Access to Finance -
Is the Private Sector Taking Advantage of the Resources Available?

Keynote Address

by

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Introductory Remarks

I want to thank the conference organisers for inviting me to speak to this forum on the topic "Access to Finance - Is the Private Sector Taking Advantage of the Resources Available?" This is an area that is of the utmost importance to us in the Caribbean given the central role which the private sector is expected to play as the engine of sustained growth. It is also a subject of more than passing interest to my own institution, the Caribbean Development Bank, whose mandate is financing long-term development in the region.

I would like, therefore, to use my remarks today to accomplish three things.

First, I want to explore the view that availability and access to finance are binding constraints to the emergence of a vibrant and dynamic private sector.

Second, I want to review CDB's experience with providing financing to the private sector across our borrowing membership.

And third, I will point to some lessons which we can learn from the CDB experience and those of other providers of financing to micro, small and medium-sized enterprises (MSMEs) which can serve to strengthen small enterprises in the Caribbean. In setting the stage for this presentation, let me declare up-front, that I will be addressing the questions of financing availability and access from the perspective of Caribbean MSMEs.

Constrained by small population and market size, the private sector in the Caribbean is comprised, by and large, of MSMEs. The long-term growth prospects of Caribbean economies, therefore, are intricately linked to MSME development. Large enterprises, found mainly in the tourism and extractive industries, are financed, for the most part, by foreign investors, have access to external financing, and do not face the same set of constraints that affect MSMEs.

At the same time, it is recognised that MSMEs are the incubators for most large businesses and can be a dynamic factor in employment creation and for economic growth and development. Because of their importance, and especially in difficult economic times, it is critical that we fully understand the potential of MSME development and address the issues that constrain their rapid multiplication and advancement.

I must confess that, in researching this topic, I encountered significant challenges finding the necessary broad-based data and detailed studies which would allow me to draw definitive conclusions concerning the general state of both availability of and access to finance for the MSME sub-sector. The illustrations of MSME performance that I will use today will be drawn primarily from the experiences of Jamaica and Trinidad and Tobago as well as from CDB's own experience in the Eastern Caribbean and Belize. While this is largely expedient and based on readily available information, it is also indicative of the more advanced state of development of the financial sector in these two countries. Their experience can provide valuable lessons for the rest of the Region.

Access to Finance – Is the Private Sector Taking Advantage of the Available Resources?

The most recent attempt to answer this question in the Jamaican context is contained in a study by Dr. David Tennant.[1] In his survey of financing options for MSMEs, Dr. Tennant found that "… [a]lthough various types of institutions are involved in providing loans to MSMEs, two major categories of credit providers can be distinguished in the Jamaican context. These are the private sector providers, and the credit schemes established through the [Government of Jamaica] GOJ and/or donor agencies. There are, however, significant overlaps between these categories, as many of the private sector providers are involved in the provision of credit through the GOJ/donor schemes."

To assess the issue of availability of financing to MSMEs in Jamaica, the study tracks the real increase in disbursements from the wholesalers of funds to the financial institutions which retail these funds to MSMEs and estimated that, over the seven year period ending 2005, there had been a considerable increase of 93% in funds made available for small businesses.

One could further postulate that, with monetary policy easing by the Bank of Jamaica following the conclusion of an Agreement with the International Monetary Fund and the receipt of considerable funding from several policy-based loans, even more funds would have become available and at lower interest rates.

To estimate the amount of the actual uptake of resources by MSMEs, the disbursement performance by the retailing institutions was tracked over the same seven year period,

[1] **Tennant, Dr. David, "Policy Report for the Jamaican MSME Sector: Policy Suggestions for Improved Financing and Enhanced Human Resource Development for the Jamaican Micro, Small and Medium Enterprise Sector", March 2008.**

with the finding that, at this end of the spectrum, disbursement growth was substantially lower at 33%. The implication here is, of course, that MSMEs experienced difficulties in actually drawing down resources from the retailers, even in the face of increased availability.

The discrepancy identified between the two rates of disbursement suggests that there are factors other than availability which militate against a take-up of funds. One such factor, which coincides with a study financed by the Inter-American Development Bank (IDB) is the high risk-premium included in the interest rate spread by the retail lender in order to reflect the risk inherent in lending to MSMEs, not to mention the added risk attendant to operating in the Jamaican macro-economic environment.

The study points to a number of measures which would serve to improve access. These include, on the supply side:

(a) The establishment of **credit bureaux** which would facilitate the lending institution's assessment of credit worthiness;

(b) the creation of a **collateral registry** to restrict the possibility of fraudulent re-use of collateral;

(c) promotion of **additional financing channels**, such as equity funds and a junior stock market; and

(d) the use of **guarantee schemes**, possibly supported by the government or by multilateral financial institutions, which would reduce the risk spread in the pricing of MSME loans by sharing the risk with retail lenders.

In relation to the question of equity access for small enterprises, the experience with the creation of equity funds targeted at MSMEs in the Caribbean has not been a happy one. With the exception of the Jamaica Money Market Brokers, the equity funds launched in Jamaica during the last 20 years have had limited much success. In recent times, the Commonwealth Development Corporation (CDC)-sponsored Tiona Fund was short-lived; and the Caribbean Investment Fund (CIF) returned its capital to investors with a very small return on investment and attracted mostly multilateral development bank funding.

The establishment of **junior markets** on national stock exchanges is one modality which is being used by Caribbean governments to promote the use of equity financing by MSMEs. In Trinidad and Tobago, the junior market (referred to as the second tier market) was established in 1997 with relaxed listing requirements in terms of capital and the minimum number of shareholders. There are no fiscal incentives for listing. The market is relatively inactive, with just two companies listed – one is a small oil exploration company and the other is a venture capital fund. Barbados' junior market came into being about a decade ago and, as in Trinidad and Tobago, no fiscal incentives are offered; and it, too, is relatively inactive.

In Jamaica, a junior stock market has been established on which shares and other securities of small and medium-sized companies with share capital of up to J$500 million (approximately US$5.78 million) and whose initial public offer raises over J$50 million (approximately US$578,000) may be listed for trading. A major incentive to medium-sized enterprises is the provision for up to 100% remission of tax during the first 5 years of listing and 50% for another five years thereafter, providing that the company has at least 50 participating voting shareholders. Participating enterprises also benefit from reduced fees. The company so listed must remain active on the junior or main market for at least 15 years; otherwise the taxes remitted would become due.

Since its establishment in 2010, nine companies, drawn from the manufacturing, distribution, financial and tourism sectors, have been listed on the junior exchange. Two more companies are scheduled to be listed by the end of this month. There are possibly good lessons to be learnt from the incentives provided by Government of Jamaica to companies which list on this exchange. A successful junior market could also make equity funds more attractive as it would provide a source of exit for funds from individual MSME investments.

On the demand side, efficacious measures could include:

(a) the establishment of **business advisory services** to offer a range of assistance to small businesses which need to access financing from the market. Most MSMEs, especially those of very small size, struggle with the preparation of business plans. Many keep no formal accounting records, or if at all, they maintain financial information which does not provide a reliable basis for proper due diligence to be conducted by the financing institution to adequately determine the risk associated with the loan request; and

(b) **public education** concerning the availability of credit for MSMEs.

In Trinidad and Tobago, much of the financial assistance offered to MSMEs comes by way of **business support services** that intervene directly in areas where serious gaps exist. The Business Development Co. Ltd. (BDC), established in 2002 as the implementing agency for enterprise development, is one such entity which is attempting to bridge the gap between funding availability and accessibility.

BDC provides **loan guarantee facilities** for individuals or companies seeking to expand their business while BDC Leasing provides arrangements for commercial equipment to be used in conducting business. BDC also offers training in technical as well as theoretical areas of business in order to strengthen administrative and management systems and increase competitiveness of companies. The Loan Guarantee Programme is particularly important since a lack of collateral has been identified as a major constraint facing MSMEs in obtaining the finance. The facilities include working capital financing, inventory purchases, revolving loans and purchase of equipment.

In 2002, Trinidad and Tobago also set up the National Entrepreneurship Development Company (NEDCO) to provide loan financing to small and micro enterprises in three categories with limits of TT 50,000, TT 100,000 and TT 250,000. NEDCO also provides an Entrepreneurial Training Institute and an Incubation Centre.

In spite of much of the infrastructure being in place to facilitate both availability and access to financing for MSMEs in Trinidad and Tobago, Central Bank Governor, Ewart Williams, recently observed that "data on loan guarantees to small businesses through the Business Development Company, show a continued decline"[2], reinforcing the fundamental point that even with adequate availability, MSMEs, like all other businesses, are adversely impacted by prevailing economic conditions and will adjust their access to resources accordingly.

CDB's Experience

Naturally, the issues I have just highlighted must have raised several questions in your own mind about the role of the CDB, especially in relation to the provision and facilitation of private sector access to credit.

[2] ***Economic Outlook 2011*****, Ewart Williams, Governor, Central Bank of Trinidad and Tobago – January 14, 2011**

In understanding the Bank's role and approach to private sector financing, it is important to understand the strategic posture which underpins its engagement with that sector. It is informed by three general principles:

(a) **additionality**, that is, CDB's resources must add to, not displace nor be a substitute for funds that would otherwise be available to the private sector on appropriate terms and conditions. A key strategic objective for CDB's private sector operations, therefore, is to increase the flow of capital into and within BMCs for the benefit of private business;

(b) CDB as **catalyst,** that is, using its interventions to enhance financial intermediation and develop regional and sub-regional capital markets; and

(c) **partnership**, that is, CDB cooperating and building alliances with other financial intuitions, including multilateral institutions which are operating in the Region to increase the overall impact of assistance to the Bank's borrowing member countries.

The final consideration in reviewing CDB's private sector involvement is its relatively small resource base and the prudential exposure limits which circumscribe the private sector's access to finance from CDB. The Bank's ability to finance directly any single private sector project is limited to 2.5% of its ordinary capital, while its overall private sector exposure cannot exceed 15% of the paid-up capital. Given its limited financial as well as human resources, its assistance to the private sector has been very selective and strategically focused.

In addition, the direct lending segment has been targeted at the relatively large private sector, which is generally adequately served, has access to funding from, *inter alia,* commercial banks and merchant banks and, in some cases, can mobilise resources on the international capital market.

Direct lending to the private sector has, therefore, been highly restricted. Of cumulative approvals in excess of US$3.8 billion since the Bank commenced operations in 1970, only about 6 projects totalling US$23 million can be attributed to CDB's direct private sector interventions. One of these intervention (an US$8.2 million loan to the energy sector in Belize) was the only direct loan to the private sector (excluding private financial intermediaries) recorded in the past 10 years.

CDB's major interventions in the private sector arose, and is still largely defined by, an ongoing concern about market failure; so that while access, in general, has improved, particular segments of the market, notably MSMEs continue to experience varying degrees of difficulty accessing affordable credit. The growth of the CDB's relationship with the development financial institutions (DFIs) mainly in the smaller islands of the Eastern Caribbean and the expansion of the Bank's lending through these institutions have been guided by concerns about market failure in these territories and attempts to direct resources to those sectors/ activities and subsectors which have limited access to credit.

Performance of Development Finance Institutions

Given its limited direct engagement with the private sector, a review of CDB's role in private sector activity is, indeed largely a review of its lending to the DFIs, which has been the main conduit for its lending to MSMEs.

Let me highlight just a few of the key features in the performance of CDB's lending to DFIs:

(a) Since 2003, financial intermediaries accounted for an estimated 83% of total commitments by CDB's Private Sector Division, compared with 4.2% and 6.9 % for direct loans and equity injection, respectively.

(b) There has been a trend decline in lending to DFIs. Cumulative approvals to this segment for the period 1970-2010 account for 18% of the Bank's total portfolio compared with over 21% in 1970-89 and almost 23% in 1970-1999. The extent of that decline has, however, been distorted somewhat by the sharp increase in the Bank's fast-disbursing policy base lending to sovereigns commencing in 2006.

(c) There has also been a noticeable shift in the DFIs' portfolio away from the "traditional" private sector (that is, agriculture, manufacturing and commerce) and towards student loans and mortgages. In 1990, for example, 84% of DFI financing went to MSMEs, whilst in 2010 approvals were solely to the education and housing sectors. The risk generally associated with lending to MSMEs was, of course, exaggerated by the 2008 global recession, and the consequential downturn in regional economic activity and also helps to explain the rising level of loan delinquency and declining asset quality in some DFIs.

(d) A recent study of DFIs commissioned by CDB revealed a sharp decline in their importance in the financial sector reflecting, in part, faster growth in commercial bank assets and, in part, the collapse of the Development Finance Corporation (DFC) in Belize, the closure of the Development Bank of Barbados, and the takeover of the DFIs in St. Lucia and St. Vincent and the Grenadines by commercial banks. Since 2003, there has been a sharp decline in DFI assets/total bank assets (commercial banks plus DFIs) in 8 of 9 countries studied, suggesting a sharp decline in the importance of DFIs relative to commercial banks.

(e) In the DFIs' portfolio, the agriculture and industrial (AIC) lines of credit, in particular, performed poorly, an indication of weak MSMEs that were constrained by, *inter alia*, small size; failure to achieve scale economies; the inability to be competitive internationally or even regionally; and by high shipping costs; and

(f) The study also found that the level of non-performing loans by the Development Bank of Jamaica, which is an apex bank, and the Dominica Agricultural and Industrial Development Bank (DAIDB), was unacceptably high, reflecting a combination of poor project selection and weak monitoring and collections.

The Future Role of CDB in Private Sector Lending

CDB is currently reviewing its private sector lending strategy, prompted in part by the changing structure of its financing to DFIs; by the shift in the sectoral distribution of DFI lending; and by the poor financial performance of a large number of them. The thrust of CDB strategy must also take account of the need to improve the overall competitiveness and sustainbility of the regional private sectors in order to reposisiton Caribbean economies in the global economy.

Underpinning this review, however, is the general perception that CDB's intermediation role will continue to be important for ensuring adequate access by MSMEs to development financing. Many of the DFIs, especially the smaller ones, remain dependent on CDB financing; and discontinuation of funding by CDB would significantly impair their ability to provide any support to the private sector and other borrowers, despite the presence of commercial banks and other financial institutions. Many of these already experience difficulty raising funds, and are, therefore, heavily dependent on lenders such as the CDB. There is also a perception that commercial banks are not very interested in lending to the MSMEs which are considered high risk customers; hence the DFIs are often the main if not the only source of financing available to MSMEs.

Clear evidence of market failure surfaced, for example, in Belize once the Development Finance Corporation ceased to operate. It appears that the original rationale for the creation of DFIs in the 1960s and 1970s still has some validity; and that the withdrawal of support by CDB for them would create major bottlenecks to MSMEs' access to credit and seriously jeopardise the realisation of CDB's poverty reduction objective.

The policy focus, therefore, will be to maximise CDB's impact on poverty reduction by continuing to use DFIs and, increasingly, other financial institutions to intermediate its funds. However, the emphasis will have to shift to engaging only with financial institutions that are healthy or display a strong inclination to improving their governance structures and retaining a focus on good credit analysis and capital adequacy.

Expanding the number of institutions through which CDB intermediates its funds should also increase funding availability and access for qualified MSMEs. Institutions like credit unions and national development foundations are beginning to play a bigger role in the regional economies, in some cases with an asset base that is substantially larger than that of some small commercial banks.

To date, CDB has intermediated its financing mainly through the DFIs but the growing pool of other financial institutions broadens the scope for lending directly to them or using select DFIs to serve as apex financial institutions. A careful balance between the reduced management cost to CDB and the additional interest costs to the borrower would be extremely important if an additional layer is to be introduced between CDB and the final borrower. Naturally, on-lending rates of these institutions would have to be competitive and their financial operations would have to be sound to make this proposal feasible. CDB would also need to provide financial and other advisory services, especially to the smaller financial institutions to make sure that they are suitably equipped to meet the financial and other performance requirements.

Conclusion

Let me highlight a few of the key lessons that our experience to date with MSMEs have taught us about what needs to be done to propel MSME growth and development.

First, access by MSMEs to financing is a function, not only of availability, but also of the prevailing economic environment, the regulatory framework and the conditions of MSMEs themselves;

Second, the mainstream financial system is obliged to address the issues of funding MSMEs, especially in small economies like the Caribbean. In connection with the need for resurgence in economic activity in Trinidad and Tobago, the Central Bank Governor recently spoke to the importance of a social compact for the medium-term where "…it will be important for Government, the banks and the business sector to work to enhance small business development programmes." Specialised credit windows by commercial banks, for example, have increased the availability of finance for MSMEs; but shortcomings remain in how credit risk and business viability are assessed, which in turn affects access. Mechanisms will, therefore, have to be put in place to induce traditional lending institutions to lend to MSMEs on terms that will enable both to be viable. These mechanisms will include legal and regulatory reform to encourage the development of credit bureaus, credit guarantee funds and collateral registries.

Third, critical success factors for MSMEs include the adoption of appropriate business planning, management and accounting systems, human resource development, increased awareness through access to business information; and a culture of innovation.

Fourth, the legal reforms which encourage MSMEs to raise equity financing by listing their companies on local junior markets must be implemented to facilitate growth and expansion of small businesses. Important lessons can be learned from the experiences of the three junior markets currently in existence in the Caribbean.

Fifth, there is scope and need for CDB to continue to intermediate funding to MSMEs through public and privately-owned financial institutions. However, careful attention will have to be paid to the pricing of CDB's funding through the privately-owned institutions, in particular to ensure that their on-lending rates are competitive.

In closing, I wish to point out that the current business environment, while still being difficult because of the ongoing recession, has presented us with a window of opportunity in the form of increased funding and lower interest rates that are now available for MSMEs. Tackling the bottlenecks that impede MSMEs' access to finance, therefore, should be a high priority for policymakers at this time. Without a dynamic MSME sector, economic growth and recovery will be stymied and our goals of sustainable growth with employment creation, and poverty reduction will remain elusive.

Mr. Chairman, I thank you!