expected that growth in Jamaica in the coming years will have to be largely export-led. To realise such export-led growth requires improving the competitiveness of the private sector, involving cost reductions and investments in restructuring in favour of more competitive activities.

As interest rates are trending down, factors limiting access to credit, such as strict collateral requirements, may become an important obstacle to investment growth, especially for micro, small and medium-size enterprises (MSMEs). Small and medium enterprises (SMEs) also face important internal constraints in terms of management, technology, product quality and marketing capability. An emerging challenge is also the need to meet quality and environmental standards at the main export markets, as well as certification requirements.

Against this background, the private sector in Jamaica faces numerous developmental constraints, notably in the evolving context of globalisation and the opening of the economy, which put pressure on firms to adapt to increased competition at home and on foreign markets. Notwithstanding, Jamaica presents a wide spectrum of development opportunities, both on the local and export markets. However, in order to develop and compete, businesses need simultaneous access to finance and business development services to enhance chances of success.

### **Corporate finance brokerage services**

One of the major impediments to MSME access to bank loans in Jamaica is the inability to present viable business plans and to meet the collateral requirements set out by the lending institutions.

The Corporate Finance Broker is a PSDP activity aimed at helping enterprises to gain access to broad(er) corporate finance services from the formal financial sector. A budget of €270,000 in grant resources has been allocated to this activity. JAMPRO, as the executing PSO, is expected to contribute a total of €200,000, in implementation costs, and MSMEs at least €19,000, for services provided by the CFB.

The project involves the delivery of financial advisory services to qualified micro, small and medium-sized enterprises. It also involves the provision of assistance with the delivery of training seminars/workshops on financial matters in order to improve the technical capacity of MSMEs in that area. In addition, assistance with the assessment of applications to the PSDP will also be required.

## Target groups

The main target group is comprised of the locally-based Small and Medium-Sized Enterprises, including formal micro enterprises that need assistance in accessing corporate finance from the Jamaican financial and/or capital markets.

## Specific activities

- Carry out at least preliminary diagnostic assessments of MSME clients who are eligible for CFB assistance including companies that have been awarded grants under the PSDP cost sharing facility and reach agreement with these clients on the nature of assistance to be provided under this Activity;
- In collaboration with other service providers to the PSDP, operate as an assessor of applications submitted to the PSDP by means of the Call for Proposals (CFP) mechanism for certain PSDP Components, namely: Cost Sharing Business Development Services (BDS), PSO Capacity-Building and Consortia Business Development Services (BDS) activities;
- Provide financial planning and restructuring advice to MSME clients of the CFB;
- Identify appropriate sources of finance for MSME clients of the CFB;
- Delivery of financial assistance focussed workshops and seminars targeted at MSMEs;
- Marketing and promotional activities of the CFB
- Development of templates for diagnostic assessments of potential CFB clients that will allow the CFB and the contractor to determine the type and level of technical support to be provided to MSMEs who meet the criteria for CFB assistance;.
- Development and maintenance of constructive working relationships with stakeholders and other service providers involving the following:
  1. Procurement of the following business advisory services from a CFB outsourced provider:
    - financial restructuring advice
    - business proposal preparation
    - identification of appropriate sources of finance
    - deal brokering
    - accounting assistance
    - financial management assistance etc.
  2. Delivery of financial assistance services to the MSMEs that have been referred to the programme and who meet CFB eligibility criteria
  3. Delivery of workshops and seminars to MSMEs on select financial management topics
  4. Identification, by other PSDP components, and, via Memorandum of Understanding (MOU), referral by financial institutions of those MSMEs who could benefit from CFB services



The CFB targets are as follows:

1. 400 firms assisted by the programme
2. 100 loans facilitated through individual assistance
3. 400 loans facilitated (in conjunction with Mutual Guarantee Company)
4. 48 workshops and/or seminars conducted for SMEs

### **Assumptions underlying the project intervention**

Assumptions underlying project intervention:

- Viable options & sources for financing exist;
- Sustained collaboration with stakeholders and partners (financial institutions, PSDP);
- Commitment of MSMEs to pay fees;
- Commitment of MSMEs to attend workshops
- Adequate financial resources to successfully execute project and contract

### **Risks**

In consideration of the assumptions above, the risks associated with this contract are:

- Financial resources may prove inadequate to execute all activities;
- Inadequate support from stakeholders undermine success of Brokerage
- Inadequate commitment from beneficiaries to contribute and attend events

## Appendix 2: Guarantee funds

A Guarantee fund gives incentives to qualified, approved financial intermediaries (AFI's) involved in SME lending by providing additional coverage for loans which would normally be rejected for lack of collateral. These range from all-risk guarantees (whereby the guarantee agency e.g. the development bank covers the lender against default regardless of the cause) to partial risk -specific guarantees (covering default arising from specified events).

The main theoretical justification for guarantees is to develop domestic financial markets by allowing companies to take out loans at more attractive terms with domestic lenders through providing a guarantee to remedy the general lack of collateral of SME's, potentially increasing the supply of subordinated loans and mezzanine capital most frequently through fund structures, and generally increasing the tenor and quantum of loan financing for those already able to access debt financing.

The National Commercial Bank of Jamaica is one of two domestic commercial banks in Jamaica (the other one being Trinidadian headquartered RBTT) currently operating a loan guarantee scheme (the guarantee being provided by U.S. AID). The following questions were put to NCB, who replied as follows.

### **Question: How is your loan guarantee scheme with USAID working?**

**Answer:** In May 2006, NCB launched its SME Development Access Facility, in partnership with the USAID, through their DCA line. The facility allowed SMEs to:

- Access bank funding in cases where there may be collateral constraints.
- Access funding below market rates.
- Become more competitive within their markets.

Under this agreement, USAID guarantees up to 50% of the portfolio of this special credit facility. To date, the interest has been very strong, with disbursements at 50% of the credit line.

### **Question: Generally how is lending to SMEs going and the problems in lending to SMEs in Jamaica**

**Answer:** Particularly through innovative credit products and focus on the SMEs, NCB was able to increase its lending to just over J\$2.2B to this segment last financial year.

Some of the factors that contribute to SMEs experiencing difficulties in accessing funding include:

- Inadequate planning and research.
- Lack of adequate financial information.
- Inadequate resources ( including human resources).
- No collateral.
- Limited or inadequate funds to cover the equity portion of projects.....the financial institutions do not provide 100% financing.
- Non compliance with regulators (including taxes).

As part of the PSDP project mentioned in Appendix 3, the EU funded the following study on the Mutual Guarantee Company concept.

### **The mutual guarantee company (MGC) concept**

One of the major impediments to Small and Medium Enterprises receiving access to bank loans include their inability to meet the collateral requirements set out by the lending institutions. To address the latter, a “Feasibility Study for the Establishment of a Mutual Guarantee Company” has been undertaken by consultants Dr. Dieter Falk and Michael McMorris for ACE (Asesores de Comercio Exterior), which was completed on 30<sup>th</sup> January, 2006.

The Mutual Guarantee Company, a concept developed in Western Europe, is a company founded by a number of enterprises with the objective to issue guarantees to secure bank loans and other business contracts. It targets only those enterprises that would not be able to get a loan without its assistance.

All MGC share the same objectives to improve companies’ access to finance by providing guarantees, but they adapt to local legal, economic and social environment. There may therefore be differences in their legal status, in their regulatory and tax provisions, in the way they operate, in particular in relation to banks, and in the type of enterprise they target. Some target a single economic sector, others are multi-sector, with both types coexisting in the same country. Some are closely dependent on their banking network, while others have looser relations with a number of banks. They can be assimilated to a credit institution and controlled by the Central Bank, or be monitored by the Insurance supervision body.

Often, as MGC’s members do not have the means to invest in the company, other shareholders provide the initial capital. This is a common feature even in developed countries. Moreover, the start-up costs of the company may be offset by a grant, as is proposed under this Programme. Another characteristic of most MGC is that their founders generally include Chambers of Industry and Commerce, professional associations, banks involved in lending to the target members, and public entities, such as national or international development funds.

Authors Dr. Dieter Falk and Mr. Michael McMorris conclude that

- Jamaica could benefit from a properly structured guarantee structure for SME loans.
- Guarantee Funds are inherently risk propositions and should not be undertaken without having an experienced, prudent, independent management and an adequate capital endowment able to withstand default ratios of up to seven percent.
- The pace of the loan guarantees undertaken is critical to the long term viability of the fund and requires experienced personnel trained in non-traditional credit, treasury, and financial company management to oversee such a company. In the absence of hard demand figures, great care must be taken that the impact will be reached soon.
- Any fund should not be structured without a specialised lawyer and tax attorney.
- Respect for Guarantee Fund (GF) by the financial community which it will interact with is critical to its success.
- The ability or mechanism to reach many small businesses, both formal and informal, is integral to the effectiveness of the GF on the economy.
- The fund should not be undertaken by the central government nor openly promoted by it.

- The introduction of a credit bureau in Jamaica and the acceleration of processes necessary for the realization of collateral could greatly expand the ability of the GF to be effective and sustainable.

According to Falk/McMorris, international best practice usually foresees guarantee coverage of loans between 45% to 65% going up to 85% for start ups in some cases.

They argued that the DBJ was the best government owned institution to administer such a fund. Private sector alternative lending routes to reach SME's envisaged by the "Feasibility Study included the Credit Union network (referred to in Appendix 5) or the creation of a new private entity – either a bank (not recommended) or a specific purpose company.

According to Professor Maxwell Fry (pg 357) "The evidence as to whether guarantee schemes actually work in practice is ambiguous." In his view "By not guaranteeing 100% of the loan, credit guarantee schemes save themselves from disaster. At the same time, however, this feature ensures that voluntary participation by private banks is insignificant in practice, precisely because the schemes apply specifically to high-risk lending."

### **Guarantee structures: a description of OPIC funds**

OPIC mobilizes risk capital for emerging markets by providing, through guaranties, long-term debt capital to private equity funds. OPIC's involvement often serves to encourage institutional investors who may not routinely invest in emerging markets to participate in such funds. OPIC's support, in addition to the equity raised by fund managers from private sector institutions, is directly invested in private companies in emerging markets. OPIC provides in most instances approximately one-third of the fund's total capital. The debt is structured similar to that of a zero coupon bond: most of the interest expense is capitalized until the fund liquidates its investments, with the tenor often in parallel to the fund's life, and repayment occurring in the later stages of a fund's life.

In addition to mobilizing capital, OPIC Investment Funds also support economic development by mobilizing expertise. OPIC-supported fund managers provide knowledge and experience to the companies in which they invest. These fund managers guide the strategic direction of portfolio companies, participate actively on company boards, and help companies recruit experienced operational managers. The result is enhanced productivity, reliable financial controls, improved corporate governance, modern business practices, and improved worker health and safety conditions. Fund managers also serve as active advocates for the improvement of the local legal and regulatory environment, protection of private property and shareholder rights, and the expansion of robust capital and financial markets.

In general, the funds are organized by experienced sponsors of previous investment vehicles who raise the funds' equity capital through private placement of equity interests with sophisticated institutional, corporate, and other qualified investors. Funds are typically managed by an affiliate of the sponsor(s) with a proven track record in direct equity investments, portfolio management, and relevant regional or sectoral experience. The fund manager is expected to add value to the portfolio investments by providing management expertise, improved marketing, and access to international manufacturing technologies, and to implement a coherent strategy for the eventual liquidation of investments. The fund manager typically becomes a voting member of the board of directors or other governing body of any company in which a fund invests.

OPIC-supported funds typically are organized and structured like other private equity investment vehicles, i.e., as limited partnerships or limited liability companies. OPIC supplements private equity capital by lending long-term debt (typically with a 10 to 12 year maturity) to a fund. OPIC's new program standard generally limits the amount of debt to one-third of the private equity capital invested in the fund. OPIC receives commercially-based fees and a small profit participation component as compensation for the financing provided to the fund, and the program is structured to

ensure that fees and profit participation will fully cover costs and a modest return. In addition, OPIC's terms allow the fund manager to make distributions pro rata along with the equity investors subject to certain covenants being met.

Typically, OPIC financing will be provided to the fund in the form of a loan in which certificates of participation guaranteed by OPIC (and backed by the full faith and credit of the U. S. Government) are sold to "eligible investors" as defined in OPIC's governing statute. In general, eligible investors include: U.S. citizens; U.S. corporations, partnerships, or the like which are more than 50% beneficially owned by U.S. citizens; and foreign entities wholly owned by U.S. citizens. OPIC requires either:

1. that the fund manager or general partner be eligible investors, or
2. a significant percentage of the limited partner capital of the fund (typically, an amount equal to 25% of the OPIC financing) be provided by eligible investors. OPIC does not offer any guaranty of the fund's equity, and all equity investments in OPIC-supported funds are fully at risk, and subordinate to any OPIC lending.

### Appendix 3: The Jamaican credit unions

Edited description of Jamaica Cooperative Credit Union League & National Association of Credit Unions situation from President Samuda's speech of November 3<sup>rd</sup>, 2006.

Credit Unions have been self-regulated under the aegis of the Registrar of Co-operatives and Friendly Societies for nearly sixty-five years. The Movement successfully weathered the hostile economic environment of the 1990's financial crisis, with the contraction in the numbers of credit unions over the past decade being a deliberate strategy on the part of the Credit Union Movement, whilst increasing their membership base of over eight hundred and fifty thousand (850 000).

The IMF in its March 2006 report on the Jamaican financial sector positively highlighted the role of the credit union movement as an example of the strength and diversity in the financial sector while arguing for institutional strengthening and closer more uniform supervision. With respect to regulation however, the IMF observed that "*Planned Bank of Jamaica (BOJ) supervision of credit unions will also need to preserve the extensive outreach of credit unions to small savers and borrowers under an appropriately designed risk-based system*" <sup>1</sup>.

According to the movement, Credit Unions have consistently outpaced growth in the general economy and projections are that this will continue. In terms of market share, the league argues they occupy more than 10% of personal savings and supply over 20% of personal loans. Membership growth is expected to continue growing at about 6% per annum. Deposits are expected to continue growing at more than 13% per annum and loans will grow at 12% annually.

Credit Unions successfully secured a doubling of loan limits for unsecured credit. Instead of the originally proposed 5% of total loans, there is now acceptance that it will be 10%. Again, the IMF put it very well reporting "*the proposed limit on unsecured credit would restrict credit unions that lend against moveable property and borrowers' income flow, thereby potentially curtailing loans*".

They believe however that planned regulations for a \$20M minimum capital requirement (in place of the current situation of no requirement) for new credit unions could work against co-operative interests, as it would impede people coming together to help each other - the basic credit union philosophy - preventing the formation of new Credit Unions.

The relevance of this to a paper on development banking is Credit Unions would appear to be one way of the best ways of increasing competition for lending and deposits, as well as one of the suggested intermediaries for the loan guarantee scheme.

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<sup>1</sup> International Monetary Fund Financial System Assessment March 8 2006 Section 6

## Appendix 4: The National Investment Fund Credit Facility

In addition to the development banks in the Belize and the OECS countries, Jamaica has now adopted the controversial practice of borrowing from their national security schemes, in this case the National Investment Fund, with the recent creation of a Jamaican \$1 billion National Investment Fund Credit Facility. As originally proposed in the Prime Minister's budget speech, the NIF credit facility was actually a micro-credit scheme. It now appears to have evolved into a loan facility for small business, an area that is not currently really catered for by the existing DBJ etc.

The billion-dollar loan scheme, created by Prime Minister Portia Simpson Miller from a drawdown on the National Insurance Fund (NIF), will offer loans of up to \$5 million to debtors who, once acquiring the funds will pay no more than 10 per cent interest. The fund targets small operators. According to a ministry paper titled 'NIF credit facility for small and medium enterprises' presented at the official launch of the scheme, the funds will be disbursed through participating financial institutions which will be charged with the responsibility of managing the loans. These institutions will borrow the funds at four per cent interest but will be required to cap the rate charged to customers at the maximum retail rate of 10 per cent on the reducing balance. Borrowers will be afforded a maximum of six months moratorium on principal and interest payments as part of the repayment terms, which is capped at 48 months. The micro- small- and medium-enterprise sector, which employs well over 50 per cent of the work force, is the intended target market of the scheme, but will place particular focus on "enterprises involved in value-added activities."

"These would include but are not limited to light manufacturing; provision of business services; agro-processing; and production of craft items," said the ministry paper.

The Ministry paper advises, as is the normal practice for current development bank lending in Jamaica, that loans will be made to small and medium enterprises through an existing network of public and private sector financial institutions. The NIF will not therefore be a direct lender, and the credit risk will be borne by the financial institution and not the NIF.

The Ministry paper describes the NIF Credit Facility as a policy response to the needs of small and medium enterprises. It adds that the entire Micro, Small and Medium Enterprise Sectors, (MSME) employs well over 50% of the work force and are integral to an economic development model intended to ensure equity for all, and comes to the uncontroversial conclusion that "research indicates that Jamaica does not provide adequate and appropriate finance options for the small and medium enterprises."

The paper goes on to say that: "The NIF Credit Facility is well timed to support the development of small and medium firms, increase job opportunities for individuals with a range of skill levels and impact directly on community development. The facility also comes at a time when other Government initiatives such as that recently launched by the Jamaica Business Development Centre, Business Incubator Services and the Ministry of Industry, Technology, Energy and Commerce planned establishment of Small Business Incubators island-wide. The latter will provide much needed non-credit support for small enterprises. The wholesale rate, the rate at which loans will be made to the financial institutions is 4%, on the reducing balance. The maximum retail rate will be 10% on the reducing balance. The facility is initially for five years with built in reviews and impact assessments to guide further programme and policy decisions."

The NIF/CF/SME will make loans to a network of lenders hereafter referred to as Participating Financial Intermediaries (PFI). PFIs are established financial institutions that meet the requirements of internationally established ratios for lenders to the small and medium enterprise sectors.

An economist working for one of the major "Multilaterals" commented as follows on the proposed scheme:

"In addition to the fiduciary irresponsibility of channeling funds either to pay actuarially unsustainable benefits or for special "social purpose" investments, such as the proposed micro-credit scheme, the latter sets a potentially damaging precedent regarding the return on the Fund's portfolio. Our understanding is that the "wholesale" rate of interest charged by the NIF to the on-lending institutions will be capped at 4%. In recent years the NIF has earned interest rates triple and quadruple that rate. This is an unfair and hidden tax on the participants in the NIF pension scheme which if expanded for other similarly socially motivated uses of the resources could seriously undermine the long-run solvency of the Fund. Ultimately the central government would have to bail out the NIF, further contributing to the fiscal deficit.

Also worth mentioning is that the proposed credit program will undermine the market for micro - finance, as it will require administered passive and active rates for the program to be way below the current market rates, and the spread allowed to the participating intermediaries will be insufficient to cover their operating costs. If anything the program will be more costly for the retail intermediaries to administer than their other lines of credit, because it will require an elaborate non-price rationing mechanism, given that demand for funds will exceed supply at the subsidized on-lending rates proposed.

Moreover, banks typically take funds like these and use them to lower their cost of funds without making any net new loans. There is substantial experience within the IDB, the World Bank, the Asian Development Bank and with other development institutions that substantiates the futility of schemes such as this and the harm they do to financial market development."



## Appendix 5: Focus on Improving the Business Environment in Jamaica

From IDB Private Sector Assessment of Jamaica

### Establishing the Collateral Framework in Jamaica

#### 1. Conditions for Collateral Framework

To understand what is necessary for establishing a framework for secured transactions, it is essential to understand the four economically important stages of being able to pledge collateral that can be used to secure loans. Those stages are similar to those described in the section on pledging real estate, namely:

- **Creation.** The process by which the creditor establishes a security interest in a specific property (the collateral).
- **Priority.** This is the process by which the lender establishes the priority of the security interest. This step ensures that the collateral has not been pledged to anyone else. It requires the lender knowing whether any other security interest might have been filed and when the filing occurred. In the most modern systems, the date of filing is recorded along with the time. In Jamaica, a company charge is only effective when it is entered in the company file in the Company Registry and when a security interest is discharged, it needs to be noted in the company file in the registry. In addition, a separate registry for bills of sale exists, so that both the Company Registry and the Bills of Sale Registry must be searched to ensure that the lender has priority.
- **Publicity.** This is the process that makes public the priority of the security interest. This ensures that other potential lenders are aware of the security interest, thereby minimizing the possibility of disputes over the ownership of the collateral.
- **Enforcement.** This is the process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy his claim. The cheaper this procedure, the more value can be placed on collateral. In modern systems, this process only takes days, which means that lenders can realize a high percentage of the value of the collateral that they hold. In systems that do not work well, it can take months or even years. Such delays greatly degrade the value of movable property as collateral. In Jamaica, enforcement of judgments is slow and difficult. An order must be obtained from the court, which in itself is not quick. Once judgment is obtained, the winning lawyer must notify the bailiff at the parish level. Since there is only one bailiff per parish, who also serves the Supreme Court, the process is very slow. Typically, it can take 4 to 6 months to receive an answer. The net result is that lenders are forced to hold collateral many times the value of their loans. This raises the risks to borrowers as well – they stand to lose much more than the value of the loan.

#### 2. Effectiveness

To work effectively, each of these stages must be effective before the secured transactions framework can be used reliably as security for lending. Although there are forms of collateral instruments available in Jamaica they are rudimentary and not easy to use, raising the costs of creating security interests. Some instruments that constitute standard forms of collateral in modern economies are not used at all in Jamaica. For example,

floating charges over accounts receivable are not taken by banks, excluding one of the largest assets of many companies from being used as collateral.

### 3. Law of Bailment:

- The UK Law of Bailment that predated 1961 is the law that governs warehousing in the country. This law, however, is outdated, and not suitable for modern practices. Similarly, ships mortgages, commodities bills of sale, crop liens, back to back financing are available under outdated English Common Law structures. However, they require lawyers to draw up individual instruments and examine the law to ascertain what is permissible. As in many other Caribbean countries, high quality legal expertise is expensive, so the cost of creating security interests is high.

### 4. Access to Pledging Capital:

- A further problem is that sole proprietors have little access to pledging collateral other than using Bills of Sale financing. Lenders indicated that they generally were not prepared to accept significant exposure under this instrument. In practice, therefore, the majority of businesses in Jamaica are excluded because they are sole proprietors.

## Reforming the Collateral Framework in Jamaica

5. The collateral framework is outmoded and does not serve the needs of business. Jamaica's laws do not meet the necessary conditions that would allow for the inexpensive and predictable use of movable property as collateral. The framework for lending that meets the standards for creation, priority, publicity, and enforcement of security interests is not in place. While it is possible to use some forms of collateral, the process is costly, inefficient and risky to lenders—the existing framework does not permit the effective use of collateral as security for loans. These shortcomings have significant adverse economic consequences for Jamaica, by inhibiting the development of comparative advantages in such areas as agriculture, services and tourism, resulting in a loss of potential high value export opportunities. The current system inhibits the growth of businesses, prevents commercial opportunities from being fully exploited and especially disadvantages the poor among the Jamaican population who wish to operate as sole proprietors. The difficulty of purchasing equipment on credit harms productivity and inhibits growth.

The authors therefore recommend that the IDB assist the government in a reform of the collateral framework in Jamaica. Technical assistance would help reform comprehensively the legal, regulatory and technical framework for secured transactions. The outputs of the proposed TA would be:

An in depth analytical study of the legal framework for secured transactions, emphasizing the economic problems arising from features of the present laws and the potential economic gain from proposed reforms.

A legal and regulatory framework for secured lending, involving a new secured transactions law, an electronic transactions law, and abrogation of all legislation that might impinge on the ability to pledge collateral effectively.

Reforming the system for the repossession of collateral in the event of a default, including more effective repossession, as well as protection to ensure that unscrupulous lenders did not repossess assets to which they are not entitled.

An Internet-based notice filing archive, supplied on a turnkey basis.

The technical and administrative regulations governing the Internet-based notice filing archive for security interests.

A supplemental program for capacity building, public awareness building, and monitoring support.

A revocation of those sections of the Financial Institutions Act that prohibits the sharing of information on borrowers.

Establishing the legal foundations for the operation of credit bureaus and the sharing of financial information.

6. There have been many attempts at such reform in other countries, most of them unsuccessful. Legal analysis without corresponding analysis by economists of reform suggestions has failed in most countries in which they have been tried. Internationally known legal practice may not represent best economic practice. In many places, model laws have provided the foundation for attempts to reform the collateral framework. However, fiddling with model laws is often much less desirable than rewriting laws from scratch.
7. A good project requires close coordination between the economists, international lawyers, local lawyers, and technical experts. Local lawyers perform crucial functions both at the first stage, in research, and in the second stage, explaining the work to other local people. Failing to integrate the local lawyers and the international experts can only produce poor results. The international experts cannot make sensible recommendations without considerable input from the local lawyers, so it is futile to depend on the international experts to rescue the work at the end. Furthermore, leaving legal drafting only to lawyers is a common donor practice but it is almost always a mistake. Economists and technical experts should be involved from the outset of the project, collaborating with lawyers in a diagnosis of the issues and elaborating drafting options.
8. Examples of successful reform do exist and serve as a model of what could be done in Jamaica. A recent reform of the secured transactions framework in Romania has transformed Romania's lending environment by facilitating the use of collateral as security for lending, not only from the banking system, but also from equipment suppliers, wholesalers, and agricultural suppliers. There were many similarities between the Romanian financial sector before this reform and that in Jamaica – severe financial underdevelopment, inability of a large sector of the economy to access credit, and a distrust of banks.
9. The secured transactions reform in Romania tightly integrated diagnosis, and the drafting of the laws and regulations and is one of the main reasons for its success. This methodology has rarely been followed in reform efforts elsewhere. Even in the United States, reforms of the collateral framework have proved to be much more expensive than they needed to be.<sup>2</sup>
10. Informing a technical assistance project of this nature would be a philosophy that would reverse many procedures that are common in the public sector in Jamaica. Such practices would be abjured that involve:

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<sup>2</sup> The State of Maryland reformed its secured transactions law, but left in the unnecessary condition that original documents had to be filed. This necessitated the development of a very expensive scanning system in order for the system to be accessible on-line. The final cost was over \$10 million, compared with substantially less than \$1 million for the Romania reform.

11. These steps would go a substantial way towards promoting further development of the financial market in Jamaica.

- Creating forms asking for unnecessary information that is not required by the law.
- Refusing action until unnecessary information is supplied.
- Failing to collect information that the law requires and that creditors need.
- Delaying the process by reviewing documents for authenticity or correctness.
- Imposing excessive fees to raise revenue beyond the actual needs of the archive.
- Using complicated fee structures with no basis in the law and that discourage credit.

## Appendix 6: Improvement in access to financial information

### Caricris - Improving access to the regional capital market

New Regional Rating Agency CariCRIS could be critical to improving access to regional capital market for corporates. This is an abridged version of Gleaner article on seminar/interview with CEO Venkat Raman.

The Caribbean's first regional credit rating agency, the Caribbean Information and Credit Rating Services Limited (CariCRIS), formally launched operations in Jamaica at a seminar on Wednesday October 12, 2005. CariCRIS is widely held, with a shareholder base including central banks, multilateral agencies, commercial banks, insurance companies, brokerage houses, mutual funds, a stock exchange, and India's premier rating agency CRISIL, now majority owned by U.S. rating agency Standard and Poors.

The initiative is focused on fostering an integrated, vibrant Caribbean capital market by supporting the development and integration of regional debt markets in the Caribbean.

Mr Keith Duncan, President of the Jamaica Security Dealers Association (JSDA) gave a market players' perspective on the utility of credit ratings. He said, "as a key stakeholder in the financial markets of Jamaica, the JSDA fully supported the idea of a regional credit rating agency and saw it as another important step towards the full integration of regional bond markets".

Minister of Finance Omar Davis commented "CariCRIS could not have come at a better time in the context of the growth of the Caribbean Single Market and Economy. The benefits of credit ratings are well-established and the introduction of regional credit ratings will help to further promote the regional capital markets."

He further added, "that for investors and issuers this initiative would benefit them by committing them to a higher degree of financial discipline and transparency in the market place. For credit institutions such as banks, this will mean a transition towards rating-linked credit decisions, with lesser emphasis on other features such as guarantees". Adding a word of advice to the rating agency, the Minister added, "in achieving its objectives CariCRIS would also have to establish its own credibility through the quality of its ratings. In this vein, Minister Davies noted that the governance architecture that CariCRIS has adopted with the separation of the Board and Rating Committee functions was a step in the right direction.

Chairman of CariCRIS, and former Group CEO of RBTT, Mr. Terrence Martins, stated that the availability of "Regional Scale Ratings will facilitate a greater depth of locally relevant credit information and a higher degree of differentiation in the creditworthiness of regional issuers than is possible on the global rating scale used by global rating service companies. This is because global scale ratings available today in the Caribbean are few and most of them are bunched at the lower end of the scale."

Mr. S. Venkat Raman, the CEO and Chief Rating Officer of CariCRIS, explained further "All ratings are relative. For a US or UK based investor with worldwide investment choices, the Global rating provided by Standard and Poors and Moodys is more relevant." For this type of investor, the fact that all Jamaican investors will be B or B- due to the sovereign country rating limit is not a problem.

However, in looking at a company such as a Grace Kennedy with a significant degree of assets as well as most importantly cash flows outside of Jamaica, a regional scale rating would provide much more information as to its better credit profile.

Mr. S. Venkat Raman believes there is a need to go beyond a regional to a local rating scale. “As long as there is a market for issuers and investors in local currency e.g. Jamaican dollars, then you will need a national scale. You need to be able to distinguish the creditworthiness of the Jamaican Government from that of a Lascelles, who would in turn also need to distinguish itself from that of a smaller or medium sized Jamaican company.

At the seminar, Mr. S. Venkat Raman had commented “Institutional investors, such as National Insurance or Social Security Boards, Trust Funds, Pension funds, Money Market funds and Insurance companies, which handle large amount of public funds and have a fiduciary responsibility to do judicious investments, can now do a better evaluation of credit risk and secure their investments by asking for a credit rating before they invest. Before CariCRIS this was really not an option available to them.” He argued that the key goal of CariCRIS was to protect investors by changing the investment culture to make it more risk sensitive. In his view “Crises happen when you put a lot of emphasis on name based lending”.

Mr. Raman agreed with this analysts view (Keith Collister) at the time that “The widespread issuance of commercial paper could come back on the back of ratings, assuming regulatory approval”.

### **A credit bureau would increase access to credit in Jamaica**

Financial services are a key element of economic development. With relatively small loans, small businesses and the poor can leverage their ideas and hard work to develop viable businesses, generating incomes for their families and, in some cases, generating employment and income for others.

Credit bureaus help the poor build credit histories that they can then use to shop around for the best and most appropriate financial services available, turning their reputation-defined in a formal credit history-into collateral to access financial services. As credit histories and credit bureaus develop, they facilitate other types of business transactions; for example, poor entrepreneurs can use their credit history as references for business relationships with suppliers and other business connections.

Credit bureaus can help the poor use their good reputation to gain access to other services, such as telephones, that can improve their quality of life and, in some cases, their business opportunities. Depending on the data included and used in credit bureaus, they also facilitate business-to-business transactions and commerce. This is particularly important in countries where the pledging of collateral is difficult and expensive.

Credit bureaus are being established in more and more markets, selling more information on more people to more firms. For those in the business of providing financial services to low-income populations, these institutions are critical - the information they collect on loan histories, bankruptcies, foreclosures, and criminal records enables banks, other financial intermediaries, and commercial enterprises to make informed decisions about individuals and businesses that may otherwise be considered bad risks. For lending institutions, credit bureaus can help increase access to client information, thereby lowering costs on loan appraisal, collections, and losses. They can increase competition for smaller borrowers, which expands access to credit and lowers costs on financial services for these traditionally underserved segments. When credit bureaus expand their databases and services to include sectors beyond banking-into utilities, telephone companies, and department stores, for example-they can facilitate expanded access to these service markets as well. The lack of credit information in Jamaica harms most those who do not have large private assets to pledge as security. Protecting “privacy” effectively harms many of those that this policy is meant to help.

Small businesses and low-income microentrepreneurs are the primary market segments that can benefit from the establishment and expansion of credit bureaus in developing countries. They allow people and firms to turn their reputations (credit and social history) into collateral for loans to finance businesses, home improvements, and consumer purchases and to respond to other opportunities and needs that require financial services. Borrowers can use their credit reports as substitutes for formal financial statements and traditional collateral to access loans usually unavailable from the formal financial sector. There is strong evidence from the US and elsewhere that access for lenders to timely credit information increases substantially the access to credit for a substantial number of households.

The small business loan market is perhaps the segment of the credit market where asymmetric information [the gap in knowledge between lenders and borrowers] is most pronounced. Independent analysis of most small businesses is usually not available. Small businesses are also very diverse, so it is difficult to identify clear predictors of success. Further complicating matters is the fact that many small business owners mingle their personal finances with those of their company. In countries such as Jamaica, these problems are even greater due to economic volatility and widespread tax evasion.

The traditional response of banks—the main source of untied credit for small firms—has been to put significant resources into studying business plans and cash flows and requiring collateral to back loans. This approach is time-consuming and results in high fixed costs, making many small business loans too costly to undertake. Credit registries which collect standardized historical data on borrowers can create a new kind of collateral—reputation collateral—which can help both in reducing problems of adverse selection and moral hazard. Credit scoring technologies that make use of such data greatly reduce per-loan costs, thereby opening up new lending opportunities. Both data on small businesses and on their owners has proven to be relevant in determining the risk and profitability of small business loans.

The empirical results in many countries confirm that credit registries contribute to more effective financial intermediation as evidenced by greater access to credit. In particular, the average debt/capital ratio for firms in countries where credit bureaus are used widely is higher and access to credit is greater than those countries where misguided privacy rules prevent the use of borrowing history. Countries with better developed credit registries enjoy lower financial restrictions than those where credit bureaus are underdeveloped. In particular, well performing credit registries can account for significant reductions in the sensitivity of a firm's investment decisions to availability of cash flows. In Jamaica this translates into more lending for those to whom credit is unavailable – the small and the poor.

It can be argued that this would be a much better policy direction than providing subsidized credit from the people future pensions.

## **Appendix 7: A Caribbean stock exchange – charting the way forward**

In his opening address to the participants of the Jamaica Stock Exchange (JSE) Inaugural Regional Conference held at the Half Moon Hotel in Montego Bay in January 2006, former JSE Executive Chairman Roy Johnson set the tone for the key first session of the Conference “A Caribbean Stock Exchange – Charting the Way Forward” by suggesting the need for clear action steps to move the issue of a Caribbean Stock Exchange forward.

### **Interminable gestation of caribbean stock exchange**

For Mr. Johnson, the conception and birth of a Caribbean Stock Exchange has experienced an interminable gestation. He addressed squarely the practical hurdles which militate against having one single Caribbean Stock exchange, the chief of which is the fact that the established Exchanges are not likely to apply for voluntary redundancy.

### **A view from the Barbados stock exchange**

Mr. Marlon Yarde, General Manager of the Barbados Stock Exchange, argued that it was first necessary to define what was the objective of a single regional capital market, which he defined as meeting the needs of the Issuers, Investors and Intermediaries for predictability (particularly with respect to rules and legislation), cost-effectiveness, transparency and fairness, and liquidity. He emphasized that foreign investors in particular would require predictability in investing across borders, and cited the example of the success of the Committee of European Securities Regulators in achieving the maximum possible harmonization of rules and regulations.

### **Current reality**

The current reality was that there were seven small separate Caribbean stock exchanges – Bahamas, Barbados, Eastern Caribbean, Guyana, Jamaica, Suriname, and Trinidad & Tobago, with relatively high transaction costs, low liquidity, a relatively small number of listed companies, and a few securities dominating trading on an exchange, whilst legislation and trading rules varied across the region.

### **Liquidity**

In his presentation, Mr. Yarde, stressed the key importance of liquidity. He argued that the best way to achieve improved liquidity was a common trading platform approach, with CARICOM-wide connectivity using state-of-the-art technology connecting local brokers (intermediaries) in the multiple stock markets through a single network. This would create a fair and well-informed market for financial securities, and ultimately an internationally competitive market. By interconnecting the stock exchanges of the region in this fashion, he believes one would be able to create a single regional capital market.

Issuers will still list on their home market, but brokers from throughout the region would be able to trade their shares through their local exchange. This removes the notion of a single exchange displacing the existing well established exchanges, whilst broadening the scope of operations of all exchanges as all participating exchanges will give their brokers access to the companies listed on each others boards.



This would encourage more companies to list because of the cost-effectiveness of the process. When a company does an Initial Public Offering (IPO) and subsequently lists on their local exchange, they now have the opportunity of making the IPO to the entire region because they know that when they list brokers throughout the region can trade their shares for their shareholders wherever they are in the single regional capital market.

For Mr. Yarde, stock market integration meant :

“Stock market integration means that investors can buy and sell shares in those markets without restriction and that identical securities can be issued and traded at the same price across the markets after foreign exchange adjustment.”

### **Settlement**

Brokers will have a bank account with the settlement bank chosen through which settlement will be effected. Intra regional settlement will be by the use of a commercial bank that has a regional presence or via the all the participating Exchanges having a clearing/settlement account in the various regional central banks.

### **Cross listing does not necessarily increase liquidity**

Mr. Yarde argued that once there is interconnectivity amongst the regional stock exchanges, there will be no need for the cross-listing of companies on different exchanges. In any case, he argued that there was a greater need for new product e.g. new listings. Mr. Yarde cited the example of Barbados in arguing that increasing cross listing did not necessarily increase liquidity. Although the Barbados Stock Exchange now has 26 listed companies, only 20 are local companies, and liquidity still remains very poor.

### **Bias of debt over equity**

Mr. Yarde also stressed the importance of reducing the bias of debt over equity funding in encouraging greater participation by issuers e.g. small businesses and investors in our regional stock markets. Currently, interest costs can be applied against one's tax payments, but not the costs of equity capital. In his view, dividends (or the equity cost of capital) needed a level playing field with interest in terms of its tax treatment to create a regional equity culture.

### **Harmonisation still required**

A working group consisting of issuers, investors, intermediaries, regulators and stock exchanges should be established to bring about the integration of the trading rules, procedures and market practices of the participating exchanges.

### **The Eastern Caribbean stock exchange (ECSE) view**

The vision espoused by Mr. Yarde appears to be somewhat at odds however with the vision of Mr. Trevor Blake, General Manager of the ECSE. Citing the forces of globalisation, Mr. Blake argued that liquidity appears to be becoming increasingly concentrated, with a major portion of global market activity being channelled into large regional centers, with the result that regional exchanges cannot expect to be immune to its effects. Therefore, he believes that there must be consolidation in the industry leading to a single regional exchange which would have at least some critical mass to ensure the continued existence of a market in CARICOM.

## A regional solution

Mr. Blake argued that the solution to the call for a CARICOM wide single integrated exchange already existed in the Eastern Caribbean States regional exchange. The Eastern Caribbean Securities Exchange (ECSE) has already been successfully established as an efficient, transparent and accessible securities market that transcends national borders (the majority of the Caricom's member states) and was according to him the first fully electronic regional securities market in the Western Hemisphere.

- The exchange has the following key features:
- a trading engine that has both a primary e.g. initial public offerings (IPO's) and a secondary market platform continuing trading;
- issuers, intermediaries and investors connecting from multiple locations across the region;
- automated order processing that transcends national boundaries;
- connectivity for market institutions via IP/VPN and by direct dial-up networking;
- a dematerialised environment that allows for transfer of securities by book entry transactions;
- a central registry that maintains and services shareholder records on behalf of issuers in a dematerialised environment and that has the capability to accommodate the needs of the Caribbean region;
- confirmation of trades between direct market participants on trade date, and final settlement no later than T+1;
- processing of all money settlements using SWIFT generated messaging;
- market institutions that follow global norms such as those recommended by the CPSS, IOSCO and other international standards;
- a uniform body of legislation (a regional securities act and accompanying regulations) that provides for market transparency, investor protection and minimization of systemic risk throughout the region;
- an independent regional regulatory body, the Eastern Caribbean Securities Regulatory Commission (ECSRC), which is responsible for the regulation of all securities business and the registration, licensing, monitoring and surveillance of all market participants;
- an on-line database system for regulatory filings by public companies and for access to historical market data;
- an exchange owned by a broad base of regional institutional investors committed to the success of the market;
- investor diversification across geographic boundaries to preserve and grow market;
- interest and investments, and provide increased visibility for listed companies.

Mr. Blake said these features were a result of the critical design choices that had to be made in order to surmount the geographic challenges of a multi-state jurisdiction, and lend themselves to replication across CARICOM.

For example, security issuers domiciled in other jurisdictions and regulated by a recognised regulatory authority are permitted to seek secondary listing on the ECSE for publicly traded issues

that have a primary listing on another recognised exchange through an abbreviated filing affording all issuers of publicly traded securities in CARICOM States the opportunity to list on the ECSE without the duplication of extensive regulation and the related expense.

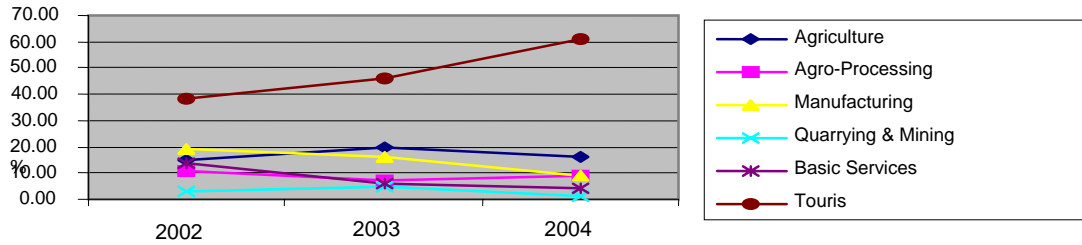
Intermediaries (broker/dealers) licensed by non-ECCU regulatory authorities are also permitted to become members of the ECSE and to utilise its facilities. As brokers licensed by any recognised regulatory authority obtain ECSE membership and access the network via the IP/VPN, any investor anywhere in CARICOM will be able to have local access to the market for all securities listed on the ECSE.

### **The other exchanges**

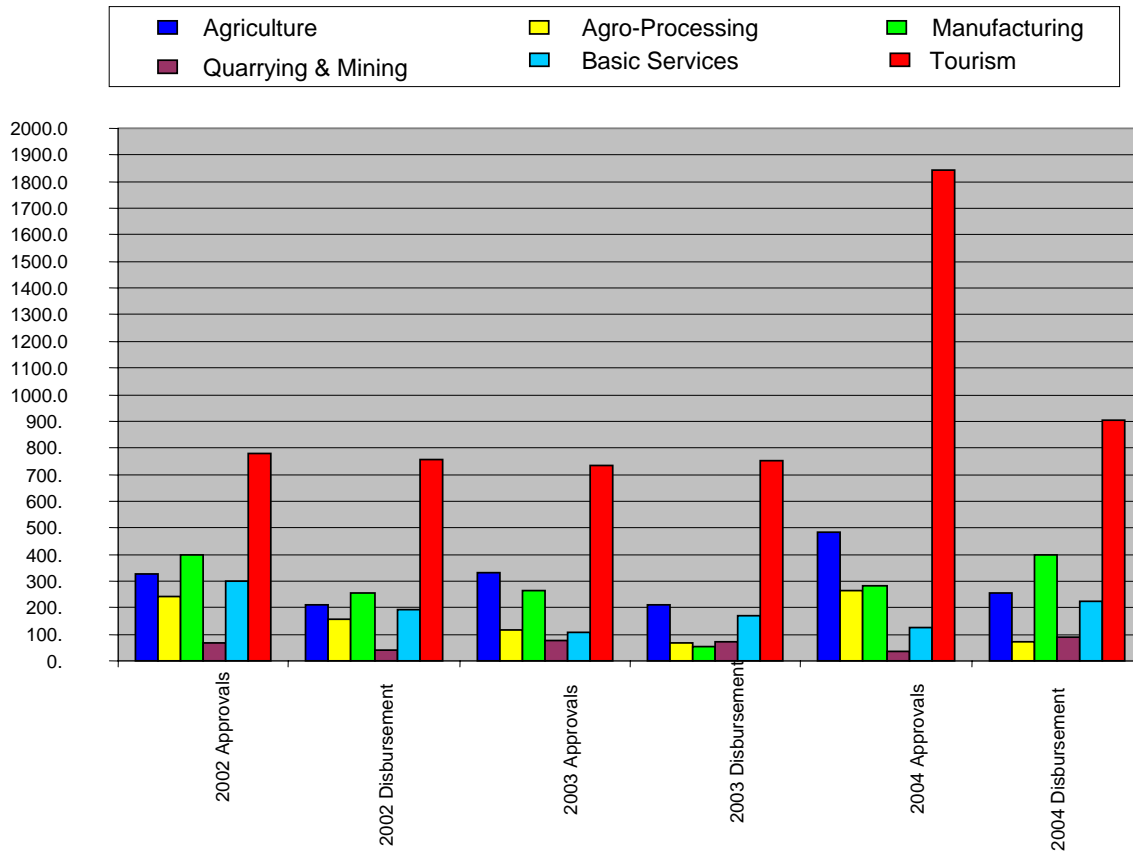
Ms Marlene Street- Forrest, General Manager of the Jamaica Stock Exchange, and Hugh Edwards appeared to have similar views to Mr. Yarde. Ms Street emphasized the importance of new products, whilst Mr. Edwards appeared the most forceful of the big three exchanges in rejecting the ECSE view in his presentation, coming as he did after Mr. Blake's presentation.

## Appendix 8: Analysis of development bank lending in Jamaica

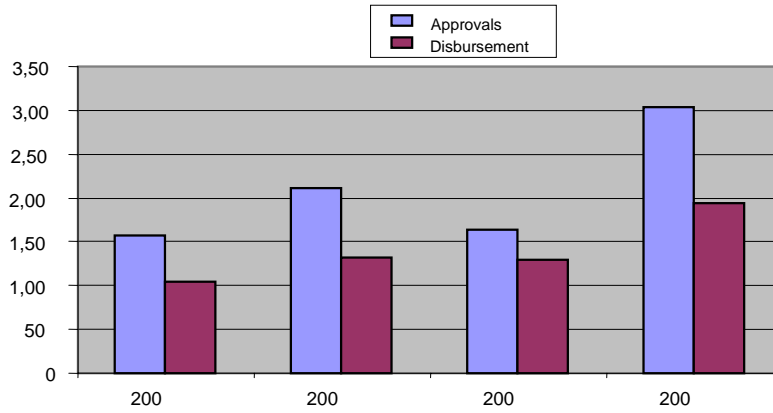
**Figure 1**  
**DEVELOPMENT BANK OF JAMAICA DISTRIBUTION OF LOAN APPROVALS**



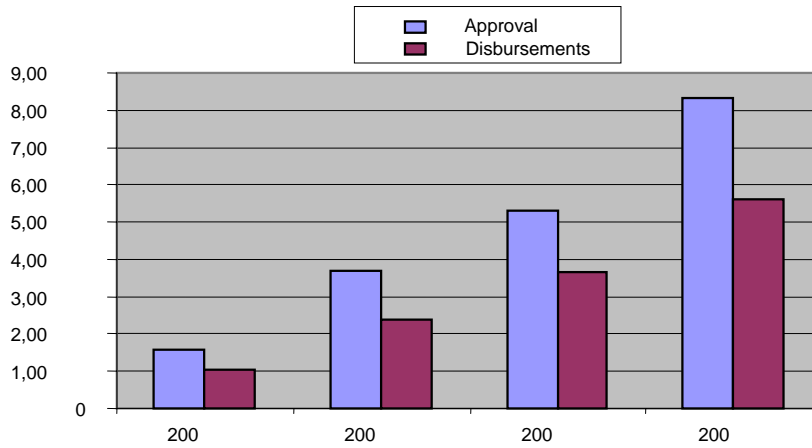
**Figure 2**  
**DEVELOPMENT BANK OF JAMAICA APPROVALS AND DISBURSEMENTS (J\$ MILLION) (2002 DISBURSEMENTS DISTRIBUTION IS ESTIMATED)**



**Figure 3**  
**DEVELOPMENT BANK OF JAMAICA APPROVALS AND DISBURSEMENTS BY YEAR 2001 – 2004**  
*(J\$ Million)*

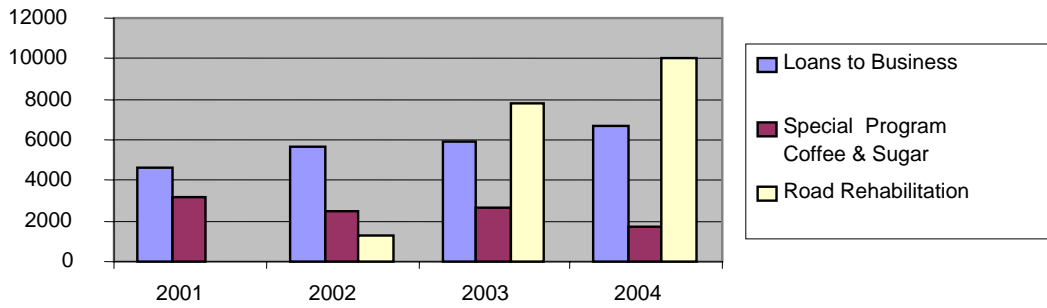


**Figure 4**  
**DEVELOPMENT BANK OF JAMAICA CUMULATIVE APPROVALS AND DISBURSEMENTS 2001 – 2004**  
 As can be seen from the Figure above Disbursement always fall short of Approvals.

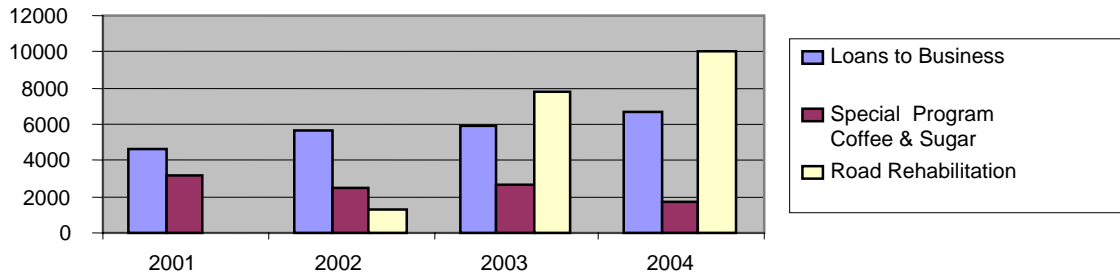


The Figure below above shows the cumulative shortfall of approximately \$2 Billion. What happened? Is there a long gap between Approval & Disbursement?.

**Figure 5**  
**CUMULATIVE APPROVALS AND DISBURSEMENTS BY SECTOR 2002 – 2000**

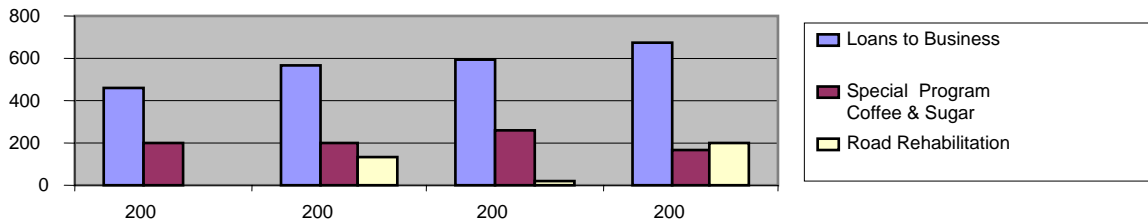


**Figure 6**  
**DEVELOPMENT BANK OF JAMAICA: ALLOCATION OF LOANS (J\$ MILLION)**

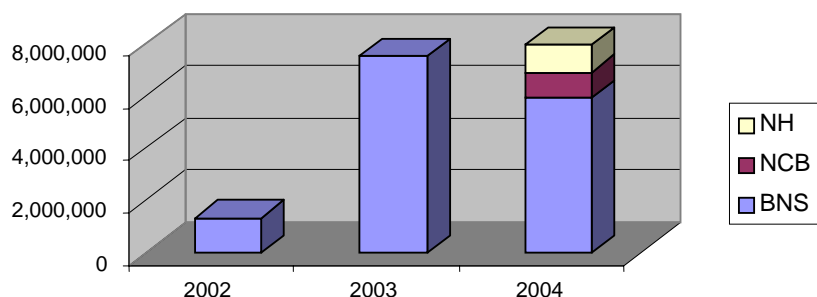


**Figure 7**  
**DEVELOPMENT BANK OF JAMAICA ALLOCATION OF LOANS (J\$ MILLION) EXCLUDING SPECIAL ROAD FUNDING**

Although the Loans to Road Rehabilitation show a steep rise in 2003 and 2004 the position is not so lopsided when the special Road Rehabilitation Funds are removed.



**Figure 8**  
**DEVELOPMENT BANK OF JAMAICA SOURCE OF FUNDING FOR ROAD REHABILITATION**



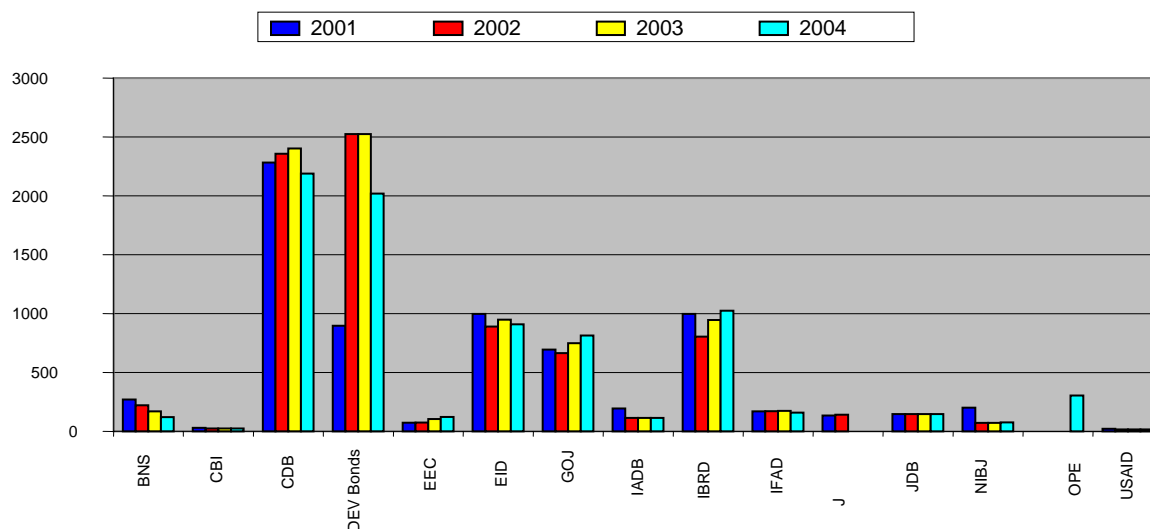
**Table 1**  
**SOURCES OF FUNDING**

As can be seen The Loan Portfolio roughly matches the source of funding for 2001 to 2003.

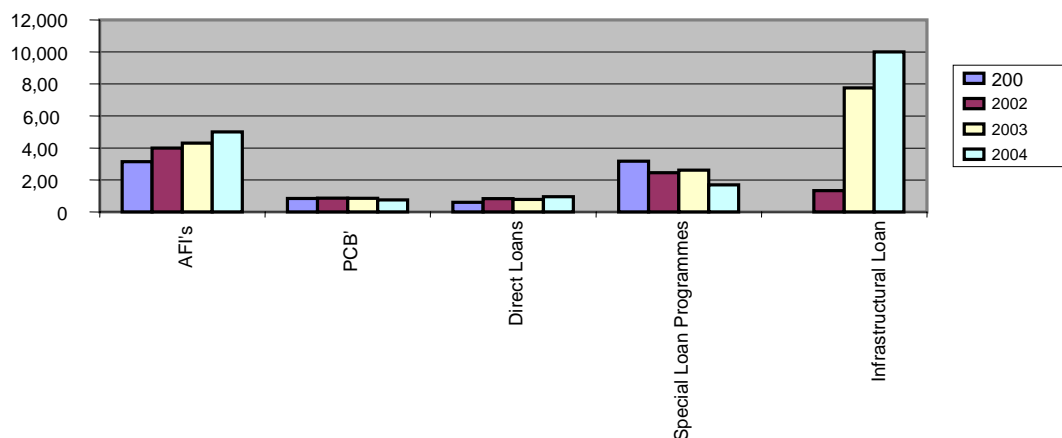
However in 2004 there is a shortfall of \$2 billion (Unpaid Interest Capitalised?) which could be the difference between the loans given for Road Rehabilitation and the Funding for same.

<b>LOAN PORTFOLIO</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
AFI's	3 144	3 994	4 302	5 006
PCB's	844	870	859	758
Direct Loans	601	835	781	958
Special Loan Programmes	3 179	2 456	2 625	1 699
Infrastructural Loan		1 341	7 758	9 998
	<b>7 768</b>	<b>9 496</b>	<b>16 325</b>	<b>18 419</b>
<b>FUNDING</b>				
GOJ				
Ministr Agr + Mining	138	138	138	138
CBI	30 000	23 333	23 333	23 333
Int Fund Agr Dev	49 970	49 970	49 970	49 970
IADB	136 212	55 487	55 487	55 487
IBRD	935 219	738 902	872 031	945 616
USAID	18 228	12 015	12 015	12 015
Hurricane Rehab	4 500	4 500	4 500	4 500
IFAD	39 543	39 543	39 543	23 851
GOJ Debentures	694 453	664 731	748 956	812 962
NIBJ	200 840	71 477	71 377	76 265
	<b>2 109 103</b>	<b>1 660 096</b>	<b>1 877 350</b>	<b>2 004 137</b>
<b>LENDING AGENCIES</b>				
MIDA	667	586	586	544
USAID	3 056	3 056	3 056	3 056
Int Fund Agr Dev	80 200	81 958	83 959	85 771
IBRD	62 522	64 448	73 075	77 843
IADB	58 013	58 013	58 013	58 013
OPEC				305 029
	<b>204 458</b>	<b>208 061</b>	<b>218 689</b>	<b>530 256</b>
<b>DIRECT BORROWINGS</b>				
CDB	2 283 458	2 357 240	2 402 374	2 189 125
BNS	270 714	220 714	170 714	120 714
J WRAY	134 927	140 802		
EEC	71 910	74 037	104 342	122 172
EID	997 308	890 483	948 585	908 370
BNS Road		1 315 403	7 534 254	5 900 000
NHT Road				1 079 221
NCB Road				1 000 000
DEV Bonds	896 819	2 524 464	2 524 464	2 019 572
JDB	145 614	145 614	145 614	145 614
IDB	400	25	105	105
GOJ			18	18
	<b>4 801 150</b>	<b>7 668 782</b>	<b>13 830 470</b>	<b>13 484 911</b>
Total	<b>7 114 711</b>	<b>9 536 939</b>	<b>15 926 509</b>	<b>16 019 304</b>

**Figure 9**  
**DEVELOPMENT BANK OF JAMAICA: MAJOR SOURCE OF FUNDS**  
**(NON ROAD REHABILITATION) 2001 – 2004**  
*(J\$ Million)*



**Figure 10**  
**DEVELOPMENT BANK OF JAMAICA LOAN PORTFOLIO 2001 – 2004 (J\$ MILLION)**



The Aggregate amount of non-performing Loans to Financial and Agricultural Institutions in 2003 – 2004 was \$944.7 Million (15%) as against 456.1 Million in 2002/2003 (12%). The figures for 2001-2002 are not available from the Annual Reports.

In order to assess the performance of DBJ and its impact on the Jamaican Economy it would be of considerable assistance if the Annual reports were consistent in their content.

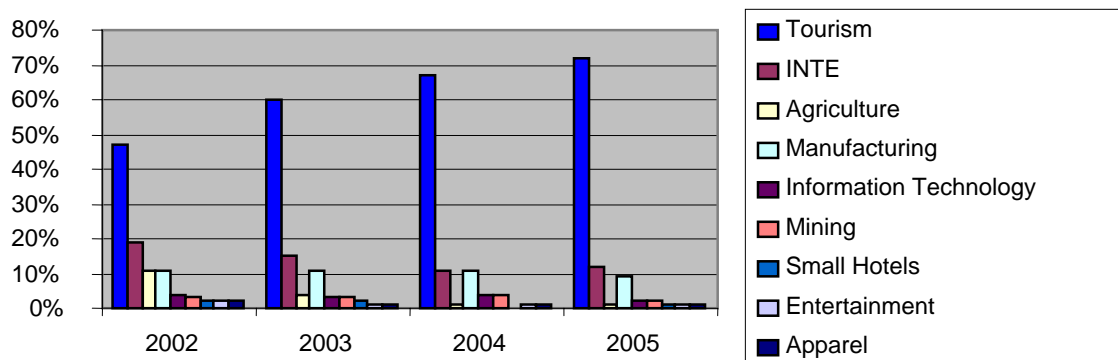
Ideally they should present the following:

- Breakdown of Approvals and Disbursements by Sector for each year
- No of Approvals and Disbursements by Sector and by size of Project as was shown in 2002-2003.



- Full details of non-performing Loans including those guaranteed by GOJ
- Reasons for continuing shortfall of Disbursements as against Approvals
- Budgets

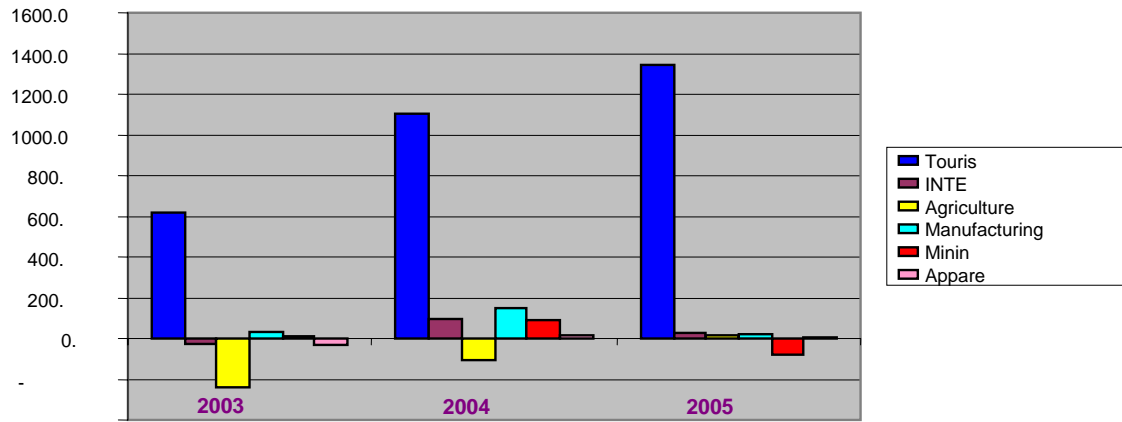
**Figure 11**  
**DEVELOPMENT BANK OF JAMAICA APPROVALS IN 2002 – 2003**



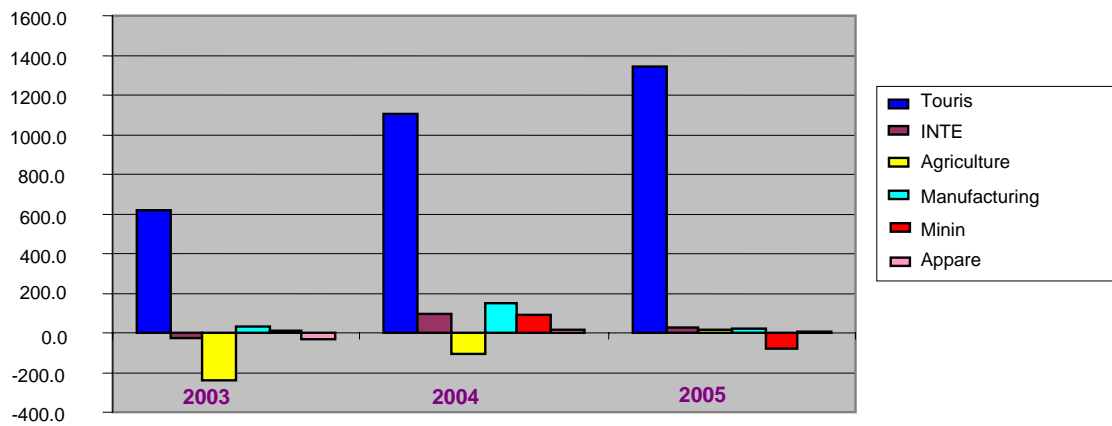
**Table 2**  
**NATIONAL INVESTMENT BANK OF JAMAICA: PORTFOLIO BY SECTOR**  
**DEVELOPMENT BANK OF JAMAICA APPROVALS IN 2002-2003**

	Amount	Nº	Average
Agriculture	333.30	198	1.68
Agro-Processing	116.00	5	23.20
Manufacturing	265.80	10	26.58
Quarrying & Mining	75.20	2	37.60
Basic Services	105.50	2	52.75
Tourism	736.00	5	147.20
<b>TOTAL</b>	<b>1 631.80</b>	<b>222</b>	<b>7.35</b>

**Figure 12**  
**NATIONAL INVESTMENT BANK OF JAMAICA NET INVESTMENT**  
**(J\$ MILLION) THREE YEAR PERIOD TO 2005**



**Figure 13**  
**NATIONAL INVESTMENT BANK OF JAMAICA NET INVESTMENT BY YEAR (J\$ MILLION)**



**Table 3**  
**NATIONAL INVESTMENT BANK OF JAMAICA INVESTMENTS**  
 (\$J Million)

2002		2003		2004	
Achendown Newtown Development	94.5	Achendown Newtown Development	201.5	Achendown Newtown Development	797.4
Technological Solutions	6.5			Technological Solutions	1.8
Pathway Technologies	150.0			Pathway Technologies	1.7
Teleservices Jamaica	28.6	Wasi Art	0.1	Teleservices Jamaica	7.7
TLP	150.0	Highgate Foods	18.6	Bloody Bay	100
Proprieter Strata Plan	1.7	Western Cement	53.0	Swept Away	180.5
Runaway Developments	0.7	Directline Telenet	2.0	TLP	22.5
Heeva Limited	20.0	Advanced Digital Services	9.0	Touchpoint Centres	3.9
Grizzlies	18.1	Western Cement	0.3	Pathway Technologies	0.4
Information Services	0.4			Mavisbank	8.4
Runaway Bay Developments	190.4			Blooming Things	0.5
Pulse	12.0			TLP	0.0
13 Investments	672.9	7 Investments	83.0	13 Investments	1 124.8

In order to consider NIBJ and its impact on Jamaican Business the Figure below shows its net investment in the major sectors. As can be seen Tourism is the main beneficiary.

The Accounts for 2002 through 2004 were examined and new investments noted. During the years 2002 through a total of \$1,009 Million was invested in Achendown Newtown Development, part of the famous Sandals Whitehouse investment. This represents more than half of all new investment for the period. The figures for 2004 were not included in the Annual Report.



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