

SME HIGH LEVEL SYMPOSIUM

June 05, 2008

WAYNE DASS

Part 1

What problems require innovative lending technologies?

A couple of comments I want to make in terms of the broad topic, "Access to finance", and I'll start off by saying that, from a broad perspective, access to finance is not really or should not really be an issue because there are a lot of institutions outside there who claim to be extending SME financing.

I think what distinguishes the institutions that are more successful, if you like, in doing that, are institutions that, not just provide money, funding, but also provide support services to go with the funding.

I think that, to start-off with, is a big factor in terms of actually being able to make capital reach where it's needed in the SME's and where it's actually utilized in an efficient manner ... that's the first thing. And if you look around the Caribbean, there are not a lot of institutions that actually do that.... that actually go beyond just having a line available for SME's to come and take funding from.

Second thing, there is this general feeling again that, with SME's then at that level, there's a lack of information and, generally speaking, banks and so on, tend to take a cautious approach because of a lack of confidence, essentially, in what they're getting into.

But I want to introduce the whole concept of Ratings and SME Ratings because that is something that is well utilized in many countries around the world and certainly in India, it's a big thing right now.

The whole idea behind SME Ratings is that there are many SME's outside that are unable to access financing right now.

- Some of them may have banking relationships;
- Some of them may be growing and actually may need additional funding;
- Some of them actually can't access a bank at all.

However, with the SME Ratings, where an independent Rating Agency goes in and does a complete assessment and it comes up with a rating, or score if you like, that is on a common scale and, certainly for the Caribbean, we can introduce something that is common to the Caribbean, so that SME's in St. Lucia, or wherever they are, can actually access funding from an institution in Trinidad and vice versa.

With this SME Rating which, actually, can be made public, so that anyone can go in and have a look at this rating and see what it is. I think that is another set of features of the market that can be introduced to help overcome this problem of a lack of transparency and a lack of information and so on.

So, those are two (2) things that I want to sort of bring on the Table, in terms of consideration for Access to Financing for SME's.

WAYNE DASS

Part 2

Actually, the point I wanted to make related to this discussion is in fact, what I see is that institutions need to take a full sort of enterprise view when we're doing lending to SME's. You don't just look at an asset and finance that asset.

So you need:-

- To assess working capital needs;
- To assess what are the capital requirements going forward, based on business plan;

The point is that, once there's a sound idea, once there's a sound business plan to back up that idea, I think that an institution needs to look at the overall enterprise and determine what are the funding requirements from a total perspective. And again, that I have seen in the past is one of the errors that a lot of the banks make. They just look at financing a particular asset and everything else is not in place, so that the enterprise might get the funding for that asset but cannot grow as it wants to grow.

That's one thing. The other thing is, in terms of debt and equity, of course I agree with Gerry that these operations must be separated but, again, in doing the overall assessment for what this enterprise needs, going forward, you must determine the debt requirements, as well as the equity requirements.

Of course, you must ensure that the entrepreneur is fully committed and has enough capital in there and plans to put in more capital. But at the same time, again, if there is a sound business idea and it's backed-up by a sound business plan, then the institution needs to determine the level of debt and the level of equity that this enterprise needs to grow. Now, as to how they actually organize that, in terms of actually putting in the debt and the equity, those are of course separate functions within the institution. It could be another institution but the point is that you need to determine, at the point of assessment, what are the debt requirements, what are the equity requirements. Don't go in for just one aspect of the business. You have to take a full enterprise view on this whole thing.

I just want to respond to the earlier point, just to make this distinction. There is National Scale Ratings, and you can do National Scale Ratings, which is where you essentially compare entities within the same country. But you could also do Regional Scale Ratings, where you're comparing entities, e.g. a manufacturer operating in Trinidad with a manufacturer operating in St. Lucia or Guyana. And, our point of view, certainly from CariCRIS, in fact that's the value proposition that we bring to the table, is that right now you have all these large rating agencies, S&P, Modies and so on, who provide global scale ratings. In other words, when they assign a rating to an entity in Trinidad or in Jamaica, or in Barbados, that entity is being compared with entities right across the world.

The question is, in the Caribbean here, is that really relevant because what we have are institutions who want access financing from different countries within the Caribbean and so, therefore, what we need is a scale that allows that. A Caribbean or Regional Scale, where entities are compared with different entities within the Region, rather than across the Globe, and that's the basis behind the Regional Scale Rating.

WAYNE DASS

Part 3

I want to take up on one of the points in the summary there, which is the need for Scoring and Credit Scoring, and I want to talk a little bit about the use of models in the assessment of SME's.

We all know that, in terms of assessing, proper assessment of SME's and ongoing monitoring of these SME's are becoming more and more challenging now, with new regulations coming into place like, for instance, BASEL II, and their own requirements.

You have SME's expanding and going into different countries, so you have cross-country exposures on the books now. And, one effective way of dealing with these new challenges is really to look at models and the use of models in the whole risk assessment.

Now, the research shows well that, in terms of the use of models by the size of the institution, certainly if you look at the volumes, if you look at what is required to assess the smaller enterprises as opposed to the larger enterprises, just purely from the economics of the thing, it makes a lot of sense for the assessment of the smaller enterprises to be driven by the use of models.

The problem is that a lot of the models, wherever there are in fact models, a lot of these models are really archaic, in terms of their relevance and their ability to be comprehensive, in terms of the assessment. And what is really needed is models that sort of bridge the gap between the actual speed at which you can do the assessment and come out with a scoring, and complete the loan and the safety, of course, of making the right decision and pricing the loan effectively.

So, that is one of the things that must be sort of taken into consideration when you're looking for a suitable model.

The second thing is that most models tend to be one dimensional, in the sense that they will give you a rating for the company itself, or the obliga, but they can't go on to give you an actual rating or scoring for the facility or the transaction, so they tend to be one dimensional.

If you look at the BASEL II requirements, it actually requires models for them to be considered at all, to be two dimensional in their whole structure. So that is one of the things that, again, has to be factored in into the right choice of models that you use.

The other thing is that you also need models to be more dynamic than they are right now. A lot of models are static, in the sense that it captures information and that's it. You need a model that can actually capture ratings on an ongoing basis, or risk assessments on an ongoing basis, so that you can actually start to build a sort of transition matrix, or a probability of default matrix because, as we all know, the risk of an enterprise changes over the course of time.

It starts off at a very high risk, in terms of probability of default, and as you go into the years of the SME's, the risk profile actually changes and you need a model that can be dynamic in that sense, to be able to reflect the changing risk profile of the company. A lot of the models that we have right now are very static and give you one view of everything.

These are some of the factors that must be considered if you are to look at a model and use a model to help you with the assessment. Certainly, in terms of a credit ratings perspective, we rely on the use of a model and, what I would say is that, the larger the enterprise, the less of an input the model is. There is more discussion that is needed as you go up to larger enterprises because, it has to be a mixture of both the objective and subjective factors, and when you go to the larger enterprises, there are a lot more subjective things that you need discussion on. You need to tap into the brains and the experience of the credit analysts who are concerned. So that is the first point I want to talk about on the use of models.

The second thing is, in terms of SME Ratings, we spoke a little bit about it before but if you look at some of the literature, you would see that the studies actually show that larger banks tend to lend to the larger, older SME's. Small institutions tend to rely more on softer information and lend to SME's, which they have stronger relations.

Other studies actually show that SME's are less likely to receive loans from foreign banks, which are typically large banks. That brings into context the whole thing with RBC coming into the scene here and it sort of begs the question, "What is going to happen to SME lending with RBC coming on the scene?", if you sort of take that perspective.

But the point I'm making is that, generally speaking, the evidence supports that if there's an improvement in the institutional environment, in terms of more transparency and a better enforcement of the rule of law, general speaking, that enhances lending on the whole to SME's.

With that in mind that the whole concept of SME Ratings comes into play because that is exactly what SME Ratings do:-

- They increase the overall transparency;
- They bring more information;
- They reduce the information asymmetries that exist right now and, therefore, can only be down to SME's and their ability to access financing.

So those are the two (2) quick points that I just want to put on the table for discussion.