JAMAICA/U.S. FULL SERVICE MERCHANT DEVELOPMENT BANK

CONCEPT PAPER

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I. CONCEPT

1. This discussion paper has been prepared at the request of the Bureau for Private Enterprise (PRE) and the Jamaican Mission of the U.S. Agency for International Development (AID) and is intended to describe the role which a new Jamaica/U.S. Full-Service Merchant Development Bank can play in helping achieve economic development and growth through expansion and stimulation of the private sector in Jamaica.

2. Under the Government of Prime Minister Seaga, Jamaica has embarked upon a serious, across-the-board program of measures to encourage expansion of private sector productivity and output and lead to substantial new investments in agriculture, manufacturing, and related service industries. The private sector is looked upon as the major driving force for economic rehabilitation, and investments from the United States and local entrepreneurs are being counted upon to bring new vitality and diversification to the Jamaican economy, reverse the outward flow of private capital, transfer new technologies, and help solve the country's balance of payments and unemployment problems.

3. Seriously limiting the achievement of these goals is the lack of an adequate institutional infrastructure to provide equity funding and aggressive medium- and long-term credit facilities to stimulate capital investment. Existing institutions in Jamaica, both in the public and private

sector, suffer from shortages of foreign exchange funding, limited numbers of skilled project lending and administrative personnel, the unavailability of equity funding, the small size and limited horizons of most financial institutions, the scarcity of risk capital to finance the early stages of project development, the sometimes exaggerated perceptions of risk which lead to excessive collateral requirements, and the extreme shortage of medium- and long-term loans which can be used to finance worthwhile capital investments. External lenders are not interested in, nor are their facilities designed to finance the kinds of small to medium size investment required by the scale of Jamaica's economy and the preferences of local and foreign investors.

4. In light of the above, the subject of this paper is the formation of a for-profit, privately-owned Jamaica/U.S. Full Service Merchant Development Bank (hereinafter referred to as the "Bank"). The Bank will be a new kind of institution, offering not only loans and equity for private sector development projects, but also providing "hands-on" management support by offering the services of experts in such areas as financial planning and control, general corporate strategy and long-range planning, marketing and sales promotion, and the recruitment and training of key management personnel. These services will help to assure

their success after the completion of construction and the disbursement of funds.

5. The establishment of the proposed new Bank would be an appropriate endeavor of the Rockefeller Committee, which has the objective of "formulating programs for the facilitation of U.S. private investment in Jamaica and the transfer of technology, taking into account such encouragement and assistance as will be provided by the United States Government."

6. The new Bank would also appear to meet fully the objectives of U.S. AID's new private sector initiative, which is designed to "help establish, finance, and improve privately-owned financial institutions which will provide the capital and management expertise for expansion of the private sector in developing countries." The investment policies of the Bank would furthermore emphasize and be fully integrated with the development priorities established by the Government of Jamaica. The Bank would place special emphasis on lending to, investing in, and otherwise supporting those sectors and areas of the economy which offered the greatest development advantages and would have a favorable impact on employment, national income, and the balance of payments.

II. ECONOMIC CLIMATE AND PRIVATE INVESTMENT

1. The present Jamaican government, elected in 1980, has reoriented the economic policies established by its predecessor, emphasizing the leading role assigned to the private sector. The recovery process, begun in 1981 and 1982, is expected to accelerate in 1983.

2. The main economic programs that the Government is implementing include rehabilitation and reorientation of existing productive capacity; repair and expansion of infrastructure including roads, power, water, etc.; training of workers and managers to increase productivity and job skills; undertaking measures to encourage return of managerial and technical personnel; improving the investment climate by encouraging bilateral cooperation and attempting to facilitate capital transfers; and attempting to keep peace with the labor movement and restrain unreasonable demands by the latter. The Government is also undertaking an ambitious public investment program to alleviate the unemployment problem, rehabilitate the agriculture and tourism sectors, and stimulate the rest of the economy.

3. In order to attract private capital and investment, the Government has attempted to restore an atmosphere of confidence in the country and in the quality of its own economic management, as well as to provide appropriate stimuli. The Government has also launched a vigorous promotional campaign to identify and develop investment opportunities and has created the Jamaica National Investment Promotion Company to help potential new investors.

4. As of April 30, 1982, the following investment proposals and inquiries had been received by JNIP:

	Total		Of Which: In Production	
	Number	Investment (US$ million)	Number	Investment (US$ million)
Manufacturing	186	242.8	34	16.5
Agriculture	93	97.6	16	23.4
Mining	3	0.6	-	-
Tourism	20	50.1	3	2.5
Construction & Housing	14	406.3	-	-
Communications & Transport	1	..	-	-
Miscellaneous	20	27.1	3	0.5
TOTAL	337	824.5	56	42.9

5. Average project size is US$1.4 million and average employment creation is slightly below 50. As shown below, the number of projects involving local investors only exceeds the number of those involving foreign investors, but the average investment associated with the former (US$.6 million) is considerably less than the average for the latter (US$2.1 million). The vast majority of "foreign only" projects are from the United States. Some 28 projects would be joint ventures.

Investor	Number	Investment (US$ million)
Local Only	165	94.7
Foreign Only	144	300.8
Joint Ventures	28	429.0
TOTAL	337	824.5

6. As a check on the above figures, it may be useful to refer to a preliminary estimate of potential manufacturing sector investment by 211 Jamaican firms, made by First Washington Associates in 1981. Detailed interviews with present manufacturers indicated that more than J$100 million (US$60 million) would be required over the 1981-83 period for plant, equipment, land and buildings if satisfactory medium and long term financing (presently unavailable) could be arranged. A separate estimate, based upon loan inquiries to the Rehabilitation Fund Jamaica Ltd., indicates that demand exists for at least US$50 million of foreign exchange loans to meet the 1983 investment needs of the present members of the manufacturing sector.

7. It is important to note that the availability of new sources of medium-and long-term financing on reasonable terms and conditions would be essential to assure the implementation of almost all of these projects. Without new sources of government and private sector credit, most worthwhile new investment projects will not be able to proceed.

III. EXISTING FINANCIAL INFRASTRUCTURE

1. Jamaica possesses a fairly extensive financial infrastructure which closely resembles the British financial system in its fundamentals. The Bank of Jamaica -- the central bank -- oversees the activities of all financial intermediaries, with the largest share of lending activities being transacted by the commercial banking subsector. In addition, there are trust companies, leasing companies, finance companies, merchant banks, building societies, credit unions, the National Housing Trust, insurance companies, and peoples cooperative banks. Altogether, the financial institutions had over J$2.2 billion in outstanding loans to the private sector at the end of 1981. Of this, the commercial banks accounted for over 54 percent, while the existing merchant banks accounted for only 2 percent or J$38 million of outstanding loans to the private sector.

2. In addition to the above, there are a number of government lending programs that operate mainly through the commercial banks to provide foreign exchange credit to the private sector. The major government institutions are the Jamaica Export Credit Insurance Corporation (providing short-term facilities through its lines of credit), the Export Development Fund (providing short-term funds to the manufacturing sector) and the Rehabilitation Fund (providing medium- and long-term loans but now virtually fully committed).

3. As part of Jamaica's structural adjustment program, two public sector institutions are now being organized to channel longer term credit to the private sector. The Agricultural Credit Bank and the National Development Bank will borrow funds externally, and on-lend them to ultimate beneficiaries through the commercial banks. However, neither institution has yet started a significant volume of lending activity, nor do they plan to offer the range of services contemplated by the proposed Jamaica/U.S. Full Service Merchant Development Bank. Because they are public sector organizations, their scope and activities are more limited, and they do not plan to have extensive direct lending contact with the business community as would the new Bank. Therefore, the new Bank will supplement and complement the ACB and NDB, rather than compete with them.

4. There are eight commercial banks with approximately 150 branches doing business in Jamaica. They are: the Bank of Nova Scotia Jamaica Ltd., National Commercial Bank Jamaica, Ltd., Citibank N.A., Bank of Commerce Jamaica, Ltd., Workers Savings and Loan Bank, Jamaica Citizens Bank, Ltd., First National Bank of Chicago Jamaica, Ltd., Royal Bank Jamaica, Ltd., and the Bank of Credit and Commerce. Although increasing in nominal terms in the last two years, the total assets, deposits, and loans of the commercial banking system have virtually stagnated or decreased in real terms in the past nine years. The

commercial banks do extremely little medium- or long-term lending, and that which is done is only for old, large, well-established customers. The medium- or long-term lending which takes place is not well coordinated with the development priorities of Jamaica, nor does it address the need for development investments. The commercial banks also do not provide the management services which, in Jamaica, are a necessary supplement to medium- or long-term lending and development investments.

5. Although commercial bank interest rates have been relatively low in real terms, they have been regarded by many borrowers as a hindrance to more ambitious capital investment plans. An even more significant barrier to the fulfillment of investment plans has been the commercial banks' insistence on very conservative collateral requirements.

6. The existing finance companies and leasing companies are very small operations.

7. At present, there are five so-called merchant banks in Jamaica. Three are subsidiaries of large, internationally well-connected commercial banks: West India Company of Merchant Bankers Ltd. (Bank of Nova Scotia), Caribbean Merchant Bank (Citibank), and Jamaican American Merchant Bank (Bank of America). The other two banks are indigenous institutions: Jamincorp International Merchant Bank and Eagle Merchant Bank of Jamaica.

8. The merchant banks which are affiliates of commercial banks act basically as vehicles of convenience for their parent banks. They handle limited amounts of medium-term loans (usually when the parent has a lending limit problem), mortgage loans, and leasing. They have small staffs (three to six people, generally), are wholly dependent on the parent company for upper level management, and have offices which are not particularly well situated. They do not usually advertise their services or attempt to market themselves in other ways. The commercial bank affiliates are not presently examining ways to offer new services nor to expand old ones significantly.

9. The two indigenous merchant banks also have small staffs (three to six people) and shortages of skilled management. Although their offices are better located and they appear interested in seeking new business, the indigenous institutions have a number of constraints which the commercial bank affiliates do not face, including: a smaller equity base and more difficulty in arranging complementary financing; the involvement of merchant bank management in a number of other non-banking ventures; strict limitations on time and money available to develop and market new services; and lack of expertise required to become active in new areas (which cannot be remedied by calling on a parent organization).

10. The merchant banks as a group have not, to any significant extent, been performing the main funcitons for which they were established. Their activities have been concentrated largely in the areas of deposit-taking and a low level of lending. The merchant banks are not really functioning in such areas as underwriting, secondary markets, and investment management.

11. There is no evidence that the merchant banks have been influential in attracting foreign investments, although some banks have raised funds on foreign markets for financing loans to the government and its agencies, and in one case for a substantial private sector investment. The merchant banks have, to only a limited extent, established affiliates or subsidiary financial institutions. The total value of merchant bank loans outstanding at the end of July 1982 was only J$53.5 million, and total capital of all six merchant banks was only J$5.3 million.

12. There were three previous proposals for new merchant banks or investment company ventures in Jamaica. The first was considered by Royal Bank Jamaica and JNIP at the request of Prime Minister Seaga in early 1981, and is presently inactive. A second merchant banking proposal was under consideration by a very limited sponsor group in 1981. The third proposal was a venture capital corporation, under study by the International Finance Corporation (IFC).

With the exception of the original Royal Bank proposal these ventures would not involve broadly-based Jamaican or foreign ownership, nor provide the range of technical and management services which represent a major segment of the new Bank's proposed activities.

IV. ACTIVITIES OF THE NEW BANK

1. The new Bank will provide a vehicle through which funds can be marshalled, both internally and externally, for establishing, supporting, and expanding viable private sector projects in the interest of national development. The Bank will fill needs not adequately met by other parts of the financial system, including: (a) the extension of medium- and long-term loans at reasonable rates and with reasonable collateral requirements for new custmomers; (b) the provision of equity financing; (c) the offering of leasing and other specialized financial services; (d) the provision of experts to provide management assistance; (e) training in financial, managerial, and other disciplines; (f) the marshalling of external capital for worthy private sector projects; and (g) carrying out feasibility studies, and other project promotion services.

2. Lending to, and investing in, private enterprises will constitute the Bank's major activity. The loan portfolio should be properly balanced with regard to risks, terms, and sectors. In its early years of operation, the Bank should place major emphasis on medium-term loans of up to five years maturity, gradually shifting into longer-term commitments of up to ten years maturity. Reasonable grace periods and collateral requirements should be

incorporated, and loans should bear interest at rates which are compatible with the going market rates. The Bank should probably also charge a one-time administrative fee in order to cover its expenses of processing a loan. The average loan size will probable be between US$100,000 and US$500,000, which would cover the average investment size of US$600,000 presented by Jamaican sponsors to JNIP (assuming that the Bank financed 70 percent of the project's cost and the sponsor financed 30 percent with his own equity). As a matter of policy, the Bank's total exposure to any one company should not exceed 10 percent of its own equity.

3. The provision of risk capital will also be an important function of the Bank. In Jamaica, there are often project sponsors who have good and feasible ideas but who lack the funds to provide the venture with a sufficient capital base. The Bank can become a partner in order to help get the project off the ground. This provision of seed capital is an essential contribution the Bank can make to the development of the economy, since it will bring projects to life that otherwise would not have been implemented for lack of capital. It will also activate a new class of sponsors, thus widening the group of Jamaican businessmen. Once a project is well established, usually after a period of four to five years, the Bank should divest its shareholding. This will enable the Bank to have a greater impact on the

economy. Investment priorities and criteria will be the same as for loans. Equity investments should be made in the form of common stock, preferred stock, or convertible debentures. The Bank should take only minority equity position, often combined with additional loan financing. The Bank not only should be represented on the Board of Directors, but also directly participate in the management of its investee companies, which will enable it to remain in close contact with these companies and facilitate the provision of necessary technical assistance.

4. One of the major innovations the Bank might make to the Jamaican financial scheme would be in the area of aggressive lease financing of capital equipment. Large-size transactions have been handled in the past by multinational banks and small-size deals have been financed by the several local leasing companies. The new Bank would concentrate, therefore, on the medium-size market, where facilities have been severely limited in recent years because of problems encountered in securing adequate collateral, the minimal capitalization of many companies, and their lack of an established track record with the financial community. The Bank should offer to finance sale and leaseback arrangements, direct leasing, and leveraged leasing. A special examination of Jamaican tax laws will be in order to see whether changes should be requested in order to facilitate lease financing and thus contribute to economic development.

5. Special management services which the Bank might undertake would include the provision of experts who would offer hands-on management assistance in such areas as:

i) Financial planning and management.

ii) Definition of financial policy and strategies for future placement of debt and equity and public underwritings.

iii) Establishment of financial control systems.

iv) General corporate strategy and long-range planning.

v) Identification of new product lines and entry into new markets.

vi) Negotiations for entry of new shareholders, acquisitions, investments, mergers, or the creation of subsidiaries.

vii) Marketing and sales promotion activities.

viii) Organization of production or control systems.

ix) Relations with research, development, and engineering institutions and industrial groups.

6. In order to assure the success of projects which it finances, as well as to prepare other firms to undertake new projects in a professional manner, the Bank should offer formal training in basic financial and managerial disciplines to its Jamaican clients. Because of its international affiliation and domestic expertise, the

Bank should be able to obtain good instructors, and should be able to arrange for meaningful and productive courses in a broad range of subjects. Because of the unique capabilities in the areas of U.S. technology and management expertise embodied in such organizations as the International Executive Service Corps (IESC) and the Young Presidents Organization (YPO), the Bank should avail itself of the services provided by these organizations. Initially, the Bank's courses might concentrate on skills necessary to develop and manage new projects, and then on other subjects of more general use to Jamaican businesses. The Bank should have no trouble in finding clients willing to pay for such instruction, because of its mixed U.S./Jamaican ownership and the fact that U.S. managerial and technical skills are highly regarded in Jamaica.

7. The Bank should play a major role in attracting foreign investors to Jamaica, and in putting together joint-ventures between Jamaican and foreign partners. By virtue of the quality and range of its shareholders, the Bank will be in an excellent position to assume this role of catalyst. While contacts with foreign companies will, at the Bank's initial stage, be made as need arises through specific projects, the Bank should later on pursue the promotion of joint-ventures more actively.

8. By the very nature of its loans and investments, the Bank will need in-house capacity to generate, structure, evaluate, and develop projects. Applicants for financial assistance will often not be in a position to present a thoroughly documented application and they may not have the know-how and financial means to conduct a feasibility study. The Bank's international contacts should enable it to call in foreign technical assistance where necessary, but it must also be capable of making its own analysis of projects. The Bank should not merely await the receipt of applications. Instead, it should become involved in projects at an early stage of consideration in order to assure their proper development--and thus enhance the later quality of its own portfolio. For this purpose, the Bank should offer to conduct pre-feasibility and feasibility studies for clients, for a cost, which may or may not be financed by the Bank for the interested customer.

VI. FORMATION, OWNERSHIP, AND CAPITALIZATION

1. It is proposed that the Bank be established in the first quarter of 1983 under the sponsorship of the Joint U.S./ Jamaica Commission with the objective of facilitating U.S. and local investment in Jamaica, and of making a profit for its shareholders through a full range of financial services.

2. The Bank will be a Jamaican registered, privately-owned, limited liability entity, incorporated as a merchant bank under the Companies Act. The Bank's duties and powers will be defined by its Memorandum and Articles of Association.

3. The Bank will be regulated by the Jamaica Depositors Act of 1966 and 1974 and certain provisions of the Bank of Jamaica Act.

4. The initial capitalization is envisaged as being J$5 million (US$3 million) of common stock, divided into one million shares of five Jamaican dollars each, and U.S. AID/PRE subordinated convertible debentures totalling U.S.$2.5 million.

5. The distribution of ownership will be such that (a) there will be broad participation in the Bank's ownership;[1/] (b) no single individual or entity would own more than

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[1/] The structure embodied in the Royal Bank proposal may be used as a base.

5 percent of the proposed equity; and (c) no shares would be offered directly or indirectly to any public sector institution, whether Jamaican or foreign.

6. In order to make ownership of the Bank's equity more attractive, the Government of Jamaica will be asked to make all dividend payments of the Bank exempt from Jamaican corporate tax, and thus taxable only to the recipient. In the case of U.S. investors, such earnings would be protected from double taxation by the provisions of the U.S./Jamaica tax convention.

7. It is assumed that additional debt capitalization will subsequently become available in the form of a long-term loan from U.S. AID. Availability of such a loan on an extended term of payment with a reasonable rate of interest, would help to assure success of the new organization. Such a loan would be a key source of foreign exchange for worthwhile projects and would serve as "seed money" to interest other international lenders in supporting the Bank.

8. Other potential sources of debt financing for the Bank would include:

a. International financial institutions.

b. Lines of credit from foreign or local commercial banks.

c. Deposits from Jamaican firms.

d. Credits from other financial institutions such as life insurance companies, etc.

e. Allocations of counterpart funds agreed between U.S. AID and the Government of Jamaica.

9. It would be desirable for the Bank to obtain a mix of foreign and domestic debt financing, and thereby leverage the lending/investment capacity of the Bank in relation to its initial equity base.

10. U.S. AID is expected to subordinate its loan to that of other lenders. This would be equivalent to making the U.S. AID contribution a quasi-equity, and would permit the Bank to achieve greater leverage from the AID funds.

VIII. DIRECTION AND MANAGEMENT

1. The basic authority of the Bank will be vested in its Board of Directors, consisting of proportionate representation by U.S. and Jamaican investors.

2. The Board should set the Bank's overall policies and define priorities, delegate responsibilities, and supervise management.

3. The Board should unanimously approve the terms of a technical assistance contract to be entered into with a well-qualified investment bank, merchant bank, or commercial bank with diversified experience applicable to the new operation. This contract should be in effect for at least the first year of the Bank's operation, providing all technical and managerial assistance necessary to start up the operation and train the Bank's employees to assume all responsibilities exercised by contract personnel. U.S. AID expects to provide a grant of up to US$500,000 to cover the costs associated with such a technical assistance contract.

4. Execution of the policies established by the Board of Directors would reside with the Bank's Managing Director, whose appointment would be unanimously approved by the entire Board.

5. The day-to-day management of the Bank would rest with the Managing Director and the principal officers such as the Financial Comptroller, Vice Presidents for Operations, etc.

6. Operations would be conducted by a qualified staff composed of the numbers and specializations of people required to achieve the Bank's objectives.

7. The Board of Directors of the Bank would establish and regulate the financing approval limits of an investment or loan committee consisting of designated officials. Such limits will be reviewed from time to time, and may be adjusted as necessary and desirable.

8. All financing decisions involving amounts of equity or credit in excess of the limits approved for the loan committee would be submitted for consideration to the Board of Directors. Approval of such decisions would normally require consent by a majority of the directors except as may be decided otherwise.

9. Equity in, or credit to, enterprises owned or controlled by a Director of the Bank would require the unanimous approval of the directors present at the relevant meeting. In such cases, the director involved should not take part in the discussion or the voting, nor should he be included in the quorum.

10. The Bank should not invest in, nor grant credit to, any enterprise in which a manager, officer, or employee of the Bank, or their families, have personal financial interest.

11. Principal officers and individuals to whom decision-making authority is granted would be appointed only with Board of Directors approval, and would have to meet strict professional competence criteria.

12. The Bank will need a relatively limited number of skilled senior officers and clerical employees and should seek to keep the organization small, highly-focused, and well-motivated. Managers will be expected not only to manage, but also to perform, much of the work in their areas of responsibility. The initial personnel component should consist of about twenty people, including all support staff.

VII. IMPLEMENTATION

1. The first step to assure implementation of the new Bank is to proceed with the formation of a broad-based sponsor group. Expressions of interest should be obtained from U.S. AID, the Jamaica-U.S. Joint Commission, and the Government of Jamaica.

2. A thorough feasibility study should then be carried out, proving up the marketing, managerial, financial, technical, and economic aspects of the proposal, and drawing up a comprehensive business plan. This study could be expected to cost approximately $100,000 and might be co-financed with the sponsors' equity and feasibility study financing provided by U.S. AID/PRE on a 50/50 cost-sharing basis.

3. The completed feasibility study should be used by project sponsors as a basis for obtaining firm commitments of equity participation from U.S. and Jamaican sponsors. It should also be used as the basis to obtain debt financing decisions from AID and others.

4. Based upon a firm financing and organization plan, project sponsors should draw up the Memorandum and Articles of Association, and take all legal steps necessary to incorporate, issue stock, contract debt, and do business, both in Jamaica and abroad.

5. Arrangements should be concluded for office space and other basic facilities. The technical assistance contract should be negotiated and recruitment of qualified staff should begin.

6. Stock should be issued, the initial stockholders meeting should take place, directors should be appointed, and the Board should meet to appoint officers and direct the start-up of operations.