

**STRENGTHENING OF SMALL BUSINESS
AND MICROENTERPRISE IN RURAL AREAS**

(TC-95-04-46-7)
(TC-95-04-49-1)

EXECUTIVE SUMMARY

EXECUTING AGENCIES: The Superintendencia de Bancos [Bank Superintendency] (SB) and the Asociación de Instituciones Rurales de Ahorro y Crédito [Federation of Rural Credit Unions] (AIRAC).

OBJECTIVE: The purpose of the project is to expand and improve the efficiency of financial and nonfinancial services for small businesses and microenterprises in rural areas by strengthening AIRAC-affiliated credit unions and bringing these intermediaries into the formal bank supervision structure.

DESCRIPTION: Accomplishing these objectives will call for participation by two executing agencies. The SB will be responsible for prudential supervision, and AIRAC will act as the SB's counterpart in the prudential supervision system and in strengthening services involving training, technical assistance, information processing and financial products.

(1) Bank Superintendency: This component will provide support for the SB in the design and implementation of a system for credit union supervision. In coordination with AIRAC, the SB will develop appropriate prudential standards and portfolio rating procedures to measure and monitor the exposure of those intermediaries. Since they are relatively small in size and are spread out across the country, a system for *indirect* supervision will be implemented, with joint participation by AIRAC and the SB.

(2) Federation of Rural Credit Unions: The project's objectives will be accomplished by means of several components aimed at reducing risks and enhancing the efficiency of intermediation in rural savings. The project would strengthen the following five areas: (1) information systems, (2) training services for small businesses and microenterprises, (3) financial products, (4) external supervision, and (5) management of sector exposure.

Executive Summary

Page 2 of 2

FINANCING:	Modality:	Grant
	MIF Facility I:	US\$ 255,000
	MIF Facility III:	US\$1,275,000
	Local:	US\$ 545,000
	Total:	US\$2,075,000

IMPLEMENTATION SCHEDULE: The project will be carried out within 36 months after the date of signature of the financing agreement.

SPECIAL CONTRACTUAL CONDITIONS:

- (1) The SB is to present evidence that the credit union supervisory unit has been set up.
- (2) The SB and AIRAC are to present evidence that a coordinating committee has been appointed for project execution.
- (3) AIRAC is to present to the Bank evidence that:
 - (a) The table of budgetary contributions from its member organizations has been revised to increase each member's monthly dues and show them as a percentage of total assets rather than a nominal value, as is currently the case.
 - (b) AIRAC has set up an equipment replacement fund, governed by appropriate regulations and with a separate accounting system, for the deposit of proceeds from the sale or lease of computer equipment provided by the MIF. In addition, the contract of sale or financial lease and the contract for advisory services in the area of information processing are to be submitted to the Bank.
 - (c) The operating procedures and credit regulations have been drawn up with an eye to establishing a lending service for officers and employees of AIRAC-affiliated credit unions. The credit unions are to revise their internal credit policies to prohibit direct lending to senior officers and employees; this restriction is to be written into the bylaws at the next General Meeting.
 - (d) A three-year action plan has been drawn up, describing how the project is to be executed.

ENVIRONMENTAL CLASSIFICATION: The Environment Committee, at its meeting of August 10, 1995, classified this as a Category II operation.

I. COUNTRY ELIGIBILITY

- 1.1 On September 12, 1994, the Dominican Republic was declared eligible for all modalities of financing from the Multilateral Investment Fund.

II. BACKGROUND

A. The economy of the Dominican Republic

- 2.1 In 1990 the Dominican Republic was faced with one of the harshest crises in the country's economic history. The country ended the year with 101% inflation and a real decrease in GDP of almost 5%. The authorities subsequently adopted a program of economic adjustment and structural reforms and were successful in stabilizing the country and restoring economic growth from 1991 to 1993. Fiscal discipline and a restrictive monetary policy substantially reduced average annual inflation to a mere 4.8% in 1993. Meanwhile, GDP rose 3% in 1993, compared with 7.8% in the previous year. Balance was restored in public finances, and GDP showed a surplus of 0.4% in the period 1991-1993, following a 5% deficit in 1990.
- 2.2 The impact of the restrictive fiscal and monetary policies was reflected in an increase of international reserves from US\$180 million in 1990 to US\$736 million in 1993. The deficit on current account rose from 3.6% of GDP in 1990 to 8% in 1992, owing chiefly to poor performance of traditional exports and an increase in imports, mainly consumer goods. This deficit began to decline in 1993, and has reached 2.9% of GDP.
- 2.3 In 1994 the performance of the Dominican economy was influenced by the presidential elections in May and the ensuing post-election uncertainty. The stability that had prevailed since 1991 was impaired by deterioration of the public finances, which brought pressures to bear on the international reserves, domestic inflation, and the exchange rate. In September, the monetary and fiscal policies became restrictive, and despite the uncertainty associated with the elections, GDP grew 4.3% while inflation averaged 8.3%. The deficit on current account continued to show positive performance, standing at 1% of GDP in 1994.
- 2.4 Thanks to favorable external conditions, in the first half of 1995 the Dominican economy grew at an annualized rate of 3.5%. The exchange rate has stabilized at around 13.35 pesos to the dollar, and cumulative inflation from January to June was at only 3.5%. The balance of payments on current account showed a surplus equivalent to 0.4% of GDP.

B. The financial market

- 2.5 As is the case in other countries with similar per capita incomes, the financial system in the Dominican Republic has been dominated by the commercial banks. During the seventies, the government promoted the establishment of specialized financial institutions (development and mortgage banks) and gave them important fiscal incentives and preferential access to subsidized credit through the Central Bank. This institutional structure, coupled with an excessively interventionistic regulatory framework and the macro-economic instability of the eighties, imparted a marked urban bias to the system and led to the development of a two-tier financial market. 1/
- 2.6 In addition to this multiplicity of financial companies, the situation led to inordinate growth in the number of regulated financial institutions. This process of institutional growth and fragmentation culminated in 1989 in the onset of a deep financial crisis in which several "nonregulated" financial companies failed. The data presented in Annex A-I-1 clearly show the periods of institutional expansion (1980-1989) and contraction (1990-1994).
- 2.7 In 1990 the Central Bank launched a financial reform program, with IDB support (773/OC-DR), which stressed gradual liberalization of the tangled skein of regulations and a strengthening of prudential supervision. Mounting aversion to risk on the part of the Dominican depositor (triggered by the financial crisis) and the liberalization of regulations contributed to an important process of institutional mergers and consolidation. Conversion of the specialized banks into multiple-service banks moved rapidly forward. 2/ One of the most important components of the financial reform was institutional strengthening of the Bank Superintendency [Superintendencia de Bancos] (SB) and modernization of the philosophy of prudential supervision to emphasize the measurement and control of the exposure of financial intermediaries.
- 2.8 The immediate effect of the SB's new portfolio rating system and the relatively high levels of reserves required will be that banks will tend to increase their safety margins in lending operations and more severely ration access to customers regarded as borderline (small-scale businessmen). The recent rise in bank liquidity levels may signal greater aversion to exposure on the part of the

1/ A study published in 1986 detected more than 600 "nonregulated" financial companies operating on the Santo Domingo and Santiago markets. See James Zinzer, *Mercados Financieros No-Regulados*, Centro de Estudios Monetarios y Bancarios, Santo Domingo, 1986.

2/ At this writing there are four multiple-service banks in operation, three more have been authorized but are not yet in operation, and three applications are pending consideration.

national banking system. Consequently, and in view of the urban bias of the banks, the impact of this rationing may be expected to fall disproportionately on the rural economy in the coming years.

C. Rural small businesses and microenterprises

- 2.9 Private banks have penetrated very little into the hinterlands of the country because of high transaction costs (low population density), sector risks, inappropriate monetary and financial regulation, and a long tradition of subsidized participation by public banks in this economic sector. Inland bank branches show a low ratio of loans made to savings acquired, as most of these resources are transferred to the major urban centers to meet preferred customers' demand for credit.
- 2.10 Up to the middle of the last decade, the government's sector policies were skewed markedly to the industrial and urban sectors, and the urban consumer was favored over the farmer. The policies on prices, taxes, subsidies and public expenditures turned the terms of trade against the rural economy, reducing the profitability of agriculture and therewith the median income of the rural population.
- 2.11 The channeling of subsidized credit through Banco Agrícola was the government's most important financial instrument for encouraging investments in the country's agricultural sector, and more specifically in rice growing. ^{3/} Two thirds of this bank's portfolio is concentrated in financing rice production. Banco Agrícola is also participating directly in the marketing of this commodity and in the setting of its domestic prices. Despite the great changes that have taken place in the Dominican economy over the last 20 years, this institution has evolved very little, and is of insignificant relevance to small business and microenterprise. In addition, the explicit and implicit subsidies (tolerance of slowness to repay) in the service of farm debt introduce major distortions in rural financial markets that hinder their effective development and growth.
- 2.12 Credit unions [*cooperativas de ahorro y crédito*] are the most important intermediaries serving small business and microenterprise in rural areas. Despite a long history in the Dominican Republic, dating back to the forties, it was not until the middle of the last decade that these cooperatives began to show sustained growth and important institutional development following a far-reaching reform of their philosophy and operations. Since that reform, they have focused on the mobilization of household savings, which has been the engine of their institutional development. The rapid growth of

^{3/} This institution has been excluded from the financial reform program because it is exempt from prudential supervision by the SB.

these intermediaries over the last five years clearly bespeaks the large unmet demand on the rural financial market.

- 2.13 As a signatory of the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA), the Dominican Republic has undertaken to gradually reduce its international trade barriers. Many farm products are still subject to high real protection and removing that protection is bound to have a significant effect on their profitability, which could have a negative effect on credit union loan portfolios. These cooperatives have been serving the credit demand of their members passively, evaluating their ability to pay and real guarantees before granting loans. But if the structure of the rural economy undergoes profound changes as a result of a major shift in relative prices (and in relative profitabilities), their investments will require more strategic analysis and administration.
- 2.14 Interest in the part played by small business and microenterprise (SBM) in the economic system has been rising with their growing share in national employment and GDP. Structural reforms implemented throughout the region have reduced employment opportunities in the public sector and in the traditional import-substitution sector. Microenterprise not only performs an economic function but also acts as a force for social stabilization by providing productive employment for people who have not yet found it in activities on another scale.
- 2.15 Recent research on the sector has yielded important data on SBM in the Dominican Republic. ^{4/} This sector is estimated to comprise about 320,000 enterprises employing a total of over 830,000 persons. Ninety-seven percent of these enterprises have fewer than five employees. Of this total, 9,269 enterprises employing a total of 135,639 persons have staffs ranging from 11 to 50 persons (small businesses). The microenterprise sector is showing great dynamism, and a high turnover of enterprises arising and disappearing. In addition, women own more than 37 percent of them and are joint owners of an additional 8 percent.
- 2.16 The principal institutions servicing small business and microenterprise in the Dominican Republic are nongovernmental organizations

^{4/} These studies have focused mainly on the urban sector. FONDOMICRO has financed several studies on small business and microenterprise. See, for example, Miguel Cabal and Patricia Cely, *Demanda de Crédito y Niveles de Desarrollo de las Microempresas y Pequeñas Empresas en la República Dominicana*, FONDOMICRO, Santo Domingo, 1994; Frank Moya Pons and Marina Ortiz, *Microempresas y Microempresarios*, FONDOMICRO, Santo Domingo, 1994; and Miguel Cabal, *Microempresas y Pequeñas Empresas en la República Dominicana: Resultados de una Encuesta Nacional*, FONDOMICRO, Santo Domingo, 1992.

(NGOs) and credit unions. At the close of 1994 the 11 leading NGOs in the country held a combined portfolio of RD\$254.6 million (US\$19.5 million), of which 78.6% was concentrated in Asociación para el Desarrollo de Microempresas, Inc. (ADEMI) (see Annex A-I-1). ADEMI finances its portfolio with grants, loans, and deposits received from the general public. ADEMI has been charging its microentrepreneur customers an effective interest rate of between 3.8% and 4.6% a month. It is one of the financially soundest and most efficient NGOs on this market. Almost without exception, the most visible programs in support of microenterprise concentrate their lending programs on the urban commercial sector, and almost always excludes the agricultural sector. The stable cash flow of this clientele and its geographic concentration hold down the transaction costs of the intermediaries and their commercial risks.

- 2.17 In view of the pronounced institutional weaknesses of support for small business and microenterprise in rural areas, the proposed project is designed to strengthen the nascent structure of credit unions all over the country that are members of the Federation of Rural Credit Unions. Though the principal function of these credit unions has been to provide financial services for SBM, this institutional structure offers an important opportunity to increase the provision of nonfinancial services to the same clientele.

D. The Federation of Rural Credit Unions

- 2.18 The Federation of Rural Credit Unions [Asociación de Instituciones Rurales de Ahorro y Crédito] (AIRAC) is a nonprofit association established under the Associations Act (Law 520) in 1990 by seven credit unions. Though it has other functions, its reason for being is to perform services for its affiliated institutions. Though these affiliates are institutions with their own legal standing, AIRAC imposes a high degree of homogeneity on the strategic aims, financial policies and operating practices of the system and provides an effective mechanism for self-regulation and control.
- 2.19 At the end of 1994, AIRAC counted 16 affiliated credit unions serving more than 34,000 members in the hinterlands of the country. ^{5/} According to its financial statements to the close of 1994, it held assets totaling the equivalent of RD\$13.2 million (US\$1 million). The most important asset item is the investment portfolio, which is fed by funds administered by the credit unions. Though it has a small loan portfolio (US\$100,000), it is not a financial intermediary and does not receive funds from the public. This portfolio consists of loans at medium term to support the

^{5/} Not counting the Teachers' Credit Union, AIRAC-affiliated credit unions represent about 80% of the assets of all the credit unions in the country. The Teachers' Credit Union receives contributions and recovers loans by a payroll withholding system of the Department of Education.

institutional development of its affiliates, which have been used mainly to finance computer equipment, furniture, and building construction at commercial interest rates.

- 2.20 AIRAC is a technical service institution, and its most important services are the development and support of management information systems, training and technical assistance, and wholesale financial services to its affiliated institutions. It offers essentially two financial services: (1) a money desk to facilitate the channeling of cash surpluses among its affiliates; and (2) the administration of an investment portfolio in commercial banks and the Santo Domingo Stock Exchange in order to increase the return on the portfolio of cash investments of the credit unions in a manner consistent with the preservation of principal. AIRAC is financially self-supporting, and earns its income from three main sources: (1) the financial spread on the portfolio of loans and investments (46.9%); (2) fees charged for training and technical assistance services (24.2%); and (3) the budgeted quota contributions of the member cooperatives (23.9%). AIRAC's total assets have grown more than 100% over the last two years (Annex A-I-1).

E. Credit unions

- 2.21 There are seven types of financial institutions in the Dominican Republic: commercial banks (multiple services), development banks, mortgage banks, savings and loan associations, financial companies, small-loan companies, and credit unions [*cooperativas de ahorro y crédito*]. At the close of June 1995 the combined assets of these seven groups of institutions totaled some RD\$65,245 million (US\$4,731 million). The 16 credit unions affiliated with AIRAC held total assets of RD\$250.5 million (US\$18.1 million), or 0.38% of the assets of the financial system as a whole. By comparison, the small-loan companies held total assets of RD\$140.9 million (US\$10.2 million), or 0.22% of the system's assets.
- 2.22 Despite their relatively small size, since the end of 1993 ^{6/} the credit unions have grown faster than any other group of institutions in the system (see Annex A-I-1). Only the commercial banks, savings and loan associations, and credit unions have been increasing market share, which reflects the institutional consolidation toward multiple banking (development and mortgage banks) and a loss of market share by financial companies and small-loan companies.
- 2.23 At the end of June 1995, total credit union assets were distributed as follows: 59.5% in the loan portfolio, 23.6% in cash investments, 6.3% in fixed assets, and 10.6% in other assets. 16.1% of these assets had been financed with equity capital, 79.7%

^{6/} Before 1993 the last *Boletín Estadístico* was published by the Bank Superintendency in 1986.

with capital contributions, savings and time deposits received from their affiliates, and the remaining 14% with other liabilities (see Annex A-I-1). As can be seen, these institutions finance the bulk of their assets with savings received from their members, which at the close of last June totaled RD\$175 million (US\$12.7 million), and RD\$24.5 million (US\$1.8 million) in capital contributions from their members.

Quality of the portfolio and solvency

- 2.24 At this time the credit unions have no portfolio rating system or standards for the level of reserves required on the basis of an evaluation of the credit risks they face. At the end of July 1995, 13.1% of the installments due on the combined portfolio of AIRAC's affiliated credit unions were past due and related to 18.6% of the loan balances involved. These cooperatives maintained reserves for bad loans of about 2%. In view of the small size of the average loan and the characteristics of the borrowers, the policy on required reserves should be based on the age of the default (which is the same policy applied by the SB on consumer loans of the banking system). 1/
- 2.25 Credit analysis and administration suffers from important shortcomings in the credit unions: lack of an optimal information system for stricter analysis and monitoring of borrowers, efficient recovery mechanisms, and an inappropriate structure of internal incentives. There are also problems exogenous to the management of those cooperatives, such as a high correlation between yields in the different sectors of the local economy, and problems associated with changes in the economic structure of several regions (for example, the sugar and rice-growing sectors) generated by the process of opening the economy to the outside world. In addition to strengthening of their lending processes, these entities need support in strategic analysis to help them identify and evaluate sector risks and so control their exposure.
- 2.26 Though these institutions finance most of their assets with deposits, the equity investment of their members is relatively large compared with other institutions in the financing sector. At the close of June 1995 the capital of the credit unions came to 16.1% of their total assets and 27.1% of their portfolios, and their

1/ Applying the method used by the SB for consumer loans, the portfolio reserve requirement at the close of July 1995 is about 10.9%. Hence these reserves are about 9% short ($10.9\% - 1.9\% = 9\%$). By comparison, the SB's latest evaluation (December 1994) of the banking system brought out a level of 9.4% for the institutions under its supervision.

institutional capital ^{8/} amounted to 6.3% and 10.7%, respectively. Table 1 summarizes the average financial indicators of 11 AIRAC-affiliated credit unions, showing a sound financial situation. ^{9/}

Table 1 Comparative financial ratios of AIRAC affiliates 1992-1994			
	1992	1993	1994
Yield on portfolio	52.1%	49.3%	43.1%
Weighted cost of deposits	17.2%	15.4%	14.4%
Financial spread/generating asset	26.5%	26.2%	24.5%
Institutional capital/total assets	5.8%	7.4%	8.7%
Capital/total assets	15.8%	17.6%	18.6%
Operating costs/generating asset	24.8%	15.3%	19.3%
Yield/contributions	31.6%	59.6%	50.7%
Yield/assets	3.3%	5.5%	4.7%
Average total assets in US\$000s	255.0	1.066	1.315

F. Legal framework and supervision of credit unions

- 2.27 Credit unions are mutual-type financial institutions organized under the Cooperatives Act (Law 127), promulgated in 1964, for which implementing regulations were issued in 1986. Law 127 was enacted to govern all enterprises organized as cooperatives, whether supermarkets, transportation companies, financial institutions, or production enterprises. While it may suffice to regulate commercial and production cooperatives, the act has been found inadequate in the sphere of financial intermediation.
- 2.28 Though financial intermediaries that receive deposits from the public, the credit unions lack regulations that set minimum standards for their supervision. For example, the law sets a capital of as little as RD\$3,000 (US\$222) as a qualification for legal recognition (Article 107 of Law 127), and thereafter says

^{8/} Institutional capital is the capital less the members' contributions. It is made up chiefly of capital reserves resulting from the reinvestment of their surpluses, and cannot be distributed among the owners of the institution.

^{9/} Three institutions opened their doors in 1994, and in two others the financial business is not preponderant and their indicators are not comparable to those of the others.

nothing whatever. There are no limits on the concentration of credit, requirements on provision for past-due loans, limitations on investments in nonfinancial businesses, or essential minimum liquidity levels.

- 2.29 Law 127 is too broad to properly regulate financial institutions like credit unions. Though it does not raise high obstacles to the development of these intermediaries, it is in need of revision. AIRAC has been participating with the Instituto de Desarrollo y Crédito Cooperativo in a working group to promote a revision of Law 127 and the drafting of a new law on credit unions. This new law must be designed to take account of the structure of bank regulation and of overlap between the two sets of legislation.
- 2.30 Law 31, promulgated in 1963, created the Instituto de Desarrollo y Crédito Cooperativo [Cooperative Development and Credit Agency] (IDECOOP), a decentralized public-sector agency. That law gives it the purpose of "promoting the development of the cooperative system in the Dominican Republic" (Art. 2). Article 5 of the law establishes that one of its functions is "to promote, advise, educate and coordinate the cooperative movement in the Dominican Republic."
- 2.31 Though IDECOOP must oversee compliance with Law 127 and its Regulations, it is not a financial supervision agency. Its sector promotion functions and the fact that five of the 11 members of its directing council are from the cooperative sector give rise to major conflicts of interest incompatible with a supervisory function. Just as pharmaceutical cooperatives are subject to the regulations of the Ministry of Health, and transportation cooperatives to those of the National Bureau of Surface Transportation [Oficina Nacional de Transporte Terrestre], credit unions are subject to the provisions of the Monetary Board and the SB.

III. DESCRIPTION OF THE PROJECT

A. Purposes

- 3.1 The purpose of the project is to expand and improve the efficiency of financial and nonfinancial services for small business and microenterprise in rural areas by institutionally strengthening AIRAC-affiliated credit unions and bringing them into the formal bank supervision structure.

B. Description

- 3.2 Accomplishment of the aforementioned purposes entails the participation of two executing agencies: the SB for supervision, and AIRAC to act as the SB's counterpart in the supervision system and

in strengthening the services of training, technical assistance, information processing, and financial products.

- 3.3 1) Bank Superintendency: The purpose of this project component is to support the SB in the design and implementation of a system for supervision of credit unions. The SB will develop, in coordination with AIRAC, appropriate prudential standards and a portfolio-rating mechanism to measure and monitor the exposure of these intermediaries. Because of the small size of the intermediaries and their wide dispersal throughout the country, an *indirect* supervision mechanism will be implemented in which AIRAC will participate in the process in conjunction with the SB.
- 3.4 The resources to finance this component of the project will be used to set up in the SB a unit or division specializing in credit unions, and training resources to facilitate implementation of the supervision system at AIRAC and the credit unions. Specifically, the resources will finance computer equipment, the initial personnel and travel costs, the training of the participating entities, and a trip to observe what other bank supervision institutions have done that have more experience in the integration of these intermediaries.
- 3.5 The *indirect* supervision system will be applied initially to AIRAC-affiliated credit unions, but all credit unions operating in the country will be required to adapt their operations to the prudential standards to be developed under this project. Unaffiliated credit unions may contract for technical assistance from AIRAC to help them adjust to the SB's regulations. Otherwise those credit unions will have to submit to direct supervision by the SB. The mechanisms for supervision of credit unions that are not affiliated with AIRAC will be shaped in greater detail during execution of the project.
- 3.6 Meanwhile, IDECOOP will continue promoting the cooperative sector and ensuring that the mutual ownership structure of these entities and the mechanisms for their administration are not altered. The SB will transfer to IDECOOP one of the computers to be financed by this component for use in its promotional work. IDECOOP technical personnel will be invited to attend the SB's training courses. In addition, an IDECOOP officer will join in the observation trip to be financed by the project for two SB officials to acquire a fuller understanding of experiences of credit union supervision in another country of the Region.
- 3.7 2) Federation of Rural Credit Unions: The project's objectives will be accomplished by means of several components aimed at reducing risks and enhancing the efficiency of the intermediation in rural savings. The project proposes to strengthen the following five areas: (1) information systems, (2) training services for small business and microenterprise, (3) the department of financial

products, (4) external supervision, and (5) the management of sector risk.

- 3.8 a. Information system: At present 15 of the 16 credit unions have an automated data processing system installed on PCs operating independently or as part of a network. Each credit union processes its operations locally using essentially the same version of the program, while AIRAC provides technical assistance in the implementation and maintenance of those systems. The equipment in use in AIRAC and the different institutions are underconfigured and on the verge of obsolescence. The supporting infrastructure (UPS, electrical generators, etc.) needs to be improved, especially in view of the uncertain state of the electric power service.
- 3.9 The project includes an equipment replacement plan for the purchase or development of the applications the credit unions require to improve their management information processing systems. This implies the replacement of every PC in current use and development of the requisite infrastructure.
- 3.10 The equipment financed with resources of this operation will be donated to AIRAC, which, however, will in turn sell it to its member institutions or enter into a financial lease contract with them. Together with the equipment, the project will finance the services of a computer specialist at long term and of another at short term to support the development of the integrated applications. Each institution will sign a data processing service contract that will be written to make the service self-financing.
- 3.11 b. Entrepreneurial training services: The credit unions have become important centers that serve as a focal point for the small businesses and microenterprises of the towns in which they operate. They have become active members in this sector because they give access to financial services that banks traditionally do not offer. The growth and success of credit unions over the last six years has been due primarily to that active membership, animated by a strong sense of belonging. Credit unions have so far focused on providing financial services and offering entrepreneurial training courses of limited scope.
- 3.12 Under this component, AIRAC will strengthen the entrepreneurial training program it has been carrying out through its various member institutions. The resources invested in this program will be used to hire a specialist in entrepreneurial development issues, who will develop a strategy and operating plan for training services targeting the small business and microenterprise sector, to be carried out through member credit unions. AIRAC has so far been providing these services by hiring outside consultants and charging a fee to cover service costs. The intent is that this unit or division should become a major income earner for AIRAC, covering not just its own costs but also the fixed costs of the federation itself.

- 3.13 c. Financial Products Department: A great weakness of the credit unions is the lack of a capability for the development of new financial products into which they could expand and that would make their services to small business and microenterprise more competitive. The reason for this is that they are too small to enjoy the economies of scale that would make it interesting to introduce the most modern financial technologies and products, in addition to the weaknesses of their personnel. Proper risk management and control of transaction costs are needed to improve their operations with small business and microenterprise.
- 3.14 The project resources will be used to engage a professional with extensive experience in the national financial sector. This professional will be supported by short-term consultants specializing in matters of interest. The purpose is to support the development of new products for the acquisition and investment of resources. The development of new products, such as credit cards for microenterprise, and current accounts on which payments may be made through commercial banks, will help reduce the transaction costs of these entities and make them more competitive. This department will be run on a commercial basis, and only products that generate enough income for AIRAC will be supported.
- 3.15 d. External supervision: The project will institutionalize an appropriate mechanism for external supervision consistent with the philosophy for reform of the financial sector on which the Central Bank and the SB have been operating. Since the credit union sector is relatively small and the institutions are dispersed throughout the country, the supervision model proposed is designed for maximum effectiveness in taking account of the high transaction costs it could impose on the SB. Since AIRAC has been regulating the practices and policies of its members and has developed an early warning system for the detection of risks, the proposed project will seek to make use of the existing structure in building an effective supervision system.
- 3.16 The SB will define prudential standards and a methodology for rating portfolios and policies on reserves against risks. Meanwhile, the SB will implement a training program for officers of AIRAC and the credit unions to explain and discuss these standards. With the support and supervision of the SB, AIRAC will draw up a plan for the gradual implementation of those standards among its affiliates. AIRAC will also collect, process and analyze the financial statements and any other information that the SB may require. This information will be processed by the SB's methods and delivered to the SB. AIRAC's direct contact with the credit unions will be governed by the guidelines laid down by the SB, which, however, does not preclude direct SB supervision of credit unions chosen by random sampling.
- 3.17 The resources supplied by the project will be used to hire three technical experts specializing in the inspection and supervision of

credit unions. In addition to these experts, the project will channel resources for the hiring of consultants or specialized lawyers to support reform of the existing laws and regulations so that they will be consistent with the prudential standards to be developed with the SB. Two staff members of this division will participate in the international trip to learn of the experience of credit union supervision in other countries of the region.

- 3.18 e. Management of sector risk: The credit unions lack the capability and access to the information needed to evaluate the impact of macroeconomic and sector policies on regional economies and hence on their own institutions. They require support in the analysis of these risks and technical assistance in the design of financial policies for their management.
- 3.19 The project resources will finance a specialist for two years to manage the risk analysis process. In addition there will be resources to hire short-term experts to support, in that sectoral risk analysis, its possible impact on credit unions and the financial policies they should adopt to address those risks. This department will coordinate directly with the training department for the holding of workshops and seminars to disseminate the results to its member institutions.

C. Costs of the project, sources of financing, and recovery of costs

- 3.20 The total cost of executing the project has been estimated at the equivalent of US\$2.08 million, of which the MIF would finance US\$1.56 million. The following table summarizes the salient items of the budget broken down among the components and itemizing the local contributions to be made by the executing institutions. A detailed version of the project budget may be found in Annex A-II-1.

Table 2 Strengthening of small business and microenterprise (in United States dollars)				
	TOTAL	MIF	SB	AIRAC
Component I	430,000	240,000	190,000	
Component II	1,615,000	1,260,000		355,000
Evaluation	30,000	30,000		
Total	2,075,000	1,530,000	190,000	355,000

- 3.21 The MIF resources will be provided to the project's executing institutions on a nonreimbursable basis. The resources for the SB will facilitate the establishment and placement in operation of a special division to supervise the credit unions. The MIF will finance one third of the estimated remunerations of the three staff

members assigned to the new credit union supervision division in each of the three years of the project's execution, and the SB will cover the other two thirds. The design of the joint supervision mechanism itself ensures that the recurring costs to be covered by the SB after the end of the external financing will be minimal.

- 3.22 In the case of AIRAC the computer equipment will be sold to the credit unions or transferred under contracts of financial lease. The income obtained from those transactions will be deposited to a technological renewal fund that will operate as a revolving fund to go on financing the renewal of equipment into the future. Similarly, each institution will have to enter into a contract for the purchase of data processing services to keep that service financially sustainable.
- 3.23 The new services to be provided by AIRAC will increase its operating costs. The MIF will finance two thirds of the remunerations of the technical personnel in the supervision division, training, financial technology and risk analysis, and AIRAC will cover one third during the three-year project execution period. This initial subsidy is considered necessary because the products and services to be offered for sale will take some time to develop. The increase in costs associated with the supervision unit will be covered by an increase in member dues, while the recurring costs of the other divisions will be covered by the sale of services and products (information processing, training seminars, etc.).

IV. IMPLEMENTATION OF THE PROJECT AND DISBURSEMENTS

A. Institutional structure of the project

- 4.1 The proposed model for credit union supervision calls for the participation of two institutions: the SB and AIRAC. The SB has been acquiring a rich fund of experience in the supervision of the banking system over the last two years, but has had no experience with credit unions. This project is highly innovative in proposing extensive coordination between a public agency and a private one for the accomplishment of a common purpose. The SB has the clear function to protect a "public good" (deposits of the public), and the credit unions are interested in joining the formal financial system so that they may become more stable and competitive on the market. Because of this, it is reasonable to expect that a good working relationship will develop.
- 4.2 To be efficient, the proposed system requires a single vision of the aims in view and close coordination between the two institutions. To this end a coordination committee will be formed with members of the SB and AIRAC. The function of this committee will

be to provide, as its name implies, close coordination between the two institutions for effective execution of the project.

B. Special conditions precedent to the first disbursement

- 4.3 For maximum effectiveness in execution of the project and the accomplishment of its long-term goals, the two executing agencies will have to fulfill, in addition to the general conditions, the following special conditions:
- 1) The SB is to present evidence that the Credit Union Supervision Unit has been created.
 - 2) The SB and AIRAC are to present evidence that a coordination committee has been appointed for execution of the project.
 - 3) AIRAC is to present to the Bank evidence that:
 - a. The table of budgetary contributions from its member organizations has been revised to increase in real terms each member's monthly dues and show them as a percentage of total assets rather than a nominal value, as is currently the case.
 - b. AIRAC has set up an equipment replacement fund, governed by appropriate regulations and with a separate accounting system, for the deposit of proceeds from the sale or lease of computer equipment provided by the MIF. In addition, the contract of sale or financial lease and the contract for advisory services in the area of information processing are to be submitted to the Bank.
 - c. The operating procedures and credit regulations have been drawn up with an eye to establishing a lending service for officers and employees of AIRAC-affiliated credit unions. The credit unions are to revise their internal credit policies to prohibit direct lending to officers and employees; this restriction is to be written into the bylaws at the next General Meeting.
 - d. A three-year action plan has been drawn up, describing how the project is to be executed.

V. VIABILITY AND RISKS

A. Viability

- 5.1 Over the last ten years, credit unions have been growing into a major source of financial services for small business and micro-enterprise in rural areas of the Dominican Republic. Their active

and innovative participation in the rural savings market has sparked their institutional development and improved the channeling of rural savings into productive investment among the low-income population. All this has been accomplished without the protection of an appropriate supervision system and in the midst of the severe crisis in the financial sector. Bringing these intermediaries under the supervision of the SB will further spur their development by increasing the flow of resources to small business and micro-enterprise in rural areas by the positive effect of reducing the perceived risks of these entities among the depositing public.

- 5.2 As a service institution whose members are rural credit unions, AIRAC has shown itself capable of performing efficient, self-financing services for its member institutions. The project would activate the growth of this financial structure through the development of novel financial services with a modern and efficient information technology. This will, in turn, enhance its institutional viability by reducing the risks to which its members are exposed and making them more competitive on the country's financial market.

B. Risks

- 5.3 Owing to some basic differences of philosophy, not all the Dominican Republic's credit unions are AIRAC affiliates. All AIRAC's member institutions are vehemently in favor of its joining the SB's formal bank supervision structure because they believe that the external discipline will benefit their members. The participation of IDECOOP as the institution for promotion of the cooperative sector is of decisive importance because it understands and supports the integration of credit unions into the formal bank supervision system. Its participation in training and in publicizing the purposes of supervision is important because of its promotion work among credit unions that are not AIRAC members.

VI. COMPLIANCE WITH PROJECT ELIGIBILITY CRITERIA

- 6.1 The proposed project is consistent with the general purpose, goals and objectives of the Agreement Establishing the MIF in that it supports appropriate policies that foster small business and microenterprise while particularly favoring the participation of society at large.
- 6.2 The proposed project is also consistent with the programming objectives and specific programs and activities of the Technical Cooperation Facility (Facility I) and the Small Enterprise Development Facility (Facility III). In relation to the former, it promotes the strengthening of a modern financial system and the institutional strengthening of the bank supervision institution.

In relation to the latter, it supports the development of complete financial services (credit and savings), the participation of nonprofit institutions (AIRAC and credit unions) in the sustainable development of the private sector, the strengthening of financial intermediaries, and the introduction of novel financial technologies.

VII. CONSISTENCY WITH THE BANK'S COUNTRY PROGRAM

- 7.1 The proposed operation is consistent with the guidelines set down in the most recent country programming paper for the Dominican Republic in that it promotes intensification of the financial reform program by making the credit unions subject to the bank supervision process. In addition, it supports the small business and microenterprise sector by strengthening financial intermediaries that evince a strong affinity for this segment of the entrepreneurial sector. It also favors the country's rural sector by bringing benefits to the low-income population in particular. Finally, it favors the development of popular nonprofit institutions in which women are very active participants, and are particularly dedicated to serving the low-income population.
- 7.2 The proposed operation constitutes a very important component of the Bank's strategy of support to the rural sector. The program to enhance the competitiveness of the Dominican Republic's agriculture sector (TC-95-05-30-8), proposed by the Junta Agroempresarial Dominicana, Inc. to the MIF, is an operation that seeks mainly to improve the competitiveness of small farmers. These small entrepreneurs constitute an important segment of the membership of the credit unions affiliated with AIRAC. Strengthening these entrepreneurs will improve the prospects of their becoming good candidates for credit from the credit unions, which in turn will receive support from the MIF.

VIII. AVAILABILITY OF MIF RESOURCES

- 8.1 **Modality of financing.** The expectation that the project will be financed by a grant is based on the following considerations: (i) on September 12, 1994, the Donors Committee declared the Dominican Republic eligible for all MIF modalities; (ii) compliance by the Dominican Republic with the criterion of eligibility for grant funds at the country level (Section 5b, Article 3 of the MIF Agreement) is set forth in detail in section III, paragraphs 3.1, 3.2 and 3.3 of the country's eligibility memorandum (MIF/GN-27), and (iii) the proposed project will have an important catalytic effect as required by Section 5(a) of the MIF Agreement in that it

will have an important impact on the supply of financial services to small business microenterprise.

IX. REPORTS, EVALUATION AND MONITORING OF THE PROJECT

A. Monitoring and reports

- 9.1 To ensure the availability of information for evaluation of the accomplishment of the project's purposes, a management information system will be set up in both AIRAC and the SB. Both AIRAC and the SB will have to present to the Bank semiannual reports evaluating the progress made and obstacles to execution of the project. These reports will be based on the management information system at the two institutions, and be stated in terms of the purposes and indicators described in detail in the logical framework presented as Annex III-1.

B. Evaluations

- 9.2 The Bank will perform an midterm evaluation of the execution of the project to make sure that it is being satisfactorily implemented and that the purposes set by the project will have been accomplished at its completion. This evaluation will be made after 18 months of execution. It must be based on a review of the indicators presented in Annex III-1 and also of any other indicators that the evaluating team considers important. Special importance will attach to the institutional design of the supervision mechanism, the framing of the prudential standards contained in the project, and the financial sustainability of AIRAC.

CREDIT UNION AND AIRAC FINANCIAL STATEMENTS

Table 1 Number of Regulated Financial Institutions Dominican Republic					
	Commercial Banks	Development Banks	Mortgage Banks	Savings and Loan Associations	"Finance Companies"
1980	12	17	8	15	nd
1989	23	36	16	19	600
1994	13	21	4	19	161

Table 2 Principal Non Governmental Organizations Credit for the Small and Microenterprise Loan Portfolio Thousands of RD\$				
	1991	1992	1993	1994
ADEMI	52.226	86.961	142.397	200.241
Other 10 NGOs	20.220	24.968	37.350	54.322
Total	72.446	111.929	179.747	254.563

Table 3 Total Assets of the Financial System by Groups of Institutions Millions of Pesos RD\$								
INSTITUTIONS	Dec 93	Distr %	Dec 94	Distr %	Jun 95	Distr %	93/94	94/95
Commercial Banks	36.231	66,9%	40.603	64,8%	44.681	68,5%	12,1%	10,0%
Development Banks	5.697	10,5%	7.586	12,1%	5.383	8,3%	33,2%	-29,0%
Mortgage Banks	770	1,4%	662	1,1%	679	1,0%	-14,0%	2,6%
S and L Associations	7.175	13,2%	9.147	14,6%	10.029	15,4%	27,5%	9,6%
Finance Companies	3.999	7,4%	4.296	6,9%	4.081	6,3%	7,4%	-5,0%
Small Loan Houses	157	0,3%	145	0,2%	141	0,2%	-7,5%	-2,8%
Credit Unions	156	0,3%	214	0,3%	251	0,4%	37,1%	16,8%
Total	54.185	100,0%	62.653	100,0%	65.245	100,0%	15,6%	4,1%

Table 4 Aggregate Estimate of Credit Risk of CUs affiliated to AIRAC July 31 1995			
Age of delinquency	Delinquent Portfolio RD\$	% of Provisioning	Required Provision RD\$
1 - 30 days	3.199,542	0	0
31 - 60 days	4.103,897	1	41.039
61 - 90 days	2.023.682	10	202.388
91 - 120 days	2.248.411	20	449.682
More than 120 days	19.608.892	80	15.687.114
Total:	23.888.488		16.380.223

Table 5 Comparative Annual Balance Sheets Association of Rural Savings and Loan Institutions Values expressed in US\$ December 31st			
	1992	1993	1994
Cash on Hand and in Banks	14.504	1.847	10.562
Accounts Receivable	6.511	15.166	13.721
Short Term Investments	216.849	446.822	839.149
Loan Portfolio		65.034	99.499
Fixed Assets	4.268	4.749	38.171
Other Assets	4.349	13.268	9.979
Total Assets	246.481	546.886	1.011.081
Accounts Payable	3.336	1.279	24.500
Funds under Administration	192.721	399.687	670.246
Donations in Process			65.461
Other Liabilities	16.853	5.880	11.066
Total Liabilities	212.909	406.846	771.273
Donated Capital and Reserves	34.698	135.484	236.885
Net Operating Income	(1.126)	4.556	2.924
Total Net Worth	33.572	140.040	239.808
Liabilities and Net Worth	246.481	546.886	1.011.081

<p>Table 6 Income and Expense Statement Association of Rural Savings and Credit Institutions Values expressed in US\$</p>			
	1992	1993	1994
Income			
Interest on Loans	161	21.980	31.903
Interest on Investments	13.564	27.949	52.046
Interest on Deposits	2.737	39.240	73.796
Commissions charged on services	9.538	15.159	11.888
Budgetary Contribution	17.152	29.058	31.290
Other Net Income	160	14.670	19.858
Sale of Assets	0	9.789	6.508
Total Income	43.311	157.844	227.291
General Administrative Expenses	31.760	98.714	126.701
Interest Paid	12.497	54.377	96.348
Commissions Paid	180	197	1.318
Total Financial Expenses	12.677	54.574	97.666
Total Expenses	44.437	153.288	224.367
Net Income	(1.126)	4.556	2.924

<p align="center">Table 7 Consolidated Balance Sheet of CU affiliated to the AIRAC System December 31st Thousands of RD\$</p>				
	1992	1993	1994	1995 ^{1/}
Cash on Hand and in Banks	7.919	19.823	17.717	29.067
Liquid Investments	21.300	17.432	31.017	30.153
Other Investments	2.026	4.574	4.522	3.868
Loan Portfolio	57.913	93.634	132.440	148.951
Fixed Assets (Net)	6.404	9.405	13.148	15.819
Accounts Receivable	593	7.439	9.961	17.930
Deferred Expenses	1.617	950	724	1.186
Other Assets	1.193	3.121	4.927	3.527
Total Assets	98.965	156.378	214.456	250.501
Passbook Savings Accounts	27.930	37.002	49.889	56.842
Time Deposits	46.679	75.940	103.038	118.206
Short Term Liabilities	4.448	4.666	4.994	4.804
Long Term Liabilities	433	2.791	2.720	4.641
Deferred Credits	800	6.520	10.023	17.866
Other Liabilities	1.361	3.163	6.217	7.737
Total Liabilities	81.651	130.082	176.881	210.095
Member Share Investments	11.427	15.441	20.074	24.546
Donations	701	1.219	2.737	1.509
Reevaluation of Assets	244	2.232	954	694
Retained Earnings and Reserves	1.870	2.135	4.128	8.693
Profit or Loss of the Period	3.072	5.269	9.682	4.963
Total Net Worth	17.314	26.296	37.575	40.406
Total Liability and Net Worth	98.965	156.378	214.456	250.501

^{1/}June 30th.

<p>Table 8 Consolidated Balance Sheet of CU affiliated to the AIRAC System December 31st Thousands of US\$</p>				
	1992	1993	1994	1995 2/
Cash on Hand and in Banks	630	1.552	1.357	2.108
Liquid Investments	1.695	1.365	2.375	2.187
Other Investments	161	358	346	280
Loan Portfolio	4.607	7.332	10.141	10.801
Fixed Assets (Net)	509	736	1.007	1.147
Accounts Receivable	47	583	763	1.300
Deferred Expenses	129	74	55	86
Other Assets	95	244	377	256
Total Assets	7.873	12.246	16.421	18.165
Passbook Savings Accounts	2.222	2.898	3.820	4.122
Time Deposits	3.714	5.947	7.890	8.572
Short Term Liabilities	354	365	382	348
Long Term Liabilities	34	219	208	337
Deferred Credits	64	511	767	1.296
Other Liabilities	108	248	476	561
Total Liabilities	6.496	10.187	13.544	15.235
Member Share Investments	909	1.209	1.537	1.780
Donations	56	95	210	109
Revaluation of Assets	19	175	73	50
Retained Earnings and Reserves	149	167	316	630
Profit or Loss of the Period	244	413	741	360
Total Net Worth	1.377	2.059	2.877	2.930
Total Liabilities and Net Worth	7.873	12.246	16.421	18.165

DETAILED BUDGET

Strengthening of Rural Small and Microenterprise TC9504467 and TC9504491 Thousands of US\$							
Component I: Banking Superintendency (BS)							
	Year 1	Year 2	Year 3	TOTAL	MIF	BS	ARSLI
Office Equipment: 4 Computers, printer, fax, copying machine <u>1/</u>	30			30	30		
Specialized Technician (3)	90	90	90	270	90	180	
Per Diem for Domestic Trips	10	10	10	30	20	10	
Short Term Consultants (1)	25	25		50	50		
International Travel <u>2/</u>	15	15		30	30		
Training	10	10		20	20		
Sub-Total:	180	150	100	430	240	190	
Component II: Association of Rural Savings and Loan Institutions (ARSLI)							
	Year 1	Year 2	Year 3	TOTAL	MIF	BS	ARSLI
SUPERVISION DIVISION							
Specialized Technicians (3)	72	72	72	216	144		72
Per Diem for Domestic Travel	15	15	15	45	30		15
Communication	5	5	5	15	10		5
Interational Travel	15	15		30	30		
Short Term Consultancy (2)	20	20	20	60	60		
Training	15	15	15	45	45		
Sub-Total:	142	142	127	411	319		92
INFORMATION MANAGEMENT DIVISION							
Equipment: (16 Telecom, 25 computers, 3 servers, UPS)	200	125		325	275		50
Long Term Consultant (1)	30	30	30	90	60		30
Software Development / Short Term Consultancy (1)	30	30	20	80	80		
Instalation and Operation of the System	30	20	20	70	50		20
Sub-Total:	290	205	70	565	465		100

1/One computer will be transferred to IDECOOP by the Banking Superintendency.

2/Travel of one IDECOOP official will be financed with these resources.

Strengthening of Rural Small and Microenterprise TC9504467 and TC9504491 Thousands of US\$							
	Year 1	Year 2	Year 3	Total	MIF	BS	ARSLI
TRAINING - SME							
Long Term Consultant (1)	24	24	24	72	48		24
Per Diem Domestic Travel	10	10	10	30	20		10
Training	25	25	25	75	50		25
Communications and Printing	10	10	10	30	20		10
Sub-Total:	69	69	69	207	138		69
	Year 1	Year 2	Year 3	Total	MIF	BS	ARSLI
FINANCIAL TECHNOLOGY - SME							
Long Term Consultant (1)	30	30	30	90	60		30
Short Term Consultants (3)	30	30	30	90	90		
Communications	10	10	10	30	20		10
Printing Expenses	5	5	5	15	10		5
Sub-Total:	75	75	75	225	180		45
RISK ANALYSIS							
Long Term Consultant (1)	24	24	24	72	48		24
Short Term Consultants (5)	20	20	20	60	60		
Printing Expenses	5	5	5	15	10		5
Training	20	20	20	60	40		20
Sub-Total:	100	101	102	207	158		49
INTERMEDIATE EVALUATION:		30		30	30		
TOTAL:				2,075	1,530	190	355

PROPOSED RESOLUTION

REPUBLICA DOMINICANA. NONREIMBURSABLE TECHNICAL COOPERATION FOR A
PROGRAM OF STRENGTHENING OF SMALL BUSINESS AND MICROENTERPRISE IN RURAL AREAS

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreement or agreements as may be necessary with the Superintendencia de Bancos of the República Dominicana and with the Asociación de Instituciones Rurales de Ahorro y Crédito, and to take such additional measures as may be pertinent for the execution of Components I and II, respectively, of the technical cooperation program described in document MIF/AT- , the objective of which is the strengthening of small business and microenterprise in rural areas.

2. That the following amounts are authorized for the purposes of this resolution: (a) up to the amount of US\$255,000, or its equivalent, chargeable to the resources of the Technical Cooperation Facility of the Multilateral Investment Fund, for the execution of Component I of the technical cooperation program referred to in Clause 1 above; and (b) up to the amount of US\$1,275,000, or its equivalent, chargeable to the Small Enterprise Development Facility of the Multilateral Investment Fund, for the execution of Component II of said program.

3. That the above-mentioned sums are to be provided on a nonreimbursable basis.