OECS
Private Sector Financing:
Bridging the Supply-Demand Gap

November 2007

Caribbean Country Management Unit (LCC3C), Finance and Private Sector Development (LCSPF) and Poverty Reduction and Economic Management (LCSPE) Latin America and the Caribbean Region
CURRENCY EQUIVALENTS
(Exchange rate effective as of 11/30/2007)
Currency Unit: Eastern Caribbean Dollar (EC$)
US$ 1 = EC$ 2.70

FISCAL YEAR
January 1 – December 31

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

ASYCUDA  Automated System for Customs Data
ATM     Automated Teller Machine
DA      Development Agency
DB      Development Bank
CAS     Country Assistance Strategy
CB      Commercial Bank
CCRIF   Caribbean Catastrophe Insurance Facility
CDB     Caribbean Development Bank
CFSC    Caribbean Financial Services Corporation
CIF     Caribbean Investment Fund
CRNM    Caribbean Regional Negotiating Machinery
CSME    Caribbean Single Market Economy
CTCS    Caribbean Technology Consultancy Services
CU      Credit Union
ECCB    Eastern Caribbean Central Bank
ECCU    Eastern Caribbean Currency Union
ECEF    Eastern Caribbean Enterprise Fund
ECHMB   Eastern Caribbean Home Mortgage Bank (ECHMB)
ECSE    Eastern Caribbean Securities Exchange
FSAP    Financial Sector Assessment Program
GIDC    Grenada Industrial and Development Corporation
GDP     Gross Domestic Product
GNI     Gross National Income
HHI     Herfindahl-Hirschman Index
IMF     International Monetary Fund
LAC     Latin America and the Caribbean
NDF     National Development Foundation
NGO     Non-Governmental Organization
OECD    Organization for Economic Co-operation and Development
OECS    Organization of Eastern Caribbean States
PEARLS Protection, Effective Financial Structure, Asset Quality, Rates of Return,
        Liquidity, and Signs of Growth
PSDP    Private Sector Development Program
RGSM    Regional Government Securities Market
SEDP    Small Enterprise Development Project (St. Lucia)
SEDU    Small Enterprise Development Unit
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ACKNOWLEDGMENTS

This study is the result of the work developed by a World Bank team, in coordination with a Regional team. The international team visited the six OECS countries that form part of the Eastern Caribbean Currency Union (ECCU): Antigua and Barbuda, the Commonwealth of Dominica, Grenada, the Federation of St. Christopher and Nevis, St. Lucia, and St. Vincent and the Grenadines. The visit took place from February 19th to March 2nd 2007. The World Bank team was led by Mr. Mario Guadamillas (World Bank) and included Ms. Stefka Slavova (World Bank), Mr. Marco Arena (World Bank) and Mr. Michael Corlett (World Bank). This study has been produced in close consultation with the Eastern Caribbean Central Bank (ECCB). The local team comprised officials from the ECCB and was led by Mr. John Venner (Adviser, Financial and Enterprise Development Department) and included Mrs. Patricia Welsh-Haynes (Deputy Director, Banking and Monetary Operations Department), Mr. Shawn Williams (Bank Examiner, Bank Supervision Department), Mr. Leon Bullen (Economist, Research Department), Ms. Martina Regis (Research Officer, Financial and Enterprise Development Department), Mr. Christopher Louard (Economist, Statistics Department and Maria Barthelmy (Adviser, Governors’ Immediate Office). The team was also assisted by ECCB resident representatives: Mr. Albert Lockhart (Antigua), Mr. Edmund Robinson (Dominica), Mrs. Linda Felix-Berkley (Grenada), Mr. Gregor Franklyn (St. Lucia) and Ms. Elritha Dick (St. Vincent and the Grenadines). Peer reviewers of the study are John Pollner (OPCIL), Clara Ana Coutinho Sousa (LCSPE) and Marius St. Rose (ECCB). Additional valuable inputs were received from Antonella Bassani (World Bank), Errol George Graham (World Bank), Ernesto May (World Bank), Lily L. Chu (World Bank), Juan Carlos Mendoza (World Bank), Jane C. Hwang (World Bank) and James Hanson (World Bank).

The Team is also very thankful to all the entities interviewed that provided representative views of the financial and entrepreneurial community in the OECS countries in regard to private sector financing. In particular, in addition to meetings with staff of the ECCB, the team attended meetings with representatives of the Ministries of Finance, financial institutions (commercial banks, credit union, development banks, and national development foundations), SMEs’ entrepreneurs from different economic sectors (tourism, manufacturing, cottage industries, and services), property registrars, Small Enterprise Development Units, industrial and development corporations, and Chambers of Industry and Commerce. In addition, the Team has reviewed available surveys and studies for the Caribbean region including OECS countries (see Annex I for a detailed list of entities interviewed and surveys used in the study).

Results of the study have been shared with officials at the Eastern Caribbean Central Bank (ECCB). Nevertheless, views expressed in this document are those of the authors, and do not necessarily represent those of the ECCB or any of the Governments within the Eastern Caribbean Currency Area (Anguilla, Antigua and Barbuda, Grenada, Dominica, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines).
EXECUTIVE SUMMARY

1. The high levels of public debt and persistent fiscal deficits limit OECS governments’ ability to pursue counter-cyclical fiscal policies during future economic downturns, leaving private investment as the key driver of future growth. Mobilizing private investment, in turn, entails, among others elements, meeting the financing needs of the OECS private sector for its diversification and growth. According to “Doing Business 2007: Organization of Eastern Caribbean States” access to finance is one of the main areas identified as an obstacle for private sector development. Access to credit is also consistently cited by the private sector, which mainly consist of small and medium enterprises (SMEs), as one of the greatest barriers to growing a business in OECS countries. High cost and low access to finance were cited as one of the four most binding constraints to doing business according to the investment climate survey conducted in Grenada (2004).

2. Access to finance constitutes a critical element to improve the country investment climate, which is necessary to attract and retain investment in order to foster economic growth and reduce poverty. The private sector will be central to this new strategy and will have to increase its competitiveness to take advantage of emerging opportunities in the global market place. This study analyzes the issue of access to finance from three different angles:

   i) the demand side;
   ii) the supply side; and
   iii) the enabling environment.

   It is not possible to fully analyze problems of access to finance without a broad approach. Demand side, supply side and the enabling environment are jointly analyzed in this study to identify key measures that could be applied in order to improve the enabling environment, create better opportunities for business growth and innovation (diversification), and place financial sector institutions in a position to provide finance, especially to SMEs, in a sustainable way.

3. The issue of access to finance for SMEs in the OECS must be considered in light of the context in which OECS countries operate that imposes specific challenges compared to those faced by medium and large economies. Some elements of this context are: i) small size and insularity, ii) high level of government indebtedness, iii) business culture and skills, and iv) absence of a common enabling environment. The small size and insularity of the economies make it difficult to achieve economies of scale in a globalized international market. The high government debt burden of most economies limits the capacity for government action and hence there is a high dependence on external funds. Business culture, skills and innovation opportunities are negatively affected by an emigration level of ten times the current population of the OECS countries (approx. 600,000). Finally, the lack of an adequate and common
enabling environment creates obstacles in building the needed infrastructure, both financial and real sector, thereby imposing high transaction costs.

4. The OECS countries recognized early the need to adopt integrative approaches to overcome these and other challenges. Notable successes include Eastern Caribbean Central Bank’s (ECCB) stewardship over a stable currency and financial system. Going forward, OECS governments have committed to deepen integration efforts through creation of an economic union as a bridge to participation in the Caribbean Single Market and Economy (CSME). Recently, OECS (and other Caribbean) countries adopted an integrated framework, the Catastrophic Risk Insurance Facility, to mitigate risk posed by natural disasters (see Annex III).

5. On the demand side the study answers two major questions:

   - What are the growth constraints (both from the real sector and financial sector) for the already established businesses?
   - What are the main constraints for an innovation agenda? What are the main constraints for the establishment of new firms (start-ups)?

6. SMEs in the OECS countries are basically constrained by high collateral requirements and hence resort to retained earnings as the main source of financing. Those firms which have managed to obtain a bank loan reported collateral requirements to secure the loan sometimes well in excess of 100 percent of the loan value. Collateral used includes both company real property (land and buildings) and owner’s personal assets. Given reported difficulties in obtaining external finance, the majority of OECS firms rely on internal sources of finance and own savings to fund their working capital and new investment. Other forms of external finance such as trade credit, equity finance or venture capital are not common as sources of both working capital and new investment funding in the OECS.

7. Although interest rates are sometimes mentioned as an important constraint, it is not possible to say whether interest rates are prohibitively high and stifling new investment projects. Interest rates were reported to vary between 9 and 12 percent for recently approved loans (2005 and later) denominated in Eastern Caribbean dollars across interviewed OECS companies.

8. The availability of external finance to private OECS firms will highly depend on their capacity to generate viable projects that can be financed in a sustainable manner by the financial sector institutions. There is a sentiment, expressed often by interviewed banks and other lenders, that the private sector is not bringing viable, profitable projects for financing. Entrepreneurship is reportedly not vibrant, and many successful businesses (mainly small hotels and tourism-related firms and light manufacturing) prefer to stay small rather than expand their operation. There are however others who have indicated interest in expanding (so-called “cottage firms” which operate out of the homes of the entrepreneurs) but have been unable to do so due to a variety of constraints (some of which of a financial nature).
9. **Business and industry associations exist in the OECS but are not very effective in either providing business development services (such as training, marketing, management, quality certification information, etc.), or in insuring that firms benefit from higher levels of integration among members (cooperatives, joint ventures are few).** Business associations can play an important role providing members with access to information, services and common strategies with the objective of reducing transaction costs. Interviewed OECS manufacturing and tourism firms revealed that while they do belong to industry associations (chambers of commerce or Hotel and Tourism Associations), these provide limited services. While OECS member-state associations belong to regional (at the sub-region or wider Caribbean) industry associations, there is a sentiment that common strategies and approaches in the OECS are very weak.

10. **On the supply side the study answers three major questions:**

- How do financial institutions approach the SMEs segment (definition and involvement, credit risk management, obstacles/constraints)?
- What are the factors influencing interest rate spreads? Is there room to increase competition in a fragmented market with an uneven distribution of liquidity? 
- How to drive the action of the public sector and non-for profit organizations (DBs and NGOs) to a pro-market activism agenda in a sustainable way?

11. **SMEs finance segment is not yet considered a strategic area neither by commercial banks (CBs) nor credit unions (CUs).** Heterogeneity in the operative definition of SMEs shown across the OECS countries reflects different internal frameworks and operational structures for providing credit to SMEs. The requirements for providing credit to SMEs are similar for both domestic and foreign banks in the OECS region. However, in the case of foreign branches/subsidiaries, the lending decision is taken outside the OECS region after particular lending thresholds. Currently, credit unions (CUs) constitute the main mechanism for mobilizing low-income people savings as well as meeting their credit needs. However, CUs lending to small business is very limited. The recent trend in consolidation across CUs (e.g. in Grenada and Dominica) and the formation of strategic alliances reflect that CUs have realized that the issue of scale is critical to improve the efficiency of their financial services and capacity for lending.

12. **The main challenge/constraint cited by CBs for providing credit to SMEs was their inability to provide the necessary financial statements and reports.** The latter is reflected in the presentation of inadequate cash flows and incomplete business plan proposals. In addition, CBs mentioned that other important reasons for rejection of loan applications are: (i) projects not financially viable, (ii) inadequate collateral, and (iii) poor credit history. Without exception, all CBs that were interviewed mentioned that much more training in business management, entrepreneurial cultural development, promotion of financial literacy is needed for SMEs lending activities. Some CBs pointed out that what SMEs need in many cases is equity financing (venture capital) rather than commercial loans.
13. **The main challenge for the interviewed CUs is the high level of delinquency ratios.** To mitigate high delinquency ratios CUs provide technical assistance (TA) to small businesses (preparation of business plans, skills management, marketing, and even product pricing) through counseling and workshops that in some cases are considered as part of the loan package. Due to the lack of resources, CUs cannot provide TA on a regular, and formal basis.

14. **Interest rates on commercial loans and overdrafts charged by CBs in OECS countries are set at some spread above the prime rate (between 8.5 percent and 10.5 percent across the OECS countries), which takes into account operating costs, profit margin and risk levels.** Over the last year, the range of interest rates for commercial loans has been between 8.5 percent and 12 percent and for overdrafts between 15 percent and 20 percent. However, the interest rate for mortgage loans is between 7 percent and 9 percent, which has shown a decline in the last two years, reflecting higher competitive pressures relative to other market segments. The cost of funding is between 4.5 percent and 6 percent. Interviewed CUs follow CBs’ interest rates. Interest rates on commercial loans range from 12 percent to 14 percent. However, in the case of mortgages, interest rates range from 8 percent to 9 percent, which suggests that CUs respond to CBs’ competitive pressures.

15. **In the context of a fixed exchange rate regime, it seems that at least, in the medium term, local interest rates (lending and T-Bill) do not follow the movements in international US dollar interest rates.** Lending and T-Bill rates do not show much variability across time, which would imply that spreads against the US interest rates are mostly determined by the movements in the latter. Given that the local currency is pegged to the US dollar, the ECCB cannot use monetary policy instruments (e.g. open market operations) to provide signals regarding the level of the interest rate. Currently, the ECCB, uses the discount rate as the only instrument to signal interest rates. However, given the context of relatively high liquidity, it is not used on a regular basis. In addition, the interbank money market has been relatively small and inactive. Foreign-owned banks lend to their branches. This environment is isolating domestic interest rates from external interest rate movements.

16. **The higher spreads of foreign-owned banks raise the question on whether they are exercising market power.** The literature on foreign bank entry has identified that the presence of foreign-owned banks introduces both better financial (low-cost efficient) technology and potentially more pressures for competition. Grenade (2005) shows that the Herfindahl-Hirschman Index (HHI) is lower for foreign-owned banks than that of domestic banks. However, care is needed to interpret this result because the HHI is not a precise measure of competition. Domestic banks, which have to pay higher costs for capital and in many cases have higher operating costs than foreign-owned banks, may just be following the behavior of foreign-owned banks (“follow the leader” model).

17. **Finance to the private sector in the OECS countries, in particular to SMEs, is mainly dominated by basic commercial banks lending instruments.** There are also additional but limited sources of funding that are made available through non-bank FIs (e.g. credit unions, National Development Foundations, and Development Banks). In this
scenario, the most common financial instruments offered to SMEs are those related to working capital (credit cards, overdrafts, and lines of credit), trade finance (pre-exporting and importing financing and letters of credit), surety bonds, and commercial (investment) loans with an average period of maturity of 5-6 years.

18. The lack of financial instruments limits the capacity of enterprises to diversify. This is particularly problematic in the context of the CSME, which calls for the economic diversification and export-oriented economies. Thus, the private sector is in need of a broader set of financial instruments; i.e., going beyond lending, that would allow them not only to take advantage of new (export) businesses opportunities but also to strengthen their capacity and investment in innovation. However, the private sector has indicated both its lack of capital financing options for working capital (e.g. trade finance, factoring) and for long-term finance (e.g. securitization, private equity-venture capital, leasing).

19. There is a need to broaden financial instruments both, for working capital and long term financing. CBs do not have incentives to offer financial products beyond lending, overdrafts, and in some cases trade finance because SMEs are not considered yet a strategic sector for most CBs in the OCES region. Some exceptions are found in Grenada, where some CBs have differentiated units to engage SMEs. In addition, CU’s and DBs are mostly competing with CBs. Credit guarantees and credit insurance could help private equity firms to raise its sources of funding. Equity finance constitutes an alternative source of finance to SMEs and in many cases CBs mentioned that SMEs require equity financing rather than debt financing. However, private equity firms, as in the case in Grenada, struggle to get credit from both local and overseas banks.

20. A number of institutions have tried to cover the access to finance gap in the OECS countries, namely NDFs and DBs, with very limited success. NDFs have been unsuccessful in covering the gap and they are barely able to survive with NPLs ranging from 30 to 60 percent. DBs have basically been competing with commercial banks more than covering a development agenda, sometimes on a sustainable basis sometimes unsustainably. The ECCB is trying to set up a regional institution to cover the gap, the Eastern Caribbean Enterprise Fund (ECEF).

21. High levels of non-performing loans affect directly both the lending and borrowing capacity of the NDFs. The NDFs in Antigua, Dominica, and St. Vincent have very high levels of delinquency ratios (40 percent, 37 percent, and 60 percent respectively). These high delinquency ratios reflect not only the credit risk associated to the loans but also a non-payment culture that has its roots in the assumption that loans from the NDF are the same as grants. On the one hand, due to the high delinquency ratios, NDFs cannot tap funds from external borrowers at concessional rates or even just to get funding. On the other hand, NDFs have to cut their lending and to put more stringent credit requirements, particularly the collateral, in order to reduce non-performing loans.

22. DBs have not been a successful instrument in providing SME finance. The analysis of DBs has been done answering a set of key questions:
i) do DBs aim at mitigating a well-defined problem of access to finance?

*DBs seem to be competing with more than complementing commercial bank activity as an important and increasingly large proportion of their activities consist of the provision of mortgage finance and student loans.*

ii) how is the access problem incorporated into the legal mandate and is the mandate defined in a static or dynamic manner?;

*The Statutory Laws of the different institutions define DBs mandates with a broad and dispersed scope. None of the DBs institutions were born or have a dynamic mandate that obliges them to redefine themselves with the achievement of their objectives. Absent legal reform, the very limited degree of change in these DBs could only be a function of management quality.*

iii) are the institutional form, functions, and instruments of the DBs consistent with a market-friendly mandate?;

*Most DBs in the OECS countries are quasi-fiscal institutions which do not take deposits from the general public. The development banks remain tied to the governments and lack information transparency and adequate regulation and supervision. Governments appoint management and all board members. Governments and their associated organizations remain important funding sources, through guarantees of international loans and through direct provision of domestic resources. Transparency is limited, with DBs reporting to the corresponding Ministries as mandated by their organic laws but there is lack of supervision by financial regulators.*

iv) how is compliance with the mandate being measured and is the mandate achieved through a sound and sustainable way?

*The performance of the development banks in the ECCB area has been generally poor. A number of factors have had an impact on the overall performance of the local DBs, among them, the over-exposure to risks in the domestic economy, high transaction costs, a dearth of long term domestic finance, technical capacity, and political influence on decisions concerning credit allocation. In terms of mandate achievement, no indicators have been elaborated or monitored.*

23. **The ECCB is working towards the establishment of the Eastern Caribbean Enterprise Fund (ECEF).** The ECCB has been undertaking a series of studies on the financial and technical resources available to enterprises in the ECCU as well as a survey of commercial bank lending to the private sector. According to the ECCB results of these studies indicate that while a number of initiatives have been developed to provide risk financing to enterprises in the Caribbean (e.g., Caribbean Investment Fund, CIF) and others, there is still a general lack of risk financing for stimulating and supporting the growth of potentially successful enterprises within the OECS region. In addition, there is a lack of diversity in financial instruments. The ECEF is envisaged as a private equity
fund to serve as an alternative mechanism for mobilizing technical and financial resources needed for promoting growth and expansion of enterprises within the region.

24. **Regarding the enabling environment the study answers two major questions:**

   - How to reduce transaction costs both on the demand and supply side with common and integrated approaches to the enabling environment?
   - Is the tax system creating additional burdens for SMEs access to finance (e.g., higher cash flows needs)?

25. **OECS member states have recognized the need to reform customs hardware and administration, and efforts are ongoing in several of them to improve electronic systems and technologies, train customs staff and generally raise the efficiency of customs operations.** For instance, St. Lucia completed an upgrade of the ASYCUDA++ system in customs in 2006. St. Kitts and Nevis is also implementing a new electronic system at customs. Grenada is planning an upgrade as well – with funding by a new World Bank loan. Such improvements in electronic data exchange and processing are commendable but a remaining concern is that the new systems are not directly compatible across the OECS member states, thereby reducing potential benefits to be had. More harmonization at customs, especially given the CSME and regional trade initiatives, would be needed to encourage trade flows.

26. **There is a wide disparity in the number of days it takes courts in one of the OECS member states to resolve a debt collection case, even though it is governed by the same Civil Procedure Code.** According to Doing Business in 2007, the OECS should work toward improving the administration of the courts, through better case management, performance-based incentives for judges and court staff, and through introducing expedited procedures for simple debt cases (e.g., where the debt is undisputed or the debt amount is not too high). The latter has already been done in the new Civil Procedure Rules for the entire OECS. A review of the rotating judge arrangements currently in place in several of the islands is also warranted, as there is a sentiment that the amount of time judges spend in a single jurisdiction (about 6 weeks per annum) is not sufficient to clear the caseload.

27. **All OECS member states have a functioning unified registry which records security interests. However, this functions as part of the general registry system and no specialized collateral registry exists.** Furthermore, the registries often combine property, company and other civil registrations (see next section), which causes backlogs and higher burdens for the registrar officials. Some ongoing efforts exist to move to a paper-less electronic registry system, which would then allow for speedier registration of collateral and faster access by users who would like to ascertain existing liens on a piece of property. Interviews with private sector representatives in the OECS have pointed to a lack of capacity and staff working in the public registry systems, and delays in transfer of land titles and land registration. One way to improve the functioning of the registry offices is to train staff and introduce performance-based incentives to speed up the registration process. Grenada has embarked on this type of reform in its Public Registry.
28. The lack of some important elements of the financial sector institutional and infrastructure framework makes it difficult to define benchmarks for the credit granting process. There is a lack of common approach for the application of accounting standards and presentation of audited financial statements throughout the OECS countries. The lack of formal credit information systems make borrowers highly dependent on “physical collateral” versus “reputation collateral”. There is not a formal credit reporting system, either public or private, and banks and financial institutions rely on the exchange of information on an informal basis. Company registries in the OECS display some notable deficiencies. At present, none of them uses electronic records, which makes searching of company information a laborious and time-consuming task. Often these are combined with land and other civil registries, which exacerbate the ease of use.

29. Newly implemented Value Added Tax (VAT) may pose disincentives for the manufacturing sector if the administration of the VAT tax is inefficient (i.e. if there are long delays to get VAT refunds). In order to lower prices, manufacturing companies, need to import in bulk quantities (usually inputs for their production) and this requires that they maintain a higher level of cash flow for the administration of the tax, especially by export-oriented companies that need to wait a for a refund. Though the VAT has only been recently introduced in Antigua and Barbuda, firms are complaining that the refund process is too slow, causing cash flow problems and imposing added costs to exporters. This problem is compounded by the banking system’s lack of products for working capital and the lack of usage of the ECCB’s Export Credit Guarantee Schemes.

30. There is low interconnectivity among payment systems networks increasing transactions costs of retail payments and the absence of a direct debit instrument makes payroll payments more inefficient and limits retail banking competition. Until the late nineties, few commercial banks had ATMs and POS terminals were practically non-existent. Over the past decade, many banks have installed ATMs and banks are issuing internationally brands debit and credit cards to be used in POS transactions, also including a cash withdrawal function. However, while the banks are making progress in the use of technology there is still lack of infrastructure that would allow for interoperability. The absence of direct debit means that employees have been restricted to the banking services of their employer creating inefficiencies. The ECCB has recognized these payment system deficiencies and has embarked on a payments system reform. At the beginning of the 2000s the ECCB launched a Real Time Gross Settlement System for large value and time critical transactions (GLOBUS). This major advance will be completed with operational upgrades at the retail system level driven to achieve the interoperability and technical compatibility among ATMs and POS.
<table>
<thead>
<tr>
<th>Demand Side</th>
<th>Issues in Access to Finance</th>
<th>Recent/ongoing and short term measures</th>
<th>Medium to long term measures or considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>● Private firms do not generate enough viable investment projects which demand external financing</td>
<td>● Enhance firms capacity to develop business plans and apply for loans, especially for micro and small firms</td>
<td>● Further pursue efforts, at the level of business clusters or associations, to train micro and small entrepreneurs in basic business planning and management</td>
</tr>
<tr>
<td></td>
<td>● Private firms suffer from lack of sufficient scale of production</td>
<td>● To achieve higher scale of operation, firms need to form clusters or value chains and attain a higher degree of regional integration (across the OECS and Caribbean as a whole)</td>
<td>● Further pursue the creation of value chains and firm associations, such as clusters, which could potentially reduce transaction costs and bring about economies of scale; cluster development is a long-term endeavor</td>
</tr>
<tr>
<td></td>
<td>● Firm partnerships, such as business associations and clusters, are relatively weak or non-existent</td>
<td>● Improvements in quality infrastructure (e.g. laboratories, metrology and standards) are needed</td>
<td>● Further invest in a better quality system, perhaps with a focus on regional bodies (laboratories, institutes, etc.)</td>
</tr>
<tr>
<td></td>
<td>● Low quality of certain products (agriculture) and lack of consistent supply of these reduce competitiveness</td>
<td>● Ongoing government programs offering BDS and other assistance, are underway across the OECS</td>
<td>● Making BDS programs sustainable should be pursued; once a market is established, the role of the Government could diminish over time</td>
</tr>
<tr>
<td></td>
<td>● Business development services (BDS), such as training in management, marketing and accounting, are not widely available in the market</td>
<td>● Programs offered by donors and governments could be better aligned with firm needs and better targeted</td>
<td>● Target establishment of backward linkages from the tourism sector to local agriculture and agro-processing</td>
</tr>
<tr>
<td></td>
<td>● Existing programs to provide BDS are often fragmented and not sustainable over time</td>
<td>● Entrepreneurial skills could be enhanced through targeted interventions in the educational system</td>
<td>● Address other bottlenecks related to transportation and distribution, which make OECS products uncompetitive internationally. The ECCB and the OECS Secretariat are currently exploring the establishment of an OECS Distribution and Transportation company.</td>
</tr>
<tr>
<td></td>
<td>● Entrepreneurship is not vibrant; loss of worker skills poses problems</td>
<td>● Linkages from tourism industry to other industries have been week</td>
<td></td>
</tr>
<tr>
<td>Supply Side</td>
<td>Issues in Access to Finance</td>
<td>Ongoing and Future Possible Actions</td>
<td>Medium to long term measures or considerations</td>
</tr>
<tr>
<td>-------------</td>
<td>-----------------------------</td>
<td>------------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>• Need to broaden financial instruments both for working capital and long-term finance. The lack of financial instruments available to SMEs limits their capacity to diversify.</td>
<td>• Recent cases of increased competition in the mortgage market could be explored to extend competition to other segments (e.g., SME finance).</td>
<td>• It would be recommended to follow the case of Grenada that established the GARFIN (Grenada Authority for the Regulation of Financial Institutions) Act in Parliament in order to strengthen the supervision of the non-bank financial sector.</td>
</tr>
<tr>
<td></td>
<td>• Need to unify and strengthen the supervision of the non-bank financial institutions (credit unions, insurance companies, off-shore banks)</td>
<td>• <strong>Establishment of regulatory bodies for non-bank financial institutions (SRUs) across the OECS. This has already been initiated. See the case of Grenada (GARFIN)</strong></td>
<td>• Provide consistent and targeted technical assistance to the SME sector together with a qualitative improvement in the enabling environment in order to increase the number the projects that will be considered bankable by financial institutions.</td>
</tr>
<tr>
<td></td>
<td>• The SME segment is not yet considered a strategic sector neither by commercial banks nor credit unions.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Development Agenda</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• DBs have not been a successful instrument in providing SME finance</td>
<td>• <strong>St. Lucia and St. Vincent and the Grenadines merged/are merging the DBs with commercial banks. Other Governments are discussing alternatives sources of finance (e.g., taking deposits form the public) to make DBs compete on a sustainable basis with other financial sector providers</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• DBs remain tied to the governments and lack information transparency and adequate regulation and supervision</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The financial performance of DBs has been generally poor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The ECCB is working towards the establishment of the ECCF</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Development Agenda</strong></td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enabling Environment</td>
<td>Issues in Access to Finance</td>
<td>Ongoing and Future Possible Actions</td>
<td>Medium to long term measures or considerations</td>
</tr>
<tr>
<td>----------------------</td>
<td>----------------------------</td>
<td>-----------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td></td>
<td><strong>Tax System</strong></td>
<td><strong>Tax System</strong></td>
<td><strong>Contract Enforcement, Collateral Registration and Repossession</strong></td>
</tr>
<tr>
<td></td>
<td>- Delays in processing VAT refunds cause cash flow problems for exporters</td>
<td>- CARTAC-IMF have working closely with OECS members on VAT design and implementation</td>
<td>- Need to work toward improving the administration of courts, through better case management</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Monitor performance of VAT in order to remedy refund problems</td>
<td>- Full Automation and rationalization of registries</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Dominica intends to conduct a comprehensive review of VAT performance by September, 2007</td>
<td><strong>Benchmarking, Information Transparency and Credit Reporting Systems</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Contract Enforcement, Collateral Registration and Repossession</strong></td>
<td></td>
<td>- Improve accounting, financial reporting and auditing practices and effectively aligning them with international standards</td>
</tr>
<tr>
<td></td>
<td>- Wide disparity in the number of days to resolve a debt collection case</td>
<td>- OECD are reviewing rotating judge arrangements</td>
<td>- ECCB is well positioned to serve as the coordinator for a reform agenda in credit reporting</td>
</tr>
<tr>
<td></td>
<td>- No specialized collateral registry</td>
<td>- Improvements in registries automation</td>
<td>- Improvements in the companies’ registries.</td>
</tr>
<tr>
<td></td>
<td><strong>Benchmarking, Information Transparency and Credit Reporting Systems</strong></td>
<td></td>
<td><strong>Retail Payments System Development</strong></td>
</tr>
<tr>
<td></td>
<td>- Lack of common approach for the application of accounting standards and audited financial statements</td>
<td>- Authorities in the OECS countries should take a leadership role in motivating the development of credit information systems</td>
<td>- Pursue automated clearing house (ACH) for the broad use of new payments instruments. The ECCB should take a leadership role to help achieve the necessary agreements among banks and other major stakeholders</td>
</tr>
<tr>
<td></td>
<td>- Borrowers highly dependent on “physical collateral” versus “reputation collateral”</td>
<td>- ECCB has embarked on a comprehensive payments system reform</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Retail Payments System Development</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Mainly based on cash and cheques</td>
<td>- Low interconnectivity among networks increasing transactions costs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Absence of a direct debit instrument makes payroll payments more inefficient and limits retail banking competition.</td>
<td>- Absence of a direct debit instrument makes payroll payments more inefficient and limits retail banking competition.</td>
<td></td>
</tr>
</tbody>
</table>
I. INTRODUCTION AND MOTIVATION

31. According to “Towards a New Agenda for Growth”, growth in the OECS has been strong over the last few decades but by the end of the 1990s had experienced a slowdown. This slowdown was due to deteriorating external conditions including the loss of trade preferences and the events of September 11, 2001. Governments have pursued counter-cyclical fiscal policies to smooth economic downturns characterized by slack private investment, but this has led to worsening fiscal deficits and soaring public debt to the extent that some OECS countries are now among the most indebted in the world. While economic activity has picked up notably over the last few years, averaging 3.7 percent during 2003-2005, and 6 percent in 2006 driven by investment ahead of the 2007 Cricket World Cup. The sub-region is concerned about sustaining growth following the Cricket World Cup. The high levels of public debt and persistent fiscal deficits will likely limit governments’ ability to pursue counter-cyclical fiscal policies during future economic downturns, leaving private investment as the key driver of future growth. Mobilizing private investment, in turn, entails, among others elements, meeting the financing needs of the OECS private sector for its diversification and growth.

32. According to “Doing Business 2007: Organization of Eastern Caribbean States” access to finance is one of the main areas identified as an obstacle for private sector development. The OECS countries perform well on the ease of starting a business, dealing with licenses, and the strength of investor protections. But they fall behind on the ease of getting credit, enforcing contracts, and closing a business. Results vary for trading across borders, registering property, and paying taxes (see Table 1).

<table>
<thead>
<tr>
<th>Country</th>
<th>OECS Ranking</th>
<th>Global Ranking (out of 175 countries)</th>
</tr>
</thead>
<tbody>
<tr>
<td>St. Lucia</td>
<td>1</td>
<td>27</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>2</td>
<td>33</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>3</td>
<td>44</td>
</tr>
<tr>
<td>Dominica</td>
<td>4</td>
<td>72</td>
</tr>
<tr>
<td>Grenada</td>
<td>5</td>
<td>73</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>6</td>
<td>85</td>
</tr>
</tbody>
</table>

Note: Rankings on the ease of doing business are the average of the country rankings on the 10 topics covered by Doing Business. The rankings for all economies are benchmarked to April 2006. Source: Doing Business, 2007.

33. Access to credit is consistently cited by the private sector, which mainly consist of small and medium enterprises (SMEs), as one of the greatest barriers to growing a business in OECS countries. Small businesses are constrained the most. Doing Business covers two dimensions of access to credit in the OECS: access to credit information and the legal rights of borrowers and lenders. Where lenders have more

1 Prepared by the World Bank and the International Finance Corporation with support from the United States Agency for International Development, the report tracks the time, cost, and problems a business faces to comply with legal and administrative requirements in startup, operation, trade, taxation, and closure. It does not track variables as macroeconomic policy, quality of infrastructure, currency volatility, investor perceptions, or crime.
information about potential borrowers, they can make better loans to a broader base of customers. And, where a broad pool of assets may be pledged and lenders can collect them easily, more loans are extended. Getting credit is difficult across the OECS (see Table 2). Doing Business 2007 finds that the OECS countries rank an average 98 (out of 175) in terms of ease of obtaining credit, and all six countries fall in the bottom half of the global ranking on the ease of getting credit.

**Table 2: Getting Credit and Enforcing Contracts Ranking**

<table>
<thead>
<tr>
<th>Country</th>
<th>Getting Credit (rank out of 175)</th>
<th>Enforcing Contracts (rank out of 175)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grenada</td>
<td>83</td>
<td>160</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>83</td>
<td>47</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>101</td>
<td>125</td>
</tr>
<tr>
<td>Dominica</td>
<td>101</td>
<td>159</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>101</td>
<td>143</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>117</td>
<td>135</td>
</tr>
</tbody>
</table>

*Source: Doing Business, 2007.*

34. **High cost and low access to finance** were cited as one of the four most binding constraints to doing business according to the investment climate survey conducted in Grenada (World Bank, 2004). Eighty-five percent of the firms’ managers that were interviewed revealed that they meet their working capital needs using own funds and retained earnings as the primary sources of financing, and thought that commercial banks did not provide the venture and project support required by many companies. Interestingly, a small survey of 40 publicly-listed companies in the Caribbean (including several firms in the OECS) found that the majority of financial managers prefer to rely on a hierarchy of financing sources headed by internal finance and “straight debt” rather than trying to maintain a target debt-to-equity when seeking financing for new investments (Robinson, 2003).

35. **In sum, access to finance constitutes a critical element to improve the country investment climate, which is necessary to attract and retain investment in order to foster economic growth and reduce poverty.** The private sector will be central to this new strategy and will have to increase its competitiveness to take advantage of emerging opportunities in the global market place. The study analyzes the issue of access to finance from three different angles:

   i) the demand side;
   
   ii) the supply side; and
   
   iii) the enabling environment.

It is not possible to fully analyze problems of access to finance without a broad approach. Demand side, supply side and the enabling environment should be jointly analyzed to identify key measures that could be applied in order to improve the enabling environment, create better opportunities for business growth and
innovation (diversification), and place financial sector institutions in a position to provide finance, especially to SMEs, in a sustainable way.

36. The rest of the document is organized as follows. Before entering in the specifics of access to finance form the different perspectives mentioned above, section II briefly describes some of the distinctive characteristics of these small economies (small size and insularity, high level of government indebtedness, business culture and skills, absence of a common enabling environment) and how these characteristics imposes additional constraints. Section III analyzes demand side issues including: i) firms’ financial constraints; ii) risk diversification, management capacity, economies of scale and product quality; iii) role of the tourism sector as a driver for development; iv) role of business associations and partnerships; v) concessions; and vi) government and donor programs for business development. Section IV will look into supply side issues including: i) financial institutions approach to the SME finance business; ii) interest rates and competition in the financial sector; iii) availability of financial instruments; and iv) a development agenda to cover the finance gap. Section V identifies some enabling environment constraints including: i) customs and logistics; ii) collateral registration and repossession; iii) benchmarking, information transparency and credit information systems; iv) tax system and cash-flow needs and v) retail payments system development. Finally, section VI includes some policy recommendations.

II. General Context

37. The context in which OECS economies operate imposes specific challenges compared to the challenges faced by medium and large economies. These challenges are even more acute for the SME sector. This section explicitly acknowledges the existence of these challenges in order to better understand the access to finance constraints from all aspects, demand side, supply side and enabling environment. It is important to understand this context in order to better define policy actions in the access to finance area. These constraints go beyond a policy framework to improve access to finance and some issues are being addressed through OECS Governments programs and actions.

II.1 Small Size and Insularity

38. The small size and insularity of the economies generate great difficulties to reach economies of scale in a globalized international market. The OECS comprise some of the smallest countries in the world in terms of both population and land mass. The combined population is less than 600,000, and the total land mass, 2,890 sq. km, is less than a third the size of Jamaica. All of the OECS – small open economies with limited domestic demand (which limits agriculture) and highly dependent on imports (which affects the manufacturing and services sectors) – face diversification challenges. Also, the lack of diversification combined with an exposure to natural disasters (e.g., earthquakes and hurricanes) impose a high level of concentrated risk to these economies. The insularity is also evident in the job markets, where queuing for government jobs has
exerted upward pressure on labor costs in other sectors, decreasing their competitiveness (World Bank, 2005a).

Table 3: Selected Economic Indicators and Statistics (Average 2001-05, unless otherwise indicated)

<table>
<thead>
<tr>
<th>Country</th>
<th>Population*</th>
<th>Inflation</th>
<th>Trade openness (Exports plus imports as a % of GDP)</th>
<th>External debt (% of GNI) *</th>
<th>Foreign direct investment, net inflows (% of GDP)</th>
<th>Aid (% of GNI)</th>
<th>Workers’ remittances and compensation of employees, received (US$) as a % of GNI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antigua and Barbuda</td>
<td>81</td>
<td>2.4</td>
<td>129..</td>
<td>1.057</td>
<td>1.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominica</td>
<td>72</td>
<td>1.4</td>
<td>110</td>
<td>88.8</td>
<td>5.9</td>
<td>9.284</td>
<td>1.7</td>
</tr>
<tr>
<td>Grenada</td>
<td>107</td>
<td>1.4</td>
<td>112</td>
<td>112.7</td>
<td>14.5</td>
<td>3.160</td>
<td>6.1</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>48</td>
<td>2.2</td>
<td>114</td>
<td>90.8</td>
<td>20.5</td>
<td>3.145</td>
<td>1.0</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>166</td>
<td>1.8</td>
<td>114</td>
<td>61.2</td>
<td>10.1</td>
<td>1.835</td>
<td>0.6</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>119</td>
<td>1.7</td>
<td>119</td>
<td>67.5</td>
<td>10.8</td>
<td>2.087</td>
<td>1.1</td>
</tr>
<tr>
<td>Upper middle income**</td>
<td></td>
<td></td>
<td>68.8</td>
<td>34.3</td>
<td>2.7</td>
<td>0.232</td>
<td>1.1</td>
</tr>
<tr>
<td>OECS **</td>
<td>99</td>
<td>1.9</td>
<td>113.0</td>
<td>84.2</td>
<td>12.3</td>
<td>3.428</td>
<td>2.0</td>
</tr>
<tr>
<td>Caribbean**</td>
<td>1,604</td>
<td>7.0</td>
<td>102.7</td>
<td>74.2</td>
<td>7.5</td>
<td>3.156</td>
<td>5.9</td>
</tr>
<tr>
<td>Small States**</td>
<td>1,194</td>
<td>5.3</td>
<td>118.9</td>
<td>91.7</td>
<td>7.1</td>
<td>10.579</td>
<td>5.1</td>
</tr>
<tr>
<td>LAC</td>
<td></td>
<td></td>
<td>45.9</td>
<td>40.1</td>
<td>3.0</td>
<td>0.337</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: World Development Indicators, IMF

Note: Data are presented as averages of 2001-05, unless otherwise indicated. “Small States” include Antigua and Barbuda, Bahamas, The, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, Cape Verde, Comoros, Fiji, Guinea-Bissau, Kiribati, Maldives, Marshall Islands, Micronesia Fed. Sts., Mauritius, Palau, Papua New Guinea, Samoa, Sao Tome and Principe, Seychelles, Singapore, Solomon Islands, Timor-Leste, Tonga, Vanuatu, Botswana, Equatorial Guinea, Gabon, Gambia, The, Lesotho, Malta, Namibia, Swaziland, Brunei Darussalam, Cyprus, Estonia, Qatar, Djibouti, Bahrain.

* Thousands, most recent year available.

** Simple averages.

39. The smallness and openness increases the vulnerability of these countries to external shocks. OECS countries are some of the most open economies of the world. The average trade openness (exports and imports of goods and services as a percentage of GDP) for 2005 is 118 percent of GDP. In the last decade or so, the countries have experienced such shocks as the erosion of trade preferences, which has crippled traditional banana and sugar industries, the rise in oil prices after September 11, which damaged the fiscal positions of countries that did not implement a pass-through of oil prices, high vulnerability to natural disasters, and a reduction of aid flows from traditional sources, which has forced countries to seek alternative sources of finance. All six OECS countries ranked in the top twelve in terms of natural disaster events by land area. Grenada has recently suffered disproportionate damage from natural disasters with Hurricane Ivan (September 2004) causing damages estimated at 200 percent of GDP, followed by Hurricane Emily in 2005 which caused a further 12 percent of GDP in damages (IMF, 2006a).

II.2 High Level of Government Indebtedness

40. The high government debt burden of most economies imposes a limited capacity for government action and high dependence on external funds to tackle problems of the enabling environment and SME finance markets. OECS countries are among the most indebted in the world (see Figure 1). The rise in public debt is a recent phenomenon: debt levels were below 50 percent in the mid 1990s but accelerated rapidly due to a combination of factors including poor fiscal performance, natural disasters and declining aid levels (Sahay, 2005).

**Figure 1: Public Sector Debt in Highly-Indebted Emerging Market Countries, end 2005 (in percent of GDP)**


41. **Worsening debt levels are largely explained by poor fiscal performance.** An IMF debt decomposition analysis revealed that the worsening of the fiscal accounts during the period of rapid debt accumulation (1998-2003) is largely explained by higher government expenditures, as revenues were largely stable (Rodriguez and Cashin, 2004). Increases in current expenditures, and in particular non-interest expenditures, drove fiscal performance during this period, while interest expenditures also increased in line with debt accumulation.

42. **Fiscal and debt performance have improved since 2003 due to tighter fiscal stances, debt restructurings, and improved growth performance.** Fiscal outcomes improved significantly during 2004-05 in most countries. The improved fiscal performance occurred on both the revenue and expenditure side resulting in an improvement in primary balances from a sub-regional average of -2.8 percent of GDP during 1998-2003 to an average of 1.2 percent of GDP during 2004-05 (IMF, 2007 and Sahay, 2005). On the expenditure side, non-interest expenditures account for much of the improvement while interest payments have remained relatively high reflecting the continued high debt levels. Active debt management has also improved the debt dynamics in the region, mainly through debt restructurings in Antigua and Barbuda, Dominica, and Grenada.
Table 4: Recent Fiscal and Debt Performance of OECS Countries

<table>
<thead>
<tr>
<th></th>
<th>Total Public Debt</th>
<th>GDP Growth</th>
<th>Overall Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antigua and Barbuda</td>
<td>102</td>
<td>146.8</td>
<td>137.4</td>
</tr>
<tr>
<td>Dominica</td>
<td>61</td>
<td>127.4</td>
<td>116</td>
</tr>
<tr>
<td>Grenada</td>
<td>42</td>
<td>110</td>
<td>132.7</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>86</td>
<td>161</td>
<td>179.3</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>36</td>
<td>63.9</td>
<td>69.3</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>48</td>
<td>72.3</td>
<td>78.1</td>
</tr>
<tr>
<td>OECS (simple average)</td>
<td>62.5</td>
<td>113.6</td>
<td>118.8</td>
</tr>
</tbody>
</table>

Source: IMF and World Development Indicators.

43. The composition of public debt has radically changed over the last decade. Debt composition has moved from reliance on concessional multilateral and bilateral lending in the mid-1990s to costlier commercial and debt by the mid-2000s, reflecting reduced aid levels (see Figure 2). Governments have recently turned to domestic sources of funding including social security surpluses. This source of financing may be tested as the population matures. The fledgling Regional Government Securities Market (RGSM) has provided an important source of funding, accounting for 6 percent of outstanding central government debt in 2005.

44. High public debt levels do not seem to have exerted upward pressure on domestic lending rates. Domestic lending interest rates are comparably low relative to other Caribbean countries and other small states (see Figure 3). Though data on weighted average interest rates are not available for all countries depicted in Figure 3, OECS countries have lower average lending rates than most other Caribbean countries; only Barbados, Trinidad and Tobago, and the Bahamas, all countries with substantially lower debt burdens, have lower lending rates. The fixed and stable exchange rate as well as liquid banking system could help explain the OECS’s relatively low lending rates.
Figure 3: Average Lending Rates of OECS and Selected Small States


II.3 Business Culture and Skills

45. Business culture, skills and innovation opportunities are negatively affected by an emigration level of ten times the current population of the OECS countries (approx. 600,000). Skills are important for achieving and maintaining competitiveness, and particularly important for OECS countries which are moving from a low-skill agricultural development model to one based on skill-intensive service industries.

46. The shortage of skilled labor has frequently been cited as a major constraint to increasing competitiveness (World Bank, 2004). The skill shortage is prevalent in specific technical areas as well as professional services including accounting and information technology. A World Bank report on Skill Challenges in the Caribbean finds, inter-alia, that the skills gap in OECS countries contributes to difficulty in job creation, pushes people into the informal sector, and leads to an out-migration of individuals whose skills are under-utilized (World Bank, forthcoming). “Towards a New Agenda for Growth” (World Bank, 2005a) cites several reasons for the shortage of skilled labor including: relatively low educational attainment, in terms of quantity and quality of secondary education graduates, an under-supply of tertiary education and training, overly protective labor market rules, and emigration (see below). Schooling is insufficiently focused on labor market skills and overly oriented towards an academic career.

47. The skills deficiency is exacerbated by emigration. The Caribbean region has the highest emigration rates in the world and the phenomena is particularly acute amongst the tertiary educated labor force (see Table 5) (Mishra, 2006). As indicated in the table below, a large percentage of educated OECS individuals migrate resulting in social dislocation among families and communities and a reduction in the productivity in specific sectors including public sector – where capacity is weak – and the entrepreneurial class. Assessing the overall impact of emigration is complicated by such
mitigating factors as remittance income and the circulation of emigrants who frequently return to the source country bringing business experience, investment capital, etc. Mishra (2006) estimated that emigration losses as a percentage of GDP are very large for the Caribbean in general and the Eastern Caribbean in particular, and outweigh remittances in all OECS countries with the exception of St. Lucia.\textsuperscript{3} OECS Governments have encouraged return migration and “brain circulation” to leverage skills, expertise, capital and ideas. For example, the Dominica Diaspora have moved beyond the traditional role (sending remittances) to initiatives aimed at enhancing human potential, including creating a database of skilled and professional Dominicans (Fontaine, 2006).

\textbf{Table 5: Percent of Labor Force Migrated to the OECD, 1970-2000, (By Level of Schooling)}

<table>
<thead>
<tr>
<th>Country</th>
<th>Primary</th>
<th>Secondary</th>
<th>Tertiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antigua and Barbuda</td>
<td>6</td>
<td>36</td>
<td>71</td>
</tr>
<tr>
<td>Bahamas, The</td>
<td>2</td>
<td>12</td>
<td>36</td>
</tr>
<tr>
<td>Barbados</td>
<td>10</td>
<td>24</td>
<td>61</td>
</tr>
<tr>
<td>Belize</td>
<td>6</td>
<td>49</td>
<td>51</td>
</tr>
<tr>
<td>Dominica</td>
<td>8</td>
<td>61</td>
<td>59</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>6</td>
<td>31</td>
<td>22</td>
</tr>
<tr>
<td>Grenada</td>
<td>10</td>
<td>70</td>
<td>67</td>
</tr>
<tr>
<td>Guyana</td>
<td>14</td>
<td>34</td>
<td>86</td>
</tr>
<tr>
<td>Haiti</td>
<td>3</td>
<td>28</td>
<td>82</td>
</tr>
<tr>
<td>Jamaica</td>
<td>8</td>
<td>30</td>
<td>83</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>10</td>
<td>37</td>
<td>72</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>3</td>
<td>32</td>
<td>36</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>6</td>
<td>53</td>
<td>57</td>
</tr>
<tr>
<td>Suriname</td>
<td>18</td>
<td>44</td>
<td>90</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>6</td>
<td>21</td>
<td>78</td>
</tr>
<tr>
<td>\textbf{Average}</td>
<td>8</td>
<td>37</td>
<td>63</td>
</tr>
</tbody>
</table>


\textbf{II.4 Absence of a common enabling environment}

48. The lack of an adequate and common enabling environment creates obstacles in building the needed infrastructure, both financial and real sector, thereby imposing high transaction costs. Key aspects of the enabling environment – including physical infrastructure, business environment, governance, financial sector – need to be improved in order to promote private sector led growth. Capacity constraints and diseconomies of scale necessitate common approaches to improve each of these areas.

49. High costs of physical infrastructure reduce competitiveness of productive sectors. High costs in utility and infrastructure–related services, which are key inputs into the production system, in the OECS reduce the competitiveness of niche manufacturing and broad based services sectors. Telecommunications services, particularly commercial internet access, remain costly, though the establishment of the

\textsuperscript{3} Mishra (2006) calculates emigration loss as (i) losses from simple labor demand supply framework; (ii) impact on productivity of remaining labor force; and (iii) government expenditure of education of migrants.
Eastern Caribbean Telecommunications Authority (ECTEL) introduced competition to the fixed and mobile markets and has led to lower costs. The supply and cost of electricity is consistently reported as a key business constraint. Maritime transport, particularly intra-regional, is inadequate and freight costs are high, reducing viability of intra-regional business ventures (World Bank, 2005b).

50. **Key aspects of the business environment complicate doing business.** Several areas of the tax system have been identified as barriers to doing business including the use of discretionary duty concessions and investment incentives (World Bank, 2006 and World Bank, 2005a). Weaknesses in tax and customs administration create obstacles for investors. The investment incentive regime is harmful in terms of foregone revenues and distorting investment decisions. Progress towards replacing the system of tax holidays with a system of accelerated depreciation and loss carry forward provisions has been mixed, with some successes in Grenada and Dominica. Cumbersome and non-harmonized customs regulations also pose a constraint to businesses in many OECS countries (World Bank, 2004). Reforms are ongoing in the subregion to improve customs systems, including implementing ASYCUDA++ electronic systems in St. Lucia, but efforts have not been streamlined, reducing opportunities to reap economies of scale in regional shipping of products (World Bank, 2006).

51. **OECS have advanced in the harmonization of several areas of business regulations, including business startup, legal rights of borrowers and lenders, bankruptcy procedures, and contract enforcement.** Yet differences arise in how this harmonized legislation is implemented in each jurisdiction. Other areas are pending harmonization such as: customs modernization, fiscal incentive regimes, oversight of electric utilities, regional approach to air and maritime transport, link of energy systems, common tourism strategy to target new market segments, strengthening investment and tourism promotion, etc.

52. **There are also important advances towards the integration of financial markets and institutions though the financial system is still fragmented.** There is a currency union with a common currency and a common central bank (Eastern Caribbean Central Bank, ECCB). The ECCB has established the goal for the development and integration of these markets into a single financial space within the Currency Union. The ECCB identified institutions and markets to be established at the regional level. These include: the Eastern Caribbean Home Mortgage Bank, the Eastern Caribbean Securities Market, the Regional Government Securities Market, the Eastern Caribbean Unit Trust, and the Eastern Caribbean Enterprise Fund. A major component of the ECCB’s Money and Capital Market Development initiative started in October 2001, with the launch of the Eastern Caribbean Securities Market (ECSM). In November of 2002, the Regional Government Securities Market (RGSM) was launched providing primary and secondary market facilities for government securities from the ECCU member states. The ECCB has also made progress in implementing FSAP recommendations to strengthen the regulatory framework for banks.

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4 Dominica publishes information on tax concessions each month in the Official Gazette (IMF 2007 Dominica)
III. Demand Side Factors

53. This section looks into the following questions:

- What are the growth constraints (both from the real sector and financial sector) for the already established businesses?
- What are the main constraints for an innovation agenda? What are the main constraints for the establishment of new firms (start-ups)?

Some answers to these two questions can be approached analyzing several demand side aspects such as: i) the main financing constraints, ii) risk diversification through management capacity, economies of scale and product quality, iii) role of business associations and partnerships, iv) concessions and v) government and donor programs for business development.

III.1 Main Financing Constraint: High Collateral Requirements

54. Access to finance is considered one of the main problems which private OECS firms face. Detailed interviews conducted with over 30 private firms indicate that firms perceive access to and cost of finance as one of the most binding constraints to their operations and growth. This is confirmed also by other reports, such as the Grenada Investment Climate Assessment (World Bank, 2004). Thus, 40 percent out of 201 interviewed Grenadian firms consider the cost of finance a major or serious obstacle to doing business (see Figure 4), 28 percent found access to finance (collateral) such a constraint. These constraints are viewed to be especially binding by small domestic manufacturing firms.

Figure 4: Factors Rated as Major or Severe Obstacles for Doing Business in Grenada (percent of interviewed firms)

![Figure 4: Factors Rated as Major or Severe Obstacles for Doing Business in Grenada (percent of interviewed firms)](chart.png)

Source: Grenada Investment Climate Assessment (World Bank, 2004).
55. The majority of firms in the OECS have a bank loan or an overdraft but these are predominantly used by smaller firms for financing working capital needs. For instance, 64 percent of interviewed firms in Grenada had a line of credit or an overdraft in 2004. However, 40 percent of these firms had not utilized any of the available funds at the moment of the survey. In 2007, all interviewed SMEs indicated that they had a loan or line of credit from a financial institution. Larger companies were more likely to use bank loan to finance new investment (land and buildings, or machinery and equipment), but also financed a sizable proportion (over 50 percent) of their working capital needs through a loan or credit line.

56. Interviewed micro and small firms are constrained by high collateral requirements. Those firms which had managed to obtain a bank loan reported collateral requirements to secure the loan well in excess of 100 percent of the loan value. One of the small, manufacturing firms reported that a loan approved in 2005 required security worth 125 percent of the loan value. Plant equipment had been used to secure the loan. Another spring water manufacturing firm reported that it had put up collateral worth 5 times the loan value. That had included both company real property (land and buildings) and owner’s personal assets. In Grenada, 72 percent of firms with loans indicated that they had to use collateral to receive the loans. Of these, three-quarters had put up collateral worth 100 percent or higher with respect to the value of the loan (see Figure 5). On average, the collateral-to-loan ratio reported by Grenadian firms was 136 percent.

Figure 5: Collateral-to-Loan Ratios in Grenada, Share of Firms with Secured Loans

<table>
<thead>
<tr>
<th></th>
<th>All firms</th>
<th>Tourism</th>
<th>Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;50%</td>
<td>16%</td>
<td>23%</td>
<td>23%</td>
</tr>
<tr>
<td>50-99%</td>
<td>9%</td>
<td>24%</td>
<td>23%</td>
</tr>
<tr>
<td>100-125%</td>
<td>34%</td>
<td>23%</td>
<td>23%</td>
</tr>
<tr>
<td>126-199%</td>
<td>19%</td>
<td>0%</td>
<td>15%</td>
</tr>
<tr>
<td>&gt;=200%</td>
<td>19%</td>
<td>18%</td>
<td>0%</td>
</tr>
</tbody>
</table>

1/ For manufacturing firms none of the interviewed ones report collateral-to-loan ratios between a value of 50 and 99 percent of the loan.

Source: Grenada Investment Climate Assessment (World Bank, 2004).
57. OECS firms cite insufficient collateral as the primary difficulty in obtaining long-term finance. A survey of 125 Caribbean SMEs conducted for the Commonwealth Secretariat and described in Brewster (2006) found that 28.6 percent of firms deemed insufficient collateral as the cause behind inability to access long-term loans. Inadequate firm revenue was cited by 25 percent of the firms. Insufficient collateral and insufficient income (revenue) were also cited by firms as the primary reasons for having their loan application turned down.

58. For the majority of micro and small OECS firms, lenders demanded guarantees of personal assets to secure a loan (e.g. house or vehicles). For example, 66 percent of interviewed respondents in Brewster (2006) indicated that they were made to provide guarantees of personal assets to secure a bank loan and 58 percent had to pledge assets of the business.

59. Given reported difficulties in obtaining external finance, the majority of OECS firms rely on internal sources of finance and own savings to fund their working capital and new investment. Thus, the Grenada Investment Climate Survey found that retained earnings financed 60 percent of working capital needs of interviewed firms, with bank loans providing a further 26 percent (Table 6). Bank sources of financing provided a higher share in new investments (42 percent), but retained earnings were equally important (48 percent of investment needs).

<table>
<thead>
<tr>
<th>Table 6: Sources of Working Capital and Investment Finance in Grenada</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Working Capital</td>
</tr>
<tr>
<td>Average share in total finance (%)</td>
</tr>
<tr>
<td>No. firms accessing the source</td>
</tr>
<tr>
<td>No. firms relying on the source entirely</td>
</tr>
<tr>
<td>New Investment</td>
</tr>
<tr>
<td>Average share in total finance (%)</td>
</tr>
<tr>
<td>No. firms accessing the source</td>
</tr>
<tr>
<td>No. firms relying on the source entirely</td>
</tr>
</tbody>
</table>

Source: Grenada Investment Climate Assessment (World Bank, 2004).

60. Other forms of external finance such as trade credit, equity finance or venture capital are not common as sources of both working capital and new investment funding in the OECS. In Grenada, trade credit accounted for only 4.5 percent of working capital financing (Table 6). Venture and equity funding were even less common. These findings were confirmed by interviews with about 30 private firms held in February 2007. None had access to equity or venture funding. Most, however, reported on getting supplier credit for a period of up to 60 days. One of them – a spring water manufacturer in Grenada – got about 80 percent of its working capital needs through

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5 The survey was based on a non-representative sample of 200 SMEs across 9 CARICOM countries, including 5 OECS states – Antigua and Barbuda, Dominica, Grenada, St. Lucia and St. Vincent. 125 survey responses were received and utilized in the analysis. For more on firm characteristics and a description of the survey, see Brewster (2006).
trade credit. Almost all the company’s inputs (95 percent) were being purchased on credit.

61. **Annual loan interest rates were reported to vary between 9 and 12 percent for recently approved loans (2005 and later) denominated in Eastern Caribbean dollars across interviewed OECS companies.** In Grenada, the 2004 Investment Climate Survey had similar results – interest rates varied between 8.5 and 15 percent per annum. There was more variation in terms of the duration of loans – interviewed companies in 2007 indicated duration between 36 and 84 months. In Grenada, the 2004 FIAS diagnostic study found that loan duration ranged between 1 month and 20 years.

62. **It is not possible to say whether these interest rates are prohibitively high and stifling new investment projects.** All things equal, interest rates should reflect the risk of the project to be financed. While some indications exist that interest rates could potentially be lower and that spreads between loan and deposit rates are too high in the Caribbean, it is conceivable that the observed rates are a correct approximation of the credit risk involved. Apart from the risk of the project failing and borrower default, this risk also reflects difficulties in collecting debts by lenders, which depends on the efficiency of insolvency and contract enforcement procedures\(^\text{6}\) (see section IV.2 for an analysis of interest rates and competition in OECS banking sector).

**III.2 Risk Diversification: Management Capacity, Economies of Scale and Product Quality**

63. **The availability of external finance to private OECS firms will highly depend on their capacity to generate viable projects that can be financed in a sustainable manner by the financial sector.** There is a sentiment, expressed often by interviewed banks and other lenders, that the private sector is not bringing viable, profitable projects for financing. Entrepreneurship is reportedly not vibrant, and many successful businesses (mainly small hotels and tourism-related firms and light manufacturing) prefer to stay small rather than expand their operation. There are however others who have indicated interest in expanding (so-called “cottage firms” which operate out of the homes of the entrepreneurs) but have been unable to do so due to a variety of constraints (some of which of a financial nature).

64. **There should be much more room for reductions in collateral requirements if real sector companies are able to diversify and reduce risk.** One way to do so would be to get economies of scale. Given the small market size of each of the OECS members (possibly with the exception of St. Lucia), economies of scale could only be realized if firms increase partnerships along supply chains and/or across islands. Many micro and small manufacturing firms interviewed in 2007 demonstrate very little partnership (e.g. joint ventures) with other firms producing in the sub-region and the difficulties of the enabling environment (see Box 1).

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\(^\text{6}\) Both areas are of concern to the OECS, based on data describing the effectiveness of debt collection through the courts and the efficiency of company insolvency by the Doing Business in the OECS report, World Bank and IFC (2006).
Box 1: Hot Sauce Production in the OECS – Erica’s Country Style and Susie’s Hot Sauce

Ms. Erica McIntosh is the owner and manager of Erica’s Country Style, a company Ms. McIntosh started about 15 years ago. The firm’s main products include a selection of hot pepper sauces, relishes, and cocktail dips highlighting local Caribbean flavors, and these are being exported to the USA, Canada, and more recently the European market. Ms. McIntosh – a Canada-trained biotechnologist – worked in the 1980s for the Government of St. Vincent on projects aimed to develop the farming community. She was the only trained person on the island in food technology. By her own account, Ms. McIntosh started her business with her own financing and continued so for 3-4 years initially. She then obtained funding from a US venture capital company. At the beginning she operated her business through the St. Vincent agro-laboratory, but after that was closed, moved out and built her own plant 9 years ago. At present, her main products are HACCP-certified and FDA-approved, and meet requirements of the US Bio-Terrorism Act. In terms of financing, Ms. McIntosh estimates that she would need about US$165,000 to invest in new machines. Now she mainly utilizes a 25-gallon kettle, but has no other major equipment. She has seen her business growing steadily in recent years, with current sales reaching about US$200,000 per year. The firm employs 4 full-time workers and gets inputs from about 400 local farmers (peppers, scallions, chives, cinnamon, nutmeg). Several key inputs for the pepper sauce are imported: mustard, vinegar and bottles. Ms. McIntosh sees the need for expanding and investing in equipment to meet growing demand. For example, she has just exported her first consignment to Germany and sees the EU market as a potential growth one. Among the main bottlenecks to her company’s operations, Ms. McIntosh cites the high freight rates and the system of government concessions on taxes and duties. She says that, on the other hand, her business has benefited from the EU-funded STABEX project run by the St. Vincent Ministry of Agriculture. She also invests in marketing and regularly attends industry fairs.

Susie’s Hot Sauce in Antigua started in 1960. Rosie McMaster, who took over as managing director in 1990, inherited the business from her mother and has struggled over the past 16 years to keep operating from Antigua (part of her business is based in Florida). It is another example of a cottage industry, with operation largely based in her home. At present, the business employs 2 full-time workers and 6 part-time ones. The firm sells its products locally, but also exports to the USA and other Caribbean countries (St. Lucia, Trinidad and Tobago, Dominica and Barbados.) In terms of access to financing, Ms. McMaster says that she applied for bank loans in the past but was not always successful. She purchased a plot of land from the Government of Antigua and Barbuda in 2004, in order to build a plant. The process was fraught with difficulties. First, the Ministry of Agriculture and Farming was slow in issuing the land certificate. Then, First Caribbean Bank, which financed the purchase through a loan, required a guarantee and immobilized Ms. McMaster’s personal savings deposit as a form of collateral (since no land ownership certificate had been issued). As of early 2007, the issuance of the land title was still pending. Ms. McMaster reports that she has an EC$50,000 overdraft facility from a bank, and uses trade credit to finance some of its imported inputs (such as bottles and mustard). One of her main challenges however, remains the poor state of transportation and sea-freight connection across the OECS and the wider Caribbean. To quote her: “Freight does not exist between the islands, or is infrequent.” She also faces high freight costs – at about US$3,375 to export a 20-foot container to Miami. Part of the problem is capacity – she can only produce enough sauce to fill one container at any given time. In terms of business development services, Ms. McMaster has benefited from USAID funding and received a EU matching grant of US$140,000 for marketing and promotional activities (the firm maintains a website, which services the US market). Ms. McMaster also invests in trade shows and other promotional events, and has also acquired HACCP certification and FDA approvals for her products.
65. **Risk reduction could also be achieved through improvements in firm management and a more professionalized entrepreneurship.** While both governments and donors have been working to address this area through the provision of business development services (such as training in management, accounting, business plan preparation, etc.), it is clear that substantial gaps remain in this area.

66. **Improvements in product quality would also be needed to ensure more viable business projects.** This would require better skills and supporting institutions such as laboratories to certify products and processes, as well as metrology and standards institutes. This is especially true of the local suppliers to the main hotels. International chain hotels normally require that certain product standards (ISO-9000 and HACCP) are met by producers of food and beverages, and other inputs which the tourism industry needs. Anecdotal evidence from interviewed tourism and hospitality associations (e.g. in St. Vincent) suggests that product quality and capacity to supply on a regular basis often determine the location choice of foreign investment in the sector.

### III.3 The Tourism Sector as the Main Driver for Real Sector Development

67. **The tourism industry is now the main foreign exchange earner in the economies of the OECS.** Tourism contributed, on average, over 50 percent of export revenue across the OECS sub-region in 2006, and value added in the hotels and restaurants was about 9.3 percent of total value added in GDP in 2005, which is almost twice as the contribution of agriculture (5.5 percent) or manufacturing value-added (5.2 percent). The number of stay-over visitors – the main source of tourism revenue -- rose from 780,812 over the first three quarters of 2005 to 818,409 over the same period in 2006. The 2007 Cricket World Cup, which took place in five of the OECS member states, as well as in other Caribbean countries, spurred growth in the construction industry, which contributed 13.5 percent of GDP value-added in 2005.

68. **Most of the OECS economies heavily depend on the tourism sector to generate export revenue and create new jobs.** However, tourism establishments (mostly hotels and guesthouses) are primarily supplied through imports. For instance, most of the food and beverages, including fresh fruit and vegetables, supplied to all-inclusive hotels and resorts are imported. Flowers and other inputs are also usually imported. Even some of the managerial and specialized labor employed in the hotel industry is hired abroad. Therefore, linkages of tourism establishment to local agriculture, agro-processing and manufacturing are weak. In this regard, it would be important to link the growth of the tourism sector with small and medium-sized local businesses since the latter could provide supplies and inputs to hotels and other tourism companies. In addition, the government should encourage the creation of backward linkages between hotels and local farmers and light manufacturers.

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7 2005 data show that, across the OECS, tourism generated 54 percent of export revenue, and accounted for 39 percent of employment.

69. **Backward linkages in tourism mean greater use by hotels of local agricultural and other products.** Tourism is a cluster of inter-related industries. The tourism product is the result of a multitude of economic activities which span the agricultural, manufacturing, and other services sectors, such as food and beverage production, furniture, textiles, jewelry, cosmetics, transportation and telecommunications. Tourism creates a foreign source of demand within the host economy, thereby creating new opportunities for supply of inputs by local and foreign entrepreneurs. The key question is how to capture these opportunities locally and increase the linkages between tourism and other productive sectors in the host economy.

70. **Governments and the private sector in the OECS have been aware of the low level of backward linkages and trying to foster them through different programs. However, more work is needed in this area.** Across the OECS and the Caribbean leakages, (i.e. the share of the price paid by the foreign tourist that is “leaked” abroad as a result of imports or use of intermediaries abroad), are estimated to be above 50 percent, even higher. The import content of the Caribbean tourism industry has been very high compared to other tourism destinations (between 45 and 90 percent across 9 Caribbean islands reported in Singh (2002, 2003) compared to 20 and 22 percent in Kenya and South Korea).

71. **The low capacity of OECS members’ agriculture and manufacturing and their infrastructure deficiencies (including intra-island transportation links) are among the factors cited for the high leakages and weak linkages.** For instance, local farmers might not be able to supply all the agricultural products hotels need. From the perspective of agriculture, other bottlenecks are quality standards of food and lack of information on what hotels demand and what the local farming could supply. Variations in supply would also matter. The industrial organization of international tourism chains may also prevent foreign-owned or operated hotels from buying locally, relying on overseas suppliers instead. Marketing and distribution infrastructure (cold storage facilities, rural roads, shipping companies that operate on intra-island routes) are also found lacking. Finally, some hotels require that local suppliers take out liability insurance of very high value. This imposes serious constraints and inhibits the creation of supply chains and linkages.

72. **Some of the largest all inclusive hotels and resorts in the OECS have begun increasing their supplies from local farmers, thereby enhancing linkages with local agriculture.** The Sandals Group of luxury all-inclusive resorts has been the leader in these efforts. Both Sandals St. Lucia (which owns 3 resorts in St. Lucia) and Sandals Antigua have been working with local farmers in the “Adopt a Farmer” program. With outside assistance by Oxfam, local meat and fish producers have been trained to improve health and safety requirements, while fruit and vegetable growers – on washing and packaging. Skills, equipment and linking individual farmers so that they work together have also generated improvements.

### III.4 Role of Business Associations and Partnerships

73. **Business and industry associations in the OECS exist but are not very effective in either providing business development services (such as training, marketing,**
management, quality certification information, etc.), or in insuring that firms benefit from higher levels of integration among members (cooperatives, joint ventures are few). Business associations can play an important role providing members with access to information, services and common strategies with the objective of reducing transaction costs. Interviewed OECS manufacturing and tourism firms revealed that while they do belong to industry associations (chambers of commerce or Hotel and Tourism Associations), these provide limited services. On the other hand, interviewed heads of business associations indicated that very often many members do not pay membership dues, unless they have a pending issue on which they are asking the association to help or lobby the government.

74. Only a negligible fraction (2 percent) of interviewed firms in the Grenada ICA (2004) reported that they had acquired technological innovations through business or industry associations. Similarly, training programs offered through business associations are quite irregular. For instance, the St. Vincent Hotel and Tourism Association (SVHTA), which comprises 42 hotels and 28 allied members (tour operators mostly), only “sometimes” offers training programs to its members. The main service which it provides is selling cosmetics products (small shampoos, soaps and the like) to member hotels – something that the association purchases in bulk and the on-sells to members. Its financing comes from membership dues and from revenue generated by a restaurant that the association runs. Most of the members of the SVHTA are small, local, privately-owned hotels and guesthouses. The average size of a member hotel is about 32 rooms. The largest member is the Raffles Canouan Resort, which opened in 2004 and has 132-room capacity. The latter is a high-end, luxury resort, situated on Canouan Island and operated by the Singapore-owned Raffles Chain.

75. While OECS member-state associations belong to regional (at the sub-region or wider Caribbean) industry associations, there is a sentiment that common strategies and approaches, for example, to tourism development in the OECS are very weak. This is partially explained by the fact that many of the islands see themselves as competitors and offer similar tourism products. For example, St. Vincent’s National Tourism Policy Paper 2005 defines sailing, diving, eco-tourism, sport and wedding tourism as target niche markets to develop. In many of these it faces competition from St. Lucia, Dominica, Jamaica, Belize and the British Virgin Islands, some of which have established themselves in these niche areas.

76. Insularity imposes fragmentation and very limited integration approaches (e.g., partnerships), which limits firms’ access to credit. In this regard, more education of entrepreneurs could be undertaken by government and private sector bodies on the potential benefits of integrated production and supplier networks. Unless the businesses can derive some economies of scale, they will always be deemed high-risk by the financial sector and collateral will be required to reduce this risk. This problem could be

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9 For example, in the related literature it is argued that business associations emerge as an institution to address high transaction costs and complexity in production and trade. Recanatini and Rytterman (2001) argue that in transition economies business associations have served to overcome the initial widespread disorganization following the collapse of centrally-planned economies and have provided members with information on potential trading partners and opportunities.
exacerbated in the member states where hotels and businesses are mainly small and locally-owned. In St. Lucia, for example, some of the large all-inclusive foreign-owned hotel chains, such as Sandals, have set up three resorts. The same thing is true for Antigua. These hotels are more likely to be able to easily access credit due to their larger scale, better-quality product and the fact that they are part of an international hotel network. The small, family-owned hotels however would have a harder time accessing loans.

### III.5 Concessions

77. Concessions on taxes and import duties are quite common in the OECS even though they limit business opportunities and skew incentives to innovate and grow. In Grenada, 45 percent of interviewed firms reported that they are using a duty concession on imports of capital equipment. Tax holidays appear less common – only 20 percent of Grenadian firms enjoy one (Figure 6). Large Grenadian firms are more likely to have a tax or duty concession compared to small and micro ones – 71 percent of large firms have an import concession compared to 33 percent of micro ones. In addition, a larger fraction of interviewed Grenadian manufacturing firms enjoy a duty concession compared to tourism firms (67 percent vs. 41 percent). Over a quarter of manufacturing and tourism firms access tax holidays as well. Finally, tax holidays are enjoyed by a substantially larger proportion of foreign firms compared to domestic ones (30 percent vs. 17 percent, Figure 7). This is hardly surprising as tax holidays are usually part of the incentives package to attract foreign investors.

**Figure 6: Percent of Grenadian Firms that Use Import Duty Exemptions or Tax Holidays, by type of firm**

<table>
<thead>
<tr>
<th>Type of Firms</th>
<th>Custom duty exemptions on imported equipment</th>
<th>Tax holidays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>45</td>
<td>20</td>
</tr>
<tr>
<td>Micro</td>
<td>33</td>
<td>7</td>
</tr>
<tr>
<td>Small</td>
<td>44</td>
<td>14</td>
</tr>
<tr>
<td>Medium</td>
<td>47</td>
<td>29</td>
</tr>
<tr>
<td>Large</td>
<td>71</td>
<td>34</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>67</td>
<td>26</td>
</tr>
<tr>
<td>Tourism</td>
<td>41</td>
<td>26</td>
</tr>
<tr>
<td>Services</td>
<td>29</td>
<td>14</td>
</tr>
</tbody>
</table>

*Source: Grenada ICS data, 2004*
78. Even though OECS member states has adopted new tax legislation aimed at reducing discretionary tax exemptions, not much appears to have changed. There is a lingering sentiment among interviewed private businesses in 2007 that discretionary exemptions still remain. Often governments in the sub-region compete in the incentives packages they grant to foreign investors, especially in the tourism industry. However, discretionary concessions should be cut back and eliminated, whenever possible, as they reduce transparency and distort economic incentives.

79. In general, keeping tax rates high and then granting a series of tax exemptions, holidays and other concessions as an antidote to the high tax rate, is not efficient. Tax revenue is forgone, and entrepreneurs have the incentive to lobby for concessions, hide income and evade taxes. As confirmed by the Doing Business in the OECS Report, the tax burdens on companies across the OECS remain high and exceed 40 percent of commercial profits for firms in Grenada, Antigua and Barbuda, and St. Kitts and Nevis\(^\text{10}\). This is so despite ongoing reforms to reduce corporate income tax rates (which in all OECS countries are 30 percent, except for St. Kitts and Nevis, where the rate is 35 percent).

80. Furthermore, complex rules on tax and duty concessions increase the complexity of paying taxes and dealing with customs. In Antigua and Barbuda and St. Kitts businesses spend the longest number of hours to deal with payment of taxes in the OECS (528 and 368 hours per annum) – no doubt as a result of their high tax burdens. Ultimately, regimes with a lot of in-built concessions tend to favor the largest and well-connected firms, with the smaller ones benefiting the least.

**Figure 7: Percent of Grenadian Firms that Use Import Duty Exemptions or Tax Holidays, by ownership**

Source: Grenada ICS data, 2004

III.6 Government and Donor Programs for Business Development

81. Government programs to encourage entrepreneurship and provide business development services to SMEs across the OECS have had limited success due to a variety of problems (design, capacity, continuity of donor assistance, etc.) The need for government intervention is justified by existing market failures – when demand for services required by private firms is difficult or expensive to meet. Such services include small business management, marketing, entrepreneurship, accounting and others.

82. Firms’ demand for some business development services is higher than that for other services, and different types of firms also demand different menus of business services. In Grenada, according to the 2004 Grenada ICS data, interviewed firms demanded various types of business services, ranging from accounting and legal to IT, marketing and management consulting (Table 7). However, the share that utilized insurance services was almost three times the share that used management consulting services (77 percent vs. 28 percent). Also, small and medium-sized firms demonstrated a higher need for business development services than micro and large firms. Presumably, this reflects the nature of the businesses: micro firms have lesser needs for more sophisticated services, and large firms could afford in-house legal counsel or accountant.

83. Some business services, such as management consulting, engineering and marketing are more likely to be provided exclusively or partially by international providers, with legal, insurance and accounting dominated by domestic service providers. For instance, 46 percent of interviewed Grenadian firms received management consulting from a foreign provider, while only between 5 and 8 percent got legal counsel, insurance or accounting services from abroad. Firms which used at least some management consultants from abroad were more likely to find the services unaffordable – 20 percent of them said the services were too expensive. In contrast, locally provided management consulting services were deemed affordable – with 96 percent of domestic users indicating so.

<table>
<thead>
<tr>
<th>Table 7: Use of Business Support Services in Grenada</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>Insurance</td>
</tr>
<tr>
<td>Legal services</td>
</tr>
<tr>
<td>Accounting</td>
</tr>
<tr>
<td>IT services</td>
</tr>
<tr>
<td>Engineering</td>
</tr>
<tr>
<td>Marketing</td>
</tr>
<tr>
<td>Management consulting</td>
</tr>
</tbody>
</table>

Source: Grenada ICA 2004 and author’s calculations
OECS member-state governments and international donor organizations have implemented and are currently implementing different programs to assist SMEs and provide basic business development services. The problem, however, is that often these programs duplicate one another; are not continuous and face delays in the disbursement of their funds. A case in point is St. Lucia. It has a Small Enterprise Development Project (SEDP), which has been a sub-regional activity, financed by UNDP, ILO and other donors as well as OECS member governments. St. Lucia started its Small Enterprise Development Unit (SEDU), which is still operational, as part of the Ministry of Commerce, Tourism Investment and Consumer Affairs in 1999. Around the same time, an Office of Private Sector Relations within the Prime Minister’s Office, was established to run the Private Sector Development Program (PSDP), which is co-financed by the European Union and the Government of St. Lucia. While SEDU was responsible for entrepreneurial development (such as small business planning, marketing, financial management), market and product development (labs, testing, quality and standards), and SME training, the PSDP program was offering technical assistance and matching grants to firms to develop business plans and marketing plans and raise their competitiveness.

Some of the interviewed business people indicated, however, that processing of a grant application through the PSDP took too long – 2 years for a grant of ECS$20,000 (about US$7,400). The reason was allegedly too bureaucratic EU guidelines to comply with. Currently, St. Lucia has both programs still underway, even though long-term funding for SEDU seems to be doubtful.

A similar multitude of programs and donors doing arguably similar activities is noted elsewhere in the OECS. In Grenada, apart from SEDP, the National Industrial Development Corporation runs its own small business training programs. While there is no doubt that private firms will continue to be in need of support in the area of business development, it is desirable to make sure that programs are complementary, managed well and run with sufficient resources to make them sustainable. A key recommendation in this area would be to speed up grant approval times through better allocation of resources and more streamlined approval procedures.
IV. Supply Side Factors

86. This section analyzes the existing financial institutions engagement in SME finance and the role of the authorities in covering the gap between demand and supply. Several questions are addressed:

- How do financial institutions approach the SMEs segment (definition and involvement, credit risk management, obstacles/constraints)?
- What are the factors influencing interest rate spreads? Is there room to increase competition in a fragmented market with an uneven distribution of liquidity?
- How to drive the action of the public sector and non-for profit organizations (DBs and NGOs) to a pro-market activism agenda in a sustainable way?

Some answers to these two questions can be approached analyzing several supply side aspects such as: i) financial institutions approach to the SME business; ii) interest rates and competition in the financial sector; iii) limited availability of financial instruments; and iv) the development agenda to cover the gap.

IV.1 Financial Institutions Approach to the SME business

87. The financial system is dominated by commercial banks, which hold more than 70 percent of the system assets (foreign-owned, state-owned banks, and private domestic banks hold approximately 43, 12, and 16 percent of the financial system assets respectively).11 There are 39 licensed commercial banks in the OECS region, where 26 are branches or subsidiaries of one of the five international banking groups (Scotiabank, Royal Bank of Canada, RBTT Financial Group, Republic Bank, and FirstCaribbean International Bank) and most of them are in the OECS countries as foreign branches.12 NBFIs manage around 12 percent of the system assets where credit unions have the largest participation (4.5 percent). These cooperatives institutions, 64 in the OECS countries, focus in the provision of financial services to households and small businesses across the OECS region. During the last five years, there has been a trend for consolidation among credit unions13. According to the Financial System Stability Assessment report (IMF, 2004), the top three credit unions in each country have at least 66 per cent of total assets. The largest credit union, Roseau in Dominica, accounts for 1.2 percent of the financial system assets and have over 25,000 members (over 30 per cent of the population). There are 165 insurance company licenses in the OECS region (126 without Anguilla and Monserrat) representing 8 life insurance groups and 4 composites. Total assets of the insurance companies are approximately 7 percent of the financial system assets (approximately 12 percent of the OECS GDP). Although there are some locally-owned companies in each jurisdiction, the bulk of the business, particularly life

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11 Information as of December 2001 (see Financial System Stability Assessment, IMF, 2004).
12 RBTT Bank has subsidiaries in Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines. Scotiabank has a subsidiary in Anguilla, and the Republic Bank has a subsidiary in Grenada.
13 In Dominica, Delices, Grand Font, and La Plaine were amalgamated in 2001; In Grenada, Western was mergered with St. Georges Communal in 2003.
insurance companies, is in the hands of foreign-owned companies; mainly Caribbean based (e.g. Barbados or Trinidad).\(^{14}\)

### Table 8: Structure of the Financial System in the OECS Region

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Anguilla</td>
<td>4</td>
<td>1</td>
<td>1</td>
<td>-</td>
<td>31</td>
<td>-</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>8</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>25</td>
<td>3</td>
<td>16</td>
<td>-</td>
</tr>
<tr>
<td>Dominica</td>
<td>4</td>
<td>16</td>
<td>1</td>
<td>1</td>
<td>20</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Grenada</td>
<td>5</td>
<td>18</td>
<td>1</td>
<td>1</td>
<td>23</td>
<td>1</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Montserrat</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>8</td>
<td>14</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>6</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>31</td>
<td>7</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>6</td>
<td>11</td>
<td>-</td>
<td>1</td>
<td>13</td>
<td>2</td>
<td>9</td>
<td>-</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>4</td>
<td>9</td>
<td>1</td>
<td>1</td>
<td>13</td>
<td>2</td>
<td>9</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>39</strong></td>
<td><strong>64</strong></td>
<td><strong>6</strong></td>
<td><strong>7</strong></td>
<td><strong>165</strong></td>
<td><strong>7</strong></td>
<td><strong>47</strong></td>
<td><strong>5</strong></td>
</tr>
<tr>
<td>OECS-6(^{1/})</td>
<td><strong>33</strong></td>
<td><strong>62</strong></td>
<td><strong>4</strong></td>
<td><strong>5</strong></td>
<td><strong>126</strong></td>
<td><strong>7</strong></td>
<td><strong>31</strong></td>
<td><strong>3</strong></td>
</tr>
</tbody>
</table>

1/ OECS without Anguilla and Montserrat.*

88. This sub-section of the study complements and extends the ongoing ECCB efforts (ECCB, 2003) to understand the potential supply-side financial constraints faced by private sector firms, particularly by SMEs given their significant participation in both the total number of firms and employment in the region. The recent empirical evidence establishes that SMEs tend to be more financially constrained and that the lack of access to finance constitutes an important obstacle for their growth.\(^{15}\)

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\(^{14}\) An example of this situation is Microfin Ltd. Based in St. Lucia that focuses on lending to micro-enterprises. Caribbean Micro-Finance Ltd (Microfin) is a subsidiary of the Development Finance Ltd. It is a regional finance institution providing loans and financial services to owners of micro-enterprises in Trinidad & Tobago, Saint Lucia and Grenada. In 2005, the total Assets of Microfin were $26M, with its largest share of assets, 48% in Trinidad and Tobago, 27% in St. Lucia and 25% in Grenada. Microfin defines micro-enterprises in the region as those with 1-2 employees, assets up to $10,000 and annual turnover of up to $20,000 and those who cannot offer collateral to the banks as security. Loans approved are based on personal character and business references and range from $500 to $500,000. Eligibility requirements include the applicant to be at least 18 years old and to be the owner of the business. The business must already be operational for at least 6 months prior. The applicant must demonstrate how the additional financing will result in the growth of the business. Typical business applicants included coconut vendors, shoemakers, and tailors/dressmakers.

\(^{15}\) See Beck, Demirguc-Kunt, Laeven, and Maksimovic (2006), IADB (2004), and Scheiffer and Weder (2001) for evidence consistent with the idea that SMEs tend to be more financially constrained than large firms. Also, Beck, Demirguc-Kunt and Maksimovic (2005) and Ayyagari, Beck, Demirguc-Kunt (2007) present evidence of how financing constraints affect firm growth, particularly for SMEs.
In this context, the objective of this section, from the supply side of SME finance, is to provide a deeper understanding of the nature and potential causes of the financing conditions (or the lack of) that SMEs face in the financial sector relative to large firms and micro-entrepreneurs.

89. To fulfill this task, interviews with a group of FIs in each of the OECS countries, comprising commercial banks and credit unions were performed in order to get a deep understanding of the FIs approach to SMEs in the following areas:

(i) Operative parameters and organizational structure related to the provision of credit to SMEs.
(ii) Products offered to SMEs.
(iii) Interest rates.
(iv) Decision lending process and credit risk management for SMEs loans.
(v) Obstacles or constraints related to SME lending.

Discussions were held with 22 FIs across the six OECS countries. Also, in addition to interviews, the Team distributed questionnaires targeted to different FIs (commercial banks, credit unions and development banks) to get both qualitative and quantitative information. In 2003, the ECCB undertook a study of the private sector in the OECS countries to both determine the status of the private sector and make recommendations for accelerating private sector development by conducting interviews with both SMEs and FIs. In this context, this study builds on, complements and extends the previous ECCB study. The sample of FIs was provided by ECCB in each of the OECS countries.

IV.1 Commercial Banks

90. Commercial banks (CBs) are both the most important FIs in the OECS region and the largest providers of credit to businesses, accounting for over 70 percent of total assets of the financial system in the OECS region. As of December 2006, lending to the private sector represented 83 percent of the total value of CBs loan portfolio (EC$ 10 billion), which has been steadily increasing since 2004-an average growth rate of 12 percent in the last three years (see Figure 8). However, lending to the private sector constitutes a greater percentage of foreign banks’ total loan portfolio than that of the domestic banks (55 percent, on average, for the last 10 years).

91. The sectors/economic activities that have the largest proportion of all CBs’ portfolio are acquisition of property, tourism, professional and other services, distributive trades,16 and construction and land development (30.6 percent, 10.6 percent, 9.8 percent, 9.8 percent, and 5.4 percent as of December 2006, respectively). This pattern has been almost constant over the last 10 years and has been shared by both domestic and foreign banks (see Table 9). However, loans to the agriculture, fisheries, mining and quarrying, and construction and land development have constituted a larger proportion of the portfolio of domestic banks than that of foreign banks. With respect to disbursements to the private sector, the sectors/economic activities that have received the

16 Distribution of material goods to consumers, through retailing and wholesaling.
largest amount of credit from the CBs during the last two years are acquisition of property, tourism, professional and other services, and construction and land development. The latter is similar for both domestic and foreign banks.

**Figure 8: Growth Rate of Lending to the Private Sector: 1998-2006**

![Growth Rate of Lending to the Private Sector: 1998-2006](image)

*Source: Own elaboration*

**Table 9: Commercial Banks Loan Portfolio (lending to the private sector) by Activities**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition of Property</td>
<td>33.21 29.74 29.70</td>
<td>23.47 28.13 31.39</td>
<td>27.75 28.88 30.63</td>
</tr>
<tr>
<td>Tourism</td>
<td>7.53 6.50 8.90</td>
<td>8.56 10.06 11.96</td>
<td>8.11 8.41 10.59</td>
</tr>
<tr>
<td>Professional &amp; Other Services</td>
<td>6.36 7.38 6.77</td>
<td>5.84 5.69 12.35</td>
<td>6.07 6.47 9.84</td>
</tr>
<tr>
<td>Distributive Trade</td>
<td>15.06 15.02 11.59</td>
<td>15.48 12.06 8.27</td>
<td>15.30 13.43 9.76</td>
</tr>
<tr>
<td>Construction &amp; Land Development</td>
<td>6.35 6.32 6.36</td>
<td>3.30 3.61 5.36</td>
<td>4.64 4.87 5.81</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>4.23 3.34 2.81</td>
<td>3.98 3.20 2.41</td>
<td>4.09 3.27 2.59</td>
</tr>
<tr>
<td>Transport</td>
<td>3.09 2.80 3.33</td>
<td>3.09 3.26 1.25</td>
<td>3.09 3.05 2.19</td>
</tr>
<tr>
<td>Utilities</td>
<td>0.75 1.90 2.27</td>
<td>3.06 1.75 1.44</td>
<td>2.04 1.82 1.82</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>0.58 0.67 1.37</td>
<td>1.14 1.00 1.05</td>
<td>0.90 0.85 1.19</td>
</tr>
<tr>
<td>Entertainment</td>
<td>1.81 1.61 1.58</td>
<td>1.36 1.04 0.67</td>
<td>1.56 1.31 1.08</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.71 1.25 0.73</td>
<td>0.58 0.43 0.19</td>
<td>0.64 0.81 0.43</td>
</tr>
<tr>
<td>Mining &amp; Quarrying</td>
<td>0.15 0.33 0.56</td>
<td>0.39 0.30 0.26</td>
<td>0.28 0.31 0.39</td>
</tr>
<tr>
<td>Fisheries</td>
<td>0.27 0.35 0.20</td>
<td>0.04 0.11 0.02</td>
<td>0.15 0.22 0.10</td>
</tr>
</tbody>
</table>

*Source: ECCB*

(i) Operative parameters and organizational structure related to the provision of credit to SMEs

92. Commercial banks have different operating parameters to define SMEs not only across the OECS region but also within the same OECS countries. In most cases, CBs use the level of annual sales to define or categorize SMEs. The upper cutoff level for small size enterprises is between EC$250,000 and EC$500,000, and between EC$ 1.5 million and EC$ 5 million for medium size enterprises (see Annex II for SME definition in other jurisdictions in LAC countries and in the European Union). Also, there are cases where CBs only have an upper cutoff level to define SMEs without differentiating between small and medium size enterprises.
93. Heterogeneity in the operative definition of SMEs shown by the CBs across the OECS countries reflects different internal frameworks and operational structures for providing credit to SMEs. CBs in the OECS countries, with the exception of CBs interviewed in Grenada and St. Vincent and the Grenadines, do not have specialized units within their credit departments for providing credit to SMEs, which could reflect that SMEs are not yet considered a strategic sector for most CBs. Different units for SMEs respond to specificities in lending technologies: business model and risk management and to the need of providing a specialized form of credit.

(ii) Products offered to SMEs

94. The most common products offered to SMEs by CBs are those related to working capital (credit cards, overdrafts, and lines of credit), trade finance (pre-exporting and importing financing and letters of credit), surety bonds, and commercial (investment) loans with an average period of maturity of 5-6 years. In most of the cases, these products do not differ between exporting and non-exporting SMEs. In this sense, CBs still offer “basic” banking products not only to SMEs but also to large companies; i.e., there are no financial products like leasing and factoring even though CBs are familiar with these products. From the SMEs side, the most demanded financial products are overdrafts, lines of credit, import financing, and letters of credit. The latter reflects the major bias to short-term financing due to constraints for accessing finance with larger periods of maturity. Finally, the sectors that have received more loans in the last two years are distributive trades, tourism, construction, and transport.

(iii) Interest rates

95. Interest rates on commercial loans and overdrafts charged by CBs in OECS countries are set at some spread above the prime rate (between 8.5 percent and 10.5 percent across the OECS countries), which takes into account operative costs, profit margin and risk levels. Over the last year, the range of interest rates for commercial loans has been between 8.5 percent and 12 percent and for overdrafts between 15 percent and 20 percent. However, the interest rate for mortgage loans is between 7 percent and 9 percent, which has shown a decline in the last two years, reflecting higher competitive pressures relative to other market segments. The cost of funding is between 4.5 percent and 6 percent. Most of the CBs did not consider that the minimum deposit interest rate established by the ECCB Central Bank significantly affects the cost of funding. However, CBs report that they have to compete with insurance companies’ deposit-like products (annuities) offering returns between 6 percent and 8 percent, which put pressure in the CBs cost of funding.

17 See Section IV.3 for a further explanation on the lack of financial instruments.
18 See Section IV.2 for a further explanation on the interest rate formation.
19 In the case of Antigua, there was an additional incentive for CBs to reduce their mortgage interest rate because the government reduced the corporate income tax in 2005 (from 12 percent to 8 percent) under the condition that CBs reduce their mortgage interest rate.
(iv) **Decision lending process and credit risk management for SMEs loans**

96. The requirements for providing credit to SMEs are similar for both domestic and foreign banks in the OECS region. In the case of foreign branches/subsidiaries, the lending decision is taken outside the OECS region after particular lending thresholds.\(^{20}\) Among the main requirements there are: (i) presentation of a business plan/proposal for start-up businesses, (ii) provision of both financial and cash flows statements, (iii) information on deposits accounts, and (iv) presentation of acceptable forms of collateral.

97. CBs generally require collateral whose value is at least 70 percent the value of the required loan, and in some cases exceed in more that 100 percent the value of the loan, which reflects both the risks associated to the borrower/loan and institutional constraints related to the difficulties of executing the collateral.\(^{21}\) The types of assets most commonly used as collateral for small size enterprises are land and real state, and to a lesser extent, motor vehicles, cash and liquid assets, and bank and personal guarantees. For medium size enterprises, machinery is also used as collateral. In this context, inventories, livestock (movable collateral), and account receivables are not accepted as forms of collateral.

98. CBs’ evaluation of loans applications includes: (i) feasibility assessment of the project proposal, (ii) analysis of the financial, operational, and managerial capacity of the business using financial statements, on-site due diligence, and, if necessary, internal reports of the business; (iii) risk analysis to evaluate the level of risk involved in the project (risk-based lending), (iv) credit and background checks with other FIs given the absence of a credit bureau system; and (v) macroeconomic factors that could affect the business. In some cases, CBs that were interviewed use credit scoring (using their internal data and other data informally obtained from other CBs, due to the absence of a formal credit reporting system) to evaluate personal loan applications.\(^{22}\) However, credit scoring techniques are used to evaluate business loans applications in only a few cases.\(^{23}\) To change the credit outlook of SMEs, CBs identify monitoring indicators or triggers like turnover in accounts, financial information when available, and macroeconomic factors.

(v) **Obstacles or constraints related to SME lending**

99. As mentioned in the ECCB study (2003), the main challenge/constraint cited by CBs for providing credit to SMEs was their inability to provide the necessary financial statements and reports. The latter is reflected in the presentation of inadequate cash flows and incomplete business plan proposals. In addition, CBs mentioned that other important reasons for rejection of loan applications include: (i) projects not financially viable, (ii) inadequate collateral, and (iii) poor credit history. Without exception, all CBs that were interviewed mentioned that much more training in

\(^{20}\) For example, above the amount of EC$500,000, the RBTT in Grenada sends the loan application with a recommendation to the unit in Trinidad for the final decision.

\(^{21}\) In Dominica, for example, the average time to repossess collateral is 3 or 4 years according to the banks interviewed.

\(^{22}\) For example, the Republic Bank in Grenada, RBC in Dominica, and National Bank of Dominica.

\(^{23}\) For example, the Republic Bank in Grenada.
business management, entrepreneurial cultural development, promotion of financial literacy is needed to help facilitate SMEs lending activities.

IV.1.2 Credit Unions

100. Currently, credit unions (CUs) constitute the main mechanism for mobilizing low-income people savings as well as meeting their credit needs. However, CUs lending to small business is very limited. As of December 2005, for the six CUs that were interviewed, the proportion of their loan portfolios allocated to business was between 0.75 percent and 3 percent. Housing, personal and student loans account for over 85 percent of CUs’ loan portfolio. With respect to loan disbursements, the proportion allocated to businesses was between 4 percent and 10 percent compared to the amount allocated to housing, personal (including vehicles), and student loans, which was over 60 percent of total loan disbursements. The recent trend in consolidation across CUs (e.g. in Grenada and Dominica) or the formation of strategic alliances reflects that CUs have realized that the issue of scale is critical to improve the efficiency of their financial services and capacity for lending. In addition, CUs report plans to increase in the quality of the financial services in the near future. The introduction and/or expansion of Automatic Teller Machines (ATMs) would allow reducing and cost pooling by linking the CUs, which provides the basis for the implementation of shared services.

(i) Operative parameters and organizational structure related to the provision of credit to SMEs

101. CUs do not differentiate among small and medium size enterprises given the lower scale of their business. However, in general, CUs have upper credit limits between EC$50,000 and EC$75,000, though in some cases there are exceptions to the loan limits. For example, in Antigua, St. John’s Credit Union gave a loan of EC$500,000. In terms of organizational structure all their activity in terms of enterprises is focused on SMEs.

(ii) Products offered to SMEs

102. According to the interviewed CUs, lending to small businesses is ad-hoc, driven mainly by the members (demand driven), as they do not have a formal business portfolio. The products offered to small businesses are mainly lines of credit (working capital) and loans for the purchase of machinery and equipment with a period of maturity of up to 5 years. These products do not differ between exporting and non-exporting small businesses, as loans for working capital are the most demanded by small businesses. Based on their lending activities (sectors or economic activities that receive the loans), it seems that CUs are mainly competing rather than complementing those of CBs. The reason would be that the main, if not the only, source of funding is member’s shares and savings, which puts an obstacle or constraint to channel resources to small businesses or productive activities.

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24 See V.5 on development of retail payment systems.
(iii) **Interest Rates**

103. **Interviewed CUs follow CBs’ interest rates.** Interest rates on commercial loans range from 12 percent to 14 percent. However, in the case of mortgages, interest rates range from 8 percent to 9 percent, which suggests that CUs respond to CBs’ competitive pressures.

(iv) **Decision lending process and credit risk management for SMEs loans**

104. **The requirements for providing credit to small businesses are similar to those required by CBs, though CUs only lend to active members.** However, CUs **tend to be less stringent in their application requirements compared to CBs.** CUs’ due diligence process is similar to that undertaken by CBs including financial, operational, and managerial capacity of the business, feasibility studies, credit and reference checks with other FIs, and on-site visits to the business. With respect to collateral requirements for small businesses, CUs require not only a down payment ranging from 20 percent to 30 percent of the loan amount but also, in many cases, other forms of collateral (e.g. real estate, land, or motor vehicles). For all other types of loans, it is only required a down payment that in some cases is based on a tiered system depending on the levels of credit required.

(v) **Obstacles or constraints related to SME lending**

105. **One of the main challenges for the interviewed CUs is the high level of delinquency ratios.** In each country of the OECS region, CUs are grouped under the credit union league framework and registered under their respective Co-operative Societies Act. CUs adopted the PEARLS\(^{25}\) monitoring standard rating system. According to this rating system, delinquency ratios are between 4 percent and 20 percent. In addition, other challenges/constraints cited by the CUs for providing credit to small businesses were the lack of entrepreneurship and lack of alternative sources of funding over regular basis.

106. **To mitigate high delinquency ratios CUs provide technical assistance (TA) to small businesses (preparation of business plans, skills management, marketing, and even product pricing) through counseling and workshops that in some cases are considered as part of the loan package.** Due to the lack of resources, CUs cannot provide TA over regular and formal basis. In addition, some CUs collaborate with other institutions or agencies that can provide TA to small businesses like the Grenada Industrial and Development Corporation (GIDC) and the Caribbean Development Bank’s Caribbean Technology Consultancy Services Network (CTCS), Small Enterprise Development Units (SEDU), National Development Foundations, and Development Banks.

\(^{25}\) PEARLS is an acronym for Protection, Effective Financial Structure, Asset Quality, rates of Return and Cost, Liquidity, and Signs of Growth
IV.2 Interest Rates and Competition in the Financial Sector

IV.2.1 Interest Rates and Spreads

In the context of a fixed exchange rate regime, it seems that at least, in the medium term, local interest rates (lending and T-Bill) do not follow the movements in international US dollar interest rates. Lending and T-Bill rates do not show to much variability across time, which would imply that spreads against the US interest rates are mostly determined by the movements in the latter. When comparing the OECS spreads with those of Barbados, a country with a fixed exchange rate regime too, it is observed that the lending rate spread would also be determined by the movements in the US lending rate. However, the spread is at least 200 basis points lower than that of the OECS average. With respect to T-Bills, the spread in Barbados would show a convergence pattern compared to the OECS average spread. See Figures 9 and 10.

![Figure 9: Lending Rate Differential vs. USA](image)

Source: International Monetary Fund, IFS.

26 From 1993:Q1 to 2000:Q3 the variability of the T-Bill rate for the ECCU, measured by the standard deviation of the rate, has been zero compared to the variability of the US T-Bill rate that was 0.86. For the period 2000:Q4 – 2006:Q4 the ECCU T-Bill variability has been 0.38. However, for the same period, the US T-Bill variability has been 1.58 (see Figure 10).  
27 An analysis for the period 1993-2006 (unit root tests: ADF and Philips-Perron), quarterly data, shows that the spreads are not stationary processes; i.e., it would not be a convergence of local interest rates to those of the US. However, Grenade (2006) shows that the spreads are stationary processes for the period 1980-2005. The latter would suggest potential breaks that could alter the time-series co-movement across time. In the case of Barbados, the lending rate differential is not a stationary process. However, the T-Bill rate differential is a stationary process for the same period of analysis; i.e., it would be a convergence to the US T-Bill rate.  
28 In this context, one important question would be whether the spread is mainly explained by country, or region, risk premium.
108. Given that the local currency is pegged to the US dollar, the ECCB cannot use monetary policy instruments (e.g. open market operations) to provide signals regarding the level of the interest rate. Currently, the ECCB uses the discount rate as the only instrument to signal interest rates. However, given the context of relatively high liquidity that instrument is not used on a regular basis. In addition, the interbank money market has been relatively small and inactive. Foreign-owned banks lend to their branches. This environment is isolating domestic interest rates from external interest rate movements.

109. CBs form their prime interest rate mainly based on the cost of funding (between 4 percent and 6 percent) plus operating costs and common risks. The cost of funding is lower for foreign-owned banks than for domestic banks. Data also shows that foreign-banks pay lower interest rate for deposits than domestic banks, and that both charge similar lending rates with some exceptions in Antigua and Barbuda and Grenada (see Table 10 and Grenade (2005). However, there are no statistical significant differences in interest rates (lending and deposit rates) between foreign-owned and domestic banks. Based on this information, spreads of foreign-owned banks are higher than those of domestic banks. The latter would be related more to the cheap cost of funding for foreign-owned banks than to higher lending rates.
Table 10: Lending and Deposit Interest Rates of Domestic and Foreign Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Antigua Domestic</th>
<th>Antigua Foreign</th>
<th>Dominica Domestic</th>
<th>Dominica Foreign</th>
<th>Grenada Domestic</th>
<th>Grenada Foreign</th>
<th>St. Kitts Domestic</th>
<th>St. Kitts Foreign</th>
<th>St. Lucia Domestic</th>
<th>St. Lucia Foreign</th>
<th>St. Vincent Domestic</th>
<th>St. Vincent Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>12.92</td>
<td>15.03</td>
<td>11.59</td>
<td>11.93</td>
<td>11.95</td>
<td>12.66</td>
<td>12.09</td>
<td>12.96</td>
<td>17.47</td>
<td>14.51</td>
<td>11.68</td>
<td>12.60</td>
</tr>
<tr>
<td>2006</td>
<td>11.03</td>
<td>10.05</td>
<td>n/a</td>
<td>n/a</td>
<td>9.99</td>
<td>9.43</td>
<td>8.88</td>
<td>10.42</td>
<td>10.12</td>
<td>10.85</td>
<td>9.54</td>
<td>10.34</td>
</tr>
</tbody>
</table>

Source: ECCB.

110. With respect to the determinants of interest rate spreads in the OECS region, recent work at the ECCB (Grenade, 2005) indicates that regulatory and bank-specific factors contribute to increase banks’ spreads. The minimum savings rate, currently at 3 percent, was found to exert upward pressure on interest rate spreads by over one percentage point. Bank operating costs were expectedly found to be a determinant of bank spreads.

IV.2.2 Competition

111. The higher spreads of foreign-owned banks would raise the question on whether they are exercising market power. The literature on foreign bank entry has identified that the presence of foreign-owned banks introduces both better financial (low-cost efficient) technology and potentially more pressures for competition. However, Grenade (2005) shows that the Herfindahl-Hirschman Index (HHI) is lower for foreign-owned banks than that of domestic banks. However, care is needed to interpret this result because the HHI is not a precise measure of competition. Domestic banks, which have to pay higher costs of funding and in many cases have higher operating costs than foreign-owned banks, would just follow the behavior of foreign-owned banks (“follow the leader” model).

112. To provide a more conclusive statement on the issue of competition in the OECS banking sector, it will be necessary to develop a study following a methodology similar to the one of Panzar and Rosse (1987). Due to data confidentiality, the Team was not able to perform such analysis. In addition, that

29The industrial organization theory has shown that the competitiveness of an industry cannot be measured by market structure indicators alone such as number of institutions, HHI or other concentration indexes (Baumol, Panzar, and Willig, 1982). The threat of entry (contestability) can be a more important determinant of the behavior of market participants (Besanko and Thakor, 1992). In this context, a test of the degree of competition requires a structural, contestability approach along the lines of the industrial organization literature (Panzar and Rosse, 1982 and 1987).


31Moore and Craigwell (2002) did an analysis of interest rate spreads in the Caribbean region for the period 1990-1999 using aggregate banking data. The authors found that market power has a positive and significant effect on interest rate spreads. With respect to the OECS region, Antigua and Barbuda and St.
analysis will allow for assessing whether the issue of diseconomies of scale could affect both foreign-owned and domestic banks equally even though foreign-owned banks may have much better financial technology.

113. **Based on interviews with the CBs, banks are competing in specific markets, particularly in mortgage finance. However, there is limited competition, if any, in the SME lending market.** The latter reflects the fact that the SME sector is still not considered by most banks to be a strategic sector. As shown in Table 10, there are no indications of different sectoral lending patterns between foreign-owned and domestic banks; i.e., there is no segmentation in the lending market. It could be assumed that potential pressures for competition would come from non-bank financial institutions, particularly credit unions. However, commercial banks and credit unions are also competing in the same niches, lending to SMEs represents a very small portion of their portfolio.

**IV.3 Limited Availability of Financial Instruments**

114. **Finance to the private sector in the OECS countries, in particular to SMEs, is mainly dominated by basic commercial banks lending instruments.** There are also additional but limited sources of funding that are made available through non-bank FIs (e.g. credit unions, NDFs, and DBs). In this scenario, the most common financial instruments offered by the FIs are debt and overdraft financing, letters of credit, pre-exporting and importing finance.

115. **The lack of diverse financial instruments limits the capacity of enterprises to diversify.** This is particularly problematic in the context of the CSME, which calls for the economic diversification and export-oriented economies. Thus, the private sector is in urgent need of a broader set of financial instruments; i.e., going beyond lending, that would allow them not only to take advantage of new (export) businesses opportunities but also to strengthen their capacity and investment in innovation. However, the private sector has indicated its lack of capital financing options for working capital (e.g. trade finance, factoring) and for long-term finance (e.g. securitization, private equity-venture capital, leasing).

**IV.3.1 Financial instruments for working capital**

*(i) Trade Finance: Export Credit Guarantee*

With respect to trade financing mechanisms, the ECCB developed and manages the Export Credit Guarantee Schemes whose main purpose is the provision of guarantee coverage to FIs to enable them to provide working capital finance (see Box 2). **Under these schemes, the ECCB guarantees 80 percent of the risk and the other 20 percent is undertaken by the financial institution (lender).** In addition, the financial institution has to pay up front a fee/premium of 1 percent of the approved credit

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Vincent and the Grenadines demonstrated a statistical significant market power effect. However, the analysis does not disaggregate between domestic and foreign banks.

32 Letters of credit, pre-exporting and importing finance are offered through CBs.
limit for each guarantee to make the guarantee effective\textsuperscript{33}. As of March 2006, the contingent liability outstanding under these schemes amounted to $280 thousand. The total risk exposure was $577 thousand which included potential claim obligations of $297 thousand. The balance in the Export Credit Guarantee Fund was reported as $1.8 million in the 2005/2006 financial report. Hence the contingent liability outstanding was 32 percent.

\begin{adjustwidth}{-2.5cm}{0cm}
\begin{table}[h!]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Box 2: ECCB’s Export Credit Guarantee Schemes\textsuperscript{34}} & \\
\hline
\end{tabular}
\end{table}
\end{adjustwidth}

In 1977, the Caribbean Development Bank conducted a survey on the need for export credit guarantee and insurance in the OECS region. The study revealed that one of the main problems of manufacturers in the OECS was that they were experiencing difficulties in accessing working capital from CBs. The establishment of the ECCB in 1983 provided the framework to develop and administer the support needed by manufacturers and exporters within the Eastern Caribbean Currency Union (ECCU). An Export Credit Unit was established in the Governor’s office of the ECCB in 1984. However, it was only after the Scheme was reviewed and re-introduced in 1988 that it became functional. The Schemes are administered and promoted by the Financial and Enterprise Development Department.

The ECCB operates two Schemes: (i) a Pre-Shipment Finance Guarantee Scheme (PSFGS), and (ii) a Post-Shipment Discounting Guarantee Scheme (PSDGS). Under the PSFGS, FIs can advance working capital to bona fide exporters for the purchase of locally manufactured inputs, raw materials of indigenous or foreign origin, and finished goods due for export by export trading companies. Under the PSDGS, the exporter is allowed to discount up to 80 percent of the total gross invoice value of each export shipment on presentation to her lender/bank of documentary proof that the shipment has been made. The ECCB guarantees 80 percent of the risk and the lender undertakes the other twenty percent of the risk, for export financing provided to exporters.

Each guarantee has a life of 12 months and is renewable annually on application by the lender. In addition, an up-front fee/premium of 1 percent of the approved credit limit for each guarantee is charged by ECCB to the lender to make the guarantee effective. All the issued guarantees are for the provision of new export credit and not to cover old/outstanding obligations. For applications between EC$100,000 and EC$200,000 the normal processing time is six weeks from the day of submission. Applications above EC$200,000 will require the approval of the ECCB’s Board of Directors.

116. **However, these schemes are hardly used by the FIs, particularly CBs, because of their lack of incentives\textsuperscript{35}**. Businesses that satisfy CBs’ creditworthiness standards, good clients, will be included in their loan portfolio without making effective the guarantee; i.e., CBs have incentives to do “cherry-picking” of the clients. Having

\textsuperscript{33} In Barbados, the Central Bank covers from 75 percent until 90 percent of the risk depending of the level of risk involved in the operation. With respect to the premiums, CBs are required to pay premiums rates on the amount of the loan facility between 1 percent and 1.5 percent. The higher premium rates (1.5 percent) is applicable to loan facilities in excess of $250,000 or facilities in respect to which more than 75 percent of any loss is guaranteed.

\textsuperscript{34} This Box draws heavily on the Guidelines for Utilization of the PSFGS and PSDGS (ECCB, February 2003).

\textsuperscript{35} In some of our interviews with CBs, another reason mentioned for the limited used of the guarantee schemes was the onerous procedures and requirements under the ECGS.
low-risk clients would make it unnecessary to make effective the guarantee. When the guarantee is used by the CBs, they are not willing to undertake the 20 percent risk without collateral, reducing private sector interest, particularly SMEs, in these schemes due to the already high collateral burden on debt financing. The latter would suggest that CBs would have the incentive to mainly include less creditworthy clients under the guarantee schemes. In this sense, the schemes’ objective of helping businesses to have access to export finance without having more collateral pressures would not be completely satisfied.

117. **Additional trade facilities like export credit insurance are not provided in the OECS countries.** In the case of Barbados, the Central Bank offers an export credit insurance scheme together with the guarantee schemes. The benefit of using both facilities (guarantee and insurance) at the same time is twofold: (i) it allows CBs to increase their loans to exporters and (ii) it increases the exporter borrowing capacity. Also, Jamaica and Trinidad and Tobago have EXIMBANKs that provide many facilities for export finance.  

(ii) Factoring

118. **CBs in the OECS do not offer financial instruments like factoring even though they are familiar with the mechanics of these instruments.** CBs have not introduced these financial instruments due to a perceived lack of demand. Due to the CBs’ creditworthiness requirements, not many businesses would be able to use these financial instruments. To make the use of factoring profitable for banks and affordable for customers, achieving some degree of scale would be critical. In addition, one interviewed bank mentioned that the non-involvement in factoring activities is due to constraints from the legal and regulatory framework. While a commercial bank is permitted to set up a fully owned subsidiary to conduct such activities it is inhibited due to the limited investments that it is allowed to inject in the subsidiary. This observation calls for a more detailed analysis of this issue.

**IV.3.2 Financial instruments for long-term finance**

(i) Securitization

119. **The lack of capital markets depth makes the use of securitization difficult. A potential window of opportunity for the introduction of securitization could be done**

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36 The National Import-Export bank in Jamaica offers instruments such as the Export Credit Facility; a post-shipment facility that provides working capital support in local currency to exporters. A pre-shipment facility that offers finance in local currency to non-traditional goods manufactured or produced in Jamaica. There is also a modernization fund for exporters and a Small Business Facility. The EXIMBANK in Trinidad and Tobago provides two financing facilities: an Export Credit Insurance Scheme and Post Shipment Financing.

37 According to interviewed banks, few commercial banks have engaged in factoring. In instances where this is done, the exporter/manufacturer usually has a previous and excellent creditworthiness record with the bank.
through the Eastern Caribbean Home Mortgage Bank (ECHMB). Currently, the ECHMB, as a secondary market institution, mainly provides liquidity to primary lenders (CBs or CUs) by purchasing residential mortgages and holding them to maturity (see Box 3). However, ECHMB operations do not reduce the (contingent) risk involved in the residential mortgages. In addition, in the context of the current trend of mortgage interest rates reduction, ECHMB has moderated mortgage acquisition as its funding comes through bonds at fixed interest rates. To cover interest rate risk, the ECHMB reached an agreement with the primary lenders, which resulted in a sharing of the burden of the mortgage interest rates decline. (See Box 3)

**Box 3: Eastern Caribbean Home Mortgage Bank (ECHMB)**

The ECHMB was established in 1996 at the initiative of the ECCB with IFC support. It has 64 institutional shareholders, mostly banks, social insurance banks and credit unions of the OECS region. The ECHMB has purchased residential mortgages from 5 OECS countries (none from Dominica, Anguilla or in Monserrat yet) and funded itself through private placement of bonds of up to 15 years maturity mainly within the OECS region. These bonds have tax-free status in the region and are secured by debentures over the fixed and floating assets of the ECHMB. Interest is payable semi-annually in arrears at rates varying between 5 percent and 6 percent.

The ECHMB’s total balance sheet at March 2005 was ECS 128 million (approximately 1.1 percent of OECS GDP). 478 mortgages were in its portfolio with a total value of ECS 74 million (ECS 53 million in St. Lucia and St. Vincent and the Grenadines). The yield on mortgages (net of servicing and administration fees) is 8.4 percent and the remaining term of maturity is 13.5 years.

*Strategy in the Context of Declining Interest Rates*

During the period under review there were significant refinancing activities taking place in the primary mortgage market. Customers were taking advantage of lower mortgage rates in the market to refinance their mortgages. Some of the mortgages on ECHMB's books were purchases with funds raised by ECHMB at interest rate of approximately 7.5 percent.

In some institutions mortgages rates fell to as low as 7.25 percent. However, for the most part, interest rates ranged between 8.5 percent and 10.5 percent. ECHMB was able to minimize the interest rate risk and maintain the small interest margin allowed for in the Secondary Mortgage Market by taking the following measures:

1. Recalling some of the earlier bonds issued at 7.5 percent and re-issuing them at lower rates, 5.5 percent.

2. Negotiating with primary lenders the involvement of ECHMB in the decision of lowering rates to customers. This option provided the ECHMB with an opportunity to determine the impact and to suggest a re-pricing of the mortgages or reduction of the sale and administration fee paid to the primary lender. For the most part the sale and administration fee was re-negotiated downward by 0.5 percentage points. In cases where the impact was minimal the fee remained unchanged.

Thus, ECHMB did not absorb alone the cost of the decline in interest rates. ECHMB bonds were all issued with a callable feature, after one year, which allows it to redeem the bonds before maturity. This protects ECHMB in times of adverse interest rate scenarios.
(ii) Venture Capital

120. Established and especially start-up SMEs need equity financing to complement debt financing. Businesses with access to equity finance can reduce their collateral burden. CBs, particularly, and other FIs like credit unions do not enter in the business of equity finance due to the fact that FIs are competing in particular market segments, which are more profitable and less risky. This reflects lack of appetite to invest in SMEs which are still not considered a strategic sector. In June 2005, there was a Venturepoint in Grenada in order to help match the needs of entrepreneurs with investors. Approximately, EC$5 million worth of projects receive funding from Trinidadian, Barbadian, and Jamaican investors. However, these are isolated experiences (see Box 4).

<table>
<thead>
<tr>
<th>Box 4: Experiences in Equity Financing- Venture Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Atlantean Capital (Grenada)</strong></td>
</tr>
<tr>
<td>In November 2006 a small private equity firm started its operations in Grenada to cover the financial gap of small businesses. The firm’s starting capital was US$3.5 million (US$500,000 locally owned-capital and US$3 million from the Development Finance Limited from Trinidad and Tobago). The target entities are SMEs looking for equity finance to start their business, complement debt financing, and provide technical assistance. As March 2007, Atlantean Capital has 100 clients and a little more than US$3 million of available funds. The firm still has started to advertise their business more widely. However, this firm does not have the support of any government agency and seeks loan credit insurance to cover at least 10 percent of their portfolio.</td>
</tr>
</tbody>
</table>

| **II. Flamboyant Hotel (Grenada)**                     |
| The hotel started its operations in 1989 with 9 rooms and as of March 2007 has over 64 rooms. The hotel initiated an expansion work in 1990, which was financed with loans from two commercial banks and equity finance from the Caribbean Financial Services Corporation (CFSC) from Barbados. Mr. Lambert (hotel’s manager) mentioned that the Grenada Industrial Development Corporation (GIDC) helps him to put in contact with the CFSC, recognizing that the GIDC is a “one-stop shop” for any local business in Grenada. Mr. Lambert pointed out the benefits from equity finance as a source of long-term finance compared to the short maturity period of debt finance and its higher cost. |

| **III. Empowerment for Ownership Fund (Antigua and St. Kitts and Nevis)** |
| In August 2005 (July 2006 in St. Kitts and Nevis), the government of Antigua made a joint-venture with the Stanford Group (second largest employer after the Government in Antigua) for EC$ 10 million (revolving fund) to support a small enterprise program, which provides finance and technical assistant to SMEs by giving low interest loans of up to EC$50,000 to qualified residents of both countries. As of October 2006, the program has given 68 loans with a worth total value of EC$ 2.5 million in Antigua. In both countries the Fund is being facilitated by their Development Banks respectively. |

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38 Some interviewed CBs mentioned that the issue of scale is critical to the introduction of venture capital in order to ensure minimum returns.
(iii) Leasing

121. According to the interviewed CBs, the reasons for not engaging in leasing activities are similar to those cited for factoring. Some companies, particularly motor vehicle dealerships, offer leasing instruments, but only on a limited basis.

IV.4 Development Agenda to Cover the Gap

122. A number of institutions have tried to cover the access to finance gap in the OECS countries, namely NDFs and DBs, with very limited success. NDFs have been unsuccessful to cover the gap and they are barely able to survive with NPLs ranging from 30 to 60 percent. DBs have basically been competing with commercial banks more than covering a development agenda, sometimes on a sustainable basis sometimes unsustainably. The ECCB is trying to set up a regional institution to cover the gap, the Eastern Caribbean Enterprise Fund (ECEF). This sub-section summarizes the behavior of NDBs and DBs. The latter based on a set of questions, different from the ones used for commercial banks and credit unions, due to their different nature. The sub-section also depicts the main features of the envisaged ECEF.

National Development Foundations (NDFs)

123. As indicated in the ECCB study (2003), the NDFs\(^\text{39}\) have been the main providers of credit to micro and small businesses in OECS countries over the past decade. Besides loans, NDFs also offer TA through workshops, on-field visits, and/or training courses (knowledge and management, small business development, viability of the business plan and marketing) that in some cases is included as part of loan package. However, the scope of the provision of TA depends mainly on the availability of resources.

124. During the latest years, NDFs have experienced a significant reduction in the volume of grant funding (e.g. USAID, European Union, and CIDA). Currently, the main sources of funding are loans from CBs, Social Security, DBs that channel funds (on-lending) from the CDB, and other agency/programs that provide funding for particular projects (e.g. European Development Fund STABEX, Caribbean Project for Economic Competitiveness (CPEC), International Cooperation Development Fund (ICDF) among others). In addition, there is an increasing dependence on internal revenues as the primary source of capital.

125. NDFs are becoming more stringent in their lending requirements, which affect the developmental nature of their mandate, due to limited sources of funding and the credit risk involved in their operations. Some of the credit requirements and due diligence process are similar to those required by CBs and CUs (e.g. viability assessment of the business plan, credit and reference checks, and on-site visits) but more

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accommodating compared to those FIs. The flexibility of the collateral requirement was one of main characteristics of the lending conditions. However, currently, there is a strong collateral requirement converging to the 100 percent secured lending portfolio. Acceptable forms of collateral are real estate, equipment, machinery, cash and liquid assets, and movable property. The maximum amount that interviewed NDFs may lend range from EC$100,000 to EC$150,000, while the average loan size ranges from EC$11,000 to EC$24,000. The maturity of the loans ranges between 3 months and 5 years.

126. Interest rates charged by interviewed NDFs on business loans are not lower than those charged by CBs and CUs. The rates charged range from 10 percent to 15 percent. The cost of funding for the interviewed NDFs is between 5 percent and 7 percent. Some of the NDFs try to get funding from DBs and the CDB at concessional rates (3 percent or 4 percent).

127. High levels of non-performing loans directly affect both the lending and borrowing capacity of the NDFs. The NDFs in Antigua, Dominica, and St. Vincent have very high levels of delinquency ratios (40 percent, 37 percent, and 60 percent respectively). However, the NDF in St. Kitts has a delinquency ratio of 6 percent. These high delinquency ratios reflect not only the credit risk associated to the loans but also a non-payment culture that has its roots in the assumption that loans from the NDF are the same as grants. On the one hand, due to the high delinquency ratios, NDFs cannot tap funds from external borrowers at concessional rates or even just to get funding. On the other hand, NDFs have to reduce their lending and to demand more stringent credit requirements, particularly the collateral, in order to reduce non-performing loans. In this sense, high delinquency ratios have created a vicious circle for many of the interviewed NDFs.

128. NDFs’ main future challenge is their institutional survival due to limited source of funding. The latter directly affects their lending capabilities and the ability to offer lower interest rates in such a way that NDFs can follow the development nature of their mandate. With respect to their clients, the lack of an entrepreneurial culture and business skills was identified as an important constraint for increasing lending to small businesses.

Development Banks (DBs)

129. There are five development banks operating in the OECS countries, one per territory in Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis and St. Vincent and the Grenadines. There is no development bank in St. Lucia as it was recently merged with a commercial bank. In St. Vincent and the Grenadines the development bank is also in the process of being merged with a commercial bank. The Development Bank of St. Kitts and Nevis is the largest with $225 million of assets and $195 million in loans at the end of 2005. Dominica Agricultural Industrial Development (AID) bank had $125 million in total assets and $105 million in loans to customers at the end of 2005. The Development Bank of Grenada had $27 million in assets and $20
million in customer loans at the end of 2005. This information was not available for the
DBs in Antigua and Barbuda and St. Vincent and the Grenadines.

130. Governments in countries with underdeveloped financial systems have tried
in the past to broaden access to financial services through interventionist and laissez-
faire policies. A new policy, however, is emerging in the middle ground, favoring direct
government interventions in non-traditional and market-friendly ways. This new policy
approach recognizes a limited role for the government in financial markets and
acknowledges that institutional efficiency is the economy’s first best, but it does not
exclude the possibility that in the short run, while institutions are taking time to build and
consolidate, some government actions undertaken in collaboration with market
participants may be warranted. This is the view of pro-market activism. The pro market-
activism is a short-run solution of market-friendly innovative government interventions
that do not conflict with the long-run market solution. It must be applied understanding
the idiosyncrasies of institutional arrangements and market conditions in each country,
and the specific ways in which access problems arise in that context (De la Torre and
Schmukler, 2006).

131. The analysis of DBs in the OECS that follows is done under the context of a
pro-market activism policy. Thus, this section assesses the performance of DBs in
OECS countries through four key questions:

i) do DBs aim at mitigating a well-defined problem of access to finance?;

ii) how is the access problem incorporated into the legal mandate and is the mandate
defined in a static or dynamic manner?;

iii) are the institutional form, functions, and instruments of the DBs consistent with
a market-friendly mandate?;

iv) how is compliance with the mandate being measured and is the mandate
achieved through a sound and sustainable way?

Some of these questions are different from the ones that would be asked to assess the
performance of commercial banks. This analysis is done under the assumption that the
objective of DBs entities should be to correct a temporary market failure towards a long
run market solution. While creating market conditions DBs may offer market-friendly
financial products and services to clients that are not served by the traditional commercial
banking system but could be offered in the future by CBs if the necessary conditions are
introduced in the market.

Evolution of DBs in the OECS according to the key questions

132. Do DBs in OECS countries aim at mitigating a well-defined problem of
access to finance? The fact that a certain proportion of the population does not use
financial services, a lack of access does not necessarily mean that there is a problem of
access. To conclude that there is a problem of access, a clear definition of such a problem
is required. The problem of access is mainly introduced by two well-known constraints that hamper the ability to write and enforce financial contracts, namely, *principal-agent problems* and *transaction costs* —while conceptually distinct, are tightly intertwined in practice. The classic principal-agent problems are *adverse selection* and *moral hazard*. Even assuming that there are no principal-agent problems, a problem of access to finance may still exist where the *transaction costs* involved in the provision of finance exceed the expected risk-adjusted returns. Problems of asymmetric information and transactions costs, furthermore, can generate first-mover dilemmas and coordination problems that make the expansion of access to certain groups of the population increasingly difficult.

133. **DBs seem to be competing more than complementing commercial bank activity as an important and increasingly large proportion of its activity consists of the provision of mortgage finance and student loans.** The development banks in the ECCB area were formally launched in the late 1960s to early 1970s. The main purpose of these institutions when created, as stated in their various statutes, was to assist in the economic development of their respective countries, by providing financing and managerial assistance to prospective domestic investors. The DBs were established to intermediate between the international providers of funds and private domestic borrowers. The international providers wished to lend to the productive sectors, namely industry, agriculture and tourism, through financial intermediaries, whose liabilities the governments were prepared to guarantee. All of the DBs have gone through significant changes in both the sources and uses of their funds. Loans to industry, agriculture and tourism no longer dominate. Currently, a high portion of development banks’ loan portfolio is composed of home mortgages and student loans (see Table 11). Interest rates charged by the DBs range from 8 percent to 11 percent.\(^{40}\)

<table>
<thead>
<tr>
<th>Outstanding lending Portfolio at the end of 2005 ($ million)</th>
<th>Agriculture Loans</th>
<th>Industrial Loans</th>
<th>Tourism Loans</th>
<th>Mortgage Loans</th>
<th>Student Loans</th>
<th>Other Loans</th>
<th>Total Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development Bank of Saint Kitts and Nevis</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>38</td>
<td>50</td>
<td>116</td>
<td>204</td>
</tr>
<tr>
<td>Antigua and Barbuda Development Bank</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Grenada Development Bank</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>12</td>
<td>9</td>
<td>4</td>
<td>25</td>
</tr>
<tr>
<td>Dominica Agricultural Industrial Development Bank</td>
<td>9.5</td>
<td>19</td>
<td>18</td>
<td>26</td>
<td>33</td>
<td>11.5</td>
<td>117</td>
</tr>
</tbody>
</table>

*Source: DBs Financial Statements.*

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\(^{40}\) The exception is the Development Bank in St. Vincent, which has merged with the National Commercial Bank. The interest rates charged by the Development Bank in St. Vincent range between 7.7 percent and 9 percent as it can use a deposit base, with a funding cost between 3 percent and 4.5 percent.
134. **How is the access problem incorporated into the legal mandate? Is the mandate defined in a static or dynamic manner?** The pro market-activism policy is a short-run solution of market-friendly innovative government interventions that do not conflict with the long-run market solution. The ultimate goal is to foster the broadening of access in ways that simultaneously create financial markets where they are missing or enhance the functioning of the existing ones. Thus, the mandate needs to be redefined through the transition path to the long run equilibrium and the instrument used will eventually disappear with the solution of the problem. It is important to understand that the problem being faced is of a dynamic rather than static nature.

135. **The Statutory Laws of the different institutions define DBs mandates with a broad and dispersed scope.** All DBs organic laws define the mandate for their respective institutions broadly. Table 12 summarizes the mandates incorporated through the organic laws. None of the DBs institutions were established with or have a dynamic mandate that obliges them to redefine themselves with the achievement of their objectives. On the contrary, all of them incorporate static mandates in their Statutory Laws. Some of their initial niches are being eroded—they can hardly sustain their traditional cost-of-funds advantage vis-à-vis the commercial banks. For example, the DBs were often the first to develop mortgage lending for small borrowers. But today the cooperatives, the commercial banks and in some countries the building and loan societies compete for this business. Absent legal reform, the very limited degree of change in these DBs could only be a function of management quality.

<table>
<thead>
<tr>
<th>Table 12: DBs’ Mandate Definition in their Statutory Laws</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Institution</strong></td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
</tr>
<tr>
<td>Development Bank of Saint Kitts and Nevis</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Antigua and Barbuda Development Bank</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

59
indirectly to lend money on mortgage to individuals for housing purposes; (d) to assist persons in pursuing courses of education approved by the Board by making loans and providing other forms of financial assistance to such persons; and (e) directly or indirectly engage in such construction activity as may be necessary for the better performance of its functions and duties.

<table>
<thead>
<tr>
<th>Grenada Development Bank</th>
<th>Act of 1976</th>
<th>Art. 4 it shall be the duty of the Bank:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(a) to assist persons in establishing, carrying on or expanding development enterprises by participating in share capital, granting loans and providing other forms of financial assistance to such persons; (b) to assist persons to pursue courses of higher, technical and vocational education by providing loans and other forms of financial assistance; (c) to foster development of money and capital markets in Grenada; (d) to mobilize and coordinate available resources to be utilized in financial industrial and agricultural projects in Grenada; and (e) to grant loans to persons for the construction, extension, alteration, improvement or repair of dwelling houses on land owned or leased by them.</td>
</tr>
</tbody>
</table>


Source: Development Banks Statutory laws.

136. Are the institutional form, functions, and instruments of the DBs consistent with a market-friendly mandate? As indicated above there is a market friendly role for the visible hand of the government to promote access in the short run. The important qualifier is, however, that the government needs to be highly selective in its interventions, always trying to ensure that they work with the market, never against it. Whenever subsidies are used they need to be non-market disruptive (up-front), transparent (financed through the budget) and organized in a rational way to avoid duplication of efforts and misuse. There must also be mechanisms in place to prevent political capture that may undermine the temporary nature of the interventions or their compatibility with the long-run objective of financial market and institutional reform. The institutional setting should be one that aligns short-term with long-term-incentives. There is not a single solution but the development agency (DA) concept defined in Box 5 is an approach trying to align
incentives in an effective way. The innovation of instruments is a process of discovery and learning-by-doing as the interventions are implemented, and also creates room to give the authorities a first hand understanding of what legislation or enforcement mechanisms are missing for certain innovations to take off.

Box 5: The Concept of Development Agency (DA)

The concept of a development agency (DA) as a way to avoid the inherent contradictions of development banks (DBs) could be summarized as follows:

- DAs have an explicitly defined mandate and their effectiveness and efficiency are measured against such criteria as mandate objectives maximization at least cost and in manners consistent with market development. DAs are normally governed by their own laws, which would provide a mandate definition and a framework to define appropriate methods of measuring operational efficiency and cost effectiveness.
- DAs funding comes directly from the government, through the budget process. DAs should be unambiguously and publicly accountable for the efficient use of all public monies and government guarantees.
- DAs do not take deposits from, and do not issue debt to, the public; they are not part of the payment system, either.
- DAs have a range of efficient instruments (e.g., partial guarantees, structured finance, pooling of infrastructure costs, etc.) to increase access to financial services, through mitigation of asymmetric information, moral hazard and transaction costs problems.
- DAs finance technical assistance directly or, better yet, promote technical assistance markets and other professional services to increase the bankability of clients.

137. Most DBs in the OECS countries are quasi-fiscal institutions which do not take deposits from the general public. Governments in the OECS are reforming DBs in two different directions. On the one side, some Governments are merging the DBs with commercial banks as the nature of their activity is very similar (e.g., St. Lucia and St. Vincent and the Grenadines). The integration of the two banks with their different portfolios, cultures and systems did have some difficulties in the early years. The merger option is seen as a way of liquidating the government’s ownership share in the development bank for the early benefit of the budget. Thus, in St. Lucia, although the initial transaction did not yield any cash for the government, it later sold some of its shareholding in the merged bank to the social insurance fund for cash which went to the budget. On the other side, other Governments are discussing alternatives sources of finance (e.g., taking deposits form the public) to make DBs compete on a sustainable basis with other financial sector providers, though this would generate the contradictions indicated in Box 6.

138. The development banks remain tied to the governments and lack information transparency and adequate regulation and supervision. Governments appoint management and all board members. Governments also play an important role in stipulating loan programs (see ministerial directions information in Table 13). Governments and their associated organizations remain important funding sources, through guarantees of international loans and through direct provision of domestic resources. At an earlier stage most of the funding was provided by the Caribbean
Development Bank (CDB). Today funds from this source are less important with other donors providing significant foreign exchange funding (e.g., European Investment Bank) and domestic sources (e.g., Eastern Caribbean Mortgage Bank, and Social Security Schemes) related to the government providing EC dollars. The cost of funding ranges from 4 percent (AIDB in Dominica) to 6.5 percent (Grenada Development Bank). Portfolios are sometimes swapped between one government financial entity and another to meet liquidity needs.\footnote{For example in Dominica in 2002, the development bank sold $5 million in mortgages to the social insurance fund; in St. Vincent in 2003 the development bank purchased $5 million in mortgage loans from another government-owned bank.} Transparency is limited, with DBs reporting to the corresponding Ministries as mandated by their organic laws but there is lack of supervision by financial regulators. The only supervisory function from a financial sector institution comes mainly from the CDB through the requirements requested to the DBs for the credit granting process ECCB used to get information on their financial statements in the past but this information is not anymore available since the early 2000s.

### Table 13: DBs’ Governance and Transparency Arrangements

<table>
<thead>
<tr>
<th>Issue</th>
<th>Recognition in the Organic Laws</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ministerial Directions</td>
<td><strong>Development Bank of Saint Kitts and Nevis</strong></td>
</tr>
<tr>
<td></td>
<td>• No provisions.</td>
</tr>
<tr>
<td>Antigua and Barbuda Development Bank</td>
<td>• The Minister may, after consultation with the chairman, give the Board directions of general character or in the exercise of its borrowing powers in the public interest. (article 8).</td>
</tr>
<tr>
<td>Grenada Development Bank</td>
<td>• The Minister may, after consultation with the chairman, give the Board directions of general character or in the exercise of its borrowing powers in the public interest. (article 11).</td>
</tr>
<tr>
<td>Dominica Agricultural Industrial Development Bank</td>
<td>• No provisions.</td>
</tr>
<tr>
<td>Board of Directors</td>
<td><strong>Development Bank of Saint Kitts and Nevis</strong></td>
</tr>
<tr>
<td></td>
<td>• No less than 3 members no more than 7 nominated by the Ministry (schedule, article 1).</td>
</tr>
<tr>
<td></td>
<td>• Chairman appointed by the Ministry (schedule, article 1).</td>
</tr>
<tr>
<td></td>
<td>• The Ministry may at any time revoke the appointment of any Director (schedule, article 7)</td>
</tr>
<tr>
<td>Antigua and Barbuda Development Bank</td>
<td>• No less than 5 members no more than 11 nominated by the Ministry (schedule, article 1).</td>
</tr>
<tr>
<td></td>
<td>• Chairman appointed by the Ministry (schedule, article 1).</td>
</tr>
<tr>
<td></td>
<td>• The Ministry may at any time revoke the appointment of any Director (schedule, article 6)</td>
</tr>
<tr>
<td>Grenada Development Bank</td>
<td>• Four <em>ex-officio</em> directors (Permanent Secretary Finance or his Nominee, Attorney General or his nominee, Permanent Secretary in the Prime Minister’s office or his nominee, the manager of the Bank) and no more than 11 nominated by the Ministry (schedule, article 1).</td>
</tr>
</tbody>
</table>
- Chairman appointed by the Ministry (schedule, article 3).
- The Ministry may at any time revoke the appointment of any Director (schedule, article 6).

**Dominica Agricultural Industrial Development Bank**

- Three persons who shall be appointed by the Minister by an initial term of three years, but who, thereafter, shall be elected by the shareholders of the Bank at each annual general meeting plus five persons appointed by the Minister (article 5).
- Chairman and Deputy Chairman appointed by the Ministry (article 3).
- The Ministry may revoke the appointment of any Director under some specific circumstances (article 8).

**Disclosure**

- **Development Bank of Saint Kitts and Nevis**
  - Annual report to be presented to the Ministry not later than two months after the end of each fiscal year and made available to the public (art16).
  - Audited financial statements to be approved by the Ministry (article 15).

- **Antigua and Barbuda Development Bank**
  - Annual report to be presented to the Ministry not later than two months after the end of each fiscal year and made available to the public (art15).
  - Audited financial statements to be presented to the Ministry (article 14).

- **Grenada Development Bank**
  - Annual report to be presented to the Ministry not later than two months after the end of each fiscal year and made available to the public (art18).
  - Audited financial statements to be approved by the Ministry (article 17).

**Risk Management and Audit Committees**

- **Development Bank of Saint Kitts and Nevis**
  - No provisions.

- **Antigua and Barbuda Development Bank**
  - No provisions.

- **Grenada Development Bank**
  - No provisions.

- **Dominica Agricultural Industrial Development Bank**
  - The Law created a Student’s Loan Advisory Committee (article 23, Act 6 of 1992) that was later replaced by a Loans Committee (article 23, Act 11 of 1993).

*Source: Development Banks Statutory laws.*

139. **How is compliance with the mandate being measured? Is the mandate achieved in a sound and sustainable way?** There is an inherent contradiction between DBs mandate and their activities (see Box 6). To break this vicious circle the subsidy component incorporated in the mandate needs to be clearly identified and financed through the budget and the institutional setting (DA or similar one) compatible with this approach. The financial sector activity of DBs needs to be done on a level playing field on both grounds, regulatory and supervisory. However, performance evaluation needs to be different to the traditional soundness and sustainability indicators of the commercial banks (also important for DBs). It needs to consider the charter and mission of DBs. DBs have traditionally been evaluated by credit growth, absence of losses and outreach of the targeted population.
Box 6: Contradiction Between Mandate and Activities of Development Banks (DBs)

A. Development Banks (DBs) are established to serve a distinct public policy purpose (PPP) usually defined in their organic law and statutes. They are expected to concentrate on the specific group of clients defined according to their PPP, that is, high risk/low yield activities. The obligation to serve non-bankable clients inevitably leads to low profits or losses. (Contradiction #1 between PPP and profitability.)

B. To compensate for losses, DBs either enter into activities of CBs, pushing aside those activities most related with their stated PPP, and/or require constant, sometimes very substantial, recapitalization by their owner—the Government. (Trying to solve Contradiction #1 could lead to Contradiction #2, which is between mandate and activities.)

C. To minimize losses, governments tighten administrative control over DBs or put them under the same regulation and supervision applied to CBs. (Contradiction #3 between the PPP-defined mandate and the evaluation of their activities according to standards and behavioral rules applicable to profit oriented financial institutions.)

D. This forces DBs to abandon their PPP even more or leads them to disregard operational efficiency. (Contradiction #4 involves the reaction to confusing incentives transmitted by the conflict between evaluation standards and PPP-based expectations.)

140. The performance of the development banks in the OECS has been generally poor. A number of factors have had an impact on the overall performance of the local DBs, among them, the over-exposure to risks in the domestic economy, high transaction costs, a dearth of long term domestic finance, technical capacity, and political influence on decisions concerning credit allocation. As in so many other countries, the governments have proved to be poor owners and operators of financial institutions, allowing politics and overly optimistic ideas of development to influence loan allocation and then proving extremely poor at collecting on loans outstanding. The small size of the development banks in Grenada and the merger in St. Lucia and planned merger in St. Vincent and the Grenadines reflect their financially troubled past. In terms of mandate achievement, no indicators have been elaborated or monitored.

Eastern Caribbean Enterprise Fund (ECEF)

141. The ECCB is working towards the establishment of the Eastern Caribbean Enterprise Fund (ECEF). The ECCB has been undertaking a series of studies on the financial and technical resources available to enterprises in the ECCU as well as a survey of commercial bank lending to the private sector. According to the ECCB results of these studies indicate that while a number of initiatives have been developed to provide risk financing to enterprises in the Caribbean (e.g., Caribbean Investment Fund, CIF) 43

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43 The CIF was established in 1993 among the governments of the member states and associate members of the Caribbean Community (CARICOM). Its main objective is the investment in private sector majority owned and controlled companies and corporations located in the Signatory States. Investment modalities include new stock and share issues, joint venture participation, project financing, and loan funding. CIF has made several equity investments including in a call center in St. Lucia (Helen IT Systems), and Cara
and others, there is still a general lack of risk financing for stimulating and supporting the growth of potentially successful enterprises within the OECS region. In addition, there is a lack of financial instruments diversity. The ECEF is envisaged as a venture capital fund to serve as an alternative mechanism for mobilizing technical and financial resources needed for promoting growth and expansion of enterprises within the region. Box 7 explains some details of the envisaged ECEF.

**Box 7: The Eastern Caribbean Enterprise Fund (ECEF)**

The Eastern Caribbean Central Bank (ECCB) is pursuing the development of the Eastern Caribbean Enterprise Fund (ECEF) in an effort to foster and promote development of private enterprise within the region. The ECEF will focus on developing the real/productive sectors of the economies in the Eastern Caribbean Currency Union (ECCU). This will be accomplished by filling the existing gaps in the supply of financial and technical services to these sectors. The financing component of the ECEF’s services will include equity and debt financing to medium and large-scale private sector enterprises independently or in co-financing arrangements with regional and/or international financial institutions.

The ECEF may also provide export credit facilities and export credit insurance (ECI) through an enhanced Export Credit Guarantee Scheme (ECGS). These facilities would assist the provision of working capital to manufacturers and export trading companies within the ECCU.

The ECCB views commercial banks as strategic partners of the ECEF in fostering business growth within the ECCU. The ECEF will complement the financial support provided by the commercial banks to SMEs with technical assistance, training and equity financing. Through these means the ECEF will help to cover the gap for capacity building and equity formation critical to the long-term viability of these businesses. It is also anticipated that over time these support services would bring about the requisite transformation in the SMEs management structure, modalities and other support systems which would result in the creation of credible business proposals. This transformation would significantly increase their access to the “untapped” financial resources of the commercial banks.

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Hotels Limited. Caribbean small business hotel chain that manages five hotels in three countries (Trinidad and Tobago, St. Lucia, and Guyana).
V. ENABLING ENVIRONMENT FACTORS

142. This section analyzes the following key questions:

- How to reduce transaction costs both on the demand and supply side with common and integrated approaches to the enabling environment?
- Is the tax system creating additional burdens for SMEs access to finance (e.g., higher cash flows needs)?

Some answers to these two questions can be approached analyzing several enabling environment aspects such as: i) customs and logistics; ii) contract enforcement; iii) collateral registration and repossession; iv) benchmarking, information transparency and credit reporting systems; v) tax system and cash flow needs; and v) retail payments system development.

V.1 Customs and Logistics

143. The ease of clearing goods through customs is crucial for a country’s overall business competitiveness. Some of the most competitive and efficient economies in the world (e.g., Singapore, Hong Kong, see Figure 11) have the fastest and most streamlined procedures for processing imported and exported goods through customs, as well as some of the best functioning ports. Increasingly, as world economies become more open to trade and as countries join different regional trading blocs, it becomes necessary to speed up customs processes and to harmonize customs procedures and legislation in order to achieve improvements in handling trade flows. While this area of the enabling environment does not rank across the OECS member states as poorly as others (such as contract enforcement and insolvency regulation), it is of paramount importance because of the islands’ reliance on trade and tourism to generate foreign revenue.

144. Customs in St. Kitts and Nevis and St. Vincent and the Grenadines take the fewest number of days to process a standardized shipment across the OECS -- 13 business days, which is also how long Trinidadian customs take (Figure 11). While this is faster than in a range of comparator countries from the Caribbean (e.g. Belize and Jamaica) and other small island states shown in Figure 11, it is more than four times the time it takes in Singapore (3 days) and more than twice that of Hong Kong (5 days). This indicates that even in the OECS member states with fastest customs operations, further improvements could be sought.

145. The times to export and import are highly correlated, suggesting that when customs procedures are streamlined and customs operate efficiently, they do so for both exporters and importers alike. Thus, for the subset of countries depicted in Figure 11, the correlation coefficient between time to import and export is 0.79. With few exceptions, the time to export is less than the time needed to import goods. The difference between the two is very pronounced in St. Lucia (10 days) and Dominica (6 days). Across the 6 OECS member states, the average time to export is 13 days, while the time to export reaches 16 days.
Figure 11: Days to Import and Export a Standardized Cargo of Goods

<table>
<thead>
<tr>
<th>Country</th>
<th>Time to export</th>
<th>Time to import</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>13</td>
<td>10</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Taiwan, China</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>Belize</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Mauritius</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>OECS average</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Dominica</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Tonga</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Sao Tome</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Grenada</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Jamaica</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>Maldives</td>
<td>20</td>
<td>16</td>
</tr>
</tbody>
</table>


146. Importing into the OECS is associated with high costs, as demonstrated in Figure 12 and repeatedly mentioned by interviewed business managers in February 2007. On average, total fees, excluding import duties and levies, payable to import a 20-foot container into the OECS are US$1,206. This is nearly four times higher than costs faced by importers in Singapore (US$333). Within the OECS, St. Kitts and Nevis ranks best – with import costs of $756, and Dominica worst – with costs of US$1,512. Fees charged by the ports and for terminal handling of the cargo take up the largest share of these – in St. Kitts port and terminal charges amount to US$456, in Antigua and Barbuda – the same cost US$730, and in Dominica – US$1,203. Other fees – such as those for document preparation, customs clearance and technical control, and for inland transportation and handling of the cargo, are substantially lower.

147. Improvements in port procedures, equipment to handle containerized cargo and other port infrastructure may help reduce port and terminal fees. However, high port fees may also be a symptom of the low volumes of cargo given the small size of the islands, and the absence of economies of scale.

148. OECS member states have recognized the need to reform customs hardware and administration, and efforts are ongoing in several of them to improve electronic systems and technologies, train customs staff and generally raise the efficiency of customs operations. For instance, St. Lucia completed an upgrade of the ASYCUDA++ system in customs in 2006. St. Kitts and Nevis is also implementing a new electronic system at customs. Dominica and Grenada are planning an upgrade as well – with support from the World Bank. Such improvements in electronic data exchange and processing are commendable but a remaining concern is that the new systems are not directly compatible across the OECS member states, thereby reducing potential benefits.
to be had. More harmonization at customs, especially given the CSME and regional trade initiatives, would be needed to encourage trade flows.

**Figure 12: Costs to Import a Standardized Cargo of Goods, US$ per 20-foot container**

<table>
<thead>
<tr>
<th>Country</th>
<th>US$ per 20-foot container</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>333</td>
</tr>
<tr>
<td>Tonga</td>
<td>360</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>425</td>
</tr>
<tr>
<td>Mauritius</td>
<td>683</td>
</tr>
<tr>
<td>Taiwan, China</td>
<td>747</td>
</tr>
<tr>
<td>St Kitts and Nevis</td>
<td>756</td>
</tr>
<tr>
<td>Grenada</td>
<td>984</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>1093</td>
</tr>
<tr>
<td>St Lucia</td>
<td>1163</td>
</tr>
<tr>
<td>Fiji</td>
<td>1170</td>
</tr>
<tr>
<td>OECS average</td>
<td>1206</td>
</tr>
<tr>
<td>Samoa</td>
<td>1265</td>
</tr>
<tr>
<td>Jamaica</td>
<td>1350</td>
</tr>
<tr>
<td>St Vincent and the Grenadines</td>
<td>1354</td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>1467</td>
</tr>
<tr>
<td>Dominica</td>
<td>1512</td>
</tr>
<tr>
<td>Maldives</td>
<td>1784</td>
</tr>
<tr>
<td>Seychelles</td>
<td>1842</td>
</tr>
<tr>
<td>Vanuatu</td>
<td>1975</td>
</tr>
<tr>
<td>Belize</td>
<td>2130</td>
</tr>
</tbody>
</table>

*Source: World Bank Doing Business 2007 database*

**V.2 Contract enforcement**

149. **Fast and efficient resolution of firms’ contractual disputes is important for access to finance.** If collection of disputed claims is not certain and takes a long time, a lender would be less willing to rely on the courts to collect from a defaulting borrower. Moreover, a lender would be less willing to lend in the first place or would charge a higher interest rate to cover for the higher risks involved in collecting in case of non-payment. Indeed, a study by Laeven and Majnoni (2005) finds that judicial efficiency and inflation are the main drivers behind interest rate spreads across a sample of countries. The less efficient the judicial enforcement of debt contracts, the higher the observed spread between deposit and lending rates.

150. **There is a wide disparity in the number of days it takes courts in one of the OECS member states to resolve a debt collection case, even though it is governed by the same Civil Procedure Code.** While in Antigua and Barbuda, a court case takes about 10 months (297 days) from filing of the lawsuit until a judgment is issued and enforced, the same case would take more than twice that time in Dominica (681 days). The average
across the OECS is 528 days or about 17 and a half months (Figure 13), which is faster than in a number of comparator countries, such as Mauritius and Trinidad and Tobago. On the other hand, the OECS average is considerably longer than the case duration in other countries with more efficient court systems, such as Singapore (4 months), Hong Kong (7 months) and Jamaica (14 months). Within the OECS, courts also appear slow in St. Lucia (635 days from filing to enforcement), St. Kitts and Nevis (578 days) and Grenada (583 days). In St. Vincent and the Grenadines courts are reportedly faster, taking about 13 months (394 days) to close the case and for the judgment to be executed.

151. The above duration of commercial dispute resolution in court is reflected in the overall ranking of OECS member states on the Enforcing Contracts index by the Doing Business in 2007 report. While Antigua and Barbuda ranks 47th out of 175 ranked countries, the other OECS members rank considerably worse: from 125th for St. Vincent and the Grenadines to 160th for St. Lucia. Apart from the time needed to resolve a debt collection case in court, the Doing Business index also takes into account the costs of so doing (in terms of official attorney and court fees), and the number of procedures that the plaintiff and the defendant have to complete according to the law.

Figure 13: Time to Resolve a Commercial Dispute

![Figure 13: Time to Resolve a Commercial Dispute](image)


152. Going to court is one of a series of mechanisms which firms can use to resolve disputes when such arise. In fact, since contract enforcement in court is expensive and time-consuming in many countries, firms in many countries prefer to resolve out of court, through negotiation or mediation, for example, or through other third-party mechanisms, such as business associations, informal networks or extra-legal enforcement channels. It is also possible to try to avoid disputes altogether, by dealing only with known, established customers and declining trade credit to customers that are unknown. The
latter strategy is, however, inefficient, as trade is foregone. New entry into the market would be more difficult. Many studies, both theoretical and empirical, argue that the possibility of anonymous trade and the existence of a state-run court enforcement system are one of the hallmarks of the market economy (e.g. Greif (2005), among others).

153. Given the inefficiencies in the functioning of the OECS courts, many respondents interviewed in early 2007 noted that they prefer to settle their disputes with clients and suppliers out of court. This is also confirmed by the 2004 Grenada ICS, whereby only 12 percent of firms who had experienced disputes reported going to court. Among those who decided to settle out of court, the main reason for choosing not to go court was the lengthy court process. On the positive side, most Grenadian survey respondents expressed a high degree of confidence in the judiciary: three-quarters were of the opinion that the judicial system would uphold their contractual and property rights in business disputes.

154. Most countries around the world have found that the way to make courts faster and more efficient is through reforms of the court administration system – i.e. the rules and procedures for handling court cases, and the court case management system. According to Doing Business in 2007, the OECS should work toward improving the administration of the courts, through better case management, and performance-based incentives for judges and court staff. A step in the right direction has been the introduction of expedited procedures for simple debt cases (e.g., where the debt is undisputed or the debt amount is not too high) into the new OECS Civil Procedure Rules. A review of the rotating judge arrangements currently in place in several of the islands is also warranted, as there is a sentiment that the amount of time judges spend in a single jurisdiction (about 6 weeks per annum) is not sufficient to clear the caseload.

V.3 Collateral Registration and Repossession

155. Collateral registration, the ease of re-possession, and creditor rights in bankruptcy proceedings matter a lot in the process of pre-credit appraisal, and, once credit is granted, in cases of borrower default. In an environment of high-level collateral requirements, as experienced by borrowers in the OECS, the ease of registration and repossession of collateral is even more important in facilitating access to finance. In the absence of creditor information, banks would normally require a security which is put up as collateral to insure that the lender would recover some loan value, if the borrower cannot repay the loan. Depending on the law, different assets could be used as collateral. Generally, countries, which allow a broader range of assets to serve as collateral and establish dedicated collateral registries where all security interests are recorded and can be easily accessed by borrowers and lenders, are shown to have a higher level of private credit to GDP. When these are lacking and credit information is scarce or non-existent, fewer loans are extended.

156. The OECS countries rank an average of 6 on the Legal Rights index (on a scale of 1 to 10), which measures creditor rights in collateral use and bankruptcy proceedings (Figure 14). Six of its constituent sub-indices are related to collateral law, and the other 4 – to rights afforded to creditors in bankruptcy. Higher values of the index
indicate better protected creditor rights with respect to collateral and insolvency. While the average OECS index score is similar to that of other Caribbean countries, such as Trinidad and Tobago and Jamaica, it should be noted that there exists some disparity across the OECS, with Grenada and St. Vincent scoring the highest (7), and St. Kitts and Nevis scoring the lowest (5).

157. More importantly, however, if we isolate the collateral-related elements of the index, the OECS does not do nearly as well (Table 14). For instance, while Antigua and Barbuda, Dominica and St. Vincent and the Grenadines score 4 points (out of 6), Grenada and St. Lucia get only a score of 3, and St. Kitts and Nevis – a score of 2. Universally lacking in the law is a provision granting secured creditors priority in the execution of collateral outside of bankruptcy proceedings. The law also does not always ensure that all types of assets can be used as collateral and all types of debt can be secured (as in Grenada and St. Kitts and Nevis). With the exception of St. Lucia, the law allows any natural or legal person to be a party to a collateral agreement, which is desirable. Finally, only in Grenada do secured creditors have a priority of claim to their collateral in bankruptcy procedures.

Figure 14: Legal Rights of Creditors in Collateral and Bankruptcy Procedures, Index Value (0-10)

Table 14: Scores on Collateral-Related Legal Provisions

<table>
<thead>
<tr>
<th>Different aspects of rights with respect to collateral</th>
<th>Antigua and Barbuda</th>
<th>Dominica</th>
<th>Grenada</th>
<th>St. Kitts and Nevis</th>
<th>St. Lucia and the Grenadines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the law allow all natural and legal persons to be party to collateral agreements?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Does the law allow for general descriptions of assets, so that all types of assets can be used as collateral?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Does the law allow for general descriptions of debt, so that all types of obligations can be secured?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Does a unified registry exist for all security rights in movable property?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Do secured creditors have absolute priority to their collateral outside bankruptcy procedures?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Do secured creditors have absolute priority to their collateral in bankruptcy procedures?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Score (out of 6)</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>


158. As Table 14 above confirms, all OECS member states have a functioning unified registry which records security interests. However, this functions as part of the general registry system and no specialized collateral registry exists. Furthermore, the registries often combine property, company and other civil registrations (see next section), which causes backlogs and higher burdens for the registrar officials. Some ongoing efforts exist to move to a paper-less electronic registry system, which would then allow for speedier registration of collateral and faster access by users who would like to ascertain existing liens on a property.

159. Interviews with private sector representatives in the OECS have pointed to a lack of capacity and staff working in the public registry systems, and delays in transfer of land titles and land registration. This finding is also confirmed by the Doing Business in the OECS, 2007 report. One way to improve the functioning of the registry offices is to train staff and introduce performance-based incentives to speed up the registration process. Grenada has embarked on this type of public registry reform.

V.4 Benchmarking, Information Transparency and Credit Reporting Systems

160. Effective financial intermediation depends on the tools to reduce informational asymmetries between borrower and lenders, such as credit registries and bureaus, property registries, accounting and auditing standards, and company
registries. Past studies have shown that countries which allow access to past borrower history, both positive and negative, as well as where the credit registry has a higher coverage of the population, have deeper and more developed financial markets (e.g. Jappelli and Pagano (2002), Beck (2006)). Company registries could also potentially ameliorate informational asymmetries as they provide some basic company information, including financial data updated annually.

161. **The lack of some important elements of the financial sector institutional and infrastructure framework makes difficult the definition of benchmarks for the credit granting process.** They include: lack of a harmonized approach for accounting and auditing standards; lack of a formal credit reporting system; and lack of automated companies registries to create sector benchmarks.

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**Box 8: Institute of Chartered Accountants of the Caribbean**

The Institute of Chartered Accountants of the Caribbean was formally established under the Laws of Jamaica and incorporated as a Company in October 1988, bringing together Accountants of the English-speaking Caribbean. The founding members of the ICAC were Bahamas, Barbados, Belize, Guyana, Jamaica, St. Lucia, Trinidad & Tobago. Since its establishment, the Institute of Chartered Accountants of the Caribbean has provided a forum for the advancement of the accountancy profession in the Caribbean. It is the vision of the ICAC to establish a regional Accountancy profession that meets internationally acceptable accounting standards and practices and provides a platform for the continued growth and development of the profession.

There are currently nine (9) members and three (3) affiliates of the Institute of Chartered Accountants of the Caribbean. The members are: The Bahamas Institute of Chartered Accountants, The Institute of Chartered Accountants of the Barbados, The Institute of Chartered Accountants of Belize, The Institute of Chartered Accountants of Guyana, The Institute of Chartered Accountants of Jamaica, The St. Kitts–Nevis Association of Chartered Accountants, The Institute of Chartered Accountants of St. Lucia, The Institute of Chartered Accountants of Trinidad and Tobago, The Institute of Chartered Accountants of Antigua and Barbuda. The affiliates are: The Association of Chartered Certified Accountants, The Institute of Chartered Accountants in England and Wales, The Certified General Accountants of Canada (CGA).

The objectives of the ICAC are to:

- Promote internationally acceptable standards of best practice within the region.
- Foster a strong, cohesive and self regulated regional Accountancy profession.
- Implement and coordinate a regional monitoring program in collaboration with reputable providers.
- Promote an institutional framework under the umbrella of territorial institutes within which individual Accountants may associate and participate for mutual professional and fraternal benefit.
- Standardize the qualification entry requirement and rules of professional conduct among member Institutes.
- Provide leadership on emerging issues as they affect the accounting profession in the region.

There are currently five regional committees, which have been established for the functional areas of Education/ Examination, Joint Seminar, Membership, Technical and Publicity.
162. **There is a lack of common approach for the application of accounting standards and presentation of audited financial statements throughout the OECSs countries.** The preparation and presentation of financial statements follows the regulation established for each territory in the Companies Law. The profession is to a large extent self-regulated and there is not a common framework for financial reporting. The “big four” auditing companies are active in the OECS countries. The presentation of audited financial statements is regulated for each territory and auditor’s certification processes are not in place. There is an institutionalization of the auditing profession at the broader Caribbean region level (see Box 8), through the Institute of Charter Accountants of the Caribbean but not inclusive of all the OECS countries.

163. **The lack of formal credit information systems make borrowers highly dependent on “physical collateral” versus “reputation collateral”**. There is not a formal credit reporting system, either public or private, and banks and financial institutions rely on the exchange of information on an informal basis. This limits the amount and type (e.g., negative or positive) of information shared. Also it is not possible to determine the quality of the information exchanged. This results in poor quality of information sharing and the inability of developing modern tools of creditworthiness assessment such as credit scoring.

164. **Company registries in the OECS display some notable deficiencies.** At present, none of them uses electronic records, which makes searching of company information a laborious and time-consuming task. Often these are combined with land and other civil registries, which exacerbate the ease of use. Finally, often registry offices are part of the court registration system, which is again associated with limited access and longer processing times.

### Table 15: Features of Companies’ Registries in the OECS

<table>
<thead>
<tr>
<th>Company Registry</th>
<th>Company registry combined with real property registry</th>
<th>Company registry exists outside of the court system</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Paper-based</strong></td>
<td><strong>Electronic</strong></td>
<td></td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>Yes</td>
<td>No, separate Land Registry exists</td>
</tr>
<tr>
<td>Dominica</td>
<td>Yes</td>
<td>Yes, separate Commercial and Intellectual Property Registry</td>
</tr>
<tr>
<td>Grenada</td>
<td>In process</td>
<td>Yes, separate Registry Department</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>Nevis</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>Partially, St. Kitts</td>
<td>No, part of High Court</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>Yes</td>
<td>No, separate Land Registry exists</td>
</tr>
<tr>
<td>St. Vincent and the Grenadines</td>
<td>Yes</td>
<td>n.a.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>No, part of High Court</td>
</tr>
</tbody>
</table>
V.5 Tax System and Cash Flow Needs

165. Many OECS countries are pursuing tax reform measures with the aim of reducing reliance on trade taxes while improving efficiency and transparency. The cornerstone of these efforts involves the introduction of Value Added Tax (VAT) system\(^\text{44}\), which was recommended by the OECS Tax Reform Commission report (ECCB, 2004). Dominica and Antigua and Barbuda have already introduced VAT, in March 2006 and January 2007, respectively. St. Vincent and Grenadines also recently introduced VAT on May 1, 2007. Grenada is actively working on plans to introduce its VAT in October 2007. St. Kitts is expected to introduce VAT in 2008 with St. Lucia to follow (IMF, 2007). CARTAC and the IMF have been working closely with OECS members on VAT design, implementation and follow-up.

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Introduction</th>
<th>Key Features</th>
</tr>
</thead>
</table>
| Dominica                       | March 2006           | - Basic rate: 15%, reduced rate of 10% for hotels and dive sector  
- Threshold: EC$60,000, estimated to be above 600 businesses  
- Statutory deadline for refunds: 6 months, 3 months for exporters, interest on late refunds paid at rate of 1% per month |
| Antigua and Barbuda (ABST)     | January 2007         | - Basic Rate: 15%, transitional rate of 10.5% for suppliers of hotels and holiday accommodations.  
- Registration threshold: EC$300,000  
- Statutory deadline for refunds: 6 months, 3 months for exporters, interest on late refunds paid at rate of 1% per month |
| St. Vincent and the Grenadines | May 2007             | - Basis rate 15%, 10% for hotel accommodation %  
- Threshold: EC$60,000  
- Statutory deadline for refunds: 6 months, 3 months for exporters, interest on late refunds paid at rate of 1% per month |
| Grenada                        | Set to be introduced in October 2007 | - Basic rate: 15%, reduced rate of 10% on tourism related services.  
- Registration threshold: EC$100,000  
- Statutory deadline for refunds: 6 months, 3 months for exporters, interest on late refunds paid at rate of 1% per month |
| St. Kitts and Nevis            | Expected to introduce VAT in 2008 | Currently no sales tax: consumption and excise taxes include excise consumption, Hotel Room Occupancy, Hotel Services, Stamp Duties, Entertainment, Telecommunication, and Insurance, and a variety of international trade taxes. Rates range from 4 to 17% |
| St. Lucia                      | Exploring possibility of a VAT. | Currently no sales tax: consumption and excise taxes include excise consumption, Hotel Room Occupancy, Stamp Duties, Entertainment, Telecommunication, and Insurance, and a variety of international trade taxes. Rates range from 5 to 35% |


166. Newly implemented VAT may pose disincentives for the manufacturing sector if the administration of the VAT tax is inefficient (i.e. there are long delays to

\(^{44}\) The intention is for the VAT to replace all indirect taxes as well as a number of nuisance taxes (Tax Reform and Administration Commission, 2004).

\(^{45}\) List of zero rated items is broadly similar in all countries and includes basic foods items, medicines, agricultural inputs, and minimum consumption of electricity and water. Exemptions include financial, educational, medical and dental services, rent.
get VAT refunds). In order to lower prices, manufacturing companies, need to import in bulk quantities (usually inputs for their production) and this requires that they maintain a higher level of cash flow for the administration of the tax, especially for export-oriented companies that need to wait a for a refund. Though the VAT has only been recently introduced in Antigua and Barbuda, firms are complaining that the refund process is too slow, causing cash flow problems and imposing added costs to exporters. This problem is compounded by the banking system’s lack of products for working capital and the lack of usage of the Export Credit Guarantee Program (see Supply Side section).

167. International experience with VAT suggests that problems arising from the VAT refunds, described by the IMF as the “Achilles’ heel” of the VAT (IMF, 2005) mechanism, are quite common. VAT refunds should be handled in an expeditious manner with payment following receipt of VAT return, usually less than 4 weeks in developed countries. However, in many developing countries it often takes several months to process refund claims, seriously undermining the competitiveness of export sector. Country experience shows that refund delays usually the result of poor design and implementation inefficient tax authorities’ efforts to prevent fraud and budgetary pressures to withhold refunds due to shortfalls in tax collection.  

<table>
<thead>
<tr>
<th>Box 9: International Best Practices for VAT</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Keep number of VAT payers at manageable level (threshold)</td>
</tr>
<tr>
<td>• Keep proper control of VAT registration</td>
</tr>
<tr>
<td>• Ensure sufficient funds available for refund claims</td>
</tr>
<tr>
<td>• Process refunds within reasonable statutory period</td>
</tr>
<tr>
<td>• Pay interest on late refunds</td>
</tr>
<tr>
<td>• Offset VAT refunds against other tax obligations (e.g., income tax, customs duties)</td>
</tr>
<tr>
<td>• Refund promptly to exporters with sound compliance history.</td>
</tr>
<tr>
<td>• Audit VAT refund claims as part of a wider audit program</td>
</tr>
<tr>
<td>• Implement risk-based audit program</td>
</tr>
<tr>
<td>• Provide appropriate sanctions against refund claim frauds</td>
</tr>
<tr>
<td>• Establish transparent and functioning appeal system</td>
</tr>
<tr>
<td>• Improve taxpayer service</td>
</tr>
</tbody>
</table>

Source: Harrison and Krelove, 2005

46 Dominica is making efforts, supported by the IMF PRGF to address some of the problem areas in the VAT. IMF staff have characterized refund times as adequate, though private sector firms complain. Authorities have committed to avoid any further weakening of the VAT base and measures to improve administration including by providing adequate resources to strengthen VAT administration, implementing good audit and risk management programs and mechanisms to detect stopfilers, and making timely refunds. (IMF, 2006b). Dominica intends to conduct a comprehensive review of VAT performance by September, 2007.
V.6 Retail Payments System Development

168. **Retail payment systems are mainly based on cash and cheques.** Total value of banknotes and coins is high compared to other countries in the LAC region (see Figure 15). The ECCU has maintained a level above 10 percent of GDP, only reached by other countries in the region under a banking crisis situation (e.g., Argentina). Regarding non-cash payment instruments, use of cheques is dominant (about 10 million items exchanged in 2006).

![Figure 15: Use of Cash in Selected LAC countries](image)

Source: CPSS and WGPS-LAC.

169. **There is low interconnectivity among payment systems networks increasing transactions costs of retail payments.** Until the late nineties, few commercial banks had ATMs and POS terminals were practically non-existent. Since there was no coordination of standards, the Banks developed proprietary networks and processes to operate their ATMs with no interconnectivity to other commercial banks. As a result, a user of ATM services was generally restricted to the bank where an account was maintained. The multi-branch banks\(^{47}\) that had operations in several ECCU territories allowed their customers to access cash withdrawals throughout their networks. The domestic banks had no interconnectivity for ATM transactions. Over the past decade, many banks have installed ATMs and banks are issuing international brands of debit and credit cards to be used in POS transactions, also including a cash withdrawal function. However, while the banks are making progress in the use of technology there is still lack of infrastructure that would allow for interoperability.

\(^{47}\) Royal Bank of Canada (RBC), Bank of Nova Scotia (BNS), Barclays Bank, Plc. And CIBC Caribbean Ltd (the latter two merged in 2003 to form FirstCaribbean).
Figure 16: Relative Importance of Payment Instruments in Selected LAC countries (2004, volume of transactions)

Source: CPSS and WGPS-LAC.

170. **The absence of a direct debit instrument makes payroll payments more inefficient and limits retail banking competition.** The absence of direct debit means that employees have been restricted to the banking services of their employer. Therefore, employees had to open accounts in the same banks than their employers and obtain ATM cards to withdraw their payroll funds. Other option was to use a cheque to pay for merchandise and services. Some employers provided other banks with a list of payroll credits and a cheque for the total amount to facilitate the process for interbank direct
deposit of payroll, but this takes extra time, at least one day, due to the manual processing. Finally, some employers maintain multiple accounts at different banks to pay their employees.

171. **The ECCB has recognized these payment system deficiencies and has embarked on a payments system reform.** The reform is based on assessments by the Commonwealth Secretariat and the Western Hemisphere Payments and Securities Settlement Initiative (WHI).\textsuperscript{48} The reform includes several important actions. First creation of an adequate institutional framework through the establishment of the Eastern Caribbean Payments Council (ECPC) established in 2006 and the envisaged reform of the legal and regulatory framework.\textsuperscript{49} At the beginning of the 2000s the ECCB launched a Real Time Gross Settlement System for large value and time critical transactions (GLOBUS). This major advance will be completed with operational upgrades at the retail system level driven to achieve the interoperability and technical compatibility among ATMs and POS.

\textsuperscript{48} See www.ipho-whpi.org

\textsuperscript{49} The ECCB staff is working on the draft of a Payments System Act to bring payments system legislation closer to international standards. The legal changes would also include changes to the Bills of Exchange Act (addressing issues such as truncation and cheque imaging) and the draft of a Money Services Bill to address other players in the financial sector that are involved in the electronic transfer of funds.
VI. POLICY ISSUES AND OPTIONS

172. **The issue of access to finance for SMEs in the OECS must be considered in light of the challenging context in which OECS countries operate.** Integrative approaches could be pursued to improve the general macroeconomic context and business environment.\(^{50}\) The sub-region must continue to pursue fiscal consolidation efforts in order to bring debt levels to sustainable levels. Achieving the fiscal benchmarks agreed upon at the Monetary Council meeting in July 2006 could go along way towards placing fiscal accounts on a sustainable path as well as protecting the currency peg.\(^{51}\) The lack of skills could be ameliorated by implementation of free movement of labor in the sub-region and in the context of the CSME.\(^{52}\) High infrastructure costs could be tackled through integrative approaches, particularly high utility rates and transportation issues.\(^{53}\) Harmonization of the investment incentive regime could reduce damaging competition for FDI while preserving tax revenues and thereby also supporting the fiscal consolidation effort.

173. **Importantly, donors must deepen harmonization efforts to better support the sub-region’s development.** Common complaints concerning donors have included lack of coordinated interventions, unpredictable disbursements, and overburdening already weak institutions. Declining aid flows further heighten the importance of achieving better coordination of multilateral and bilateral donor efforts in the sub-region.

*Demand Side*

174. **The availability of external finance to private OECS firms will highly depend on their capacity to generate viable projects that can be financed in a sustainable manner by the financial sector institutions.** Thus, there should be much more room for reductions in collateral requirements if real sector companies are able to diversify and reduce risk. In order to diversify and reduce risk some actions are needed, among them:

\(^{50}\) This paragraph draws heavily from World Bank and IMF policy recommendations in “Towards a New Agenda for Growth” and IMF reports.

\(^{51}\) Fiscal benchmarks were enacted by ECCU members in 1998, though progress in achieving them was less than satisfactory. New fiscal benchmarks were enacted in 2006 but need to be accompanied by increased commitment. Authorities indicated reluctance to adopt enforcement mechanisms which they consider to have been ineffective in the European Union (IMF, 2007).

\(^{52}\) OECS countries fear that free movement of labour under the CSME will potentially hurt their job markets both through an influx of low cost labor and outflow of professionals “brain drain” to larger islands. However, a recent CRNM study (“To Assess the Likely Impact of the Free Movement of Labour in the CSME on the OECS Labour Market”, CRNM, 2007) based on surveys conducted in several OECS countries, found little evidence to support the argument that CSME will result in significant movement of labor. Moreover, surveys indicated an overwhelming support for the CSME and general support for the free movement of labor.

\(^{53}\) The establishment of Eastern Caribbean Telecommunications Authority (ECTEL) introduced competition to the fixed and mobile markets and has led to lower costs.
- Reaching economies of scale that could be realized if firms increase partnerships along supply chains and/or across islands.

- Improvements in firm management and a more professionalized entrepreneurship.

- Improvements in product quality would also be needed to ensure more viable business projects.

- Eliminating concessions that introduce wrong incentives for entrepreneurship and innovation.

175. **Improvements in product quality will be needed to ensure more viable business projects.** This would require better skills and supporting institutions such as laboratories to certify products and processes, as well as metrology and standards institutes. This is especially true of the local suppliers to the main hotels. International chain hotels normally require that certain product standards (ISO-9000 and HACPP) are met by producers of food and beverages, and other inputs which the tourism industry needs. Anecdotal evidence from interviewed tourism and hospitality associations (e.g. in St. Vincent) suggests that product quality and capacity to supply on a regular basis often determine the location choice of foreign investment in the sector.

176. **Tourism is an important sector for all OECS economies but its strength will be only fully realized if backward linkages can generate revenue and jobs growth in other sectors.** Backward linkages in tourism mean greater use by hotels of local agricultural and other products. Tourism is a cluster of inter-related industries. The tourism product is the result of a multitude of economic activities which span the agricultural, manufacturing, and other services sectors, such as food and beverage production, furniture, textiles, jewelry, cosmetics, transportation and telecommunications. Tourism creates a foreign source of demand within the host economy, thereby creating new opportunities for supply of inputs by local and foreign entrepreneurs. The key question is how to capture these opportunities locally and increase the linkages between tourism and other productive sectors in the host economy.

177. **Private firms across the OECS would benefit from better and more targeted programs which offer business development services and enhance entrepreneurship.** At present, programs run by the member governments, often with international donor support, are not functioning nearly as well as they should. The main areas where intervention is needed should be identified and then addressed. For example, anecdotal evidence suggests that business planning, marketing and management, as well as simple business accounting and IT skills, are in need of improvement across most micro and small firms. Some of these programs could be developed and run in conjunction with chambers of commerce and business associations.

178. **Business associations and generally a higher level of partnership among firms would be desirable.** To achieve economies of scale, private firms across the OECS must learn to form cooperatives, supplier chains and clusters, in and between islands. Only then would local agro producers, for example, be in a position to compete with
international supply and distribution networks. This is especially important for the tourism industry, which theoretically could absorb local farming and agro-processing supply (provided the latter is up to standard and consistent supply is ensured).

179. **Governments and donors could try to fill gaps in the market for business development services.** If the local market is not able to provide the quality of business services (such as management consulting or marketing), which are needed to access foreign markets and become more competitive, firms have to rely on bringing in these services from abroad, which could be costly, especially for smaller firms. This is the rationale for government and donor programs. Also, the economy of the OECS has shifted from agriculture (sugarcane and bananas) to more services (tourism, ICT), and some light manufacturing. There is a case for government intervention to support the transition to a new economic structure, at least for some time. OECS member-state governments and international donor organizations have implemented and are currently implementing different programs to assist SMEs and provide basic business development services. The problem, however, is that often these programs duplicate one another; are not continuous and face delays in the disbursement of their funds. While there is no doubt that private firms will continue to be in need of support in the area of business development, it is desirable to make sure that programs are complementary.

180. **Given existing skills shortages, technical and vocational training systems could be strengthened, with a focus on the set of skills demanded by the private sector.** Of course, in the presence of high emigration, especially among young and educated persons, there would be some leakage of trained personnel. Nevertheless, aligning both the formal education system and vocational training with private business needs (tourism, agriculture, off-shore finance), would be a step to address deficiencies in the workers’ skills which the private sector at present encounters (e.g. many hotels bring in managers and skilled workers from abroad).

Supply Side

181. **The OECS authorities and the ECCB should cooperate to level the playing field among the different institutions providing financial services as a way to provide incentives for greater competition.** The establishment of regulatory entities for non-bank financial institutions (SRUs) across the OECS will contribute to this task. Even though the systemic relevance of the NBFIs (e.g. credit unions, insurance companies, offshore banks, etc.) is less than that of the CBs, it is necessary to unify and strengthen their supervision. There are already steps in this direction. For example, Grenada has established the GARFIN (Grenada Authority for the Regulation of Financial Institutions) Act in Parliament in order to strengthen the supervision of the non-bank financial sector that includes the insurance sector, credit unions, the offshore sectors and money changers. The lack of supervision of NBFIs could have negative spillovers for CBs. For example, insurance companies offer deposit-like products (annuities) at higher rates than that of commercial banks, which would push up the cost of funding of CBs, particularly domestic banks, and consequently lending rates, which reduce efficiency and competition. Also, CUs invest their resources in insurance companies’ products in significant amounts due to the high returns. These returns may not reflect the equilibrium
deposit interest rates in the banking sector, which would mislead the interest rate formation and spreads. In addition, the need to improve the supervision of off-shore banks has already been made explicit in the last FSSA (2004). This is also an opportunity to strengthen even more the collaboration between the ECCB and the Ministry of Finance in each country of the OECS region.

182. **There is a need to broaden financial instruments both, for working capital and long term financing, beyond the basic banking products.** CBs do not have incentives to offer financial products beyond lending, overdrafts, and in some cases trade finance because SMEs are not considered yet a strategic sector for most CBs in the OCES region. Some exceptions are found in Grenada, where some CBs have differentiated units to engage SMEs. In addition, CUs and DBs are mostly competing with CBs. Credit guarantees and credit insurance could help private equity firms to raise its sources of funding. Equity finance constitutes an alternative source of finance to SMEs and in many cases CBs mentioned that SMEs require equity financing rather than debt financing. However, private equity firms, as in the case in Grenada, struggle to get credit from both local and overseas banks. Annex IV presents some examples of innovation in the creation of financial instruments.

183. **The access to finance problem (e.g., SMEs financing) and lack of adequate financing instruments may justify a short term pro-market activism intervention from the authorities.** Financial markets rely heavily on the production and processing of information, which is typically a public-good, in the sense that it is non-rival in consumption and costly to exclude. Investors may not find it optimal to screen and finance certain borrowers because once these borrowers obtain a good credit history they can chase credit from other investors, who will not share the initial screening costs. This may be the case in OECS countries for SME finance. Similar spillovers occur when lenders invest in new credit technologies. While they will bare all the costs in case of failure, it is often difficult to prevent other investors from adopting the new technology once it has proven successful. A cost pooling approach may be a way to address this issue (see NAFIN example in Annex IV).

184. **OECS countries should consider two main elements in defining their access to finance development agenda for the future: i) the need for an integrated financial sector and economies of scale to reduce transaction costs; and ii) transitory and market-incentive solution of well defined access to finance problem.** A regional integrated instrument to implement an access to finance development agenda could benefit from reduced transaction costs and less political interference while creating incentives for financial integration. Of course, this type of solution would require a very high level political mandate among the countries involved and adequate governance arrangements. The administration of this type of instrument should be done by a financial institution with high reputation in all countries involved. The ECCB is well positioned to perform this role through being the banking sector supervisor in ECCU countries may create some conflicts of interest.

185. **If DBs continue to be used as an important instruments for the development agenda on access to finance significant changes are needed.** They include:
• **Definition of narrow and dynamic mandates.** Mandates should be defined in the laws following a *pro-market activism* approach and, thus, in a dynamic way. Mandates need to be redefined through the transition path to the long run equilibrium and the instrument used will eventually disappear with the solution of the problem. It is important to understand that the problem being faced is of a dynamic rather than static nature.

• **Governance arrangements improvements.** One important step is to shift control away from government, even when government remains the owner of the instrument. Governance arrangements should include measures such as Board independence through the introduction of independent Board members; higher accountability of Board; improvements in disclosure through annual submission of operational and financial plans; creation of the Risk Management and other type of internal committees.

• **Innovative instruments to broaden access.** Given its commercial nature, DBs no longer need to engage in some current activities such as mortgage lending. Governments need to reconsider the programs presently financed by DBs to determine whether public sector support continues to be necessary. Innovation of instruments is necessary as there is a general lack of financial instruments in OECS countries beyond the typical bank loan (e.g., absence of venture capital, factoring, guarantees schemes, etc.). The innovation of instruments is a process of discovery and learning-by-doing as the interventions are implemented, and also creates room to give the authorities a first hand understanding of what legislation or enforcement mechanisms are missing for certain innovations to take off.

• **Sustainability has to be combined with mandate achievement on a transparent way.** The financial sector activity of development needs to be done on a level playing field on both grounds, regulatory and supervisory. In view of this consideration it is suggested that DBs or DAs are subject to financial sector regulation and supervision even when they do not take deposits from the general public. However, performance evaluation needs to be different to the traditional soundness and sustainability indicators of the commercial banks. It needs to consider the charter and mission of the DB or DA. New financial instruments and roles will require a change in how institutions are being evaluated considering indicators such as financial activity promoted vs. credit given, real sector impact evaluation.

*Enabling Environment*

186. Improving accounting, financial reporting and auditing practices and effectively aligning them with international standards, will support OECS countries’ efforts to increase private investment thereby ensuring sustainable and accelerated economic growth. The long-term benefits associated with improved corporate accounting and auditing practices include:
• **An enhanced business climate** – A business climate that fosters investor confidence and thus can attract foreign or domestic investment requires a high level of financial transparency on the part of private or state-owned companies operating in the domestic markets, and the observance by these companies of sound practices of accountability and governance. These requirements imply a financial reporting regime that provides investors, creditors and other third parties with timely and accurate information for their investment and other business decisions.

• **Greater economic integration on regional and international levels** – Perhaps most important, by observing financial practices similar to those of its main economic partners and aligned with internationally accepted standards, OECS will enhance its ability to integrate its economy in regional and international markets.

• **Capital market development** – Reviving OECS’s securities market will require greater confidence on the part of investors; this can only be achieved if the company financial reporting regime which investors rely upon when making investment decisions can be regarded as timely and accurate. Therefore if companies adhere to strict standards of accounting and reporting, and auditors perform their role effectively, they can help foster an essential improvement in the investment climate.

• **Reduced risks in the financial sector** – The banking sector’s ability to assess credit risks properly depends largely on the accuracy and reliability of corporate financial reporting. Improving the quality of the financial information provided by enterprises therefore contributes to mitigating the risks for banks and other lenders. In the current circumstances, better and timelier financial information from borrowers can ease liquidity constraints in the banking system.

187. **One of the most important infrastructure elements is a well-functioning credit reporting system which provides rapid access to accurate and reliable standardized information on potential borrowers, be they individuals or firms.** Credit reports strengthen borrower discipline and reduce moral hazard, since late or non-payment with one institution can result in sanctions in many others. Credit reports which include both positive and negative information, so that responsible borrowers can document good credit histories, also help to build “reputation collateral”. In segments of the credit market where physical assets are limited, such as consumer lending – especially for lower income consumers, micro-enterprise or small business lending, reputation collateral is particularly important. Credit reporting can also play a key role in improving the efficiency of financial institutions, by reducing loan processing costs as well as the time required to process loan applications. Lenders may also use credit data to better monitor their existing portfolios as standardized data enables the development of sound internal models to measure credit risk and allocate the necessary capital and/or provisions, identify potential problems and develop and sell enhanced products, through more accurate pricing and targeting, thereby contributing to their profitability. By providing a standard measure of borrower quality, credit data can facilitate the development of secondary markets and securitized portfolios. Since credit registries promote transparency and reduce the information advantage that institutions have over
their existing clients, they can also encourage greater competition, which can lead to lower interest rates and greater access to credit.

188. **Authorities in the OECS countries should take a leadership role in motivating the development of such an important piece of financial infrastructure.** The ECCB is well positioned to serve as the coordinator for a reform agenda in credit reporting due to their unique supervisory position for the banking sector, their understanding of the role of credit reporting in the financial sector. Credit reporting systems involve a broad spectrum of public and private actors, especially when they include information from retailers, firms and service providers in addition to the usual bank and financial institution data. In the case of OECS countries, not only are a large number of private actors involved, but also public actors as public databases also provide valuable information to the system. For this reason, a reform agenda for credit reporting needs to take into account a wide variety of actors, from those concerned with consumer protection to providers of information in the private and public sectors to bank supervisors. While it would be advisable for the ECCB to take a leadership role on the reform agenda for credit reporting, they will need to coordinate these efforts with others in the public and private sectors.

189. **The company registries in the OECS member states could be improved through digitizing records and making information (company name, locale, and accounting information) available online.** Also, it could be worthwhile linking companies across the OECS in a single company registry, available online, as suggested by the Doing Business in the OECS report. While reforms are currently underway, with Grenada digitizing company records, observed work in the registry offices in St. Vincent and Antigua, and St. Lucia (all paper-based) demonstrated that weaknesses remain and further reforms would be desirable.

190. **The cash flow problems for the manufacturing sector arising from slow VAT refund process can be minimized through effective VAT design and tax administration.** Several factors are necessary to have an efficient refund system. The initial registration of taxpayers should be set at a level which does not overburden tax authorities. Risk management systems should be in place to facilitate speedy refunds to exporters with sound compliance history. Governments should monitor closely the performance of VAT with respect to refunds to exporters in order to identify and remedy problems relating to refunds. In this regard, Dominica plans a comprehensive review of its fledgling VAT system. Finally, Governments should ensure that adequate funds are available for refund claims.

191. **In order to promote the intensive use of retail electronic payment instruments an automated clearing house (ACH) is needed for the broad use of new payments instruments (such as electronic transfers, direct debits, etc.).** In many countries, the implementation of such a system has been a major component in the context of the overall efforts to modernize the national payments system and has generated important reductions of costs for banks and their customers. It is therefore of great importance that the ECCB engages itself in efforts and even take a leadership role to help achieve the necessary agreements among banks and other major stakeholders in
the retail arena (i.e. institutions that handle large volumes of collections and/or payments) so that an ACH begins operations soon and on the largest scale possible (i.e. by including as many participants and as many recurrent services as possible).
ANNEX I. LIST OF ENTITIES INTERVIEWED AND DATA SOURCES

I. Commercial Banks

3. ABI Bank Ltd. (Antigua).
4. Republic Bank (Grenada).
5. RBTT Bank (Grenada).
7. Royal Bank of Canada (Dominica).
9. RBTT Bank Caribbean Ltd. (St. Vincent).
10. Bank of St. Lucia (St. Lucia).

II. Development Foundations


III. Development Banks

2. Antigua and Barbuda Development Bank (Antigua).
3. Grenada Development Bank (Grenada).
4. Dominica Agricultural Industrial and Development Bank (Dominica).

IV. Credit Unions

1. Caribbean Confederation of Credit Unions (St. Kitts).
2. St. John’s Co-operative Credit Union Ltd. (Antigua).
3. Grenada Public Service Credit Union (Grenada).
4. Roseau Co-operative Credit Union Ltd. (Dominica).
5. St. Alphonsus Co-operative Credit Union Ltd. (Dominica).
6. General Employees Cooperative Credit Union (St. Vincent).
7. Kingstown Cooperative Credit Union (St. Vincent).
8. Civil Service Credit Union (St. Lucia).

V. Authorities

1. Financial Secretary representatives (Antigua).
3. Authorising Officer (NAO)/European Development Fund (EDF), Ministry of Finance and Planning (Dominica).
4. Ministry of Finance representatives (Grenada).
5. Ministry of Finance- Director General Finance and Planning (St. Vincent).
6. Ministry of Finance representatives (St. Lucia).
7. Office of Private Sector Relations (St. Lucia).
8. Financial Secretary representatives (St. Kitts).

VI. SMEs Entrepreneurs

1. Premier Beverages (Antigua).
2. King Glass (Antigua).
3. Susie’s Hot Sauce (Antigua).
4. Glenelg Spring Water (Grenada).
5. Antoine’s Woodwork (Grenada).
6. De La Grenade Industries (Grenada).
7. Concepts Marketing (Grenada).
8. Marketing and National Importing Board (Grenada).
11. Finishing and Furnishing (St. Vincent).
12. Island Purified-Water Company (St. Kitts).
13. Ross University (St. Kitts).

VI. Associations

1. Association of Industry and Commerce (Dominica).
2. Hotel and Tourism Association (Dominica).
3. Caribbean Open Trade Support program (Dominica).
4. Grenada Hotel and Tourism Association (Grenada).
5. Chamber of Industry and Commerce (St. Vincent).
6. Hotel and Tourist Association (St. Vincent).
7. St. Lucia Industrial and Small Business Association (St. Lucia).
8. St. Lucia Hotel and Tourism Association (St. Lucia).
9. St. Lucia Chamber of Commerce (St. Lucia).
10. Caribbean Confederation of Credit Unions (St. Kitts).

VIII. Registrars

1. High Court Registrar (Antigua).
2. Registrar-Intellectual Property (Antigua).
3. Property Registrar (Dominica).
4. Supreme Court Registry (Grenada).
5. Registrar of Properties (St. Vincent).
6. Land Registrar (St. Lucia).
7. Companies Registrar (St. Kitts).

IX. Other Agencies/Private Sector Initiatives

1. Atlantean Capital-Venture Capital firm (Grenada).
2. Inter-American Institute for Cooperation for Agriculture (Grenada).
3. Small Enterprise Development Unit (St. Lucia).

X. Data Sources (Surveys/Reports)


3. Doing Business 2007, OECS.


The European Commission (EC) introduced a common SME definition in 1996 for the European Union (25 countries), which has been updated in 2003 (applicable since January 1st, 2005) in order to reflect general economic developments since 1996, such as developments in prices and productivity, and awareness of the specific constraints that SMEs face in the economy (e.g. access to finance). See Table 17 below.

### Table 17: SME Definition in the European Union

<table>
<thead>
<tr>
<th>Category</th>
<th>Employment (Headcount)</th>
<th>Annual Turnover</th>
<th>Annual Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro enterprise</td>
<td>&lt;10</td>
<td>€ 2 million (previously not defined)</td>
<td>≤ € 2 million (previously not defined)</td>
</tr>
<tr>
<td>SE</td>
<td>&lt;50</td>
<td>≤ € 10 million (in 1996 ≤ € 7 million)</td>
<td>≤ € 10 million (in 1996 ≤ € 5 million)</td>
</tr>
<tr>
<td>ME</td>
<td>&lt;250</td>
<td>≤ € 50 million (in 1996 ≤ € 40 million)</td>
<td>≤ € 43 million (in 1996 ≤ € 27 million)</td>
</tr>
</tbody>
</table>

Source: European Commission (2005)

However, it is difficult to find a common definition across countries even those that belong to the same income group. For countries in Latin America, there is heterogeneity in the definition not only in the cutoffs but also in the variables (criteria) used to categorize SMEs. See Tables 18 and 19 below.

### Table 18: Criteria used to categorized SMEs in Latin America

<table>
<thead>
<tr>
<th>Country</th>
<th>Employment</th>
<th>Sales</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Bolivia</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Chile</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>El Salvador</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guatemala</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Panama</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Source: FUNDES (Entorno Empresarial, March 2002)

### Table 19: SME Definitions in Latin America

<table>
<thead>
<tr>
<th></th>
<th>Argentina (sales)</th>
<th>Bolivia (empl.)</th>
<th>Chile (sales)</th>
<th>Colombia (empl.)</th>
<th>Costa Rica (empl.)</th>
<th>El Salvador (empl.)</th>
<th>Guatemala (empl.)</th>
<th>Mexico (empl.)</th>
<th>Panama (turnover)</th>
<th>Venezuela (empl.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>Up to 1.25</td>
<td>Up to 10</td>
<td>Up to 2,400</td>
<td>Up to 10</td>
<td>Up to 4</td>
<td>Up to 10</td>
<td>Up to 150,000</td>
<td>Up to 10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SE</td>
<td>Up to 7.5</td>
<td>Up to 19</td>
<td>Up to 25,000</td>
<td>Up to 50</td>
<td>Up to 49</td>
<td>Up to 25</td>
<td>Up to 1 million</td>
<td>Up to 50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ME</td>
<td>Up to 60</td>
<td>Up to</td>
<td>Up to 200</td>
<td>Up to</td>
<td>Up to 60</td>
<td>Up to</td>
<td>Up to</td>
<td>Up to 100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1/ Stated in million pesos. The definition applies to the manufacturing and mining industry. For commerce: micro (up to 1.85 million), small (up to 11 million), and medium-sized (up to 88 million). For services: micro (up to 0.5 million), small (up to 3.4 million), and medium-sized (up to 22.4 million). For agriculture: micro (up to 0.5 million), small (up to 3 million), and medium-sized (up to 18.2 million). For construction: micro (up to 0.5 million), small (up to 3 million), and medium-sized (up to 24 million).


3/ In UF$s. A UF (Unidad de Fomento) is equivalent to approximately U$S 32. Definition by employment is as follows: micro (up to 4 workers), small (up to 49), medium-sized (up to 199), large (over 199).

4/ Based on the new MSME Act. Further to this, there is the asset-volume definition (measured in minimum wages).

5 New classification defined by the Deputy Minister of Micro enterprises, Ministry of Economy. Published in the Diario de Centro América, in its edition of May 17th, 2001. Prior to this, the standard classification was: micro (up to 4 workers), small (up to 49), medium-sized (up to 199).

6/ Definition applicable to the manufacturing industry. For commerce: micro (up to 10), small (up to 30), and medium-sized (up to 100). For services: micro (up to 10), small (up to 50), and medium (up to 100).

7/ Stated in dollars (or balboas). In Panama, the exchange rate with the US$ equals one balboa is in effect.

8 Only for industry businesses. New classification derived from the Decree Law referred to in previous paragraphs. The prior definition (on which enterprise-count was based) refers to micro enterprises (up to 4 workers), small (up to 20), medium-sized (up to 100; further divided into medium-low (21-50) and high (51-100)). A second definition based on annual sales classifies micro (up to 9,000 TU), small (up to 100,000 TU), medium-sized (up to 250,000 TU), large (over 250,000 TU). A TU (tax unit) is equivalent to approximately U$S 12. According to the new Law, in case of confusion the competent ministry authorities shall determine to which definition strata such industry belongs to, according to the methodology established by the Decree-Law regulations referred to in previous paragraphs.

Source: FUNDES (Entorno Empresarial, March, 2002); Diario Oficial de la Federación – México (December, 2002); and Disposición SSEPYMEYDR N° 147/2006 y N° 22/2001 (Argentina).

With respect to the Caribbean region, there is no common definition of micro, small and medium sized businesses. In the case of Barbados, the proposed Small Business Development Act defines a small business for the purpose of Fiscal Benefits: "As any enterprise which has majority local ownership whether owner managed or not, and meets the following criteria: (i) not more than Bds$1.0 million (US$500,000) authorized or paid up capital, (ii) not more than Bds$2.0 million (US$1.0 million) in sales annually, and (iii) not more than 25 employees." In addition, it must not be a wholly owned or majority owned subsidiary of a larger group, corporation or company or of directors of any such larger corporation or company. The Barbados Small Business Association also adopted the above definition as criterion for membership. However, the financial institutions in Barbados have adopted their own definition for lending purposes.

With respect to Jamaica, surveys on micro and small enterprises have adopted various definitions while institutions adopt their own criteria for assistance. “The 1996 Micro and Small Enterprise Survey of Jamaica defined Micro Enterprises as less than ten employees and with less than J$200,000 (US$5,480) initial capital investment. The USAID definition of Micro Enterprise in Jamaica includes enterprises with 10 or less employees. The Government’s Industrial Policy Green Paper defined a small business as an enterprise with less than J$3 million (US$82,192) in capital investment (excluding land and

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building) and involved in a range of manufacturing and service endeavors, as well as forms of retail and wholesale distribution.“ (ILO, 1999)

There is no formal definition of micro and small enterprises in Guyana. According to ILO (1999), discussions with shareholders revealed a consensus view. Accordingly, small enterprises are owner managed, employing between one to twenty-five persons, whereas micro enterprises can be classified as owner managed, employing between one to five persons. “An "unofficial" definition is as follows: Small enterprises utilize less than 4,000 square feet of manufacturing space; and less than 10 acres of agricultural lands. On average, they have annual sales of less than $5.5m (US$39,000) per annum. Their average investment in equipment is less than 4.5 m (US$25,000). The general opinion among the key players in the sector is that "Micro enterprises can be classified as owner managed, employing between one to five persons, and investment in equipment at G$500,000(US$3,012). While Small Enterprises can be classified as owner managed; employing up to 15 persons with an investment up to G$1.5 million (US$9,036) in equipment". (ILO, 1999)

In Trinidad and Tobago, there is no formal or legal definition in Trinidad and Tobago with regard to SMEs. According to ILO (1999), “the closest that comes to a definition of small business in the laws of Trinidad and Tobago is to be found in Section 18A of the Corporation Tax Act Chapter 75:02. This latter Act provides that an Approved Small Company is, inter alia, one which has machinery, equipment and working capital, the value of which does not exceed one million, five hundred thousand dollars.” In addition, “in 1995, the Government-appointed Task Force on Small and Medium Enterprise Development recommended that the following definitions should be adopted as guidelines:”

<table>
<thead>
<tr>
<th>MICRO Enterprises</th>
<th>SMALL Enterprises</th>
<th>MEDIUM Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner managed 1-5 employees</td>
<td>6-25 employees</td>
<td>26-50 employees</td>
</tr>
<tr>
<td>Assets -</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TT$1.00- $100,000 (Up to US$15,873)</td>
<td>$100,001 to $300,000 (US$15,874 to $47,619)</td>
<td>$300,001 to $1.5mn (US$47,620 to $238,095)</td>
</tr>
<tr>
<td>Loan requirement:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TT$500 to $30,000 (US$79 to $47,619)</td>
<td>$30,000 and above ($47,620 and above)</td>
<td></td>
</tr>
<tr>
<td>Sale - up to:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TT$99,000 (US$15,714)</td>
<td>$100,000 to $750,000 ($15,873 to $119,047)</td>
<td>above $750,001 to $6mn (above $119,048 to $952,380)</td>
</tr>
</tbody>
</table>


In Grenada, an OECS country, there is no formal definition of "micro" and "small business". However, according to ILO (1999), in 1991, the Government of Grenada did adopt an acceptable definition recommended by the National Small Enterprise Development Advisory Committee but this definition has never been formalized into a legislation or Act. The definition was similar to the one used by the Caribbean

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55 The definition was similar to the one used by the CTCS of the Caribbean Development Bank, which is explained in the main text.
Technological and Consultancy Services of the Caribbean Development Bank. The CTCS adopted a definition for Micro enterprises: (i) it is owner managed with less than five employees, (ii) less than US$25,000 investment in equipment and (iii) usually a home based operation. In this context, according to ILO (1999), “a small enterprise is defined as a business with: (i) less than 25 employees; (ii) less than 4,000 sq. ft. of manufacturing area; (iii) less than US$50,000 investment in equipment; (Note: Investments exclude real estate); and (iv) less than US$125,000 annual sales.”

A recent survey of SMEs in selected CARICOM countries by the Commonwealth Secretariat defined SMEs as businesses employing between 10 and 100 full time employees and generating revenue of between US$ 100,000 and US$ 5 million per annum.\(^6\) Also, in its questionnaire on credit market conditions, the ECCB defines SMEs as businesses with assets less than $5 million Eastern Caribbean dollars (US$ 1.9 million). The cutoff (upper level) used by CBs to define SMEs is between EC$2 million and EC$5 million, where the highest upper level (between EC$4 million and EC$5 million) is used in Grenada. In this context, a potential cutoff level to define SMEs based on sales in the OECS could range between EC$ 2 million and EC$ 5 million.

However, to validate this suggestion it is necessary to analyze the distribution of firms by assets and sales, by economic sector if possible, by each OECS country in order to identify potential asymmetries in the data across countries, which would imply different cutoff levels within the OECS region. In this context, the potential definition has to take into account both the volume of output or sales and the level of assets. The accuracy of the cutoff level is critical because it would determine the consistency and effectiveness of policy measures, particularly for the issue of access to finance for both start-up and already established SMEs. As mentioned by ILO (1999) the significance of the criteria may vary according to the national/institutional priorities, including the promotion or protection of SMEs or the application of labor/investment/tax legislation.

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\(^6\) The countries surveyed were Barbados, Belize, Grenada, Guyana, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.
ANNEX III. OECS PARTICIPATION IN THE CARIBBEAN CATASTROPHE INSURANCE FACILITY

The Caribbean Catastrophe Insurance Facility (CCRIF)\textsuperscript{57} is an innovative and integrative approach to address liquidity constraints that governments incur following the occurrence of a natural disaster. The CCRIF provides participating OECS countries (Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines) with insurance coverage against natural disasters (earthquakes and hurricanes). The CCRIF allows participating countries to pool their country-specific risks into one, better-diversified portfolio, resulting in a substantial reduction in premium cost of 45-50 percent.

Caribbean countries are highly exposed to adverse natural events (including hurricanes, earthquakes, volcanic eruptions, and tidal waves), which can result in disasters affecting their entire economic, human, and physical environment. Based on the experience since 1970, a natural disaster inflicting damage equivalent to more than 2 percent of the affected country's GDP can be expected to hit the Caribbean basin once every two and a half years.

Caribbean countries affected by natural disasters generally see their access to credit dramatically reduced right at the time when they need it most, limiting their capacity to respond to emergency needs. The limited lines of credit that are available often take time to materialize and add to the debt burden because they must usually be repaid in a very short time frame. Caribbean island states also have limited access to international insurance markets. High transaction costs, the inability to spread risk over a large territory, and the relatively small business brought to the market keep insurance penetration in the region to a minimum. In the absence of easy access to debt and well-functioning insurance markets, most of the economic losses stemming from adverse natural events are borne by governments and households. As a result of their small size and limited access to credit and insurance, Caribbean island states depend on extensive financing from international donors to fund post-disaster needs. Unfortunately, donor assistance often takes many months to materialize, and usually supports specific infrastructure projects. A critical challenge confronting the governments of small states in the aftermath of a disaster is the need for short-term liquidity to maintain essential government services until additional resources become available.

The Caribbean Catastrophe Risk Insurance Facility (CCRIF or Facility) provides participating countries with an insurance instrument that will help shelter them from natural disasters. The Facility will enable governments to purchase catastrophe insurance coverage against adverse natural events, such as a major earthquake or the passing of a hurricane. As of January 30, 2007, 16 Caribbean countries confirmed their participation in the CCRIF, including Dominica, Grenada, St. Lucia, St. Vincent and the Grenadines, Anguilla, Belize, the Bahamas, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Haiti, Jamaica, Montserrat, St. Kitts and Nevis and Turks and Caicos Islands. This high level of enrollment will allow the CCRIF to efficiently diversify its portfolio and thus access reinsurance on better terms.

\textsuperscript{57} World Bank (2007).
## Annex IV. Selected Market Incentive Compatible Instruments

<table>
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<tr>
<th>Instruments (Institution)</th>
<th>Brief Description</th>
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| Structured Finance for Working Capital Financing (Fira) | - FIRA created a structured finance program, involving Ocean Garden (large shrimp distributor), shrimp producers, shrimp feed suppliers, and private banks. Ocean Garden signs supply agreements with individual producers and advances working capital finance. Credit rights are then transferred to a trust fund and sold to banks  
  - The transaction helps to deal with information problems  
    - Ocean Garden provides know-how in screening and monitoring producers  
  - The pooling of debt obligations allows banks to diversify their risks and avoid exposure to a specific producer. Banks do not face Ocean Garden’s credit risk (SPV is bankruptcy remote). Pooling also reduces transaction costs  
  - To align incentives all industry participants provide liquid guarantees to cover initial credit losses  
    - Producer and feed suppliers provide guarantees for specific loans covering initial credit losses up to a certain level  
    - Ocean Garden provides a general guarantee covering initial credit losses up to a certain level  
    - Once these guarantees are exhausted investors start facing losses  
  - FIRA provides a guarantee that covers second losses |
| Development of common financial infrastructure (Bansefi) | - Institutional building through in the Cajas sector through:  
  - Technical Assistance  
  - Training  
  - Technological Platform  
  - Common services network: L@ Red de la Gente  
  - Broadens the clients base (economies of scale)  
  - Allows for differentiated products (economies of scope)  
  - Allows for access to the national payments system through Bansefi (network economies) |
| Creation of a factoring market through infrastructure development (Nafin) | - Internet-based system to provide reverse factoring services to SMEs created in 2001.  
  - The system works by creating chains between buyers and their suppliers  
    - Buyers are large creditworthy firms  
    - Buyers must invite their suppliers to participate  
    - Banks take credit risk of large reputable buyers (factoring without recourse)  
  - NAFIN’s system helps to ameliorate information problems  
    - Screening is outsourced to buyers that have an informational advantage relative to banks  
    - Banks only need to assess creditworthiness of large buyers  
    - Buyers post receivables into the systems preventing fraud  
    - System creates a credit history for suppliers  
  - The use of an electronic platform reduces transaction costs capturing economies of scale and increasing speed of transactions  
  - The system fosters competition among financial institutions |
REFERENCES


