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A

Partner Early Draw Bank

A New Microfinance Institution for Jamaica

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List of Abbreviations

ATM	Automated teller machine
BNS	Bank of Nova Scotia Ltd
BoJ	Bank of Jamaica
CBL	Citizens Bank Ltd
CBNA	Citibank N A
CIDA	Canadian International Development Agency
ECB	Eagle Commercial Bank Ltd
EU	European Union
FFI	Frontier Finance International Inc
FIA	Financial Institutions Act
FINSAC	Financial Sector Adjustment Corporation
GoJ	Government of Jamaica
GoN	Government of the Netherlands
GSB	Government Savings Bank
IT	Information technology
IVB	Island Victoria Bank Ltd
MLU	Micro Lending Unit
MSE	Micro and small enterprise
NCB	National Commercial Bank Ltd
PO	Post Office
POSS	Post Office Savings System
ROSCA	Rotating savings and credit association
TCB	Trafalgar Commercial Bank
TDB	Trafalgar Development Bank
USAID	United States Agency for International Development
WB	Workers Savings and Loan Bank Ltd

G

SCOPE OF WORK

The Contractor will perform a due diligence assessment of the Workers Bank Postal Savings System, the Micro Credit Program, Small Lending Portfolio, and Consumer Lending Portfolio

H

Executive Summary

Would it make sense to establish a new institution in Jamaica which would lend to micro and small enterprises (MSEs)? This is one of several options, and the technical, institutional and financial steps that would have to be taken for its implementation are described here

Building a successful microlending operation in Jamaica would be a challenge The financial system is ailing Most commercial banks are losing money, some such as *Workers Bank* incurring serious losses and scheduled for merger into Union Bank Wages and salaries are high by international standards, due in part to the fact that the exchange rate has been maintained at an artificially low level Finally, Jamaica has a population of only around 2 5 million, which limits the overall demand for microfinance services

There is in principle no reason why this challenge cannot be mastered, as demonstrated by the experience of the microloan program carried out by Workers Bank This program has been supported since its inception in 1996 by USAID, which furnished assistance in project design as well as technical and financial support The program has a portfolio of 2,200 loans amounting to USD 800,000 which are managed by a total of 10 loan officers However, it has not yet reached the breakeven point The number of borrowers served and the outstanding lending volume are still too small for the program to be profitable As a result, ambitious plans have been developed which envisage a major expansion of the program Workers Bank has high expectations regarding the impact of this bold strategy

No less high are its expectations regarding the potential contribution of the "other half" of microfinance Workers Bank plans to mobilize micro and small savings via the branch network of the Jamaican Post Office which would be used to fund lending Here as well, though, there are certain open questions First should the collection of savings deposits from low-income households be combined with lending to micro and small enterprises? Second, if it makes sense to mobilize savings via the branch network of the Post Office, then should loans also be offered via this network?

Thus, what is needed is not first and foremost a *credit technology* that will render it possible to issue loans to micro and small enterprises, but rather an appropriate *institutional framework* which would place micro-lending on a commercially sound footing free from dependence on subsidies There are essentially three options that could be implemented each entailing a different institutional choice

- ***Option I Leave things as they are*** One option would be for Workers Bank to continue to be responsible for the microloan portfolio with the PO Savings component continuing to be handled by Workers Bank The advantage of this arrangement would be that, at least at first glance, it would not require extensive institutional adjustments The current setup would be retained The disadvantage of this approach is that it is difficult enough to integrate a microloan portfolio into the operations of an established

commercial bank, and even more problematic to do this when a new bank is involved which has yet to position itself in the market Similar questions arise with regard to PO savings, which are mobilized via an external infrastructure

- ***Option II Lending and savings in a single institution*** The second option would be to spin off the microfinance components, and install them in a new financial institution which would offer both microloans and simple savings products delivered either completely or partially via the infrastructure of the Post Office This solution would appear to be advantageous because it would make specialization possible without the necessity of building a new infrastructure But here as well, certain doubts are in order is the Post Office infrastructure a suitable "platform" for microlending? If it is not, would it prove necessary to create separate infrastructure? The apparent advantages of the "postal savings bank option," which combines microcredit and microsavings in a single institution, should not be permitted to obscure the following points it is by no means clear that the existing postal infrastructure would be suitable and if it were used, costly upgrading measures would surely be required

- ***Option III Spin off microlending into a specialized institution*** The third option deals with the problems under discussion through separate institutional solutions The banks being merged into Union Bank would not be burdened by a rapidly expanding and from their point of view, potentially risky microfinance project This option is independent of decisions regarding the PO savings The central component of this strategy is to create a specialized microfinance institution which could focus on its core business, microlending

Ironically, the option which seems simplest is the one which has the most complex set of requirements Although option I appears attractive because it seems relatively easy to implement, a closer look reveals that it is the most intricate It presupposes that the merger will not have any adverse effects on the microcredit program that the microcredit program will be accepted and supported as a normal line of business after the merger is completed, and that the PO savings component can be expanded and eventually turned into a profitable operation, which it is not at present And all of this would have to be assumed despite the fact that even an institution like Union Bank would have only limited resources to devote to such an undertaking

While spinning off the microfinance component from Workers Bank but at the same time keeping both the credit and saving components within a single institution under option II would be less complex, it would certainly be quite challenging in practice In view of the prevailing wage and salary structures financial projections make it seem very unlikely that this strategy would be commercially viable funds mobilized via the postal infrastructure turn out to be not so inexpensive after all, taking into account their administrative costs The third option, which appears to be the most intricate in fact turns out to be less complex It does not attempt to resolve all three problems at once Rather, it is based on a strict separation between the banking merger, microlending and Post Office savings

The three options require careful evaluation, which this study seeks to provide Costs and benefits of the various strategies are analyzed, as are the implications of each for the target group

This study could never have been written without the assistance of many people in Jamaica The authors would like to thank everyone who took the time to meet with them and discuss their questions, and all those who directly and indirectly supported the work of the mission Special thanks are due to the local representatives of USAID, who were particularly helpful

1 Macroeconomic Developments

Jamaica's overall economic situation has deteriorated markedly in recent years Whereas total economic output grew at an average 1 7% per year between 1987 and 1997, it has declined significantly since the mid 1990s In 1996 output shrank by 1 7%, and in 1997 by 2 4% The downward trend has continued into the current year International observers estimate that Jamaica's overall economic output for 1998 will be 2-3% down on the previous year Demand is clearly weak in the Jamaican economy

<u>Table 1-1</u> **Basic Macroeconomic Indicators**

Item	Unit	1993	1994	1995	1996	1997	*1998*
Real growth	in % against previous year	1 4	1 1	0 5	-1 7	-2 4	*-3 0*
Inflation	in % against previous year	30 0	27 0	26 0	16 0	9 0	*5 0*
Budget balance	in % of GDP	- 3 0	- 4 0	- 2 0	- 7 4	- 9 0	*- 8 0*
Current account	in % of GDP	- 5 9	- 0 5	-4 6	-5 9	-9 1	*-7 5*
Unemployment	in % of total labor force	16 3	15 4	16 2	16 0	16 5	*17 0*

Source The World Bank Planning Institute of Jamaica 1998 data are estimates

This decline has been caused by developments at the macroeconomic level filtering through to the microeconomic level Pre-eminent among these has been exchange rate stabilization, which has increasingly become an obstacle to growth and development The strategy was adopted at the start of the 1990s with the aim of dispelling inflationary expectations, which were threatening to destabilize the economy However, inflation was slow to come down, and this led to an appreciation of the Jamaican currency in real terms, making a decline in Jamaica's competitiveness inevitable This in combination with an industrial monostructure which depends largely on bauxite banana cultivation and tourism, created serious balance of payment problems

There has been a continuous deterioration in Jamaica's current account balance On average for the period 1987-1997 Jamaica earned trade balance surpluses of almost 2% of its GDP However, in 1996 the surplus was down to only 1% and by the following year the trade balance slid into the red with a deficit equivalent to 5 6% of GDP Not until the second half of 1998 did Jamaica start to report surpluses again largely because the persistently low level of demand reduced the volume of imports

Jamaica's capital account has seen an accelerating trend away from government lenders and toward private lenders In 1986 the country's balance of payments deficit was financed mainly by bilateral and multilateral donors ten years later most borrowing was from private-sector sources In principle this is a positive development, because it shows that Jamaica can now hold its own on the international capital markets However, the fact that capital inflows are mostly short-term borrowings is a cause for concern Almost 55% of all debt owed to private foreign creditors is short-term and Jamaica currently expends 24% of its export income to service this debt, raising the question whether the foreign-currency regime can be sustained

Table 1-2 **Exchange Rates and Lending Rates**

Item	Unit	1993	1994	1995	1996	1997
Nominal Exchange Rate	J$	25 68	33 35	35 54	37 02	35 58
Real Exchange Rate Index	1993 =100	100 0	107 3	129 6	146 2	165 2
Nominal Lending Rate	% p a	50 0	46 0	49 0	42 0	35 0
Real Lending Rate	% p a	20 0	19 0	23 0	26 0	26 0

Source The World Bank Planning Institute of Jamaica

The intense liquidity squeeze of recent years also had wide-ranging consequences for the financial sector By 1996 many banks were struggling with non-performing loans High required reserves, high interest rates, massive mismanagement and widespread insider lending pushed more and more banks into a desperate situation, which they believed they could escape by engaging in ever more risky projects Many banks had close connections to insurance companies which had extensive shareholdings in other companies, extensive writedowns on the value of these investments caused difficulties for the insurance companies, and with them the credit institutions to which they were linked In February 1998, Jamaica's government, represented by the *Financial Sector Adjustment Corporation (FINSAC)*, assumed control of broad segments of the financial sector The government is now working closely with McKinsey & Company consultants to restructure the banking system and resume commercial lending

The banking system illustrates the close interplay between macroeconomic and microeconomic factors The crisis is not by any means due solely to microeconomic factors Mismanagement, insider lending and criminal activities are widespread, but these do not fully explain why almost all banks are in crisis On the other hand, macroeconomic factors alone would not provide a sufficient explanation of why some banks are in much worse condition than others Only the macroeconomic and microeconomic factors taken together explain why Jamaica's banking system has been hit by a severe crisis

Jamaica's enterprises suffer They find it virtually impossible to gain access to finance for expansion This particularly affects large enterprises, which have relied heavily on debt finance to fund investment in fixed assets and working capital, few small and micro enterprises had access to bank loans anyway Indirectly they suffer as well, since the possibility has evaporated that greater competition could increase banks' willingness to serve low-end market segments

Structural change was relatively slow even before the banking crisis Table 1-3 shows that sectoral contributions to GDP have remained almost constant The point is not so much the relative size of the services sector, a residual category covering all economic activities which cannot be assigned to one of the other sectors, but rather that industrial production and construction account for such a large share of total output, at 36 9% of overall economic output in 1997 These are precisely the areas which are dominated by a few large enterprises, which in turn had close links to banks before the crisis These monostructures can probably only be broken up "from below" i e through the gradual growth of micro, small and ultimately medium-sized enterprises

Table 1-3 **Structural Aspects of GDP**

	1993	1994	1995	1996	1997
	in %				
Agriculture	7 4	7 9	8 0	8 4	7 4
Mining	8 7	9 2	8 6	9 4	9 9
Manufacturing	18 8	18 7	18 4	18 1	18 1
Construction	9 5	8 8	9 4	9 1	8 9
Services	55 6	55 4	55 6	55 0	55 7
Total	100 0	100 0	100 0	100 0	100 0

Source Planning Institute of Jamaica

Reform should not concentrate on the macroeconomic level alone, but also address the microeconomic level Without microeconomic reforms a change in the foreign-currency regime could lead to sudden capital outflows and to a depreciation of the currency which would be far in excess of what is needed to neutralize the real appreciation of the past few years The experience of other countries shows that when this occurs, the rate of inflation quickly climbs and key interest rates must be raised further the result would be increasing instability in both monetary and real economic terms

Ultimately, a stable institutional framework must withstand changes in the foreign currency regime This is especially true of the banking system Improving banking supervision alone will not achieve this, rather, a systematic technology transfer must take place that will enable the banking system to avoid the mistakes which a supervisory authority is supposed to identify early on Not only early identification but effective prevention is needed to avert a repetition of the crisis

Building retail capacity in the banking system can help achieve stability, because

- it dilutes the relationship banking that currently dominates corporate finance,
- banks entering the retail market have incentives to organize their operations efficiently, increase productivity and make control mechanisms more stringent,
- cash flow lending methodologies replace collateral-based strategies, and
- the importance of a suitable institutional framework for lending becomes clear

Institution building within the banking system cannot solve all economic problems However, institution building can make an important contribution toward creation of a banking system which is more robust, less vulnerable to macroeconomic shocks Policy-makers would also benefit, since they would not have to be as concerned about preserving the stability of the banking system

2. Jamaica's Formal Financial Sector

2 Jamaica's Financial Sector

2 1 The Formal Financial Sector

2 1 1 Overview

Some 200 financial institutions make up Jamaica's formal financial sector, including nine commercial banks, 12 "merchant banks," 78 credit unions, 11 building societies, 13 NGOs and an array of cooperative banks, insurance companies and other lending institutions In addition, there are institutions which comprise a semi-formal and an informal sector, such as NGOs, pawnbrokers and moneylenders Jamaica's commercial banks operate a total of 150 branches Its merchant banks are registered under the *Financial Institutions Act* and are mostly linked to commercial banks Financial institutions which do not hold a full banking license under the Banking Act are limited in the businesses they can undertake

- ***Commercial Banks*** Are at the core of Jamaica's financial system Under the Banking Act they are permitted to conduct all types of banking business Prior to the crisis they accounted for more than 60% of the assets of all financial institutions Most of the commercial banks were or still are part of "financial-industrial groups" generally comprising other providers of financial services, such as insurance firms, and also industrial enterprises The commercial banks' extensive branch networks give them a presence in most urban areas in Jamaica

- ***Merchant Banks*** The merchant banks operate under the Financial Institutions Act Merchant banks are allowed to take deposits but they may not perform current account operations and are thus excluded from the general payments system The proliferation of merchant banks is due to the legal requirements for this type of institution minimum capital, minimum reserves and liquidity These are lower than for commercial banks, which therefore chose to spin off part of their operations to merchant banks It is now recognized that the requirements applying to merchant banks are out of proportion to the operations they are permitted, and steps have been taken to bring the regulatory requirements for the two types of institutions closer to each other

- ***Insurance Companies*** Although not credit institutions in the conventional sense insurance companies have played a very important role in Jamaica's financial system [1] This was particularly true before the crisis when insurance firms acquired interests in other businesses These acquisitions were funded with insurance premiums investment income and bank loans When the Jamaican economy went into profound crisis and many of these investments proved to be not particularly profitable their value declined

[1] In 1998, Jamaicans held more than 180 000 life insurance polices an extremely large number given a population of only 2 5 million This underscores the importance of the insurance industry for the financial sector as a whole

on a massive scale This put many insurers into a difficult financial situation, triggering a chain reaction which also rocked the banking system

- ***Building Societies*** Building societies date back to a law passed in 1897 Originally set up to finance housing on a cooperative basis, they evolved into full-fledged financial institutions offering a comprehensive range of services The building societies were covered by neither the Banking Act nor the Financial Institutions Act until 1995, when more and more of them became insolvent and cases of bankruptcy fraud began to mount An emergency law was passed which placed them under central bank supervision As a consequence, the number of building societies dropped from 36 in 1995 to 10 in 1997 Their functions can in principle be taken on by ordinary commercial banks, making their future cloudy

- ***Credit Unions*** Credit unions supply financial services to rural as well as urban areas They are not subject to banking supervision Their market share is very small As of March 1998, their combined total assets amounted to a mere USD 113 4 million or just over 6% of the banking system's total assets of USD 4 5 billion Their assets are spread across more than 70 institutions some of which have a business volume that is scarcely enough to enable them to break even

Jamaica's financial system was originally modeled on the British system with strict separation between commercial banks and other financial institutions This imposed specialization has gradually been eroded in Jamaica and elsewhere This trend was accelerated by the fact that it has proved possible to circumvent the rigorous provisions of the Banking Act by founding non-bank financial intermediaries If the requirements for the various types of financial institution are made to converge, this will take away the very foundations on which the Anglo-Saxon system was built, paving the way for a transition to a heavily controlled universal banking system Whether such control can be exercised wisely to create sustainable systems around the world remains to be seen

Table 2-1 **The Commercial Banking System of Jamaica**
as of June 30, 1998

Bank		Total Assets	Market Share	Total Capital	Prior years' Profits/(Losses)
		in bn J$	*in %*	*in bn J$*	*in bn J$*
Total		159 9	100 0	3 2	(7 15)
National Commercial*		69 8	43 6	3 8	(0 03)
Nova Scotia		53 6	33 5	5 2	0 10
CIBC		10 7	6 7	0 8	0 10
Citizens*		10 1	6 3	0 2	(1 10)
Workers	*Union*	4 7	2 9	(8 0)	(6 20)
Eagle	*Bank*	3 2	2 0	0 6	(0 02)
Island Victoria		2 9	1 8	0 2	(0 40)
Citibank		4 2	2 6	0 3	0 02
Trafalgar Commercial		0 8	0 5	0 1	(0 00)

* *Denotes FINSAC control*
Source Bank of Jamaica

Despite this trend toward convergence certain differentiations are based on genuine differences of substance For example banks are normally defined by their being permitted to receive deposits Protecting depositors not borrowers or other customers justifies strict supervision of the banking system Institutions which do not collect retail deposits should not be treated as if they did The relevant authorities are well aware of the basic legal and regulatory distinctions between financial institutions that receive deposits and those that do not

Nonetheless, there will be numerous changes in the Jamaican financial system designed to prevent future crises Two areas in particular will be affected first the banking regulatory framework, and second, the business policies of the banks which should concentrate less on large-scale customers and instead turn their attention to lower segments of the market Whether they will do so because of market forces is doubtful as the following sections show

2 1 2 The Regulatory Framework

The regulatory framework within which banks, merchant banks and building societies operate is defined by two pieces of legislation the Banking Act and the Financial Institutions Act In addition, the Money Lender Act requires lenders to obtain special permission from the ministry of finance to charge final borrowers interest rates in excess of 20% However, this regulation has ceased to have any practical function Special permits are issued routinely, and many financial institutions, especially in the semi-formal and informal sectors, ignore the rule altogether The following remarks focus on the Banking Act and the Financial Institutions Act First we give a brief description of these laws, then anticipate some likely developments

2 1 2 1 The Banking Act

The Banking Act of 1992 defines banks as institutions which receive deposits (including demand deposits)

> Banking Business means the business of receiving from the public, on current account or deposit account, money which is repayable on demand by cheque or order and which may be invested by way of advances to customers or otherwise, and such other business of a like nature as the Minister may, by order, prescribe [2]

The law gives the ministry of finance the power to define the kinds of business which banks may undertake The ministry is also the office to which applications for a banking license must be submitted, and the Finance Minister, after consulting the *Bank of Jamaica (BoJ)* decides whether to grant licenses

Licensing Procedures

Licensing is governed by provisions which are generally consistent with international standards

- ***Minimum Capital*** The applicant must present evidence of being able to furnish capital of at least J$ 80 million (USD 2 3 million) For foreign banks, the minimum capital requirement is J$ 250 million (USD 7 2 million) To obtain a banking license a Jamaican applicant must make an initial cash contribution of J$ 60 million foreign applicants must pay in a similar percentage of the total requirement that applies to them

[2] The Banking Act Act 17 of 1992, Part I Preliminary 2 - (1)

- ***"Fit and Proper" Criteria.*** The proposed managers must be capable of performing their duties responsibly and in accordance with the interests of the depositors Grounds for doubting their ability to do so would include a criminal record which implies dishonesty, or responsibility for a bankruptcy

- ***Foreign Shareholders*** Foreigners are allowed to own stakes in Jamaican banks Restrictions apply only to foreign governments or their organizations, which are not permitted to own more than 5% of a bank established under Jamaican law, or to exercise voting rights representing more than 5% of the share capital

Prudential Requirements

The main prudential requirements are

- ***Reserve Fund.*** Each bank must maintain a capital reserve, into which it must pay 15% of its net profits at the end of each year until the reserve has grown to 50% of paid-in equity capital From then on 10% must be paid in annually until the fund equals the amount of paid-in capital

- ***Cash Reserve*** Every bank must maintain a cash reserve at the BoJ amounting to at least 5% of total liabilities A bank's liquid assets may not fall below 15% of its liabilities

- ***Fixed Assets*** The value of a bank's fixed assets must not exceed that of its equity capital The fixed assets are to be valued at historical costs Banks may only own real estate to the extent necessary for the conduct of banking operations

- ***Lending Terms and Conditions*** Loans issued on terms that differ from market rates must not exceed 20% of the bank's equity capital if the beneficiaries are related parties according to the definition provided in the Banking Act This corresponds to the international standard definition

- ***Loan Security*** Unsecured loans to related parties must not exceed 5% of a bank's equity capital Unsecured loans to other borrowers must not exceed 10% of the equity capital

- ***Participating Interests*** Banks may acquire holdings in other companies providing that no individual shareholding exceeds 20% of the bank's equity capital

- ***Loan Loss Provisions*** Provisions must be made for loans on which no interest or principal payments have been received for more than 6 months

These prudential requirements have two shortcomings

- The Banking Act does not explicitly stipulate a ratio of equity capital to risk-weighted assets, as would be required by international standards

- Stipulations concerning loans to related parties are not clearly separated from those governing the terms on which such loans may be issued These two topics are dealt with in a single set of provisions, which may lead to misinterpretations

The main problem has been enforcement However, regulatory forbearance has been replaced by decisive action by FINSAC in cleaning up the mess

Minimum Reserves

The minimum reserve requirements for commercial banks (Table 2-2) are very high in comparison to their past levels and to those in other countries This creates incentives to establish merchant banks, which are subject to much lower rates, and potentially to engage in risky ventures

Table 2-2 **Minimum Reserve Requirements for Commercial Banks**

Commercial Banks	Domestic Currency	Foreign Currency
	*as % of total liabilities**	
Cash Reserves	23 00	20 00
Liquid Assets	45 00	40 00

* *With the possible exception of multilateral credit lines in certain cases*
Source BoJ

Shortcomings in the Banking Act are being sorted out by a task force under the chaired by the deputy governor of the central bank Its recommendations are due in 1999

2 1 2 2 Financial Institutions Act

The Financial Institutions Act of 1992 does not contain a positive definition of a financial institution but states the respects in which it differs from a commercial bank Under this law, financial institutions may engage in banking operations with the exception of

- current account management, and therefore by implication also
- domestic payments and funds transfers

They may accept other kinds of deposits, provided that these deposits do not exceed 20 times the value of equity capital The provisions of the Financial Institutions Act deviate from those of the Banking Act in two respects lower minimum capital requirements and minimum reserve rates

Local or foreign applicants for a license must demonstrate that they can provide minimum capital of J$ 25 million (approx USD 700,000), of which J$ 20 million must be paid in cash when the application is submitted

Table 2-3 **Minimum Reserve Requirements for Non-banks**

Non-Bank Financial Institutions	Domestic Currency	Foreign Currency
	*as % of total liabilities**	
Cash Reserves	17	17
Liquid Assets	35	35

* *With the possible exception of multilateral credit lines in certain cases*
Source BoJ

2 1 3 The Banking System

2 1 3 1 Evolution of the Banking System

This section presents an overview of the evolution of the financial system, focusing on commercial banks up to the general banking crisis The chapter ends by looking ahead to likely future developments

Historical Outline

The first commercial bank, the Bank of Jamaica, was founded in 1936 by British merchants (The historical Bank of Jamaica is not related to the present central bank) One year later, the Colonial Bank established a branch in Jamaica, followed by the Planters Bank and various Canadian banks including Bank of Nova Scotia

Until the 1960s there were no spectacular developments within the banking system Exchange rate stability was achieved through a currency board system Under this regime the central bank had very limited powers, if any, to bail out insolvent banks, which ensured that discipline within the banking system was tight That changed when the currency board system was abandoned and monetary policy, as well as the banking system itself increasingly came to be treated as instruments for achieving political goals This period was characterized by slow growth, relatively high inflation and notoriously heavy pressure on the Jamaican currency Workers Bank went into operation in 1974 explicitly to serve the "working people of Jamaica" and to provide a country-wide supply of financial services on favorable terms Operational inefficiencies and high loan default rates showed how problematic this model was

Table 2-4 **Commercial Banks – Consolidated Balance Sheet**

Item	06/30/97	Structure	06/30/98	Structure	Change
	in bn J$	*% of total assets*	*in bn J$*	*% of total assets*	*in %*
Assets	148 8	100 0	159 9	100 0	7 50
Cash and Reserves	38 1	25 6	11 5	7 2	- 69 8
Investments	30 1	20 2	53 7	33 4	78 4
Loans	50 2	33 8	37 0	23 1	-26 3
Fixed Assets	3 9	2 6	4 3	2 7	10 3
Other	26 5	17 8	53 4	33 4	101 5
Liabilities	140 7	94 6	156 6	97 9	11 3
Deposits	102 4	68 8	112 7	70 5	10 1
Borrowings	10 4	7 0	17 9	7 1	72 1
Other	17 9	12 0	26 0	10 3	45 3
Capital [1)]	8 1	5 4	3 3	2 1	-60 3
Paid-In and Reserves	8 1	5 4	12 1	7 6	49 4
Prior years' Profit/(Loss)	(0 5)	(0 3)	(7 1)	(4 4)	20 0
Current Profit/(Loss)	0 5	0 3	(1 7)	(1 1)	-

[1)] *Including Recapitalization by FINSAC*
Source Bank of Jamaica

Economic policy changed at the start of the 1990s A strategy of exchange rate stabilization imposed hard budget constraints Banks were privatized, including Workers Bank and the market was opened to foreign banks Old habits underwent a less dramatic change than expected however, and moral hazard made it impossible to maintain the stability of the banking system over the long term Rapid credit expansion encouraged by a stable exchange rate, was financed with short-term capital inflows The combination of these factors produced a crisis

The Crisis

Rapid credit expansion between 1990 and 1995 increased loans to the private sector by an average 42 6% a year For the period as a whole, (using year end figures), this corresponds to an expansion of 489 6% This was also a real expansion of 66% Exceptionally high inflation rates of over 80% were recorded in 1991 The burden of coping with an expansion on that scale was great In 1996 the financial system was plunged into a major crisis by the collapse of Century National Bank, and in 1997 the government took over numerous financial institutions

Various factors were to blame One set of factors was associated with the banking regulatory regime Another had to do with deficiencies in the banks' credit operations

(i) Legal Framework

- ***Legal ambiguities*** The legal framework is less clear than it should be, leaving banking regulatory requirements open to interpretation if so desired

- ***Regulatory Forbearance*** By 1996 there were signs that banks were getting into difficulties However, the authorities did not take firm action for fear of precipitating a bank run

(ii) Technology-Related and Institutional Problems

- ***Institutional deficiencies*** The formation of large financial groups and insider abuse of "house banks" co-existed with substantial institutional deficiencies in core areas of banking Banks appear to have been unable to handle large numbers of customers efficiently, due in part to insufficient information systems and technology

- ***Technology-related deficiencies*** Credit decisions based on cash flow analysis remain the exception Loans are generally issued on the basis of collateral and/or personal connections, giving borrowers' ability and willingness to repay a subordinate role

2 1 3 2 Ways Out of the Crisis

FINSAC was set up in January 1997 to reorganize the banking system and to create a new basis for the activities of the financial sector Its specific objectives are to

- restore the *liquidity and solvency* of institutions that would otherwise be closed,

- strengthen *financial management* to avoid solvency problems in the future

- raise the level of *efficiency in the financial sector* as a whole thereby making a contribution to the sector's stability that goes beyond crisis management,
- create an *attractive environment* and a favorable investment climate that will attract foreign capital to Jamaican financial institutions

A seven-year limit has been placed on FINSAC's mandate to prevent it from becoming a permanent state holding company Its purpose is to facilitate rapid reprivatization of units it has taken over and restructured The instruments it is using to rehabilitate the banking system include

- systematic consolidation of bad loan portfolios
- appointment of new management,
- sale of assets that are not part of the banks' core business
- improvement of management information systems
- collection of delinquent outstanding claims
- support for regulatory reforms

FINSAC has taken control of more than 130 financial institutions including insurance companies like *Island Life* and the largest bank in the country *National Commercial Bank* Probably one of FINSAC's most difficult tasks is to merge *Workers Bank Island Victoria*, *Citizens Bank*, and *Eagle Commercial Bank* into the new *Union Bank* which will be the third-largest financial institution in Jamaica

Future Developments

There is no viable alternative to the efforts being undertaken by FINSAC Whether they will be successful depends in particular on whether the new managements redefine their institutions' core business in such a way as to achieve long-term stability and expansion For this undertaking to succeed it is imperative that

- government influence over the banking sector be systematically reduced
- the banking supervisory authorities be willing to take preventive action
- cash flow-oriented credit technologies gradually be introduced
- banks develop stable institutional structure

2 2 Interim Conclusions

Jamaica has a population of only 2 5 million and roughly 200 financial institutions It is repeatedly claimed that the island is "overbanked" However, taking into consideration the types of customers they serve provides a different perspective The commercial banks and merchant banks primarily cater to large-scale customers Corporate finance is the dominant business at some banks, whereas others have concentrated on consumer lending to salaried employees with high incomes Micro and small entrepreneurs still turn to the informal sector to finance the expansion of their businesses

However, stable insider relationships, personal friendships and firmly cemented business relationships within financial-industrial groups began to come unstuck and some collapsed altogether As of June 30, 1998, six of the nine commercial banks reported heavy losses At least five banks are apparently technically insolvent even if this is not reflected in their published financial statements

Writedowns and write-offs have left the assets of the banking system concentrated in even fewer hands than before *National Commercial Bank (NCB)* and the *Bank of Nova Scotia (BNS)* now account for more than 77% of the total assets in the system With formation of Union Bank, lending business will become more concentrated

Thus, competition in the banking system will probably decrease This in turn makes it less probable that the banks will be willing to explore new market segments If banks launch programs geared to smaller borrowers they will tend to be public relations exercises Small-scale customers will still rely on semi-formal and informal sources at high effective interest rates that may retard development of the MSE sector

Only one serious attempt has been made to implement a professionally competent micro lending operation and integrate it into the structures of a commercial bank In 1996 Workers Bank, in collaboration with USAID, set up a credit program aimed at micro and small enterprises and designed to establish lasting relationships between the bank and these customers In addition Workers Bank is using the branch network of the Post Office to attract deposits from small households and thus to provide financial services even in rural areas However, the impending merger of Workers Bank raises the question of how the program should continue

- Should the micro credit portfolio and Post Office Savings remain within the institutional framework of the merged Union Bank?

- Should both components be spun off and integrated into a new institution?

- Should a separate solution be found for the micro credit portfolio?

To answer these questions, we present a profile of Workers Bank, and then examine the institution's experience in microfinance services (lending and savings) On this basis, we develop scenarios and consider options

3. *Microfinance in Jamaica*

3 Microfinance in Jamaica

Over the last several decades the Jamaican Government and international donors have increased their attention to the micro and small enterprise (MSE) sector A number of assessments of the MSE sector in Jamaica reveal its significant size, role in economic growth, and provision of employment The majority of studies and surveys have identified access to credit and capital as a major constraint Although the GOJ and donors have supported initiatives aimed at providing credit to MSEs, only a small portion of the sector presently utilizes credit programs The majority of microcredit programs struggle with limited outreach, excessive delinquency, low efficiency, and operating losses This section reviews the MSE sector, demand for credit, and supply of financial services for MSEs

3 1 The MSE Sector

The most recent national survey on micro and small enterprises, conducted in 1996 by the Statistical Institute of Jamaica (STATIN), estimates that there are approximately 93,000 micro and small businesses in Jamaica Although the number of MSEs has remained fairly constant over the past two decades, the micro and small business sector has experienced some changes in composition

Characteristics

The microenterprise sector is widely dispersed 22% of businesses operate in the greater Kingston area, 35% in other urban areas, and 43% in rural areas [1] Although it is difficult to track movement of microenterprises over time because of changes in statistical classification, it appears that there has been migration from urban areas to rural areas [2]

[1] "Survey of Non-Agricultural Micro and Small Businesses Statistical Institute of Jamaica 1996

[2] "A comprehensive Description of the Micro and Small Enterprise Sector Carmen McFarland September 1997

Table 3-1 **Number and Percent of Microenterprises by Geographic Location – 1996**

Location	Number	Percent
Kingston Metropolitan Area	20 470	22 0%
Other Urban Areas	32 450	34 9%
Rural Areas	40 190	43 1%
Total	93 110	100 0%

Source 1996 Micro and Small Enterprise Survey – Jamaica

Unlike countries in which many microenterprises operate from makeshift premises or transact business directly on the streets, 48% of firms in the SME sector in Jamaica in 1996 operated out of "own premises", 36% rented premises and only 4% were "squatting [3]

Growth of the MSE sector

There was substantial growth (153%) in the number of MSEs between 1983 and 1996 According to the 1996 National Survey, sole proprietorships comprise 89% of the sector, with 58,910 enterprises concentrated in wholesale/retail (63%) Non-trade activities accounted for 37% of MSEs This represented a substantial shift in business activity between 1983, when 47% of enterprises conducted retail and wholesale trade, and 1996, when 63% of enterprises were in trade

Table 3-2 **Number and Percent of Non-Agriculture Microenterprises in Jamaica By Type of Activity – 1983, 1990 and 1996**

Activity	Number			Percent		
	1983	1990	1996	1983	1990	1996
Trade	17,370	49,070	58,910	47 2%	55 2%	63 3%
Non-Trade	19,410	38,780	34 200	52 8%	44 8%	36 7%
Total	36,780	87,850	93,110	100 0%	100 0%	100 0%

Source 1996 Micro and Small Enterprise Survey – Jamaica

[3] STATIN 1996

The microenterprise sector can grow in two ways expansion of existing businesses and establishment of new businesses Expansion generally reflects increased economic opportunities whereas new businesses may simply reflect increased unemployment Simply analyzing patterns in the numbers of microenterprises reveals little about the growth or prosperity of the sector One possible measure is to analyze growth of employment by existing microenterprises, reflecting growth within the sector In general, the micro and small business sector is not a large contributor to paid employment According to the 1996 National Survey, paid workers represented about 38% of employment in the sector The majority of enterprises employed "own account" proprietors (52%), and unpaid family members (10%) [4] Employment provided by the sector increased slightly between 1992 and 1996 Average employment was 1 8 employees per firm in 1992 and 1 9 in 1996 [5]

Table 3-3 **Number and Percent of Microenterprises By Size - 1992, 1996**

	1992		1996	
Business Size	Number	Percent	Number	Percent
Own Account	41 990	47 3%	63 140	67 8%
1-4 paid employees	41 370	46 6%	26 940	28 9%
5-9 paid employees	5 490	6 2%	3 030	3 3%
Total	88 850	100 0%	93 110	100 0%

Source 1996 Micro and Small Enterprise Survey Jamaica

The total number of MSEs increased from 88 850 in 1992 to 93,110 in 1996 "Own account" firms accounted for the overall change in number of enterprises There were decreases in the number of businesses employing 1-4 workers (-34%) and in those employing 5-9 workers (-45%) In the 1996 National Survey, less than 20% of firms reported continuous expansion since beginning 20% reported expansion but that business had since slowed, and 30% reported that business had remained the same [6]

Of the approximately 2,000 enterprises interviewed in the 1996 National Survey, less than 11% were start-ups Fifteen percent had existed for one year, and 75% had been operating for over two years There was a higher percentage of young firms (1-4 years of operation)

[4] STATIN 1996

[5] McFarland, 1997

[6] STATIN, 1996

in 1996 than in 1992, and a lower percentage of older firms [7] The increase of newer firms occurred in Kingston, with the percentage of older firms increasing in rural areas

Ninety four percent of businesses surveyed in 1996 had started their enterprises from scratch as opposed to inheriting or buying existing businesses [8] This represented an increase from 86% of MSEs starting from scratch in 1983 [9]

Surprisingly, there does not appear to be a direct link between the unemployment rate and the number of "own account" and unpaid workers in micro and small enterprise [10] According to the 1997 McFarland study, unemployment dropped from 20 4% in 1975 to 16% in 1996 During the same period, the number of "own account" and unpaid workers as a percentage of the total labor force declined only slightly, from 32 4% to 31 6%

<u>Table 3-4</u> **Unemployed, "Own Account" and Unpaid Workers**

Year	Unemployment Rate	Own Account/Unpaid Workers as % of Total Labor Force
1975	20 4%	32 4%
1983	26 4%	33 2%
1992	15 8%	35 1%
1996	16 0%	31 6%

No statistical information exists on the extent that micro and small businesses are linked to larger enterprises in Jamaica A 1996 Microenterprise Assessment conducted by the Inter-American Development Bank suggests that there are fewer horizontal and vertical linkages than would be expected for a middle-income country such as Jamaica [11] Linkages where a few large enterprises contract with microbusiness are found on a limited scale in agriculture, beverage distribution and furniture manufacturing

7 McFarland 1997

8 McFarland 1997

9 McFarland 1997

10 "Unpaid workers are generally family members or apprentices who do not receive cash payment for their work

11 'Microenterprise Development in Jamaica Preliminary Assessment Mark D Wenner Inter-American Development Bank September 1996

Microenterprise is characterized by cash transactions, with very little supplier credit According to the 1996 National Survey, most MSEs reported that suppliers required cash payment at the time of delivery A very small percentage (7 6%) paid partly cash on delivery, with the balance on credit [12] Only a negligible percentage of MSEs obtain merchandise or services purely on credit

Constraints

The 1997 McFarland study lists a number of constraints faced by microentrepreneurs, pointing to issues said to face Jamaican society in general lack of discipline, high cost of living, lack of access to education, health services, and transportation, along with crime Other obstacles include bureaucratic difficulties, problems in distribution, and shortage of skilled workers

3 2 Potential for Capital and Credit

Capital and credit problems are reported to be one of the most serious constraints identified by micro and small enterprises, with the lack of working capital the most pressing obstacle to growth of the sector More than one quarter of businesses in the 1996 National Survey stated lack of access to credit as one of their four major problems with 20% listing lack of access to credit as their number one problem The majority of enterprises with 5-9 workers listed credit as their biggest problem About 30% of "own account" enterprises and firms with 1-4 workers identified credit as a major problem Reported capital and credit problems were most pressing for MSEs in the Kingston Metropolitan Area where 34% of businesses listed credit as a major problem along with low market demand Twenty four percent of businesses in other urban areas, and 27% of businesses in rural areas identified lack of credit as a major obstacle

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[12] McFarland September 1997

Table 3-5 **Problems Identified by Microenterprises by Employment Size and Location – 1996**

Problem	Total	Own Account	With 1-2 Workers	With 3-4 Workers	With 5–9 Workers	Kingston Met. Area	Urban Areas	Rural Areas
Low Market Demand	44 5%	46 7%	41 2%	41 7%	29 2%	34 5%	45 4%	48 5%
Nonpayment of Clients	33 4%	38 4%	25 2%	21 6%	12 5%	21 0%	33 0%	39 4%
High Prices of Supplies	33 2%	34 3%	32 3%	28 1%	27 8%	22 4%	34 0%	37 6%
Capital and Cash Flow	28 4%	27 8%	29 1%	28 1%	36 1%	34 4%	24 7%	27 3%
High Utility Costs	19 8%	18 3%	22 6%	26 6%	16 7%	16 4%	21 4%	20 0%
Availability of Supplies	10 0%	10 4%	9 9%	9 4%	5 6%	11 4%	9 7%	9 7%

Source 1996 Micro and Small Enterprise Survey – Jamaica

Most MSEs identified lack of additional working capital as the number one constraint to expansion, outranking low demand

Table 3-6 **Barriers to Expansion Identified by Microentrepreneurs - 1996**

Problems	% SMEs
Insufficient Working Capital	29 8%
Low Demand	22 7%
Shortage of Machinery/Equipment	17 7%
Lack of Space	14 0%
Shortage of Staff	6 8%
Other	9 0%
Total	100 0%

Source 1996 Micro and Small Enterprise Survey

According to the 1996 National Survey businesses used a variety of funding for start up capital 49% used personal savings 22% obtained funds from family and friends, and 22% "threw a partner " Other funds were found through other businesses (3%) or sale of assets (3%) Four percent of enterprises obtained financing from commercial banks, and less than 2% from credit unions It is clear that Jamaican microenterprises have not relied on financial institutions for start up capital These results represented little change from those obtained in 1992

The 1992 and 1996 National Surveys on microenterprise refer to “a reluctance of micro and small businesses to utilize finance from credit institutions ” Microenterprises interviewed in the surveys stated that they do not want to use financial institutions to finance their operations because they do not like to borrow and they want to be independent Entrepreneurs also alluded to suspicion of banks, high interest rates and fear of losing collateral The McFarland study questions these results, and refers to barriers to entry as a plausible explanation Given that the Workers Bank Microloan Program presently has over 2,000 active clients repaying loans at substantial interest rates and guaranteed by some form of collateral, deeper analysis is needed of the reasons behind “reluctance” to borrow from commercial institutions

3 3 Supply of Credit

Since the early 1980s, the GoJ and international agencies have supported wholesale programs and retail lending institutions focussed on the MSE sector Millions of dollars and strong political support has been thrown at formal and semiformal finance programs The results have been disappointing Outreach is limited providing credit to only 5% of the estimated market of possibly 40 000 microentrepreneurs who want to borrow and are creditworthy In addition, little institutional capacity has been developed

3 3 1 Formal

Commercial banks and finance companies have hardly served microenterprise Of enterprises surveyed in 1996 only 7% reported requesting loans from commercial financial institutions, and 75% of total businesses had never applied for a loan from a commercial institution Of those applying for such loans less than 6% actually obtained them

Workers Bank, with over 2 000 active clients and J$ 22 3 million (US$ 805,000) in microloans outstanding is the only bank in Jamaica presently providing microcredit on a relevant scale This program is discussed in the following section

Bank of Nova Scotia, with support from CIDA and Kingston Restoration Company plans to introduce a microloan program in 1999 in economically depressed inner-city areas of Kingston using group lending First loans will be capped at J$ 6 000 with gradual increases to over J$ 40,000 by the eighth loan cycle Small loans from other commercial banks were primarily consumer loans No bank beyond Workers Bank had specialized products, loan methodology or staff dedicated to this end of the market

Credit unions have been more active than the commercial banks in providing credit to the small end of the market Four credit unions participate in externally funded MSE loan programs As of September 30, 1998, these four served 1,311 active clients with an average outstanding loan size of approximately J$ 60,000 (US$ 1,704) and J$ 78 2 million (US$ 2 2 million) outstanding The average arrears rate in the credit unions' MSE loan portfolio was 31% Only one of these credit unions had an average loan size under J$ 10,000 (US$ 285) Average loan size outstanding for the three others ranged from J$ 54,000 (US$ 1,552) to J$ 176,334 (US$ 5,038)

3 3 2 Semiformal

The Government of Jamaica, with support from donor agencies, has supported several micro and small enterprise credit programs operated by NGOs The majority of these programs are heavily subsidized, with limited outreach excessive arrears, poor accountability, and operating losses The four major MSE credit granting NGOs operating in Jamaica collectively served 2 290 active clients as of September 30,1998 Their combined outstanding portfolio was J$ 380 4 million (US$ 10 9 million) with approximately 43% of combined outstanding portfolio at risk Average loan size outstanding within these programs ranged from a low of J$ 10 512 (US$ 300) to a high of J$ 176,334 (US$ 5,038) Interest rates charged range from 1 25% to 5% monthly

Donors have provided loan funds to retail lending NGOs commercial banks and credit unions through second tier institutions The Government of the Netherlands (GoN) and the European Union (EU) have been the largest providers of these wholesale funds The approximately US$ 5 million GoJ/GoN Micro Enterprise Project (Phase II) is the extension of the two year pilot project which began in four parishes in September 1991 Phase II which began in 1994 and extended the project through 1998 expanded coverage throughout the country The GoJ/GoN channeled funds through Eagle Merchant Bank which lent to participating retail institutions at a rate of 13% per annum The retail institutions determine their own interest rates for on-lending to micro and small enterprises A total of 1,378 sub-loans (J$ 288 6 million) were disbursed between 1994 and June 1998 The average loan amount was J$ 209 433 (US$ 6,000) As of September 1998, there was approximately US$ 8 million in the rotating loan fund with J$ 210 million (US$ 6 0 million) outstanding As this program closes at the end of 1998 the GoJ and GoN are examining new activities that could be supported with the rotating fund

The GoJ/EU Micro Enterprise Lending Scheme, which began operating in May 1995, was identical in design to the GoJ/GoN project Numerous problems arose and the EU suspended lending in early 1996 The program has been redesigned and is scheduled to resume in late 1998 The EU will channel between US$ 8 million and US$ 12 million through two apex institutions (Trafalgar Development Bank for small loans and MEDA for micro loans) that will lend at 12%-13% to retail organizations The EU has agreed to an

Table 3.7: PORTFOLIO INFORMATION
ON MICRO/SMALL LOAN PROGRAMMES IN JAMAICA

	As of September 30,1997						As of September 30,1998					
Institutions	Number Active Clients	Portfolio Outstanding (Value - J$)	Average Loan Size Outstanding	Number Loans in Arrears	Principal Balance at Risk	Portfolio at Risk (%)	Number Active Clients	Portfolio Outstanding (Value - J$)	Average Loan Size Outstanding	Number Loans in Arrears	Principal Balance at Risk	Portfolio at Risk (%)
Credit Union 1[1] (Kingston Based)	438	$38 326 994	$87 505	126	$10 860 372	28 34%	590	$55 679 681	$94 372	134	$17 903 806	32 16%
Private Non Profit Lending Agency2 (Islandwide)	1 617	$245 012 637	$151 523	190	$56 524 018	23 07%	1 492	$263 090 646	$176 334	234	$62 271 073	23 67%
Private NGO[3] (Kingston Based)	537	$8 194 385	$15 260	212	-		545	$5 729 237	$10 512	188	$2 106 527	36 77%
Credit Union 2[4] (Rural Based)	856	$3 154 008	$3 685	14	$86 112	2 73%	512	$5 070 476	$9 903	143	$1 513 960	29 86%
Government Lending Institution[5] (Islandwide)	82	$8 088 016	$98 634	-		0 00%	253	$14 595 108	$57 688	234	$13 020 202	89 21%
Credit Union 3[6] (Employee Based & Islandwide)	60	$12 649 645	$210 827	15	$5 738 144	45 36%	70	$9 850 192	$140 717	14	$2 273 301	23 08%
Credit Union 4[7] (Rural Based)	-	-	-	-	-	0 00%	139	$7 551 206	$54 325	63	$603 844	8 00%
MIDA[8] (Islandwide)		-	-		-	0 00%	-	$97 021 081	-		$85 551 425	88 18%
Workers Bank Micro Loan Program	796	5 703 343	$7 165	139	$ 846 182	14 84%	2 083	$22 288 014	$10 700	514	$1 353 197	6 07%
Total	4,386	321,129,028	$73 217	696	74 054 828	23 06%	5 684	480,875,640	$84 602	1,524	186 597,335	38 80%

NOTES

1 Information relates to their externally funded micro/small loan programmes

2 Information is at August 31 1997 and 1998 respectively as data for September 1998 were not yet available

The portfolio size and value is for their entire micro/small loan portfolio while the arrears information is only for their GoJ/GoN MEP and GoJ/EU portfolios

At September 1997 the portfolio size and value was 1628 and J$245 382,505 respectively

3 This institution only started to track outstanding principal balance of loan in arrears since 1998

4 Information relates to their Small Loan Fund and Special Credit Initiatives facilities

5 Information relates to loan programmes funded under the GoJ/GoN MEP the Small Loan Fund and Traditional Credit facilities

At September 1998 overall loan portfolio was estimated at J$83M with 785 active borrowers

6 All their MSE loans are funded under the GoJ/GoN MEP

7 All their MSE loans are funded under the GoJ/GoN MEP This institution resumed lending to the MSE sectorin the last quarter of 1997

8 MIDA reported arrears of 9% at September 1998

SOURCE Provided by Development Options Ltd. October 1998 unfortunate policy to cap retail interest rates at 23% which may not make it possible for providers to cover their inflation adjusted costs

3 3 3 *Informal*

No statistical information exists on the depth and breadth of informal finance in Jamaica However, an estimated 50% of all Jamaicans have participated in a "partner throw" the local ROSCA As previously mentioned, 22% of the microenterprises participating in the 1996 National Survey obtained start-up capital for their businesses by throwing a partner It is unclear how important this source of financing is for funding businesses in the MSE sector

Partner throws are informal groups consisting of up to 30 members though they are usually smaller Each group has a "champion" who based on social status and also to a significant degree on age, is considered particularly trustworthy The champion functions as the group's "banker", whose duties include organizing group meetings which usually take place once a week, collecting the money and issuing it to the member whose turn it is to receive the "throw" according to a previously defined roster In general a partner's rank in the roster is a function of his or her seniority of membership

Average costs of obtaining funds through a partner throw vary Some "bankers" who organize throws do not charge a fee for their services but simply take the first "draw" Other "bankers" who organize throws do not contribute in the throw but take one draw as their fee The cost of this form of financing depends on the "banker's" fee or draw, the number of participants, and in which cycle the participant receives his or her draw Costs range from an interest free loan in cases that the banker charges no fee and the participant receives the first draw, to effective interest rates well over 100%

More professional variations of informal lending have also evolved Moneylenders tend to specialize in emergency finance Rates of 250–300% p a are not unusual Often, items of value or checks are taken as security The loans are usually disbursed quickly, the precise terms are often decided partly on the basis of how much the lender likes and trusts a given borrower Veritable chains of professional moneylenders have also developed Although moneylenders operate in a legal gray area they are tolerated by the authorities and go about their business largely undisturbed Moneylenders are an important part of the financial system

3 4 Conclusions

There are almost 100,000 MSEs operating in Jamaica, most of which list lack of access to credit and capital as one of their major problems The majority of existing enterprises rank credit and capital as the number one constraint to growth of their businesses At the same time, there have been a wide variety of GoJ and donor sponsored credit programs with millions of dollars of funding aimed at this sector Most have had unimpressive results The exception has been the Workers Bank micro loan program, which has achieved significant outreach, solid repayment, and efficiency This program alone, with its 2 000 active clients, demonstrates that the demand and the ability and willingness to repay loans exist in the Jamaican MSE sector

4 Workers Savings and Loan Bank

The *Workers Savings and Loan Bank (Workers Bank)*, a full service bank dedicated to serving the working class of Jamaica, was established by an Act of Parliament in 1973 This Act incorporated the Government Savings Program, which had operated through the Post Office network, into a full service bank Initially, the Government of Jamaica and trade unions were the major shareholders After close to 20 years of operating losses the bank was privatized in 1991 The Corporate Group, led by Delroy Lindsay, purchased and assumed management of the Bank The Corporate Group included a merchant bank, insurance company, building society and other businesses Workers Bank then experienced dramatic growth For the first time, Workers Bank operated at a net profit in 1994 In 1996, it recorded a J$439 6 million deficit, and dramatically deteriorated in 1997 with losses of over J$ 2 0 billion

<u>Table 4-1</u> **Balance Sheet of Workers Bank – 1997, 1998**

Item	06/30/97	Structure	06/30/98	Structure	Change
	bn J$	*% of total assets*	*bn J$*	*% of total assets*	*%*
Assets	9 4	100 0	4 7	100 0	-50 0
Cash and Reserves	1 2	12 8	1 1	23 4	-8 3
Investments	0 3	3 2	0 8	17 0	166 7
Loans	5 2	55 3	1 1	23 4	-78 8
Fixed Assets	0 4	4 2	0 8	17 0	100 0
Other	2 3	24 5	0 9	19 2	-60 9
Liabilities	9 8	104 3	12 7	270 2	29 6
Deposits	3 6	38 3	3 0	63 8	-16 7
Borrowings	2 3	24 5	8 7	185 1	278 3
Other	3 9	41 5	1 0	21 3	-74 5
Capital	(0 4)	(4 3)	(8 0)	(170 2)	-
Paid-Up	0 08	8 5	0 03	0 6	-
Reserves and other	0 12	12 8	0 17	3 6	-
Accumulated Profits	(0 2)	(2 1)	(6 2)	(131 9)	-
Current Profit/Losses	(0 4)	(4 3)	(2 0)	(42 6)	-

Source Bank of Jamaica

In early 1998 FINSAC took control of the management and ownership of the Bank It is merging Workers Bank with three other insolvent banks McKinsey & Company is presently analyzing merger strategies and will advise FINSAC on options Bad assets will be stripped off and FINSAC will attempt recovery of bad debt The merged institution will inherit what performing assets remain, along with all deposits The merger will attempt to capitalize on the complementary strengths of each of the four banks, building synergies and increasing efficiency It is envisaged that the merged institution will purchase Government paper and gradually enter into lending The future owners have not been determined The future of Workers Bank's 14 banking outlets, card center and post office division is unclear Transamerica financial services will implement the recommendations made by McKinsey and approved by FINSAC

Economic decline in Jamaica, high interest rates and the Bank's mismanagement and reckless lending to shareholders and connected parties led to the collapse Profit and loss statements for 1996, 1997 and the first nine months of 1998 reveal interest expense consistently higher than interest income This in part is explained by the high rates of delinquency, which by September 30 1998 reached 94% of the portfolio The Director of Credit Risk for Workers Bank estimates loans to connected parties account for 55%-60% of the portfolio at risk As of September 30, 1998, only two (Half Way Tree and the Western District Post Office) of the 16 operating units/branches operated at a profit 1998 year-to-date losses were J$ 1 6 billion Operating losses were J$ 6 9 billion in 1997 and J$ 439 6 million in 1996

Total assets of Workers Bank were J$ 9 4 billion on June 30 1997 55% (J$ 5 2 billion) were loans By June 30, 1998, total assets were J$ 4 7 billion a 50% decrease in 12 months Loans equaled less than 24% of total assets [1]

To investigate options for the microloan portfolio we analyzed the characteristics and performance of the "small end" of the existing portfolio Approximately 85% of the number (as opposed to value) of outstanding loans in 1997 and 1998 were considered to be small and medium sized As of December 31 1997 Workers Bank had 16 037 loan accounts, totaling J$ 6 53 billion [2] The average loan size outstanding was J$ 406 877 (USD 11 625) If the 20 large loans to financial institutions and the 317 loans which financed large investments in tourism and professional service firms, were backed out of the portfolio, the average loan amount for the remaining 15,700 clients drops to J$ 158 736 (USD 4 535) Nine months later, as of September 30 1998 Workers Bank had 12 056 loan accounts totaling J$ 6 28 billion The average loan size outstanding was J$ 521 080 (USD 14,888) If the 10 large loans to financial institutions and the 197 loans which financed large

1 Information provided by Bank of Jamaica

2 Loan portfolio information was provided by the Director of Credit Risk at Workers Bank for 1996 1997 and the first three months of 1998 This information does not match loan portfolio balances in the draft version of the 1997 audited financial statements

investments in tourism and professional service firms were backed out of the portfolio, the average loan amount for the remaining 11,859 clients drops to J$ 166,114 (USD 4,746)

Closer inspection reveals three important influences on the average size of loans outstanding First, the 2,000 microloan program clients, with average loan size outstanding of J$ 10,000 (USD 305), are included in these figures Second, in many cases, multiple small and medium sized loans were recorded for the same borrower, generally a connected party Finally, about 4,000 loans remain active on the books with a balance of less than J$ 700 (USD 20) Because of discrepancies in calculating interest, Workers Bank has several thousand loans classified as active accounts, while clients believe they have repaid in full It would be more expensive for Workers Bank to try to collect these small balances than to write them off

Customers' deposits remained fairly constant between 1995 and 1997 Savings deposits varied between J$ 1 3 billion and J$ 1 4 billion while other deposits varied between J$ 3 3 billion and J$ 4 1 billion Liabilities including J$ 1 9 billion due to Bank of Jamaica, increased dramatically from 1995 to 1996 Total liabilities doubled from J$2 4 billion in 1995, to J$ 4 4 billion in 1996 Workers Bank received over J$ 2 2 billion from FINSAC in 1997, at a rate of 15% per year This coupled with increased borrowing of J$ 3 8 billion from Bank of Jamaica increased liabilities to J$ 7 3 billion in 1997

Other than its small microloan portfolio little remains in Workers Bank that would fit with the core business of a specialized micro and small business finance company

5. Microfinance at Workers Bank

5 1 The Post Office Division of Workers Bank

5 1 1 Overview
5 1 2 The PO Division's Market Position
5 1 2 1 Products
5 1 2 2 Development of Business
5 1 3 Infrastructure
5 1 4 Financial Aspects
5 1 5 Perspectives

5 2 The Micro Lending Unit

5 2 1 Overview
5 2 2 Current Portfolio Status
5 2 3 Organizational Aspects of Micro Lending Unit Activities
5 2 4 Growth Potential of Micro Lending
5 2 4 1 Implementation Level
5 2 4 2 Design Level
5 2 4 3 Financial Level
5 2 4 4 Summary

5 3 Are Micro Lending and Post Office Savings Complementary Products?

5 Microfinance at Workers Bank

5 1 The Post Office Division of Workers Bank

5 1 1 Overview

Financial institutions require an infrastructure Since maintaining an infrastructure is usually expensive, offering financial services through an existing infrastructure is an attractive option, especially when the aim is to serve broad segments of the population Establishing a branch in every city, town and village is hardly a feasible means of attracting and consolidating small and very small savings deposits The solution which naturally suggests itself is to use an existing infrastructure which already has a broad network through which the financial institution can offer its services And although there is only a limited connection between postal services and modern financial services, the post office infrastructure offers just this kind of network This is the rationale behind post office savings banks

In Jamaica, the tradition of combining postal services with simple savings products dates back to the 19th century Founded in 1870, the *Government Savings Bank* (GSB) collected small and very small savings deposits and invested them in government securities Immediately after the Workers Bank was founded, responsibility for Post Office (PO) Savings was transferred to Workers Bank which took over GSB However, it has continued to use the Post Office infrastructure, i e office space personnel and logistics In return the Post Office receives 3% of the monthly net transaction volume under an agreement that expires in 2001 The PO Savings Division of the Workers Bank has around 70,000 active deposits and a deposit volume of USD 10 million The program offers passbook savings and Partner Savings, a product modeled on ROSCAs, through 246 of the post office's 821

Table 5-1 **PO Savings - Overview**

Period	Deposit Liabilities	Active Accounts	Transactions
	Jamaican dollars in millions	No	No
1995	286 8	91 036	57 062
1996	311 2	83 223	54 260
1997	344 7	81 177	47 439
1998 1)	354 3	74 404	34 932

1) *End of September*

Source Workers Bank

branches Despite the relatively low fees paid to the Post Office, the PO Savings Division of Workers Bank operates at a loss, why is this the case and what can be done to put the PO Division in the black?

The following sections discuss relevant aspects of PO Savings insofar as possible based on the available data, some of which are unsatisfactory

5 1 2 The PO Division's Market Position

5 1 2 1 Products

To reach broad segments of the population via the Post Office network, products must fulfill two criteria

- *First,* the products must be easily comprehensible to the Post Office's customers, who may not be financially sophisticated

- *Second,* the products must also be easy for the staff at Post Office counters to deal with since they are not trained commercial bank employees The same applies to back office tasks It would be inappropriate for example to ask back-office staff to perform complicated interest calculations

Accordingly, the PO Division offers only two main products

- simple passbook savings, the "classic" savings product and
- Partner Savings, a savings plan based on a concept similar to ROSCAs

In addition, the *Gold Stamp Savings Plan* features a life nsurance component This is a relatively minor part of the institution's business and is not discussed in detail here

Simple Passbook Savings

The simplest product is the passbook savings which ensures the safety of depositors' funds A minimum deposit of J$ 50 (less than USD 2) and a photo identification are required to open an account These interest-bearing accounts provide depositors with a product which ensures the safety of their funds Interest at 13% p a is paid twice a year, in March and September [1] The investment income tax is withheld when interest is paid

Interest is paid on the monthly minimum balance This has various effects First, interest cost is lower than the nominal interest rate on average total deposits Second, interest is easy to calculate Third, as a kind of withdrawal fee, it could motivate depositors not to withdraw their funds, except in the period immediately after interest is posted Likewise, it could encourage deposits just before the calculation period begins For this incentive to work, customers would have to know how interest is calculated, which is normally not the case PO Savings, therefore, probably sees this arrangement as a way of keeping capital and administrative costs as low as possible

Postmasters keep only limited cash reserves on hand, and can limit a customer's withdrawal to J$ 2,000 on any given business day Withdrawals of J$ 30 000 or more must be requested approximately a week in advance and the application is forwarded to Workers Bank

This policy on withdrawals may also have helped to protect the PO when rumors were circulating that Workers Bank was illiquid Even if the depositors had wanted to withdraw their funds, it would not have been technically possible On the other hand, the restrictive policy on withdrawals hinders the establishment of long-term relationships with customers who save on a regular basis, steadily increasing their deposits Many customers who have saved around USD 1,000 which is quite feasible in the case of small entrepreneurs or salaried employees with fairly high incomes withdraw their funds and transfer them to a commercial bank – which may be the Workers Bank Restrictions on withdrawals make PO Savings inflexible with limited liquidity and thus less attractive to customers with larger deposits

The overall image of PO Savings tends to limit the potential customer base All Post Office branches with a PO Savings window feature a sign identifying them as agencies of Workers Bank However, customers are hardly aware of the difference From their point of view they are taking their savings to the Post Office not to Workers Bank The Post Office enjoys a good reputation as a reliable institution where funds can be deposited safely without danger of theft or embezzlement On the other hand however dealing with a commercial bank has a prestige value and some good' customers migrate to commercial banks When it comes to savings business the Post Office faces an inherent structural problem which cannot easily be solved what is an advantage from one point of view is a disadvantage in another context

[1] Until 1997 the interest rate on deposits was 15%

Doubts are in order as to whether the passbooks are really a completely safe product There is some question as to how immune they are to fraud, since they do not contain a photo of the account holder and are filled out by hand Classic kinds of fraud such as altering figures (changing a "one" to a "seven," for instance) can easily occur even though the PO Savings Division of Workers Bank insists that fraud is not an issue It is not completely clear how or when the Division could determine that fraud had taken place, as there is no online real-time system that would keep passbook entries and the Division's bookkeeping records consistent at all times There are also no financial printers in use, nor are there plans to acquire any Payment receipts are filled out by hand, mailed to Workers Bank and processed there in batches Depending on how long this takes, significant deviations can arise between the passbook entries and the bookkeeping records Loss of receipts also cannot be ruled out Some post offices give the impression that their archiving and filing methods are not up to modern banking standards

Audits are conducted only in certain areas and are carried out solely by internal auditors from Workers Bank Audits are typically done twice year and are based on spot-checks Therefore, it remains within the realm of possibility that cases of fraud will slip through the rather large gaps in the system of internal controls – all the more so given that postal employees act only as agents of Workers Bank They may feel less loyalty to the Bank than they would to their own institution

Partner Savings Account

In contrast to the simple Passbook Savings account Partner Savings is a savings plan requiring that regular payments be paid in to an account at Workers Bank PO Savings Division This product is modeled after the local ROSCA or partner throw Payments are normally at least J$ 200 per week, the contracts run for 16 24 36 or 48 weeks At the end of the contractual period the customer receives a bonus if all payments as agreed in the contract were made on time If even a single payment was late the bonus is forfeited The amount of the bonus can vary but it is usually equal to a single payment installment

This product is good one for two reasons One, the Partner Savings concept so closely resembles a ROSCA that customers reportedly have the impression that they are participating in a ROSCA Two the Partner Savings concept can easily be turned into a credit product by simply moving up the date of payment of the bonus sum ("early draw") Workers Bank thus offers an elegantly designed savings product which at least in principle, can be transformed into a credit product with little difficulty The product is easy for the customers of the Post Office to understand and easy for the counter staff to administer, meeting criteria mentioned above

From the point of view of the PO Division, the Partner Savings plans offer a whole range of advantages in comparison to classic passbook savings including

- ***Low administrative costs*** Regular, predictable deposits make cash management easier and thus help to reduce administrative costs

- ***Limited potential for fraud*** Because the amounts to be paid in and out are contractually agreed on in advance, there is less room for fraud, even though the Partner Savings plans are administered manually, just like the passbooks

- ***Social control*** If participants are under the impression that they are participating in a ROSCA or partner throw, a failure to comply with the contract implies that they would be harming a partner in the agreement, albeit an anonymous one

- ***Screening*** The illusion of peer monitoring that arises through participation in a fictitious ROSCA makes it possible to use the Partner Savings plan as a kind of screening system to identify persons who would presumably be good credit risks

The bonus payment is not the only feature that makes the product attractive to customers A traditional ROSCA generates transaction costs for participants primarily the compensation for the "banker" in the amount of one draw From the customer's point of view these costs do not arise with a Partner Savings plan – though in reality, there is no free lunch here either The costs are simply less transparent for the customer than they are in the case of a real ROSCA

The bank has only just begun marketing this product It is currently seeking to advertise the advantages of the Partner Savings plan in a simple and readily comprehensible manner (i e through cartoons, etc) Advertising measures are focusing in particular on

- the fact that payments can be made at the nearest Post Office
- the advantages of accumulating a large savings balance which can later be used to make correspondingly large purchases
- the need to make payments on time (usually on Fridays) in order not to lose the entitlement to a bonus

As an additional incentive to participate in a Partner Savings plan all depositors are eligible to take part in a drawing

The various aspects of the Partner Savings product underscore the fact that savings products can be well-designed without being complicated and that it makes sense to incorporate features which are already familiar to the customer In spite of this, the PO Division's market position is relatively weak as demonstrated in the following section

5 1 2 2 Development of Business

The business volume is a reflection of products which PO Savings offers its customers, and of the incentives it relies upon in its operations, as described above Post Office Savings makes a significant contribution toward supplying financial services to broad segments of the population, despite attractive products such as Partner Savings, however, this line of business does not appear to be performing very dynamically PO Savings has 246 outlets, Workers Bank 16 branches PO Savings achieves only 11 4% of the deposit volume mobilized by Workers Bank 16 bank branches attract about eight times the amount of deposits that 246 post offices can The efficiency of the operation must be questioned Has the full potential of the Post Office branch network been realized, or are there still considerable funds that could be tapped with a bigger range of products an infrastructure more attractive to customers, and better service? Or is the potential of the Post Office branch network overestimated?

This question is discussed below in terms of a few key parameters including

- the volume of business
- the number of transactions,
- the number of active accounts
- the net transaction volume

Volume of business

The Post Office Savings operation at Workers Bank has increased its deposit volume every year for the past few years From a level of J$ 287 million in 1995 deposits rose to J$ 345 million in 1997, an increase of 20% It would have taken an increase of 26% however to have simply held the deposit volume constant in real terms In other words deposits dropped by about 5% in real terms The deposit market share of PO Savings is also disappointingly low, at 0 3% The average deposit balance amounted to USD 135, indicating that the high number of accounts does not translate into a large deposit base

Table 5-2 **PO Savings Business Volume**

End-of-period data

Period	Deposit Balances	Change in	
		nominal terms	real terms
	Jamaican dollars in millions	*1995 = 100*	
1995	286 8	100 0	100 0
1996	311 2	108 5	83 0
1997	344 7	117 7	84 0
1998			
March	347 4	118 6	85 7
June	360 2	123 0	87 2
Sep	354 3	121 0	84 1

Source Workers Bank

Number of transactions

The number of transactions has continuously declined in recent years from 63 565 in 1994 to 47,439 in 1997 The number as of September 1998 was 34,932 No advantages accrue from this decline It does not directly help to reduce the fee paid to the Post Office since the calculation is based on amounts rather than the number of transactions carried out, nor does it give any indication that PO Savings' products have become more attractive to its

Table 5-3 **Number of PO Savings Transactions**

Period	Transactions	Change	Transactions per week and outlet
	No	*in %*	*No*
1994	63 565		5 0
1995	57 062	-10 2	4 5
1996	54 260	6 5	4 3
1997	47 439	-12 6	3 8
1998 [1)]	34 932		2 8

1) End of September not annualized
Source Workers Bank

customers Experience elsewhere has shown that a long-term downward trend in transactions can be a sign that an institution is gradually dying because it appeals to an ever smaller number of customers

Active and inactive accounts

The number of active accounts has also declined In 1994, there were 91,709, in 1997 only 81,177 In 1998, the number of accounts fell to 74,404 by September As a general rule, an account that has been dormant for two years or more is closed and the balance transferred to a master account According to Workers Bank, after a recent review, 28,000 accounts with balances totaling J$ 53,425,077 (USD 1 5 million) were closed The average balance in these accounts was about USD 50

<u>Table 5-4</u> **Active PO Savings Accounts**

Period	Accounts	Change	Accounts per PO
	No	*in %*	*No*
1994	91 702	N/A	377
1995	91 036	-0 7	375
1996	83 223	-8 8	342
1997	81 177	-2 4	334
1998			
Mar	80 807	-1 2	333
Jun	73 324	-8 8	302
Sep	74 404	1 4	306

Source Workers Bank

Although inactive accounts might at first glance appear to represent a "free" source of funds, the Bank indirectly pays a price for this liquidity Owners of these accounts may simply not have much interest in using them Experience in other countries indicates that this, not so much the death of account holders, causes the number of inactive accounts to increase The post office savings account opened perhaps while the account holder was still in school, has simply been forgotten

Net transactions

Net transactions are the difference between deposits and withdrawals their volume has increased rather than decreased The volume of net transactions was J$ 76 million in 1995, and J$ 113 million in 1997 The reason for this is that the Post Office Savings Bank is processing more and more third-party payments which now account for two-thirds of all net transactions Ironically, this is in competition with the Post Office itself, which also strives to conclude such agreements with telephone companies, cable TV companies and other firms [2]

Table 5-5 **PO Savings Net Transactions**

Period	Annual Net Transactions	Change
	in millions J$	*In %*
1995	76 4	N/A
1996	80 2	5 3
1997	113 2	41 3
1998 [1)]	160 3	42 0

[1)] End of September not annualized
Source Workers Bank

5 1 3 Infrastructure

Extensive investments in infrastructure would be required to make PO Savings attractive to new customers Investments would involve three areas

- physical infrastructure,
- human resources, and
- installation of modern information technology

Physical infrastructure

The Post Office s physical infrastructure consists of 821 branches Of these 318 are regular post offices (38 7%) 471 are agencies (57 4%) and 32 are sub-agencies" (3 9%) Postal agencies are usually set up in shops and are managed by the shopkeeper alongside the

[2] The Post Office will be able to cover its costs this year mainly because it was able to renegotiate the fee it receives on disbursement of pension payments Increased efficiency has not played a particularly important role here

normal business of the shop Postal agencies are generally not particularly well suited for offering financial services Potential for fraud should be sufficient reason not to use postal agencies as collecting points for savings deposits, even though this might be technically feasible

Security is less of a problem Regular post offices are usually in prominent locations near a market square or a police station, for instance Robbery of postal vehicles has so far remained rare, even when they carry considerable sums of cash But this could be due in part to the fact that few are aware that postal service vehicles also transport cash Also, the Post Office has always sought to minimize the amount of cash that the post offices keep on the premises, the average amount is only J$ 4,000 This could change completely, however, if the range of financial services were expanded and the prior notice requirement for large withdrawals were dropped in order to make PO Savings more attractive to small entrepreneurs

It is widely believed that extensive investments in physical infrastructure will be required if PO Savings is to become more attractive Who should finance improvements? The Post office is highly resistant to doing so for a variety of reasons first because it is striving harder than ever to achieve cost coverage and will make investments only if they are profitable from *its* point of view It is problematic whether it would regard outlays in physical infrastructure improvements of the kind that would benefit PO Savings as profitable because these investments would upgrade infrastructure for use by a third party Why should WB invest in infrastructure that does not belong to it? And depending on which institution paid for infrastructure improvements how would the resulting costs be allocated and precisely how would they be set off against or added to the percentage fees that go to the Post Office? Such questions also arise in regard to human resources

Human resources

PO Savings basically has the staff it needs as an institution offering simple savings products The staff of the PO Division is made up of two subgroups Post Office employees who work at the PO Savings windows, and employees of Workers Bank, who mainly perform accounting functions

The employees at the PO Savings windows are trained to explain the products to interested customers, accept new account applications and assist customers in filling out deposit and withdrawal slips The back-office staff is also trained in basic accounting tasks such as processing incoming payment slips and updating savings passbook entries Specific functions and qualifications can be described as follows

- ***Post Office employees staffing the windows*** In each of the 243 post offices in Workers Bank's PO Savings program a designated cashier is responsible for PO Savings These cashiers also have other duties and are not available during all Post Office opening hours (the windows of Workers Bank close at 2 00 p m) The 47,439 transactions conducted in 1997 works out to an average of 3 7 transactions per cashier per week, each of which takes approximately 10 minutes to execute However, high volumes of transactions go through some post offices, while others conduct very few Thus, there is scope for more aggressive marketing of existing products without having to increase the staff to any appreciable extent Measures to upgrade qualifications would not be required either However, extensive training would be necessary if modern information technology or new products were introduced

- ***Workers Bank accountants*** While all transactions at the counter are carried out by Post Office employees, back office functions are performed centrally by employees of Workers Bank Accounting is handled by a staff of 27, comprising a general manager, two supervisors and two groups of 12 employees each One group processes batches of payment slips, while the other updates savings passbooks Apart from calculating interest to be paid on the savings deposits, they are mainly responsible for ensuring that the bookkeeping records and the passbook entries are in agreement All tasks are performed manually, only data administration is done by computer The employees are accountants with basic qualifications who receive an average salary of USD 560 per month

The PO Division does not have any support staff of its own, but utilizes the personnel and infrastructure of Workers Bank This may limit the capacity to develop new products, marketing strategies or sales channels

Information technology

Modern information technology will be the deciding factor that determines whether attractive savings products can be efficiently administered and offered on a profitable basis There are still major deficiencies in this area The Post Office is not computerized at all, Workers Bank only partially There are no online connections which means manual processing and potential for record-keeping errors and greater need for monitoring and quality control The objection could be raised that the relatively low number of transactions does not justify investment information technology However, without a modern IT system PO Savings will be unable to significantly expand Sooner or later modern IT infrastructure will have to be installed

In view of these points, the infrastructure used by the PO Savings component cannot be regarded as satisfactory In principle it has the potential to become a suitable basis for offering liability-side products however in its current form it is not particularly attractive If PO Savings is to keep existing customers and win new ones serious consideration must be given to upgrading the postal infrastructure

5 1 4 Financial Aspects

The Post Office and WB should be strongly interested in detailed cost accounting to determine whether their respective activities are profitable, but no such detailed accounting has been carried out The problem is most serious for the Post Office which believes that the 3% cess on net transactions is not adequate compensation for the services it provides It estimates that actual costs of the program have been between J$ 33 7 million and J$ 40 3 annually for the past two years The cess paid by Workers Bank to the Post Office is therefore less than 15% of estimated costs

Workers Bank rationalized its accounting for income and costs for the PO Division after 1996 Since 1997, Workers Bank reports income from the savings which are mobilized and the level of costs that are actually incurred in its Profit and Loss Statement for the PO Division (Table 5-6) Workers Bank lacks a clear idea of costs actually incurred by the Post Office, and thus of any subsidy, as claimed by the Post Office

It is possible to estimate costs of the PO Savings program using two assumptions

- ***Assumption 1*** That the profit and loss information on the PO Division provided by the Director of Finance at Workers Bank since 1997 accurately reflects interest income, interest expense and all direct and indirect costs which Workers Bank incurs from the PO Savings Program

- ***Assumption 2*** That the estimated cost allocations of the Postal Savings Program to the Post Office are generally accurate and reflect the true subsidy

According to figures based on these assumptions the PO Savings Division has invariably incurred a loss Even the reduction in the interest rate paid on deposits in 1998 did little to change this situation This is in spite of the fact that the interest rate reduction was apparently motivated mainly by the increasing losses suffered by the PO Division, and did not reflect trends in interest rates Losses may be attributable to low deposit volume and high operating costs The institution reduced interest expenditure by lowering the rate paid on deposits, but the volume of deposits remains too low to cover operating costs

Table 5-6 **Profit Center Report for the Workers Bank Post Office Division**

	(J$ 000) 9/30/98	(J$ 000) 12/31/97	(J$ 000) 12/31/96
Postal Saving Deposit Liabilities	**354,300**	**344,700**	**311,200**
Income			
Institutional Interest	42,080	49,329	-
Other Income	2 170	2 222	4 042
Total Operating Income	**44,250**	**51,551**	**4,042**
Direct Expenses			
Interest Expense on Deposits	40 224	40 480	120 029
Personnel Remuneration	7 396	9 425	11 284
Personnel Benefits	2 851	3 386	3 413
Property Expense	744	508	330
Transport and Communications	2 737	2 666	2 318
Advertising and Promotion	53	108	38
Other Operating Expense	5 791	7 130	5 902
Total Operating Expense	**59,796**	**63,703**	**143,314**
Operating Profit/Loss	**(15,546)**	**(12,152)**	**(139,272)**
Indirect Expenses			
Head Office Expense	-	(912)	-
Current Month/YTD Profit(Loss)	(15 546)	(13 064)	(139 272)
Income from Branches	0	0	-
Budgeted Allocated Costs	(11 990)	(15 986)	-
Net Profit/(Loss) after allocated costs	**(27,536)**	**(29,050)**	**(139,272)**

Notes *Figures provided by the Director of Finance for Workers Bank. Institutional interest is based on deposit balances minus unremunerated required reserves. Institutional interest is the transfer price income received from the rest of Workers Bank.*

The Post Office's Subsidy – An Estimate

In order to ascertain the size of the subsidy the Director of Finance for Post and Telecommunications estimated the costs incurred by the Post Office as a consequence of

PO Savings For this purpose, the Post Office divided operating costs according to a rough estimate of PO Savings' share of the following cost items

- ***Salaries*** It was assumed that 1/8th of total salary costs incurred by the Post Office are attributable to PO Savings activities
- ***Transportation.*** It was assumed that 1/30 of all transportation costs incurred by the Post Office are attributable to PO Savings
- ***Premises*** This item was based on the proportion of the post offices' total floor space actually occupied by PO Savings, i e 1/5 of the total area
- ***Security*** It was assumed that 1/20 of the Post Office's total security bill is attributable to PO Savings
- ***Other costs*** The other types of expense were broken down according to the same ratio as was used for salaries, i e 1/8 was attributed to PO Savings

Table 5-7 shows the results of this calculation Note that the actual costs estimated by the Post Office are not related to the cess which it receives from Workers Bank The cess is based on the net volume of transactions However knowing the estimated size of the subsidy does enable us to estimate the Post Office Division's annual operating losses if it used its own resources to fully cover the estimated costs incurred by the Post Office

Table 5-7 **Estimated Allocation of Cost to PO Savings**

Item	Business Year	
	1996/1997	1997/1998
	in million J$	
Salaries	27 00	33 00
Tansportation	3 72	4 47
Pemises	0 76	0 60
Security	0 73	0 50
Utilities	1 50	1 73
TOTAL	33 71	40 29
Average Cess	5 72	5 72
Implicit Subsidy	27 99	34 57

Note The cess used in this table is based on the annualized monthly cess paid
Source Senior Director of Finance Post and Telecommunications

The Post Office Savings operation as a whole is in the red When price adjustments are no longer enough to move operations out of the red, there is a structural problem which can only be solved by structural measures For PO Savings, this means that the volume of deposits must be substantially increased in order to break even This is hardly possible given the current institutional structure Processes are not efficient and there are no clear incentives for the Post Office to strive for a rapid expansion of the volume of deposits Marketing activities and distribution channels would also have to be radically overhauled to attract more savers and more savings In addition, appropriate and secure uses for deposits need to be identified that provide sufficient interest income to cover the costs of the program

5 1 5 Perspectives

If PO Savings is to fulfill its declared mission major investments will be required at all levels

- ***Marketing*** PO Savings products must be aggressively marketed
- ***Organization.*** If the volume of deposits is to be increased, the technical and organizational prerequisites must be established for managing many times the current number of accounts There will also be a major increase in the need for quality control if the number of accounts is doubled or tripled PO Savings will also have to deploy modern software, including an online connection linking the branches to a central server
- ***Ownership*** The current ownership structure contains conflicts of interest between the Post Office Savings Bank and the Post Office Incentive-compatible solutions can therefore only be realized if the ownership structure is unified and control rights are consolidated and vested in a single entity or body

5 2 The Micro Lending Unit

5 2 1 Overview

The Micro Lending Unit (MLU) is the result of joint efforts by Workers Bank and USAID to provide micro entrepreneurs with access to loans The first cooperative agreement was signed in March 1995 and stated that USAID would support a microfinance program through the Post Office network The Microlending Unit within Workers Bank was set up 12 months later In October 1996, credit operations were initiated in five post offices In August and September 1997, lending was temporarily suspended so that the program could focus on collecting loans in arrears The arrears rate (portfolio at risk > 7 days) had remained at 10% for months climbing to 12% in July In spite of the temporary suspension there were six loan officers and 669 active clients by the end of the year with a total outstanding portfolio of J$ 8 million In February 1998, the Minister of Finance suspended all lending by Workers Bank because of solvency problems and mismanagement After lobbying by USAID and other interested parties demonstrating that the MLU was performing well, it was permitted to resume lending in April While the general credit activities of Workers Bank remain paralyzed until the merger of four problem banks is completed, MLU operations continue to grow In September 1998, it had more than 2,000 customers and 11 loan officers

5 2 2 Current Portfolio Status

The activities of the Micro Lending Unit in its present form got underway at the beginning of 1997 Prior to this, no consistent microloan program existed at Workers Bank Since January 1997 productivity has been greatly increased by making use of external advisory services The program has been able to build up a considerable portfolio in terms of number and outstanding loan balances, given its infrastructure and number of personnel (Table 5 8) The results appear even more remarkable when one considers that the program has twice had to stop lending completely The arrears rate has been kept fairly stable at a moderate level Only when lending halted did the arrears rate rise to a level which was cause for concern (Table 5-9) The increase in number of accounts in arrears reflects the tendency for arrears to occur late in the installment schedule

Table 5-8 **Key MLU Productivity Data**

	Jan 1997	Jun 1997	Dec 1997	Sept 1998
Number of outstanding loans	131	708	1 406	2 083
Outstanding loans (net) (J$ millions)	1 288	7 771	18 540	20 935
Average outstanding loan balance (J$)	9 832	10 976	13 186	10 050
Loans disbursed per month	54	387	484	402
Volume of loans disbursed per month (J$ 000)	735	5 653	9 040	8 280
Average loan amount disbursed (J$)	13 611	14 607	18 678	20 597
Loan Officers (LOs)	3	11	11	11
Loans disbursed per month per LO	18	35	44	37
Volume of loans disbursed per month per LO (J$ 000)	245	514	822	753
Loans outstanding per LO	44	64	128	189
Outstanding loan balances per LO (J$ 000)	429	706	1 685	1 903

Source MBU

Table 5 9 **Portfolio at Risk**

Month	*Year*	*Portfolio at risk (>7 days) / net loan portfolio (%)*	*Portfolio at risk (> 7 days) (J$)*	*No of accounts at risk*	*No of accounts at risk Total no of accounts (%)*
Jan	1997	2 75	35,488	8	6 12
Feb		6 07	102,506	15	8 72
March		9 29	182 682	23	11 28
April		7 57	182 682	23	8 46
May		8 13	283 148	48	13 33
June		5 95	462 075	80	11 30
July		7 02	756 254	104	9 63
August*		11 84	944 191	140	15 04
Sept*		17 42	846 182	139	17 46
Oct		5 53	429 670	117	14 01
Nov		2 46	381 875	136	11 88
Dec		2 36	436 820	119	8 5
Jan	1998	4 76	864 750	285	16 86
Feb*		5 93	1 071 610	374	20 46
March*		13 09	1 421 232	454	28 18
April*		15 18	1 418 762	430	39 02
May		8 54	1 350 483	390	30 12
June		6 73	1 203 579	348	25 70
July		4 14	975 713	319	18 62
August		5 54	1 227 951	436	22 00
Sept		6 46	1 353 197	514	24 68

* *Lending was suspended*
Source MBU

5 2 3 Organizational Aspects of Micro Lending Unit Activities

Micro Lending Unit

The organizational structure of the MLU is very decentralized Its head office is in Workers Bank headquarters in Kingston, but no business is done there Lending takes place through 13 locations – 12 post offices and one Workers Bank branch located in a Post Office building These locations are all in three population clusters Ewarton Spanish Town and Western District In the Ewarton cluster three loan officers are responsible for the operations at six post offices in Spanish Town five loan officers are responsible for the operations at six post offices, and Western District has a hybrid Post Office/Workers Bank branch with two loan officers

The loan officers must therefore travel a great deal Each has a laptop computer in which he or she enters all loan and customer data Data are forwarded to the main office in Kingston once a week for consolidation Monitoring is done by the operations manager and two supervisors

Lending

MLU's credit product is The Early Draw Partner Plan, named in reference to the popular local ROSCA, or partner throw The idea behind this was to give customers the impression that they were participating in a very large partner throw Borrowers could feel that they had received the first "pay-out" in the partner throw cycle To offer a complementary savings vehicle, Workers Bank added The Partner Savings Plan soon after the Early Draw Partner Plan began

Although the Early Draw Partner Plan is a familiar concept which can be easily communicated to customers, the program is essentially classic microcredit Borrowers pay back principal and interest in equal weekly installments Various combinations of the credit amount and maturity, and thus of installments, are available, but like most ROSCAs, cannot be further tailored precisely to suit the borrower's preferences

Table 5-10 **Loan Amounts and Maturities Offered**

Maturity in weeks	**10**		**20**		**30**		**40**	
Loan amounts offered (J$000)	5 000	10 000	5 000	10 000	7 500	9 000	5 000	10 000
	15 000	20 000	15 000	20 000	12 000	15 000	15 000	20 000
	25 000	30 000	25 000	30 000	21 000	27 000	25 000	30 000
	35 000	40 000	35 000	40 000	30 000	36 000	35 000	40 000
	45 000	50 000	45 000	50 000	45 000	60 000	45 000	50 000
	60 000	70 000	60 000	70 000	90 000		60 000	70 000
	80 000	100 000	80 000	100 000	120 000		80 000	100 000
	120 000		120 000				120 000	

Source MLU

The conditions for the maximum credit amount and maturity of the first loan and even of repeat loans thereafter, are relatively inflexible

Table 5-11 **Maximum Loan Parameters**

Loan	*Maximum term (weeks)*	*Maximum amount (J$)*
1st	20	20 000
2nd	20	30 000
3rd	30	60 000
4th	30	80 000
5th	40	100 000
6th	40	120 000

Source MBU

Interest at 1% per week is calculated on the basis of the initial loan amount not on the declining balance This translates into an effective compounded weekly interest rate of 1 8%, a monthly effective interest rate of 7 4% and a yearly effective interest rate of about 135% This cost calculation does not take into account the savings of the borrowers, a calculation applied to microfinance institutions with compulsory savings Even though the program does not contain a compulsory savings component all borrowers maintain a savings account, most of them opening it when submitting their loan application Strong recommendation to save under the partner savings plan is given by loan officers which gives these savings something of a mandatory flavor "Persons wishing to start new business ventures should be encouraged to save under the partner savings plan for their needs "[3]

Micro entrepreneurs applying for a loan must meet the following criteria

"The profile of those eligible to participate is as follows

Those persons who

- have been involved in a profitable business activity for at least one year
- are at least 18 years of age or older,
- have had an established business in the community served by the post office where they will join the plan for at least three years
- A minimum of three credit references will be required (from banker of a partner group, supplier regular savings deposits utility bills proof of regular hire purchase or other credit repayments life insurance premiums paid etc) "[4]

[3] Partner Early Draw Bankers Operations & Procedures Manual

[4] Partner Early Draw Bankers Operations & Procedures Manual

Satisfied customers advertise the credit program by word of mouth So far, the MLU has promoted the program only when lending opens at a new post office Loan officers then visit nearby marketplaces and speak to potential customers directly After a customer has asked about a loan, the first step is usually a talk with the postmistress as a form of pre-application Information is gathered about the applicant's reason for applying and previous involvement in partner plans A form is filled out on the basis of the discussion and forwarded to the loan officer responsible, who then visits the applicant at his/her place of business and carries out the first interview This interview is the basis for filling out the Early Draw Partner Application, which provides a thorough analysis of the applicant's economic situation and includes the loan officer's assessment of the applicant's personal and social situation The potential customer's ability to repay is calculated on this basis Once the customer data has been prepared and the loan officer has recommended the loan, a credit committee or decision-making committee meets, with the loan officer and the unit manager taking part (One of the two supervisors was recently authorized to participate in loan approval as well)

All loans are collateralized All kinds of household objects are accepted preference is given to objects that can be easily transported in case of loan recovery At the time the loan is approved, the customer signs a Bill of Sale allowing MLU access to the collateral

Loans approved are disbursed at the Post Office on a specified date repayments must also be made on a certain day of the week Every Post Office has one or two payment days a week, and the customer must arrange to make payments on one of these days In other words, the MLU does not fully adapt itself to the customer's payment preferences

A credit record is kept for each customer facilitating quick processing of repeat loans

Table 5-12 **Eligibility Criteria for Repeat Loans**

Term of previous loan	*Allowable no of late payments*
10	1
20	2
30	3
40	4

Source MLU

The procedures that loan officers are to carry out as soon as a customer fails to repay on the due date are as follows

Table 5-13 **Follow-up Procedures – Delinquent Clients**

Term	*Procedure*
1 day	Telephone call / visit
3 days	Written letter
6 days	Supervisor visit
2 misses	Warning letter
3 misses	Name posted in Post Office
4 misses	Bailiff letter sent
5 misses	Assets seized

Source MLU

The MLU describes its methodology as

- Small incremental loans
- Simplified application process
- Emphasis on borrower character
- Rapid processing and disbursement
- Rapid response to late/missed repayments

Financial Situation of the Micro Lending Unit

The MLU has calculated its costs since the start of 1998 The financial results have mainly been negative, with high operating cost to average outstanding portfolio, which is an efficiency indicator In 1998 these costs averaged more than 70% annualized, declining from 76% in January 1998 to 63% in August 1998 Mature microfinance institutions can reach operating cost to average outstanding portfolio of about 20%

Table 5-14 **Income Statement Of Workers Bank Micro Lending Unit**

(January – August 1998 in J$)

1998	*Jan*	*Feb*	*March*	*Apr*	*May*	*June*	*July*	*Aug*	*Total*
Interest Income									
Interest collected	1 354 904	935 428	1 342 450	875 729	799 374	1 041 018	1 299 579	1 492 636	9 1141 218
Cost of funds	196 178	179,632	140 511	107,957	134 438	180,042	221,390	244,204	1 404 354
Gross Profit Margin	**1,158,725**	**755,796**	**1,281,840**	**767,772**	**664,936**	**850 976**	**1 078,289**	**1,248,432**	**7,736,864**
Direct Expenses									
Salaries	242 000	210 000	180 000	180 000	170 000	220 000	220 000	220 000	1 642 000
Travel	70 500	64 500	58 500	58 500	58 500	77 025	77 025	77 025	541 975
Lunch & Duty	0	0	0	0	0	11 850	11 850	11 850	35 550
Incentive	86 295	47 981	34 966	14 450	8 681	47 124	76 087	101 653	417,237
Net income I*	**759,930**	**433,315**	**928,474**	**514,822**	**427,754**	**504 977**	**893,327**	**837,904**	**3,100,502**
Head office salaries	275 000	275 000	275 000	275 000	275 000	275 000	275 000	275 000	2 200 000
Salaries - Super-visors	73 758	73 758	73 758	73 758	73 758	73 758	73 758	73 758	590 064
Salaries – administrative assistants	34 166	34 166	34 166	34 166	34 166	34 166	34 166	34 166	273 328
Post office cess	243 982	177 809	251 317	160 835	137 453	176 693	230 558	274 116	1 652 765
Depreciation	36 162	36 162	36 162	36 162	36 162	36 162	36 162	36 162	289,296
Overhead expenses	100 000	100 000	100 000	100 000	100 000	100 000	100 000	100 000	800 000
Net Income II**	**(3,138)**	**(253 580)**	**158,071**	**(165 100)**	**(228,785)**	**(150 803)**	**(56 918)**	**44 701**	**(704,951)**
Loan Loss Provision	90 279	83 006	67 170	54 162	64 191	81 975	122 516	135 484	698 783
Total expenses	1 448 321	1 282 014	1 251 549	1 094 990	1 092 350	1 313 796	1 478 513	1 583 419	10 544 991
Net operating profit/loss	**(93,418)**	**(348,586)**	**90,902**	**(219,761)**	**(292 976)**	**(272,778)**	**(178 834)**	**(50,783)**	**(1,409,734)**
USAID opera-tional grant	125 000	125 000	125 000	125 000	125 000	185 000	185 000	185 000	1 180 000
Net profit/loss	**31 582**	**(221,586)**	**215 902**	**(94 261)**	**(167,976)**	**(87 778)**	**6 166**	**94 217**	**(223,734)**

* net income after direct expenses
** net income after overhead expenses
Source MLU

5 2 4 Growth Potential of Micro Lending

The Workers Bank Micro Lending Unit is remarkable In spite of difficult conditions, it has managed to build a portfolio which reached a considerable size within 18 months It has demonstrated repeatedly that delinquency can be brought under control when necessary MLU employees are dedicated and have developed an extremely good understanding of the problems and challenges of microlending USAID plays an active supporting role, shows strong interest and thus creates valuable incentives that are lacking in many other programs The program is definitely a success within its context

The question to be addressed is related to the program's future The following section of the study seeks to assess the growth potential of the program in its current form at three different levels

- The level at which the credit technology is applied – implementation level
- The level at which the program concept is developed – design level
- The level of the program's cost and revenue structures – financial level

5 2 4 1 Implementation level

The MLU's main problem is without question the lack of an adequate MIS which could support lending operations and make it possible to generate customer data and credit histories at any time The following typical problems are all more or less an outgrowth of this technical deficiency

The lack of daily documentation on the delinquency rate and other indicators and the lack of mechanisms to draw loan officers' attention to their delinquency cases leads, in turn, to the use of follow-up procedures which in some cases are ineffective The fact that a large number of borrowers are in arrears reflects this problem which was often solved by rescheduling and which probably would not have been done so often if an effective MIS were in place

Another problem area is the productivity of some loan officers (LOs) even after they have been in the program a long time Clearly defined targets and regular performance assessments could give the loan officers a clearer picture of the quality of their work If goals are not achieved it might be a good idea to review the staffing situation A closely related issue is the incentive system according to which LOs are paid The system is apparently not completely fulfilling its function so it may be worth considering a revision of the formula by which bonuses are computed

Having outlined the basic problems in terms of the MIS and loan officer productivity we will not go into any detail on specific deficiencies MLU is aware of the problems and has prepared a detailed study Solutions to these problems at the implementation level can and should be found in the course of day-to-day project work

5.2.4 2 Design level

It is very important to address problems at the design level at the outset, because what happens at this level sets the course for the development of the portfolio

Some of the problems in design are closely related to the way the MLU is institutionally linked to WB, which restricts access to loanable funds and leaves MLU not entirely free to make personnel decisions But internal cost accounting is perhaps the most serious problem at this level Because of joint products and significant overheads it is extremely difficult to make a precise cost calculation in a bank the size of Workers Bank It is nearly impossible to allocate all costs to individual departments where they were incurred The cost calculations undertaken by the MLU are thus very imprecise In addition given the institutional setting in which the program operates there will always be differences of opinion regarding, for example, the cost of funds It is to be hoped that the institutional framework in which the MLU will operate in the future can be designed to minimize problems of this kind

In addition, there is a significant need to improve the MLU

- ***organization of supervision*** Supervisors' duties apparently do not include supervising the day-to-day work Loan officers do not have a direct superior who is responsible for them and to whom they report This is a weakness in the organizational structure

- ***organization of internal control functions*** There are no established procedures for internal control and no staff assigned to the internal control function For a portfolio the size of MLU's and given its very decentralized organizational structure this position should have been filled long ago

- ***design of the range of credit products*** Credit products are kept relatively inflexible in the interests of simplicity, meaning that they can be adjusted to individual customers only within very strict limits The relatively low initial loan amounts compel even successful entrepreneurs to accept only small loans and short maturities, although successful entrepreneurs in particular seek very flexible financial services Loan amounts, maturities and the size of installments should be adapted to individual borrowers and their enterprises An appropriate MIS should help to reduce this problem

- ***organization of loan officer training*** Loan officers need to be trained much more intensively, particularly in the beginning during the trainee phase Training should be geared more toward producing bank employees, with less emphasis on communicating the vision of microfinance and the specifics of micro credit, and more on grooming self-confident credit experts

- ***organization of lending through post office branches*** Section 5 3 addresses problems associated with the infrastructure and the geographic distribution of credit extension activities It explains why the current approach of providing loans through post office branches is inappropriate given the nature of micro credit and therefore greatly hinders the growth of the program

5 2 4 3 Financial level

The fact that MLU is not profitable can be explained by its low outreach and relatively low productivity, this is typical for any micro loan program after two years There are other factors, however, which should have led to better cost coverage

- At an effective rate of 130% p a sub-borrower interest rates are high particularly in relation to the costs of funds which is 13% p a [5]

- MLU receives a monthly operational grant from USAID in addition to technical assistance by international expert consultants and documentation work done within the USAID office

- The cost calculation omits some expenses For example the MLU does not pay any rent The share of overheads to be paid to Workers Bank is not as high as the costs that an independent microfinance institution would bear

- The 13% p a interest cost of funds do not take into account the administrative costs of funds received from the Post Office Savings System However loanable funds at 13% in local currency can be considered cheap

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[5] See Workers Bank Micro Lending Unit Illustrative Revenue & Expense Sheet (as of January – August 1998)

The question is whether full cost coverage could be achieved in the near future, and if not, which parameters would need to be substantially changed It is clear that economies of scale with a higher number of active clients will generate a higher interest income Usually they also permit higher efficiency and productivity for the whole lending program In order to allow these efficiency gains to arise, expansion is required The program does not yet seem able to achieve cost coverage in the near future

5 2 4 4 Summary

The consultants feel that all of the problems discussed above should be addressed before the program begins a new period of expansion

In May 1998, projections were prepared by MLU and they were presented again in September 1998 According to these projections two years after the expansion phase, 26,831 active clients (net portfolio J$ 384 million) are to be served by 75 loan officers The projections appear unrealistically optimistic, and the institution should not attempt to reach the objectives set in the projections within the time frame defined

The prerequisites for doing so have not been established at the levels discussed above and the requisite preparations have most certainly not been made at the institutional level, which must be given top priority The question of the MLU's future institutional 'home" should be addressed first Not only must the question of a new ownership structure and a new institutional framework be resolved the MLU should be supported by long-term consultants who will work with its staff to address the other problem areas and lay the groundwork for stable and successful growth

Here it seems appropriate to quote the results of an analysis conducted by an unassociated mission which took place during the summer of 1998 and thoroughly evaluated the program at the implementation level We fully agree with its main findings

> "Expansion should not take place until all key aspects to program implementation have been developed tested and adjusted accordingly Expansion must take place at a pace that enables the organization to keep control and ensure quality of the services If any problems or potential problems exist they must be solved prior to expansion of the program "

5 3 Are Micro Lending and Post Office Savings Complementary Products ?

The decision to link the MLU to the Post Office Savings System of Workers Bank was based on the idea that the similarities of the two programs would give rise to substantial synergies on a variety of levels Over time, it has become apparent that the two components are so different that forcing them to co-exist in the same institutional framework could be detrimental to the credit program, which has grown quite rapidly An analysis of the two components, presented previously, clearly shows why the two types of product are too heterogeneous to be marketed jointly via the post offices The synergy arguments can be summed up, and refuted, as follows

- *Hypothesis 1* **The Partner Throw (ROSCA) can be used as a model from which to derive both credit products and savings products, to Jamaicans, they will appear to be two sides of the same coin Thus, the two programs serve much the same target group**

There are 80,000 savers and only 2 000 borrowers It is highly unlikely that more than 20% of the current savers are potential borrowers Many borrowers begin to save only at the time that they receive their first loan, in many cases, though not actually reluctant to save they only begin to do after having been urged to open a deposit account by MLU staff At a rough estimate, Jamaica has approximately 40 000 potential micro credit customers altogether (an estimate also used by Workers Bank) thus, the vast majority of Post Office Savings customers will never make use of the microcredit facilities Thus whether the potential of the ROSCA model is tapped to develop "accompanying credit products is irrelevant from the point of view of this very large group of savings customers As for borrowers, it is doubtful whether they would regard relatively inflexible PO products as ideal Experience in many countries has shown that entrepreneurs regardless of the size of their businesses, are quite able to understand what loans are and how the lending process works By definition, they will be the kind of people who know what credit is and why they want it Linking the two products is an interesting marketing element but probably contributes little to making the concept of loans more comprehensible

- *Hypothesis 2* **Post Office premises can be used because a) the Post Office has available capacity, thus saving costs, b) savings products and loans can be processed in the same place, c) broad segments of the population can be reached through the extensive branch network**

The quality of post office premises is such that many need renovation The need is all the more urgent if expansion of the credit portfolio would lead to an increase in the number and volume of transactions These post offices require adequate security systems improved logistics for cash movements and adequate equipment and infrastructure Processing savings products manually may be still be feasible over the medium term but the credit portfolio will quickly reach a point where it cannot continue to grow if data entry and information flows are not automated as part of an MIS

It would take a great deal of work to make post offices appropriate for lending operations The MLU has no legal right to order or carry out modernization and renovation in these buildings, given that they are either owned by the Post Office or other parties In many cases, the buildings would not be suitable even after renovation, because they are not large enough to accommodate an efficient lending business

- ***Hypothesis 3*** **Post Office staff can perform some of the tasks arising in connection with lending**

How many employees that have been selling stamps are likely to be able to switch to offering complex financial services? This arrangement may work for simple savings products, however, trained specialized employees are required when it comes to offering complex credit products Loan officers' duties are a full-time job that cannot be handled on the side by postal clerks

Postal employees could be used to disburse funds and accept payment installments They would basically be qualified to do so but whether it would be worthwhile to make the time and effort to negotiate a suitable agreement with the Post Office is unknown Reports of carelessness and irregularities in the post offices also make this seem rather unattractive

- ***Hypothesis 4*** **The micro credit program can benefit from the reputation of the Post Office, which stands for security and trustworthiness**

The fact that many Post Office savings customers tend to switch to a commercial bank when they have accumulated enough funds to enable them do so illustrates the problem Apparently, the Post Office has a very good reputation as a post office but this is not to say that it matches most people's image of a financial institution carrying out sophisticated financial transactions Microlending operations may be geared to promoting institution building in the abstract sense of "institutional development but the impact of physical "institution building" should not be underestimated either Small entrepreneurs have a clear image of a bank in their minds just as other people do Anyone wishing to establish formal banks for this informal target group should also try to ensure that the institution actually looks something like the image they have of banks while providing services that are very user-friendly One of the long-term goals, after all is to initiate growth by means of loans and to make the customers "bankable" in the classic sense

- ***Hypothesis 5*** **Cheap funds can be obtained in the form of small deposits**

Attracting small savings deposits generates considerable administrative costs because a large number of accounts must be managed This can make it more expensive to collect small and very small deposits than it is to borrow on the interbank market To put it another way If this were a cost-effective way to acquire liquidity banks would be much less reluctant to serve small and very small savers The primary reason banks do not make much of an effort to serve this market is because mobilizing small and very small deposits is too expensive

The argument that collecting small and very small savings deposits is attractive when there is an existing infrastructure for doing so, as in the case of the Post Office, is also not terribly convincing Will the onlending funds still be so cheap if the Post Office Savings Bank bears all the costs incurred in acquiring these funds? While the Post Office may be pleased to offer services to Workers Bank to recover some portion of its otherwise fixed costs through its present 3% cess on net transactions, it would also have the incentive to raise the cess if these transactions became more numerous and raised its variable costs Likewise, if better costing techniques were applied, the Post Office could press for renegotiation of the cess, which could also be triggered by changes in the Post Office's perception of the lender's opportunity costs In any case, the assertion that small and very small deposits – even if collected through the Post Office network – are a cheap source of funds cannot remain unchallenged mobilizing such deposits is usually quite expensive if due consideration is given to all of the costs of doing go

➢ ***Hypothesis 6*** **Using the post offices saves costs on a significant scale**

Just as there are no precise data available on the precise costs incurred in the operation of the Post Office Savings System, the costs that would be entailed in lending via the post offices have never been calculated Nonetheless, it is clear that the cess does not adequately reflect the costs that are actually generated The current system is based on subsidization of the credit component by the Post Office, as the costs incurred have not been made transparent This might be a legitimate procedure for a nationwide system of postal savings banks, since the mobilization of small savings deposits has an important economic and political function From this point of view, the postal savings system could be considered a kind of "public good" In the case of micro credit, this argument does not apply Micro credit can be organized in such a way that it covers its costs This means that microlending should be conducted as a business by a private enterprise that bears all of the resulting costs on the basis of transparent cost accounting

6. *Institution Building*

6 Institution Building

6 1 Options

What are the available institutional options for sustainable, commercial microfinance in view of the declining economy, reorganization of WB and the troubled state of the Jamaican financial system? What sort of institutional arrangements should be made to accommodate a quite sound existing microloan portfolio and a Post Office Savings System which could have strong growth potential if certain conditions are met?

Potential solutions arise from the problems that provide the background for the present study These problems can be summed up by asking the following questions

- What will be the future role and status of the owner of the microloan portfolio, i e Union Bank as the presumed legal successor of Workers Bank?
- What will be the future role and status of the Post Office Savings component, which can contribute to Jamaica's economic development?
- What will be the future role and status of an efficient credit program which gives micro and small enterprises lasting access to external finance?

These questions are closely linked Workers Bank was established to provide a single source of credit and savings products for low-income people It proved unable to carry out its assigned task in either strategic or economic terms The microloan component was not developed by the bank itself, but rather introduced at the initiative of a donor institution which also supported it financially In addition, little effort was made by Workers Bank to exploit the potential of Post Office Savings

Three realistic options are outlined and discussed regarding finding a new institutional "home" for both of the microfinance components These were selected from a larger field because they appear to be sufficiently practicable to be worth discussing

When considering which of these options to implement, the principal criterion should be whether it would provide a sustainable solution, making a long-term contribution to growth and development How can low income Jamaicans have lasting access to formal financial services? The options may be summed up as follows

- **Option I - Do nothing** Leave the Workers Bank PO Savings and microloan program at Union Bank, its successor,
- **Option II – Spin off and combine** Spin off both PO Savings and the microloan program, integrating both into a new financial institution which would have to be established,

- **Option III – Spin off microcredit** Spin off the microloan program into a specialized financial institution, separate from any institutional solution for PO Savings

The following section describes these options in sequence

6 1 1 *Option I Do nothing - Leave things as they are*

The first scenario implies that

- the microloan program <u>and</u>
- PO Savings

will be integrated into Union Bank What would be the implications for Union Bank, Post Office Savings and the microloan portfolio?

- ***Union Bank*** It is not clear whether maintaining the status quo would have more than marginal consequences for Union Bank Will the future owners and managers be committed or even remotely interested in supporting microloan activities or postal savings? A critical prerequisite for successful "downscaling" by a commercial bank is the complete support of the owners and managers

- In contrast to the situation at Workers Bank, both components should be fully integrated into the organizational structure of Union Bank It is very doubtful that this will happen, however, since as far as can be ascertained, Union Bank will initially focus on the purchase of government securities, and will take a very cautious attitude towards lending Efforts to persuade banks in other countries to make microfinance products an integral part of their business has shown that it is not always possible to exert sufficient influence to ensure the long-term success of micro savings and micro loan components

- The costs and hence the financial viability of the microloan division and the Post Office Savings System cannot be made completely transparent, since the bank would also be active in other fields It would take detailed cost accounting of a kind which is hardly feasible at commercial banks to prove to the owners and managers of the partner institution that the small and micro enterprise credit business generates a positive contribution margin, a point which created problems at Workers Bank Neither of the "micro components" is currently profitable, both would require further subsidy The support of the new owners and management would be absolutely essential to ensure that the necessary funds and personnel were provided to enable both programs to expand In regard to personnel, support would mean bringing in external specialists, since neither line of business falls within the realm of "normal" banking know-how In regard to PO Savings, would Union Bank be able and willing to make the extensive investments required to bring the facilities at the Post Office branches up to the banking standards? Since it is a branch network owned by a different institution, Union Bank would have good reasons not to be very willing to invest here

- ***PO Savings*** For PO Savings, the option of leaving things as they are would probably continue its "orphan" status The poor condition of the infrastructure would not allow for strong expansion, neither selling more new products nor attracting new customers in other ways are likely without extensive investment An additional factor is that the agreement with the Post Office as it currently stands may not be particularly attractive for the Post Office Since the Post Office is changing its orientation and striving to cover costs, it will insist sooner or later on revising Workers Bank agreement with Union Bank This adds a further element of uncertainty to the arrangement Therefore, PO Savings will not quickly develop into a dynamic line of business as a part of Union Bank It is more probable that PO Savings will continue to operate at a loss, with its customer base continuing to shrink and the unexploited potential remaining untapped PO Savings would not turn out to be a cheap a source of liquidity if the new bank simply continued to operate the savings service but did little or nothing to upgrade it

- ***Microloan Portfolio*** The future of the microloan portfolio is also highly uncertain In theory, it would seem possible to build up a microloan program to become an integral component of the bank's business However, plans to do so could fail to gain much support within the institution, since micro credit is widely seen as a very risky business which cannot be run on commercial lines Although this view is unjustified, it could take a great deal of persuasion to convince the new owners and management of the bank that micro credit should become a major line of business This reluctance is further underscored by remarks of the present management of WB to the effect that prudence requires that microloans not exceed 1% of total assets which means that economies of scale necessary in order to attain profitability could not be realized Micro lending would continue to be dependent on subsidies, which would discourage other potential lenders from entering the market, with adverse consequences for the micro market as a whole

The foregoing does not mean to suggest that this first option could not be successfully implemented The point is simply that the risks associated with this option are considerable, because all of the key parameters would be set by third parties, and it is by no means clear who they will be or how they will choose to act At the same time, even though leaving things as they are would instinctively seem to be the simplest course of action paradoxically the option of maintaining the status quo would in fact be highly complex However, the situation will inevitably change, and it is not yet clear who will set the parameters Uncertainty makes this option relatively unattractive

6 1 2 *Option II Spin off and combine PO Savings and microlending*

Bearing in mind the disadvantages of the first option, it would seem to make sense to remove both Workers Bank microfinance components from Union Bank and integrate

- PO Savings <u>and</u>
- the microloan portfolio

into a new microfinance institution, preferably a full-service banking operation to be built from scratch What would be the consequences of this option for Union Bank, PO Savings and the microloan portfolio?

- ***Union Bank*** would be relieved of the burden of having to subsidize both microfinance components and could concentrate all of its resources on the task of strategic reorientation However a precondition would be Union Bank's willingness to divest these operations on reasonable terms to the new institution Deposits mobilized at PO branches, which account for more than 10% of total deposits mobilized by Workers Bank, would not be available to Union Bank

- ***PO Savings*** would become an organizational division of a new bank Nonetheless, it would retain its links with the Post Office and continue to operate at a loss For a newly founded microfinance institution, the inefficient and comparatively expensive business of collecting small and very small savings deposits could become a burden It is also debatable whether such an institution would be willing or have the resources available to invest in a branch infrastructure that is not its own Furthermore, the issue of payment for the services provided by the Post Office also gives rise to considerable uncertainty The Post Office might be willing to extend the present contracts, but sooner or later the terms on which the new institution used the services of the Post Office would have to be renegotiated We therefore cannot rule out the possibility that the new institution would incur additional costs from a more expensive package of fees and investment commitments, and that these costs would be passed on to borrowers in the form of higher interest rates

- ***Microloan Portfolio*** The consequences for the microloan portfolio would be positive In a new institution, the microcredit component would be subject to the strategies of a "regular bank" The new entity could develop its core product and raise the productivity of loan officers, thereby overcoming constraints faced by the program in its current form The main risk would be on the funding side, because of uncertainty as to whether and to what extent the Post Office would drive a harder bargain and increase costs to the program

The new institution would be in the same trap as the present program having to reconcile two lines of business that differ from each other in almost every respect As explained in the preceding section of this study, there are virtually no potential synergies between the microloan component and the Post Office Savings System The new institution would face the difficult task of exploiting the potential of two currently unprofitable components This would presuppose the acquisition of two completely different forms of expertise, and more than double the size of the required investment The result would be an institution that was effectively split down the middle

Yet another issue is financial structure Presently there is less than USD 1 million in the microloan portfolio and USD 10 million in PO Savings deposit liabilities The institution would need to attract equity investment of J$ 75 million (USD 2 million) to qualify for a banking license It may be difficult to attract investment for a program that is this complex that is completely dependent on future relationships, contracts and costs dictated by the Post Office, and that is presently losing money

Thus, the second option is also problematic Moreover, this would be the second attempt to implement such a solution The first was the founding of Workers Bank in 1974, to achieve precisely what has been described here under option II, integration of PO Savings and a credit operation geared to low-income groups within a single financial institution This objective was never realized Workers Bank took almost 20 years to become profitable and then collapsed, the bank's management never made development of the small business lending operation or the mobilization of savings via Post Office branches a priority to the extent intended when the bank was initially set up The first attempt failed, how successful could the second be?

6 1 3 *Option III Spin off the microloan program into a specialized financial institution*

In light of the aforementioned difficulties, the third option proceeds from the assumption that there is no single present solution that can deal simultaneously with the problems faced in all three areas Union Bank, PO Savings and microloan activities Logically therefore each of these sets of problems calls for a different approach, option III proposes a separate institutional solution for

- the microloan portfolio

regardless of the disposition of PO Savings This would have the following consequences

- ***Union Bank*** As with Option II, Union Bank could concentrate on positioning itself in the market and would not be burdened with the considerable investment needed to revitalize the two microfinance components

- ***Microloan program.*** The consequences for the microloan portfolio would also be clear credit products would be offered through a specialized financial institution A finance company as defined by the Financial Institutions Act would be able to focus entirely on building its core business, exploiting its specific comparative advantages It would not have to make allowance for the needs or interests of either the Post Office or Union Bank, which could go their own ways in their respective markets The new specialized financial institution – let us call it the *Partner Early Draw Bank* – could obtain funds in the interbank market, only during the start-up phase would it have to rely on inexpensive credit lines provided by international donors Partner Early Draw Bank could offer micro and small loans, gradually broadening its range of products Its institutional design should be based on a clearly defined ownership structure of fit and proper investors committed to serving micro and small enterprises as the core business of the institution Managers would be committed and dedicated specialists in microlending

The third option is in principle the least ambitious, but most favorable for microenterprise It accords a small but realizable solution preference over larger schemes with smaller chances of success A micro credit institution will be good at issuing loans, but not necessarily at mobilizing savings, creating benefits from its comparative advantage and division of labor

A proposal for a separate savings institution based on Post Office Savings is found in annex 3 This is intended to respond to the scope of work governing this report, but is not included in the main text because the proposal – any proposal – for reform of this program is problematic As demonstrated in the text of this report, this program's importance does not justify according high priority to its disposition

6 2 Option III Microlending Spin Off as the Best-case Scenario

Option III describes a scenario in which the micro credit program is separated from the Post Office Savings System and from Workers Bank/Union Bank This option can work out advantageously for all parties and has the best chances of success in microcredit institution building, outreach and viability This section describes this option in more detail A business plan shows the steps to build the institution, followed by a projection of the organizational and financial results over a period of five years This part of the study is intended to answer the following questions

- ***Product range and target group orientation*** How should the lending institution's product range be designed so that it can become profitable, without giving up its strong orientation to its target group?

- *Institutional growth and stability* What are the basic organizational prerequisites that would permit the institution to achieve the growth required to attain profitability without endangering its stability?

- *Cost coverage and profitability* The main goal is to provide long-term access to formal-sector credit to individuals who have not used these services in the past How can expenditures and revenues be structured to enable the lending institution to survive without continued donor support, and achieve a level of performance that will attract private investors?

- *Project costs* How much of an "investment" would be required in the initial phase in order to ensure that the target group-oriented institution achieves sustainability and profitability in the medium to long term?

6 2 1 Design of a new microfinance institution – the *Partner Early Draw Bank*

6 2 1 1 Organizational and institutional design

The autonomous credit operation could draw on the experience and results of a program that performed well for two years and has a genuine commitment to sustainable microfinance The microcredit institution would already have a strong base to build on, with only minimal modifications required The main issue to be tackled is its institutional structure and the primary task is to establish the prerequisites for stable growth and profitability

Product range and target group orientation

The new institution's services should serve microentrepreneurs who currently rely on moneylenders or on self-financing However, the cost structures that would apply involve relatively high outlays for salaries, rent, and transport, while the estimated potential demand is limited by the size of the market Hence, it would be very difficult for the institution to cover its costs solely by offering classic micro enterprise loans with an average loan amount of up to USD 1,000 For this reason, it would be advisable to diversify the institution's products from the very start by lending to other target groups which have also traditionally had difficulty obtaining formal loans

Thus, in addition to traditional micro credit products, the range of products should also feature

- ***salary loans*** – to households having at least one member who receives a regular salary which can serve as collateral, and

- ***small loans*** – ranging from J$ 200,000 to J$ 300 000 or more to small enterprises which can provide appropriate collateral

The lower transaction costs for salary loans, on the one hand, and the higher average loan amount for small loans on the other, can help to create additional income that will allow the institution to achieve profitability more quickly

Although the institution could theoretically engage in deposit-taking, micro credit should be the main focus of its business activities because this is where the gap between supply and demand is widest Formal target group-oriented financial institutions should not assume that a deposit business catering to very small savers will improve their earnings The administrative costs of raising loanable funds via very small deposit accounts are high, in most cases exceeding the costs of funds from alternative sources Experience elsewhere shows that there is tremendous potential demand for micro and small enterprise loans, while voluntary deposits from micro and small enterprises will fund only a small percentage of a microfinance institution's lending operations To obtain sufficient quantities of funds through the market, the institution must therefore obtain the business of new target groups of savers, such as middle-income households When deciding where to place their savings, key criteria for this group are the soundness of an institution and the rate it offers on deposits

This means that deposit services should not be introduced until

- the institution is profitable and has established a solid reputation, and
- it is felt that the institution's borrowers exhibit a demand for savings products and prefer to obtain all their financial services from the same institution

In Jamaica, the supply of savings products is already bigger than that of small and micro credit services, so a new institution wishing to operate in market niches should specialize in credit and not burden itself with the additional task of building a deposit business

Institutional growth and stability institutional structure

a) Legal and institutional framework To make microcredit operations viable and sustainable, the principles of sound institution building suggest that two points are essential

- A new microfinance institution must have a **clear ownership structure**, with owners who show a vital interest in the success of the institution In most cases private development-oriented investors should be sought

- ➢ A new institution must have a legal status which makes it a formal financial institution that is monitored by the banking supervisory authority and adheres to **international banking standards**

In Jamaica, the only legal options in this case are a commercial bank or a non-bank financial institution Since the new institution does not plan to carry out payment transactions, a license under the Financial Institutions Act is appropriate In this case, the owners must provide J$ 25 million as equity capital [1]

b) Location – branch network After analyzing the MLU's constraints to growth, it does not seem advisable to continue handling lending operations via post offices An infrastructure appropriate to micro lending must be centralized to a certain degree in order to provide a foundation for the necessary decentralization of credit operations and lending decisions Centralization consists of regional main branches that can accommodate the entire back office (i e branch management, data collection, IT, cash management, etc) as well as space for all loan officers for meetings with customers, processing and analysis of credit applications, credit committees, training and other meetings This is a prerequisite not only for the feasibility of "peer monitoring" from the very beginning, but also for the formation of a clear institutional identity and a feeling of cohesion right from the outset – not to mention the image that a financial institution must convey to its customers

Jamaica's demographics and geography also call for the establishment of smaller, outlying subbranches These subbranches must make do with very reduced back-office functions while still offering all products, including disbursement and repayment facilities They must achieve a certain volume of business to cover their own costs, i e , subbranch loan officers must be able, under certain circumstances, to serve customers at locations somewhat removed from the parish centers This naturally leads to higher transaction costs and lower productivity This must be taken into account when planning the development of the institution, and is given due consideration in our projections

c) Organizational structure – corporate governance Clearly, a credit technology appropriate to a microfinance institution is an absolute necessity Equally important is an organizational structure providing the external framework and the internal basis to support growth The organizational structure and the business processes must make optimal use of human and financial resources as well as intangible resources such as knowledge and information This is another reason for centralizing the infrastructure to a certain extent Planning at the strategic and the operational level must be consolidated

In practice, this means that the bank should be run by a General Manger He/She would be responsible for designing and implementing institutional and organizational structures for the new entity and for establishing the structures and arrangements defined in its business policy guidelines He/She would carry out the decisions of the General Assembly of

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[1] After the first few years as the portfolio grows capital increases will be required so that the institution complies with standard international capital adequacy guidelines

Shareholders and the Board of Administration A Credit Division Manger would be responsible for the lending activities of the entire institution and also for the selection and training of loan officers In the start-up phase, these two key positions should be filled by international experts whose salaries are paid out of the TA package The medium-to-long-term goal would be to replace these experts with local staff who have been trained by the institution and have the requisite professional experience

Each branch will be headed by a branch manager who will bear responsibility for all its operations institutional and organizational integration of the branch within the overall framework of the new entity in accordance with the instructions of the General Manager, supervision of personnel, selection and training of staff, introduction and marketing of credit products, external representation of the institution, etc Branch managers will report to the General Manager

d) Personnel policy Apart from the professional expertise and competence of the management, how well the loan officers do their jobs is the most important determinant of the performance of a lending institution Particularly close attention should be paid to their selection and training The experience of other microfinance projects has shown that young college graduates make the best loan officers An academic background in economics and/or finance may be an advantage, but is not essential Previous professional experience in banking is also unnecessary, since the credit technology used in micro-lending is very different from banks' standard lending methodology MBU already has qualified loan officers and experience in the recruitment of suitable staff The new institution can utilize this personnel and know-how, which will make the task of staffing the bank much easier

e) Efficient management information system A customized MIS designed specifically to support the institution's operations is essential to lowering administrative costs Therefore, the first step in transferring the lending activities to an autonomous institution must install effective software The system should support the credit staff in the management of an extensive loan portfolio by automating operations at every stage of the lending process from the initial submission of the application to the moment of final repayment including analysis, disbursement and monitoring The MIS should be capable of generating reports on the portfolio, on a customer's personal data or on his/her credit history whenever required

Institutional growth and stability credit technology

The micro credit business poses difficulties which cannot be dealt with in a meaningful way using conventional bank lending technologies However, none of these problems is so formidable that it cannot be solved by utilizing a suitable technology adapted to local conditions By and large, the credit technology employed by the MLU has proved to be capable of addressing the problems posed by microlending Particular attention should be paid to the following factors

- ***Credit analysis and lending decisions*** Microentrepreneurs are frequently unable to provide clear information on their business not least because of the absence of a strict dividing line between business and household finances Therefore the lender must analyze both the enterprise and relevant aspects of the loan applicant's personal situation and character - including his/her reliability and willingness to repay - and to base its lending decision on the results of this comprehensive analysis, with particular importance being accorded to the cash-flow of the household and the enterprise

- ***Strong repayment incentives*** In contrast to the kind of collateral that banks normally require but which microentrepreneurs are very rarely able to provide, the new institution should merely insist on pledges which borrowers can offer without too much difficulty, such as business assets or household items It is not wise to forgo collateral, but at the same time borrowers should not be required to provide excessive security for their loans The items to be used as collateral should be chosen to ensure that borrowers would incur substantial costs, both financial and non-financial, if they failed to meet their obligations on time

- ***Monitoring*** Most banks separate credit analysis and lending from monitoring and recovery In contrast, the new institution – following MLU practice - would make each loan officer responsible for the entire lending process for his or her clients as well as the relationship with these clients after loan disbursement The informational advantage and the clear delineation of responsibility that characterize this system allow the institution to minimize its credit risk Another important feature is that loan officers respond immediately to missed payments, demonstrating the institution's commitment to recovering loans

- ***Lending costs*** An appropriate credit technology enables the lending institution to issue small and micro loans on a cost-covering basis without burdening the customer with unnecessarily high interest and transaction costs Cost coverage can be achieved if interest income realistically reflects both the administrative and risk related costs associated with microloans This means that interest rates, while considerably lower than those in the informal credit market, will be higher than the rates ordinarily paid by customers of commercial banks Small and micro enterprises usually achieve a very high return on equity, so they are in principle able to pay relatively high interest rates However, to ensure that debt service does not absorb an excessive share of borrowers' available funds thus limiting their ability to invest, the institution should not just pass on its lending costs to its customers in the form of high interest charges Instead, it should make a concerted effort to lower its lending costs over time through efficiency gains These features will permit the new institution to charge rates lower than those offered by MLU

Cost coverage and profitability

a) Business policy The new institution should aim to cover its own costs within as short a period as possible Approximately 18 to 24 months would appear to be realistic (see Financial Plan) To become independent of external subsidies, including technical assistance grants, in the long term and to increase its attractiveness to potential providers of equity and debt capital, the institution should aim for a profit that compares favorably with a normal rate of return for successful financial intermediaries in Jamaica This can be accomplished by utilizing the credit technology described above, with special emphasis on realizing economies of scale Moreover, the institution should strive to build long-term relationships with borrowers in order to benefit from the increasing amount of information about its customers, their businesses and their banking potential which it accumulates over time

b) Possible schedule and expansion strategy The table below shows the possible growth pattern of the new institution's lending activities and credit staff The table is based on a realistic assumption that in five years it will be possible to build a portfolio of more than 17,000 outstanding loans, presupposing that after five years, 58 loan officers will disburse 2,000 loans every month

The evolution of the loan portfolio is a function of loan amounts, maturities and disbursements per month After lending operations have been under way for two years, the loan portfolio will be J$ 133 million and after five years the portfolio will have increased to J$ 442 million A detailed breakdown of portfolio growth is given in the annex Table 6-1 shows values at the end of each year

Table 6-1 **Projected Evolution of Loan Portfolio**

Period	No of loans outstanding	Gross outstanding loan portfolio		Average loan amount outstanding	
				Micro	Small
	No	*J$ 000*	*USD 000**	*J$*	
End year 1	3 267	49 167	1 405	11 183	123 972
End year 2	6 454	133 159	3 805	12 389	179 172
End year 3	9 019	220 458	6 299	15 714	175 100
End year 4	12 833	308 183	8 805	15 240	173 173
End year 5	17 244	442 129	12 632	17 680	172 079

* 1 USD = 35 J$

This growth projection is based on conservative estimates and draws on the experience of the MLU and other microfinance institutions particularly in Latin America An important assumption is that each loan officer would be responsible for a portfolio of 297 outstanding loans by the end of the fifth year This figure would appear to be realistic based on the experience of comparable projects in Latin America The number of loans in the loan officers' portfolios can rise quickly not only because their productivity steadily increases as they achieve greater proficiency in MSE lending, but also because, after a certain point, some of their customers will be repeat borrowers whose applications can be evaluated and processed more quickly

6 2 1 2 Financial plan for the proposed microfinance institution

Income projection

Based on the assumptions outlined in the previous section and in Annex 2 we have prepared income statements for the first five years of the new institution's operations In view of the assumed increases in productivity and portfolio growth, the income statements show the institution recovering its costs after two years

Table 6-2 **Projected Income in the First Five Years**
After taxes

Item	Unit	Year 1	Year 2	Year 3	Year 4	Year 5
Income	J$ 000	15 837	44 489	90 639	131 411	181 184
Expenses	J$ 000	27 439	46 260	80 951	118 784	159 193
Profit/Loss	J$ 000	(11 602)	(2 345)	5 813	7 576	13 195
Cumulative	J$ 000	(11 602)	(13 947)	(8 134)	(558)	12,637
Cumulative	USD 000	(332)	(399)	(232)	(17)	361

** 1 USD = 35 J$*

Based on this income and expense data we compiled a five-year series of balance sheets At the end of the 5 years, the institution's total assets exceed J$ 500 million (USD 14 million) Detailed income statements and balance sheets are contained in **Annex 2**

Evolution of selected indicators

The following criteria are commonly used to judge the profitability of financial institutions supplementing the financial statements as measures of performance

Table 6-3 **Projected Evolution of Selected Indicators**

	Year 1	Year 2	Year 3	Year 4	Year 5
Loan portfolio (J$ 000)	49 167	133 159	220 458	308 183	442 129
Total assets (J$ 000)	62,403	160,695	266,172	368,735	528,519
Profit/loss (J$ 000) after tax	(11,602)	(1 771)	9,688	12 627	21 991
Return on average portfolio in % [1)]	49	41	44	44	43
Operating expenses to av loan portfolio in %	99	39	31	26	22
Return on assets (ROA) (%)[2)]	-	(1 6)	2 7	2 4	2 9
Return on equity (ROE) (%)	(86 6)	(17 1)	29	24	30

1) Sum of interest income from lending divided by average loan portfolio (%)
2) Annual after tax profit or loss divided by average total assets (%)

Costs of the project

a) Financial assistance. The initial equity capital contribution (J$ 25 million USD 700,000) will meet the institution's capital requirements From the second year on, due to the strong and sustained growth in the size of the loan portfolio, the institution will require debt finance in addition to its equity capital For at least the first few years this financing requirement should ideally be met by additional donor funds provided on concessional terms The financial plan outlined above presupposes that loans will be taken out at local market interest rates after 3 years, but funds mobilized on more favorable terms would improve the results of the projection noticeably Over the projected five years, cumulative outstanding financing breaks down as follows

Table 6-4 **Projected Evolution of Additional Funding Requirements**

	Cumulative Funding in J$ (000)	in USD* (000)
End year 1	49 005	1 400
End year 2	146 642	4 190
End year 3	240,305	6 866
End year 4	332,293	9 494
End year 5	476 883	13 625

* 1 USD = 35 J$

b) Technical assistance. Achieving the strong initial growth required to reach the breakeven point and become profitable in a reasonable length of time necessitates both extensive initial investments and the presence of international experts It will be essential to provide a technical assistance package covering the first two years if the new institution is to be successful The TA should ideally cover the following costs

- ***Training of loan officers*** The first loan officers could be trained at a project similar to the one proposed here (e g in Latin America) The cost of this training plus grants for all of the loan officers during the first three months of their appointment should be covered by technical assistance funds
- ***International consultants*** Two long-term experts with extensive international experience in institution building will be required during the first two years to launch the new institution, manage the start-up and support the expansion of operations
- ***Management Information System*** MIS implementation should be overseen by an international IT expert who will carry out short-term missions to Jamaica at regular intervals during the first two years
- ***Equipment*** In the beginning, funds will be required to repair, renovate, equip and furnish the institution's business premises so that it can begin operations These funds should be provided under the technical assistance agreement Funds should also be made available to purchase appropriate computer hardware and software

7. Concluding Remarks

7 Concluding Remarks

The situation in Jamaica investigated by the mission is complex Several factors are at work

- the instability of Jamaica's economy, negative growth, high interest rates, a decreasing level of investment and falling per capita incomes,
- the generally unhealthy state of bankrupt or insolvent banks, reflecting connected lending and moral hazard, which have been taken over by the government,
- the complex requirements of a restructuring process that will be able to create efficient sustainable institutions

Three sets of problems were taken into account

- ***Workers Bank***, which is insolvent and is due to be merged with three other banks to form Union Bank,
- the ***microloan portfolio***, which is one of the few intact components of Workers Bank's portfolio, and for which a viable solution is to be sought,
- the ***PO Savings System***, which also operates under the mantle of Workers Bank and therefore, by implication, also faces an uncertain future

These three problems call for three solutions No comprehensive solution within a single institutional framework appears robust The mission advocates a modest approach, preferring three small solutions to one grand scheme

The principal recommendation is to spin off the Workers Bank microloan portfolio to a separate, specialized micro lending institution

For ***PO Savings*** we recommend a unified ownership structure (annex 3), avoiding institutional conflicts of interest wherever possible, and accepting the restrictions that are in the nature of a postal savings operation, recognizing that it is a broker rather than a bank For ***Workers Bank***, these proposals mean that restructuring can be initiated without having to consider the possible political ramifications of dealing with the unprofitable microloan portfolio and the also unprofitable ***Post Office Savings*** component For PO Savings we recommend a unified ownership structure, avoiding institutional conflicts of interest wherever possible, and accepting the restrictions that are in the nature of a postal savings operation, recognizing that it is a broker rather than a bank

Our recommendation for the ***microloan portfolio*** is that it be integrated into the legal framework of a credit institution founded under the Financial Institutions Act This will be the first step in building a specialized microfinance institution that serves micro and small enterprises on a commercial basis That such an institution can be profitable, even in a generally difficult environment, is demonstrated by the results of our projections based on conservative assumptions The partners in this undertaking should continue to explore how the *Partner Early Draw Bank* can realize this potential

Annex 1: Commercial Banks in Jamaica

A Brief Portrait

Annex 1 Commercial Banks in Jamaica – A Brief Portrait

1 National Commercial Bank

With a balance sheet total of J$ 69 8 billion (approximately US$ 2 billion) the *National Commercial Bank (NCB)* is by far Jamaica's largest bank, as of June 30, 1998 it accounted for 43 8% of the commercial banking sector's total assets The NCB has 36 branches, its branch network is still the largest in Jamaica However, 14 branches which were deemed unprofitable have already been closed, and further closings are apparently imminent

Table Annex 1-1 **Balance Sheet of NCB**

Item	06/30/97	Structure	06/30/98	Structure	Change
	in Bn J$	*% of total assets*	*in Bn J$*	*% of total assets*	*in %*
Assets	65 48	100	69 79	100	7
Cash and Reserves	15 14	23	15 77	23	4
Investments	10 42	16	28 98	41	178
Loans	21 28	32	11 64	17	(45)
Fixed Assets	1 53	2	1 28	2	(16)
Other	17 11	27	12 13	17	(29)
Liabilities	63 46	100	65 96	100	4
Deposits	43 35	66	49 20	70	13
Borrowings	4 03	6	3 97	6	(1)
Other	16 08	25	12 78	18	(20)
Capital	2 02	3	3 83	6	90
Paid-In	0 25	0	2 03	3	712
Accumulated Profit	1 77	3	1 80	3	2

Source Bank of Jamaica

The NCB sees its role as being that of a full-service bank which offers a broad spectrum of financial services, including credit cards insurance, etc However until the mid-1990s, it focused its business on lending to large-scale customers When crisis struck the banking system, the NCB had to contend with considerable problems Comparisons of the balance sheet total and the structure of the balance sheet for 1996, 1997 and – insofar as the relevant figures are available – 1998 illustrate their extent

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The NCB's balance sheet total expanded significantly between 1996 and 1997 rising from J$ 41.4 billion in 1996 to J$ 65.5 billion in 1997 – an increase of 58%. At the same time however, problems with non-performing loans also increased markedly. When it became apparent that the NCB's financial plight was worsening FINSAC intervened and

- took control of the NCB,
- recapitalized it by injecting J$ 6 billion, and
- bought non-performing loans amounting to J$ 13.1 billion at their face value,

Thus, FINSAC's financial support for the NCB was equivalent to around one-fourth of the balance sheet total in 1994. Initially, a merger was also considered between the NCB and four other candidates – *Island Victoria Bank*, *Citizens Bank*, *Workers Bank* and *Eagle Commercial Bank*. However, this proposal was rejected, not least because of the effect that such a merger would inevitably have on competition, as the aforementioned banks together account for more than 60% of the banking system's total assets. Finally, at the urging of FINSAC, *Jamaica Mutual Life Assurance Company* acquired a 45% share in the NCB group for J$ 950 million.

Subsequently, the business policy of the NCB underwent a radical change, which is reflected in two areas

- *First*, the entire loan portfolio was audited, with the result that a significant portion of the bank's outstanding loans were written off. Although the volume of outstanding loans accounted for 32.5% of NCB's balance sheet total in 1997, this share had dropped to 15.6% by mid-1998.

- *Second*, new funds were used to dramatically increase the bank's holdings of government securities, especially FINSAC promissory notes. As of mid-1998 government securities accounted for 41.7% of NCB's balance sheet total, up from 15.8% in 1997.

These changes were implemented for two reasons. First, restructuring the existing portfolio was unavoidable, had it not been done, the NCB would have had to declare bankruptcy. Second, by focusing on the acquisition of government securities the bank would be able to pare down its lending activities, have an opportunity to make appropriate changes to its personnel structure and reallocate other institutional resources.

It is surprising that the NCB has continued to attract a considerable deposit volume – in fact, its deposit-taking activities have been even more successful since the crisis than they were prior to it. The same is true of the other banks, which have continued to attract deposits despite the fact that they are technically insolvent. This can be interpreted as a positive sign, and as an indication that depositors trust FINSAC Alternatively, though the fact that people are willing to continue depositing funds at insolvent banks could be regarded as a sign that they lack sufficient information it might also indicate, at least in some cases that moral hazard problems are involved, which is a distinct possibility given the implicit commitment on the part of FINSAC to insure deposits

NCB can now be expected to give priority to

- Systematically consolidating and writing off all non-performing loans,
- Ensuring that effective risk management systems are in place at all levels of the bank's business,
- Further streamlining the branch network and closing down five more branches,
- Introducing efficient IT systems to enhance the quality of both customer service and the management information system
- Lowering operating costs in all areas of operations Given wages and salaries which are relatively high by international standards, it will probably not be possible to do this without eliminating jobs
- Setting up an Asset Quality Control Division to ensure that non-performing loans are not accumulated in the future

It is presumably no coincidence that staff at the NCB and other banks repeatedly point to the quality of the MIS systems they currently use as a problem, and indeed, in some cases these systems leave much to be desired As a result of deficiencies in the quality of MIS functions, some members of middle management have been able to develop and implement their "own" business policy without the senior managers being appropriately informed However, this is not the only source of problems at the NCB and at other banks as well, bad business decisions were actually covered up and backed – and in some cases even taken – by the senior managers Thus, at least to some extent, the difficulties faced by the banking system today can be regarded as a consequence of bad banking It was inevitable that the repercussions of misguided business policies would come to light once the economy was in crisis

2 Citizens Bank

Citizens Bank was immediately affected by the financial crisis in 1996 After Century National Bank closed in July 1996 and large insurance companies found themselves facing persistent solvency problems rumors began to spread that Citizens Bank was in financial distress Although the ensuing run on the bank in October 1996 had repercussions which went far beyond Citizens Bank itself, the incident nonetheless provided the impetus to rehabilitate insolvent banks

Table Annex 1-2 **Balance Sheet of Citizens Bank**

Item	06/30/97	Structure	06/30/98	Structure	Change
	Bn J$	*% of total assets*	*Bn J$*	*% of total assets*	*%*
Assets	8 20	100	10 06	100	23
Cash and Reserves	1 77	22	3 42	34	93
Investments	3 15	38	3 79	38	20
Loans	1 87	23	1 23	12	(34)
Fixed Assets	0 17	2	0 22	2	29
Other	1 24	15	1 40	14	13
Liabilities	8 46	103	9 82	98	16
Deposits	5 17	63	5 88	59	14
Borrowings	1 58	19	2 08	20	32
Other	1 71	21	1 86	19	9
Capital	(0 26)	(3)	0 24	2	-
Paid-In	0 09	1	1 09	11	11
Accumulated Profit	(0 35)	(4)	(0 85)	(9)	-

Source Bank of Jamaica

It is ironic that Citizens Bank is one of the few financial institutions which had already carried out extensive restructuring prior to the crisis – a move which perhaps cast doubts on the institution's financial stability Citizens Bank had already been given a new streamlined organizational structure in the spring of 1996, the payroll was drastically reduced, basic and advanced training programs were implemented in which 93% of employees took part The costs and benefits of each individual position on the bank's permanent staff were assessed, above all for middle management personnel When redundancies were found, the positions in question were eliminated Nonetheless, during the crisis there was a considerable outflow of funds, which the bank was able to deal with only by selling government securities Thereafter, the number of non-performing loans rose rapidly because an increasing number of borrowers began to doubt that Citizens Bank would survive On May 15, 1997 FINSAC took control of Citizens Bank and recapitalized it with an injection of J$ 1 billion

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Today, the balance sheet total of Citizens Bank comes to J$ 10 1 billion, of this, loans account for only J$ 1 2 billion, or 8 4% Two years ago, loans represented nearly 34% of the balance sheet total To a great extent, lending activities were replaced with securities purchases The bank's securities portfolio currently represents more than 50% of its total assets, liquid assets – including cash holdings, which are very high by any standard – account for around 80% of the balance sheet total

FINSAC's intervention has had a highly positive effect in the case of Citizens Bank To a great extent, the problems resulting from the bank run have been resolved Citizens Bank once again funds its activities primarily through deposit-taking, which accounts for 59 9% of its liabilities In the meantime, the bank has even been able to raise its deposit volume to a level higher than that achieved immediately prior to the run However, there is some question as to whether Citizens Bank would be able to survive without a strong partner and for this reason it will be merged into the future *Union Bank*

3 Island Victoria Bank

Of the four banks which will merge to form *Union Bank*, *Island Victoria Bank* probably has the most highly developed retail banking culture, catering primarily to the upper end of the retail market In addition, corporate customers play a prominent role in its business Ambitious expansion plans have been launched, in particular in electronic banking and telephone banking Since 1996, a 24-hour service has been available, and it is used over 300,000 times a year Moreover, the bank offers ATMs and on-line real-time banking facilities at its branches Its network is quite small, with only three offices
Looking back, there was an unrestrained drive toward expansion, particularly in 1994 and 1995 The 1994 annual report states

> "Public confidence in our reliability and performance was indicated by a 166 percent growth represented in customer deposits that moved from J$677 to J$ 1 8 billion Foreign currency intake alone grew by 242 percent and local currency deposits by 150% The number of accounts in this area of operations also increased by 69 and 53% respectively By intelligent investing and by resourceful and aggressive management we were able to improve our assets by 54% and revenues by 174% "[1]

Island Victoria which was Jamaica's fastest growing bank in 1994, was taken over by FINSAC in 1997 to protect depositors from loss Today, Island Victoria has a balance sheet total of J$ 2 9 billion, or some US$ 84 million On the asset side, the loan portfolio is still the largest single item, and accounts for 44 8% of the total despite extensive write-offs

[1] Cf Island Victoria Bank (1995) Annual Report 1994 p 4

Thus far, government securities have played only a secondary role On the liability side deposits are still the bank's primary source of funding although it should be noted that the deposit volume has decreased by 10% There has been no major outflow of funds, mainly owing to the intervention of FINSAC The measures implemented by FINSAC will culminate in a merger with Workers, Eagle and Citizens Bank

Table Annex 1-3 **Balance Sheet of Island Victoria Bank**

Item	06/30/97	Structure	06/30/98	Structure	Change
	in Bn J$	*% of total assets*	*in Bn J$*	*% of total assets*	*In %*
Assets	2 56	100	2 90	100	13
Cash and Reserves	0 69	27	0 52	18	(25)
Investments	0 26	10	0 74	25	185
Loans	1 09	43	1 31	45	20
Fixed Assets	0 10	4	0 09	3	(10)
Other	0 42	16	0 24	9	(43)
Liabilities	2 36	92	2 71	94	15
Deposits	1 84	72	1 68	58	(9)
Borrowings	0 06	2	0 06	2	0
Other	0 46	18	0 97	34	111
Capital	0 20	8	0 18	6	(10)
Paid-In	0 63	25	0 63	22	0
Accumulated Profit	(0 43)	(17)	(0 44)	(16)	-

Source Bank of Jamaica

4 Eagle Commercial Bank

Eagle Commercial Bank was founded as a wholly-owned subsidiary of the Eagle Merchant Bank to enable the group to expand into classic retail banking Like Island Victoria, Eagle Commercial is one of the smaller merger candidates, with total assets of J$ 3 2 billion (approximately US$ 92 8 million) Eagle Commercial has 7 branches, 3 of which are rural

Like the three other merger candidates, *Eagle Commercial Bank* was in fact more active in wholesale banking than was warranted given its business philosophy Relationship banking and difficult economic conditions have meant that Eagle Commercial had to write off large

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portions of its loan portfolio The loan volume dropped from J$ 1 0 billion in June 1996 (around US$ 28 9 million), to J$ 303 million, or US$ 8 8 million in June 1998 – a decrease of around 70%

Table Annex 1-4 **Balance Sheet of Eagle Commercial Bank**

Item	06/30/97	Structure	06/30/98	Structure	Change
	Bn J$	*% of total assets*	*Bn J$*	*% of total assets*	*%*
Assets	2 03	100	3 17	100	56
Cash and Reserves	0 43	21	0 46	14	7
Investments	0 33	16	1 95	61	491
Loans	1 03	51	0 35	11	(66)
Fixed Assets	0 09	4	0 05	2	(44)
Other	0 15	8	0 36	12	140
Liabilities	1 56	77	2 61	82	67
Deposits	1 07	53	1 37	43	28
Borrowings	0 33	16	0 55	17	67
Other	0 16	8	0 69	22	331
Capital	0 47	23	0 56	18	19
Paid-In	0 15	7	0 15	5	0
Accumulated Profit	0 32	16	0 41	13	28

Source Bank of Jamaica

Following the takeover by FINSAC, the loan portfolio was consolidated and the bank recapitalized, as reflected in a significant increase in the volume of government securities held With equity capital of US$ 4 4 million, the bank was undercapitalized in any case, and the government securities in effect served as balancing claims which were added to the balance sheet to prevent Eagle Commercial from becoming insolvent

Common features of bad banks

Analyses of these commercial banks have a common thread they grew too quickly without attempting to change their institutional framework to accommodate this expansion Even today, some people in the banking sector seem to have the impression that expansion consists of multiplying the number of inputs by a certain factor and implementing an effective MIS However, institutions equipped to serve 200 customers cannot simply

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expand their clientele to 25,000 without also expanding and reconfiguring the entire structural basis of their operations

As a result, highly complicated, unwieldy organizational structures are created on an ad hoc basis Thus, an examination of the organization chart for *Eagle Commercial Bank* suggests that the institution's structure and operating procedures were not carefully planned in advance, but instead gives the impression that growth occurred in a somewhat haphazard fashion, with responsibilities constantly being reallocated depending on the requirements at a given point in time In the absence of an efficient management information system and without appropriate credit technologies, such expansion inevitably results in financial disaster

5 Trafalgar Group

The Trafalgar group comprises two financial institutions, one of which *Trafalgar Commercial Bank*, is commercially oriented, while the other, *Trafalgar Development Bank*, serves developmental objectives The Trafalgar group is an interesting case, not least because its commercial arm co-exists with a non-commercial institution, which makes it unique among Jamaica's banking companies

Trafalgar Development Bank has a balance sheet total of J$ 2 5 billion (US$ 71 3 million) As an institution which is at least in part geared to the promotion of developmental objectives, it is a special case Thus, it does not fit neatly into the categories which apply to Jamaica's regular banks The declared goal of the TDB, which was launched with the support of multilateral donors, is to finance investments in productive assets To this end, it offers various medium- and long-term credit facilities for the purpose of financing investments in fixed assets and permanent working capital Borrowers are granted a grace period of up to two years before they must begin making principal repayments This is problematic in two respects *first,* the terms and conditions of these facilities deviate significantly from those available in the market (similar loans are not offered by regular banks), *second,* a great deal of time elapses before it is clear whether borrowers are in fact willing and able to meet their obligations Foreign currency loans are only made if the planned investment project will generate foreign currency income

In addition to loans, the TDB also offers a variety of other financing options and instruments including equity participations In the case of participations, up to 40% of the equity capital of an enterprise or "project" may be acquired, in the form of both ordinary and preferred shares The bank is typically given a put option on the shares which enables it to sell them once the period agreed in the contract has elapsed Moreover, TDB offers a range of consultancy services covering

- enterprise restructuring,

- ➢ co-financing, should the credit facilities of TDB be insufficient, and
- ➢ preparation of business plans

However, the bank focuses on lending, which in 1997 accounted for two-thirds of total assets, and thus the lion's share of its business activities Thirty-nine percent of loans went to enterprises in the production sector, 29% to businesses in the tourism industry, and 23% to agricultural enterprises The rest of the loans issued went to businesses in the mining industry (5%) and services (4%) Eighty-four percent of all loans were issued to businesses that are either directly or indirectly export-oriented It is interesting to note that the structure of the portfolio of equity holdings is markedly different from that of the loan portfolio, especially insofar as the service sector is concerned shareholdings in service enterprises account for 39% of the equity portfolio, whereas the share of the loan portfolio accounted for by credits to service-sector businesses is far lower This is probably a reflection of the fact that the returns on investments in the service sector are noticeably higher than in other sectors

Table Annex 1-5 **Balance Sheet of Trafalgar Commercial Bank**

Item	06/30/97	Structure	06/30/98	Structure	Change
	in Bn J$	*% of total assets*	*in Bn J$*	*% of total assets*	*in %*
Assets	0 66	100	0 79	100	20
Cash and Reserves	0 19	29	0 17	22	(10)
Investments	0 11	17	0 11	14	0
Loans	0 26	39	0 40	51	54
Fixed Assets	0 02	3	0 02	2	0
Other	0 08	12	0 09	11	12
Liabilities	0 59	89	0 71	90	20
Deposits	0 42	64	0 53	67	26
Borrowings	0 07	10	0 11	14	57
Other	0 10	15	0 07	9	(30)
Capital	0 07	11	0 08	10	14
Paid-In	0 08	13	0 08	10	0
Accumulated Profit	(0 01)	(2)	0 00	0	-

Source Bank of Jamaica

Between 1996 and 1997, the TDB's balance sheet total grew by 12 8% its credit portfolio by 26 2% Thus, the bank's expansion was much more pronounced than that of its commercial sister institution, *Trafalgar Commercial Bank* (TCB) With total assets of J$ 793,687,000 (around US$ 22 million), the TCB is in any case the smallest commercial bank in Jamaica, and has had to contend with serious difficulties In 1997, it posted a loss of J$ 8 4 million and was forced to increase its loan loss reserves from J$ 4 4 million to J$ 28 2 million as a risk-provisioning measure to cover non-performing loans A further loss has been forecast for 1998, although it will probably be smaller than that incurred in 1997

The co-existence of a commercial bank and a development bank within a single group raises a number of questions For example, how is it possible that of the two, the commercial institution has incurred losses while the development bank has not? A conceivable answer is that the loans granted by the TDB have a quite generous grace period of up to two years, and that the bank is therefore unable to identify potential non-performing loans until borrowers begin to default on their interest payments The example of the Trafalgar group also underscores how difficult it is for an individual bank to post good results if the overall economic situation is unfavorable

Annex 2: Assumptions Re: Microlending Institution

Partner Early Draw Bank - Jamaica

Basic Scenario

Profit & Loss Statement

Year	Year 1	Year 2	Year 3	Year 4	Year 5
Income					
interest income from new portfolio					
interest income from micro loan portfolio	8 268 904	22 050 084	44 669 088	67 700 102	96 185 566
interest income from small loan portfolio	3 408 587	13 809 747	30 593 642	43 732 276	57 592 550
total interest income from loan portfolios	11 677 491	35 859 831	75 262 730	111 432 378	153 778 116
income from service fee (micro loan portfolio)	3 687 400	7 835 000	13 700 000	17 540 000	23 981 000
interest income from current account with other banks	260 106	793 872	1 676 409	2 438 143	3 425 269
interest income from investment of own funds	212 033	0	0	0	0
total income	15 837 030	44 488 703	90 639 140	131 410 521	181 184 385
total income after income tax	15 837 030	44 488 703	90 639 140	131 410 521	181 184 385
Expenses					
additions to loan loss provisions for new portfolio					
additions to loan loss provisions micro	1 470 099	1 696 719	2 414 778	2 114 698	4 351 691
additions to loan loss provisions small	429 427	1 338 277	907 542	1 143 486	912 543
total additions to loan loss provisions	1 899 526	3 034 996	3 322 320	3 258 184	5 264 235
salaries incl non wage labor costs					
loan officers	10 673 850	16 846 500	22 957 000	28 765 000	34 573 000
managerial and support staff	7 084 000	10 087 000	16 670 500	20 077 750	23 870 000
overheads (marketing communication others)	3 058 550	3 547 500	4 237 200	4 871 900	5 539 600
office rent	2 580 600	3 758 700	8 543 700	11 484 000	13 675 200
depreciation of fixed assets	500 000	500 000	529 167	850 000	879 167
borrowing costs	1 642 730	8 484 868	24 691 166	49 476 991	75 392 195
total expenses	27 439 255	46 259 564	80 951 052	118 783 825	159 193 396
profit/loss per period before tax on profit	11 602 225	1 770 861	9 688 088	12 626 696	21 990 989
profit/loss per period after tax on profit	11 602 225	2 344 553	5 812 853	7 576 018	13 194 593
profit/loss accumulated	**-11 602 225**	**-13 946 778**	**-8,133 926**	**-557 908**	**12,636,685**

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Partner Early Draw Bank - Jamaica

Basic Scenario

Balance Sheet

	Year	Year 1	Year 2	Year 3	Year 4	Year 5
Assets						
cash and non earning liquid assets		4 726 765	12 822 487	21 220 108	29 666 836	42 535 028
current accounts with other banks		2 458 359	6 657 970	11 022 896	15 409 169	22 106 477
central bank (mandatory reserves)		2 950 030	7 989 564	13 227 475	18 491 003	26 527 773
total new loan portfolio net		47 267 647	128 224 870	212 201 079	296 668 361	425 350 283
portfolio gross - micro		35 282 369	76 003 634	133 958 307	184 711 059	289 151 651
portfolio gross - small		13 884 804	57 155 758	86 499 613	123 472 328	152 977 892
loan loss provisions - micro		1 470 099	3 166 818	5 581 596	7 696 294	12 047 985
loan loss provisions - small		429 427	1 767 704	2 675 246	3 818 732	4 731 275
investment of own funds/loans to other banks		0	0	0	0	0
fixed assets		5 000 000	5 000 000	8 500 000	8 500 000	12 000 000
Total assets		62 402 801	160 694 891	266 171 558	368 735 369	528 519 561
Liabilities						
borrowed funds		49 005 026	146 641 669	240 305 484	332 293 278	476 882 876
total liabilities		49 005 026	146 641 669	240 305 484	332 293 278	476 882 876
Equity						
equity		25 000 000	28 000 000	34 000 000	37 000 000	39 000 000
retained earnings and losses		11 602 225	-13 946 778	8 133 926	557 908	12 636 685
total equity		13 397 775	14 053 222	25 866 074	36 442 092	51 636 685

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Partner Early Draw Bank - Jamaica **Basic Scenario**

Selected indicators after taxes	year 1	year 2	year 3	year 4	year 5
return on average equity	-86 6%	-17 1%	29%	24%	30 0%
average equity / average assets	21%	12%	9%	10%	10%
operating expenses / average loan portfolio	99%	39%	31%	26%	22%
growth rate of new loan portfolio	100%	171%	65%	40%	43%
interest income / average loan portfolio	49%	41%	44%	44%	43%

Assumptions Underlying Balance Sheet and Income Statement Projections for

Partner Early Draw Bank

I Balance Sheet

1 Assets

Cash and non-earning liquid assets & short term deposits with other banks Liquid funds comprise "cash and non-earning liquid assets" and "short term deposits with other banks"

- We assumed that cash holdings should be equivalent to at least 10% of the outstanding net loan portfolio In the model, all loans are repaid in equal installments, so there is a constant inflow of liquidity

- "Short term deposits with other banks" refers to liquid funds deposited at other banks, where they earn interest of 20% p a This item includes an amount equivalent to 5% of the outstanding gross loan portfolio as an additional reserve to make allowance for fluctuations in liquidity requirements caused by loan disbursements

Mandatory reserves In compliance with the cash reserve requirements of the BOJ, this item consists of a reserve which amounts to 5% of the institution's total liabilities It will be held at the Central Bank

Total new loan portfolio The size of the portfolio will be a function of the type of loans disbursed and their average size and maturity and also the number and productivity of the loan officers

- The portfolio will consist of micro and small loans It is assumed that variations in the average sizes of micro loans will be similar to those reported by the MLU A further assumption is that average loan sizes will initially be low Moreover, the average maturity is expected to rise over time as long-term relationships with the borrowers are established This effect was observed in the MLU In view of the MLU's experience and the difficult macroeconomic situation we expect that the institution will initially adopt a rather cautious lending policy, which will be reflected in relatively low average amounts and short maturities For the basic scenario we have assumed an initial average term of 9 months for small loans and 5 months for micro loans, which are less likely to be used for fixed-asset investments than working capital

Table Annex 2-1 **The Micro and Small Loan Portfolios Average Maturities and Average Loan Amounts Disbursed**

Year	Month	Avg Maturity	Avg loan amount disbursed	Avg Maturity	Avg loan amount disbursed
		Micro loans	Micro loans	Small loans	Small loans
No	*No*	*Months*	*J$*	*Months*	*J$*
1	6	6	18 000	9	200 000
	12	6	20 000	10	200 000
2	6	7	20 000	10	300 000
	12	7	25 000	10	300 000
3	6	8	25 000	10	300 000
	12	8	25 000	11	300 000
4	6	9	25 000	11	300 000
	12	9	25 000	11	300 000
5	6	10	30 000	11	300 000
	12	10	30 000	11	300 000

Source *projection*

- The rate of growth in the total number of loans disbursed per month will depend on how many loan officers are employed and how productive they are From the beginning, the new institution will be able to count on the services of well-trained staff members who have been working for the MLU In addition 10 new loan officers should be hired because the institution should broaden its customer base and increase its lending volume rapidly at this early stage The first group of loan officers (old and new loan officers) for training is to consist of 25 persons [1] They will receive extensive training that will enable some of them to occupy middle-management positions in the future Every six months five new recruits will join the permanent staff of loan officers after completing a training phase which lasts approximately 3 months

- As new employees are recruited, some of the more experienced loan officers will leave the bank When modeling the staff turnover rate, we assumed that one loan officer will leave the institution every six months, thus reducing the number of loan officers who have been working longest for the bank This is a very conservative modeling strategy,

[1] Realistically the institution should count on having 25 recruits for the initial training program because experience has shown that roughly 20% of the participants will change their minds and drop out If the institution starts with 25 trainees it can be assumed that after 6 months lending operations can be initiated with 20 thoroughly trained and well-motivated loan officers

[2] As a rule new loan officers receive three months of training During this time they appear neither in the credit statistics nor on the payroll They receive their pay in the form of grants which are funded from the TA package

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as it assumes that the loan officers who leave will be the ones with the highest productivity, which hopefully will not be the case

- We measure loan officer productivity by the number of loans he or she issues per month with figures determined separately for micro and small loans In other microfinance institutions, as well as in the MLU, loan officer productivity increases with lending experience a loan officer involved in the program for a year is capable of issuing more micro and small loans on average than a loan officer who has been with the program for six months The more experienced officer has a better grasp of the working procedures and the market, and will be dealing with an increasing number of repeat borrowers Thus, productivity tends to grow, although the rate at which it does so decreases over time On average, more micro loans can be issued per month than small loans Small loans require a more thorough credit analysis whereas micro loans tend to be highly standardized

  Starting from the date when trainees become members of the regular loan officer team and are responsible for administering and monitoring a portfolio of their own, it is assumed that they are capable of disbursing 10 micro loans (0 small loans) per month each After six months their productivity rises to 20 micro (0 small loans) loans per month At the end of 12 months, they are assumed to be capable of disbursing 30 micro loans (1 small loan) per month after 18 months this figure increases to 35 micro loans (2 small loans) per month After 24 months it can be expected that loan officers will be members of the institution's core group of experienced credit staff and thus a further increase in productivity is assumed bringing the monthly loan disbursement rate to 40 micro loans (2 small loans) per month

<u>Table Annex 2-2</u> **Productivity of Loan Officers**
Loans Disbursed per Month per LO

Length of lending Experience		
	Micro loans	**Small loans**
< 6 months	10	0
>= 6 months	20	0
>= 12 months	30	1
>= 18 months	35	2
>= 24 months	40	2

<u>Source</u> projection

- With a relatively small population of 2 5 million and a small degree of concentration in urban centres, costs for borrowers will marginally increase both in terms of time and money, and ultimately slow down the lending process

The table below shows a projected growth pattern of the new institution's lending activities and credit staff The table is based on a realistic assumption – that it will be possible to build a portfolio of more than 17,000 outstanding loans within five years This presupposes that after five years, 58 loan officers will be disbursing almost 2,000 micro loans every month

Table Annex 2-3 **Projected Growth of Loan Officers' Productivity by Number of Loans**

Year	Month	No of loan officers	Monthly disbursements		Loans disbursed per loan officer		Loans outstanding		Loans outstanding per loan officer	
No	*No*	*No*	*No Micro*	*No Small*	*No Micro*	*No Small*	*No Micro*	*No Small*	*No Micro*	*No Small*
1	6	22	495	12	22	0 5	1 835	57	83	3
	12	26	680	22	26	0 8	3 155	112	121	4
2	6	30	850	35	28	1 2	4 250	191	142	6
	12	34	1 035	43	30	1 3	6 135	319	180	9
3	6	38	1 195	51	31	1 3	7 405	414	195	11
	12	42	1 355	59	32	1 4	8 525	494	203	12
4	6	46	1 515	67	33	1 5	10 840	574	236	12
	12	50	1 675	75	34	1 5	12 120	713	242	14
5	6	54	1 835	83	34	1 5	14 915	801	276	15
	12	58	1 995	91	34	1 6	16 355	889	282	15

Source projection

Table Annex 2-4 **Projected Growth of Loan Officers' Productivity in Million J$**

Year	Month	No of loan officers	Monthly disbursements		Loans disbursed per loan officer		Loans outstanding		Loans outstanding per loan officer	
No	*No*	*No*	*Tot Micro*	*Tot Small*	*Tot Micro*	*Tot Small*	*Tot Micro*	*Tot Small*	*Tot Micro*	*Tot Small*
1	6	22	9	2	0 4	0 1	18	8	0 8	0 4
	12	26	14	4	0 5	0 2	35	14	1 3	0 5
2	6	30	17	10	0 6	0 3	50	29	1 6	1 0
	12	34	26	13	0 8	0 4	76	57	2 2	1 7
3	6	38	30	15	0 8	0 4	106	73	2 8	1 9
	12	42	34	18	0 8	0 4	134	86	3 2	2 0
4	6	46	38	27	0 8	0 6	155	110	3 4	2 4
	12	50	42	30	0 8	0 6	185	159	3 7	3 2
5	6	54	55	33	1 0	0 6	221	184	4 1	3 4
	12	58	60	36	1 0	0 6	289	204	5 0	3 5

Source projection

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After lending operations have been underway for two years, a portfolio of US$ 3 8 million will have been built up, after 5 years it is realistic to expect that the portfolio will have increased to over US$ 12 million

Table Annex 2-5 **Projected Evolution of Loan Portfolio**

Period	No of loans outstanding	Gross outstanding loan portfolio	
	No	*J$ million*	*USD million (rate = 35 1)*
End of year 1	3 267	49	1 4
End of year 2	6 454	133	3 8
End of year 3	9 019	220	6 3
End of year 4	12 833	308	8 8
End of year 5	17 244	442	12 6

Source projection

Given the assumptions outlined above each loan officer would be responsible for a portfolio of 297 outstanding loans by the end of the fifth year This figure would appear to be realistic based on the experience of comparable projects in Latin America The loan officers can quickly increase the number of loans in their portfolios because they are steadily becoming more proficient at small and micro lending and also because some of their customers will be repeat borrowers whose applications can be evaluated and processed more quickly Experience has shown that microfinance institutions can achieve even higher productivity levels than we have assumed in our projections

Branch network New branches will permit the loan portfolio to grow rapidly, enabling the bank's business to continue expanding even though the demand for micro and small enterprise credit in the areas served by the main branch may already be satisfied Rapid expansion of the branch network will also ensure that the institution is able to enter the market in designated areas as quickly as possible The projection does not differentiate between individual branches All assumptions with respect to growth implicitly take into account the expansion of the branch network

MLU Portfolio It is assumed that the new institution will not acquire the old portfolio of the Workers Bank, but instead will merely administer it Thus, this portfolio does not appear in the balance sheet of the new institution In addition we have assumed that the administrative fee which the new institution will receive for recovering old delinquent loans will be just sufficient to cover the costs of recovering such loans, thus, the income statement contains no items which are directly related to the old portfolio

Fixed Assets This heading covers all costs incurred in renovating premises and equipping the branch This includes the equipment installed at the cashier's window and in the banking hall and purchase of a safe, communications equipment (telephone lines, etc) and security devices (alarm systems) "Fixed assets" also include furniture and all other office equipment (computers, peripherals, local networks) Equipment will be replaced at regular intervals, and thus the value of the fixed assets will remain constant over time The costs associated with these items will be covered in part by off balance sheet technical assistance, and will therefore be borne only in part by the institution itself

2 Liabilities and Equity Capital

Borrowed funds Credit lines in local currency received from international donors, the local interbank market and other commercial banks are reported under this heading The size of this item is a function of the growth of the institution's business volume in other words, during the first few years it will depend primarily on the scope of the new lending activities We have assumed a monthly flow of funds from the respective funding source(s) to the new institution, thus, all computations were done on a monthly basis

Equity capital The bank's equity capital is determined by subtracting its total liabilities from its total assets In the model, the new institution will receive the full amount of J$ 25 million as paid-in equity Periodic capital increases will be undertaken in accordance with the capital adequacy agreement described below and will involve increments of J$ 1 million

The new institution must comply with international capital adequacy standards, which stipulate that equity capital must amount to at least 8% of risk-weighted assets The World Bank recommends that the equity capital of financial institutions operating in countries with less stable financial systems amount to at least 12% of risk-weighted assets When checking for compliance with capital adequacy requirements in our model we based our calculations on the 12% rule

Retained profits and accumulated losses brought forward In the model on which our projections are based, it is assumed that any profits earned would be retained For this reason, the full amount of the profit (or loss) shown in the income statement will be reported as a contribution to capital in the balance sheet

II Income Statement

1 Income

Interest income from loan portfolio As interest on loans will be the main source of earnings, variations in the size of the loan portfolio (assumptions regarding average loan amount, total loan volumes and maturities) and in the interest rates will have a direct impact on the result Interest income is determined on the basis of the monthly outstanding portfolio volume, and is calculated separately for the program's Micro and Small components Thus, we assumed that the compound interest rate will be 50% p a (3 4% p m) for micro and

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small loans To simplify the model, it was assumed that all borrowers repay their loans in monthly installments

Other income

- ***Service fees*** To cover the high administrative costs involved in the disbursement of micro loans, borrowers will be charged a non-recurrent processing fee amounting to 4% of the contractual loan amount (not charged for small loans)

- ***Interest income from investment of own funds*** During the first few months, some of the institution's liquid funds can be placed in accounts at other banks as time deposits, as not all of the available resources will be needed immediately to pay for fixed assets or to fund lending In the calculations, the return on these investments was estimated to be 18% p a

2 Costs

Funding costs The projections are based on the assumption that the average cost of funds provided by international investors is 15% We have projected a rise in the cost of borrowed funds over time to reflect the fact that "cheap" funding provided by international organizations will not be available indefinitely

Table Annex 2-6 **Projected Annual Interest Rates on Borrowed Funds**

%	Y 1	Y 2	Y 3	Y 4	Y 5
External funding Total annual	10%	12%	15%	20%	22%

Source projection

Loan loss provisions Experience at microfinance institutions in comparable settings has shown that arrears can be kept at less than 2% of the outstanding portfolio, bad debt losses should not exceed 1% of the portfolio We are convinced that these levels could also be achieved by a lending institution in Jamaica if appropriate credit technology and rigorous credit monitoring and recovery methods are used

Provisions need to be set aside to cover the risk of loan losses Our calculations use loan loss provisions of 3% of the outstanding portfolio for small loans and 4% for micro loans These projections are conservative and in line with the default rate for other microfinance institutions

Administrative expenses consist mainly of personnel expenses, rent and overhead

Personnel expenses are a function of the number of employees and their salary levels

- *Personnel expenses for credit staff* The new institution should adopt a fair, performance-based pay scheme In such a system, loan officers' salaries will rise over time and will be a function of the quality of their loan portfolios Loan officers' salaries should comprise a fixed component plus a flexible performance-based bonus The size of a loan officer's incentive bonus should be determined by the number and volume of loans in his or her portfolio and also by the quality of the portfolio as reflected in the arrears rate

  A performance-based salary scheme is in the interest of the institution itself A high rate of turnover among loan officers pushes up expenditures for training, lowers overall productivity because new loan officers issue fewer loans on average, and increases losses due to loans being serviced late or not at all Loan officers are responsible for monitoring and managing the loans in their portfolios and for ensuring that their customers' accounts are managed properly If they are not paid adequate salaries they will tend to be slower and less conscientious

  We were therefore generous when calculating the salaries on which the projections are based As our frame of reference, we took the average of the salaries which employees at local insurance companies, banks and credit unions receive To simplify the calculation of total personnel expenses, we estimated and reported the salaries of the loan officers separately from those of the other staff members As the loan officers become more experienced, their salaries will gradually increase The projections include bonus payments Personnel costs for credit staff are determined by taking the number of loan officers in each category and multiplying them by the relevant sum J$ 31,500 per month for officers with less than six months experience with the institution, J$ 35,000 per month for staff with more than six and less than 12 months' experience, J$ 45,500 per month for those with between 12 and 18 months' service, and J$ 52,500 per month for loan officers who have been working for the institution for between 18 and 24 months After 2 years' service loan officers can earn J$ 55,000 per month

- *Personnel expenses for non-credit staff* We have performed separate calculations for the expenses relating to the salaries of the general manager the division managers and the branch managers For the sake of simplicity, non-credit staff were divided into three categories, each of which constitutes a separate salary bracket a "management" level, an "operational" level and an "administrative" level We added a blanket 10% to the sum of all salaries for credit and non-credit staff to allow for the costs of social

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security and other non-wage labor costs All salaries include a provision for income tax assessed at the rate which applies to the various remuneration levels in the bank

Table Annex 2-7 **Personnel Breakdown and Monthly Costs per Staff Category**

End of Year	**J$**			
	Loan Officers	**Management**	**Operational**	**Administrative**
	26*	2*	4*	8*
1	31,500	70,000	52 500	35 000
	34*	3*	6*	9*
2	35 000	70 000	52 500	35 000
	42*	3*	8*	11*
3	45,500	70 000	52 500	35 000
	50*	4*	9*	13*
4	52,500	70 000	52 500	35 000
	58*	7*	12*	17*
5	55,000	70 000	52 500	35 000

* *Figures refer to number of personnel*
<u>Source</u> *projection*

The General Manager (J$ 140,000) and the Division Manager(s) (J$ 105 000) have not been included in the above table, since these positions will be funded by technical assistance during the first two years As a general rule the total number of employees is ultimately determined by the (target) business volume the type of business activities pursued and – for retail banks such as the one we are considering in our projections – the extent to which the branch network is expanded The number of employees in the credit department will rise as new loan officers are hired (new recruitment minus staff turnover) and the payroll in non-credit divisions will increase as a consequence of both regional expansion and the addition of new products to the bank's range of services In determining the composition of the non-credit staff, we drew upon the experience of other comparable providers of microloans such as *Caja Los Andes* in Bolivia

Office rent Monthly rental payments are based on an assumed price of J$ 1,000 (J$ 2,000 after 2 5 years) per square meter This is an average figure for non-renovated premises in urban areas with a high concentration of microentrepreneurs Experience in other countries has shown that it is preferable for the project to seek the owner's permission to refurnish the premises itself With this approach, a relatively inexpensive piece of property can be rented and the project itself can determine quality and design In costing the premises, we assumed that 6 m² per person would be required Utilities and incidental expenses (for water, electricity and routine maintenance) were estimated at 10% of the amount calculated for rent

Overheads

- The costs of *advertising* were estimated at J$ 3,500 per month

- *Training* costs include introductory and advanced training seminars The costs of training amount to J$ 5,000 per new loan officer No training costs for other personnel were included in the projection because we assumed that sufficiently well-trained staff for these other services could be recruited on the local labor market Ultimately, their training costs are reflected in their relatively high salaries

- We assumed that the cost of an *external audit* would be J$ 420 000 per year This will rise over time as the number of branches increases and is expressed as a monthly charge

- *Communication costs* (telephone fax, e-mail etc) were estimated at J$ 1 000 per staff member per month

- The cost of *office supplies* was estimated at J$ 1,500 per employee per month This may seem high at first glance, but note that it also includes the cost of printing loan analysis forms

- *Travel expenses* consist mainly of the costs incurred by loan officers when traveling to meet with customers We have assumed that they would amount to J$ 2,000 per month per loan officer – a conservative estimate But if the new institution expands its geographic coverage travel expenses will increase Supervision of branches will necessitate regular on-site inspections and loan officers will have to visit borrowers who live progressively further away from the branches

- *Security services* costing J$ 35 000 per month will be obtained from outside contractors

- *Contingency allowance* To allow for the fact that not all overheads (for example licensing fees) are precisely accounted for we have added 10% to the total expenses for training, advertising, communications office supplies, external audit and security services

Depreciation of fixed assets was calculated using the straight-line method over ten years The Jamaican tax authorities prescribe different coefficients to determine the depreciation on

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individual fixed assets However, the resulting figures do not deviate significantly from those obtained by applying the straight-line method

Taxes Under Jamaica's tax laws, various income categories are taxed at different rates Thus, determining the proposed institution's precise tax burden would involve many calculations and take up quite a bit of space For the purposes of our projections, we felt it would be advisable to apply a tax rate of 40% to profit figures

III General Assumptions

1 Currency depreciation risk / Exchange rate risk

The amounts used in the calculations have been expressed in current Jamaican dollars

- Currency depreciation risk cannot be ruled out However as the timing and impact of macro economic shocks are difficult to predict we decided not to make any allowance for that

- By expressing all amounts in local currency, we completely avoid having to record an exchange rate gain or loss on the financial statements of the institution with respect to external international grants or the equity shares of international investors However, if the institution obtains loans in non-Jamaican currency consideration should be given to setting aside provisions to offset the exchange rate risk It should be noted, though, that any international borrowings would most likely carry a lower interest rate than loans procured in Jamaica This means that funding costs which are assumed to come to 22% p a in the fifth year, could still be realistic assuming they would be adequate to cover both interest expenses and exchange-rate losses

- Moreover, we have chosen not to adjust the projections for inflation mainly because we felt it would have rendered the results less meaningful it would have been more difficult to compare the figures for the various years, and they would not have gauged the extent of important shifts and changes as accurately

2 Central Bank requirements

The Bank of Jamaica sets very strict minimum reserve requirements for domestic currency liabilities The requirements for foreign currency liabilities are somewhat less stringent Financial institutions are required to hold 17% of "prescribed liabilities" as cash reserves, and 35% as liquid assets Prescribed liabilities comprise

- Deposit liabilities

- Borrowings

- Interest accrued and payable on both items

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This central bank instrument creates a strong incentive to hold treasury bills As defined by the BOJ, domestic currency liquid assets include

- Cash reserves on deposit with BOJ,
- Other cash balances with BOJ,
- Money available at short notice (excluding funds taken into account in determining the liquid assets of the bank or of other financial institutions at which it is deposited),
- Jamaican dollar notes and coins,
- Jamaican government treasury bills
- Local Registered Stock and certain other government instruments with nine months or less to maturity,
- Placements with other financial institutions net of borrowing from those financial institutions

Given the nature of the new institution's business operations, it would hardly be advisable for it to hold an amount equivalent to a large share of its liabilities in the form of liquid assets and government securities During its first few years the institution will have to rely on both technical assistance and credit lines provided on favorable terms by international donors, who will almost certainly not be interested in having much of their funds help in liquid form From the standpoint of development objectives it would not be desirable for this entity to be subject to the standard central bank requirements

However, the BoJ provides for an exemption from the minimum reserve requirements, and the new institution might be eligible for it

- "Certain specific borrowings are exempt from time to time (e g certain wholesale borrowings specifically for on-lending certain borrowings from the Central Bank, etc) "

The projections presented in this study assume that this exemption would apply

As was the case with the MLU all micro and small loans will be secured by collateral All customers will sign an agreement obliging them to transfer the collateral to the institution if they default For this reason the central bank regulation which stipulates that the sum of all outstanding unsecured loans may not exceed 10% of the institution's equity capital is not pertinent here

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Annex 3: Assumptions Re: Microsavings Institution

Assumptions Underlying Balance Sheet and Income Statement Projections for the PO Savings Bank

I Balance Sheet

1 Assets

Liquid assets The institution's liquid funds comprise the items "cash and non-earning liquid assets" and "investment in short term placements"

- We assumed that cash and non-earning liquid assets should be equivalent to at least 15% of the total gross savings deposits portfolio

- The item "investments in short term placements" refers to available liquid funds which have been deposited with other banks or placed in call money up to 30 days, where they earn interest of 20% p a These are readily preterminated and demandable placements which can be used for immediate cash requirements of the bank Investments in short term placements is computed at 15% of total savings portfolio

Investment in Government & Commercial Papers and Securities Investible funds (computed as net equity plus total savings portfolio less liquid assets (cash and short term investments, mandatory reserves) and fixed assets) are placed in fixed-term investments in government papers such as Treasury Bills, commercial papers and various securities Interest rate of 18% p a is the expected return on these investments

Mandatory reserves In compliance with the cash reserve requirements of the BoJ, this item consists of a reserve which amounts to 5% of the institution's total liabilities It will be held at the Central Bank

Fixed Assets A significant portion of this account is alloted to the acquisition of computers, peripherals, local networks, and an investment in a simple but customized banking software to start up the automation of the bank's operations It is projected that, initially the 246 branches of the Postal Savings Bank will be clustered into 13 regional centers nationwide, to facilitate monitoring and report preparation for all branches Each regional center (which will be located in the most strategic branch in a region in terms of accessibility and availability of telecommunication facilities) will be equipped and linked to the head office (main branch in Kingston) via communications equipment (modem, telephone lines etc) "Fixed assets" also includes furniture fixtures and all other office equipment (money counters, security devices, etc) Investments will be made to replace equipment at regular intervals, and thus the value of the fixed assets will remain constant over time Further automation at all branches would be ideal to maximize operational efficiency and allow for development of new products and services for the public This would, however entail massive capital investment in hardware and applicable software systems, that bank management and owners can consider for future growth and profitability

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2 Liabilities and Equity Capital

Total savings portfolio The savings portfolio is a mix of three products namely regular savings accounts, which pays out 10% p a based on average daily balance (ADB), partner savings account, which earns 12% p a on ADB for account holders, and fixed time deposits which yield an interest of 15% p a The size of the portfolio will be a function of the average size of these banking products and their volume of transactions and accounts and also a function of the number of sales officers and the efficacy of their marketing efforts (sales officer productivity factor)

- The existing savings account portfolio of the PO Savings Bank Division of the Workers Bank is used as basis for projecting the total portfolio of the PO Savings Bank for the five-year projection period We have assigned a mix of 60%, 30% and 10% of the total savings deposits to comprise regular savings partner savings and fixed time deposit accounts, respectively

- Our projection assumes substantial growth in the savings portfolio over the five-year period in order to break even on the fifth year of operations This growth will only be realized if marketing activities of the sales officers will be successful The measure of such success is reflected in the number of accounts acquired over a period of time Thus, the number of accounts (not necessarily number of depositors) and the volume of savings portfolio acquired will be a function of the productivity of the sales officers

Table Annex 3-1 **Projected Evolution of Savings Portfolio**

	Regular savings	*Partner savings*	*Fixed time deposits*
End of year 1	80 458 052	40,229 026	13 257 293
End of year 2	339 488,509	169,744 254	55 938 447
End of year 3	1 046 088 362	523 044 181	172 366 832
End of year 4	2 561 055 440	1,280,527 720	421 992 090
End of year 5	4 599 287 614	2,299 643 807	757 837 164

Source projection

Equity capital. The bank has a start-up paid-in capitalization of J$ 25 million Periodic capital increases will be undertaken in accordance with the capital adequacy agreement described below and will involve increments of J$ 1 million

The bank must comply with the international capital adequacy standards, which stipulate that equity capital must amount to at least 8% of risk-weighted assets The World Bank recommends that the equity capital of financial institutions operating in countries with less stable financial systems amount to at least 12% of risk-weighted assets When checking for

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compliance with capital adequacy requirements in our projections, we based our calculations on the 12% rule As a safety net, we have provided a risk rate of 20% for all assets, excluding fixed assets, to cover possible losses from these accounts

Retained profits and accumulated losses brought forward In the projections, it is assumed that profits earned would not be distributed For this reason, the full amount of the profit (or loss) shown in the income statement will be reported in the corresponding item in the balance sheet

II Income Statement

1 Income

Interest income from investments

Interest income from investment in government and commercial papers and securities As interest income from investible funds (computed as net equity plus total savings portfolio less cash and cash reserves and fixed assets) will be the main source of earnings, variations in the size of the savings portfolio (assumptions regarding average growth rate, and total savings volume) and in the interest rates will have a direct impact on the result We assumed that the interest rate will be 18% p a

Interest income from investment in short-term placements Part of the bank's liquid funds can be placed in accounts at other banks as short term placements, as not all of the available resources will be needed immediately to pay for fixed assets or for account withdrawals The return on these investments was estimated to be 20% p a

Administrative expenses These consist mainly of personnel expenses rent and overhead

Personnel expenses Personnel expenses are a function of the number of employees and their salary levels

➢ *Personnel expenses for sales staff* The bank should make a point of adopting a fair performance-based pay scheme In such a system, sales officers' (or sales promoters) salaries will rise over time and their pay will be a function of the quality of their account portfolios The sales officers' salaries should comprise a fixed component plus a flexible performance-based bonus The size of a sales officer's incentive bonus should be determined by the number and volume of accounts in his or her portfolio Moreover, adoption of a performance-based salary scheme is in the interest of the bank itself A high rate of staff turnover (e g among sales officers) pushes up expenditures for training, lowers overall productivity (new sales officers acquire fewer accounts (or depositors) on average) As our frame of reference, we took the average of the salaries which employees at local insurance companies, banks and credit unions are known to receive To simplify the calculation of total personnel expenses, we

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estimated and reported the salaries of the sales officers separately from those of the other staff members As the sales officers become more experienced, their salaries will gradually increase The figures used in the projection already include bonus payments Personnel costs for sales staff are determined by taking the number of sales officers in each category and multiplying them by the relevant sum J$ 17,500 for officers with less than six months' experience with the bank, J$ 23,625 for staff with more than six and less than 12 months' experience, J$ 26,250 for those with between 12 and 18 months' service, and J$ 34,125 for sales officers who have been working for the bank between 18 and 24 months After 2 years' service, sales officers can earn J$ 42,000 The salaries shown here include all incentive pay received by sales officers, which varies according to the number and volume of accounts acquired, as well as the quality of the individual officer's portfolio

- *Personnel expenses for non-sales staff* We have performed separate calculations for the expenses relating to the salaries of the general manager the division managers, regional accountants, cashiers and MIS personnel Each position constitutes a separate salary bracket We have added a blanket 10% to the sum of all salaries to allow for the costs of social security and other non-wage labor costs All salaries include a provision for income tax assessed at the rate which applies to the various remuneration levels in the bank

Table Annex 3-2 **Personnel breakdown and costs per staff category**

End of Year	Sales Officers	Management	Regional Accountants	Cashiers/ Finance Asst	IT Specialists	Internal Auditors	Total
1	30*	3*	13*	247*	2*	13*	308*
2	40*	3*	13*	247*	2*	13*	326*
3	64*	3*	13*	247*	3*	13*	343*
4	80*	3*	13*	247*	3*	13*	359*
5	96*	3*	13*	247*	3*	13*	375*
Avg Salary	17 500	75 000	28 000	21 000	35 000	21 000	

* *Figures refer to number of personnel*
Source *projection*

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As a general rule, the total number of employees is ultimately determined by the (target) business volume, the type of business activities pursued and – for retail banks such as the one we are considering in our projections –the extent to which the branch network is expanded to all regions

Office rent Monthly rental payments are based on an assumed price of J$ 350 per square meter This is an average figure for non-renovated premises in across regions The branches of the bank are located within the existing Post Office premises Hence, assuming the owner of the Postal Savings Bank will be the Post Master General, rent may not be collected from the bank in actual monetary terms However, for profitability computations, it is prudent to provide for rent expense for the banking operations conducted in allocated areas within the Post Offices We assumed that $6m^2$ per person would be required for working space Utilities and incidental expenses (for water, electricity and small-scale maintenance) were estimated at 10% of the amount calculated for rent

Overheads

- The costs of *advertising* were covered by factoring in a lump sum of J$ 3,000 per month

- The costs covered by *training* include theoretical training in the form of introductory seminars and advanced training seminars for the account officers The training costs amount to J$ 1,000 per new sales officer The cost of training personnel in other departments was not included as a separate item in the projection because we assumed that sufficiently well-trained staff for these other services would already be available and could be recruited on the local labor market Ultimately, their training costs are reflected in their salaries

- We assumed that the cost of an *external audit* would be J$ 420,000 per year This figure will rise over time and is invariably expressed as monthly amount

- *Communication costs* (telephone, fax, e-mail etc) were estimated at J$ 1,500 per staff member per month

- The cost of *office supplies* was estimated at J$ 1,000 per employee per month This may seem high at first glance, but note that it also includes the cost of printing passbooks and other forms

- The item "*Travel expenses*" consists mainly of the costs incurred by sales officers when traveling to conduct marketing activities in the different regions nationwide We have assumed that they would amount to J$ 2 000 per month per sales officer and J$ 1,500 per regional accountant – a conservative estimate Regional accountants will perform consolidations of reports at the different regions as well as conduct monitoring of branch operations

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➤ *Contingency allowance* To allow for the fact that not all overheads (for example licensing fees) are precisely accounted for, we have added 20% to the total expenses for training, advertising, communications, office supplies, external audit and security services

Depreciation of fixed assets Depreciation of fixed assets was calculated using the straight-line method over a period of three years for the computer hardware, six years for the banking software and ten years for other fixed assets acquired The Jamaican tax authorities prescribe the use of different coefficients to determine the depreciation on the individual items included under fixed assets However, the resulting figures do not deviate significantly from those obtained by applying the straight-line method

Taxes Under Jamaica's tax laws, various income categories are taxed at different rates Thus, determining the proposed institution's precise tax burden would have involved a great many calculations For our projection, we applied a profit tax rate of 33 3% for profits generated by the bank

III Selected indicators Resulting from Operations

Return on Average Equity In the first four years of operations, the bank is expected to incur massive losses It would be plausible to compute for return on average equity Only in the third year will the bank post a positive total equity, but the effect of prior year's negative equity in the computation of average equity will not show a logical result for the this year The following table shows this trend

Table Annex 3-3 **Profit (Loss) After Tax vis-a-vis Total Equity**

Particulars	***Year 1***	***Year 2***	***Year 3***	***Year 4***	***Year 5***
Profit (loss) after tax ('000)	(49,766)	-(6,594)	(50,810)	(17,010)	35,708
Total Equity ('000)	(2,776)	5,630	27 820	80,810	149 518

IV General Assumptions

1 Currency depreciation risk / Exchange rate risk.

The amounts used in the calculations have been expressed in current Jamaican dollars, and thus the projections assume no serious macroeconomic shocks

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- Currency depreciation risk cannot be ruled out However, as the timing and impact of macro economic shocks are difficult to predict, we did not make any allowance for them

- We did not adjust the figures used in the projections for inflation, mainly because we felt that to do so would have rendered the results less meaningful it would have been more difficult to compare figures for the various years, and they would not have gauged the extent of important shifts and changes as accurately The inflation rate has remained stable in recent years, staying in the low single digits

- **Central Bank requirements**

The Bank of Jamaica sets very strict minimum reserve requirements for domestic currency liabilities (the requirements for foreign currency liabilities are somewhat less stringent) Financial institutions are required to hold 17% of the "prescribed liabilities" as cash reserves, and 35% as liquid assets Prescribed liabilities comprise

- Deposit liabilities
- Borrowings
- Interest accrued and payable on both items

This central bank instrument creates a strong incentive to hold government treasury bills As defined by the BOJ, domestic currency liquid assets include

- Cash reserves on deposit with BOJ,
- Other cash balances with BOJ
- Money available at short notices (excluding funds taken into account in determining the liquid assets of the bank or of other financial institutions at which it is deposited),
- Jamaican dollar notes and coins,
- Jamaican government treasury bills,
- Local Registered Stock and certain other government instruments with nine months or less to maturity,
- Placements with other financial institutions net of borrowing from those financial institutions

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In addition, the Financial Institutions Act of the Bank of Jamaica provides a restriction on deposit taking by a licensee Part IV, section 9-1 it states that "Subject to subsection (2), a licensee shall not incur deposit liabilities of an amount exceeding twenty times the amount of its capital base " In doing the projection of the savings portfolio this factor was considered However, it is unavoidable that the projections could not totally conform to this restriction as shown by the huge losses of the bank despite enormous growth in savings portfolio Such losses caused negative total equity in the first four years of operations The economic importance of the presence of the Post Office Savings Bank providing services to micro and small savers who are located mostly in the rural areas could significantly influence the Ministry of Finance or the Bank of Jamaica to exempt the bank from this restriction and provide a longer grace period until this cap on maximum deposit is complied with by the bank

Annex 4: Directory of Jamaican Contacts

Persons Met or Interviewed

ANNEX 4

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Basil Naar, Senior General Manager

Noel Watson, Assistant General Manager

Norma A Russell, Assistant General Manager, Postal Banking & Network

Orville Hill, Finance Director

Elroy Maloney, Credit Risk

Mary Powell, Senior General Manager

Glenroy Bernard, Head of Microlending

Annex 5: List of References

ANNEX 5

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