Enterprise and Cooperative Development Department

Poverty-oriented
Banking

Working paper
No. 10

Expansion of rural financial services: The development of a community-based rural credit union network in the Dominican Republic (1984-1993)

Jeffrey Poyo
(Inter-American
Development Bank)

International Labour Office Geneva

POVERTY-ORIENTED BANKING

WORKING PAPER NE 10

Expansion of rural financial services: The development of a community-based rural credit union network in the Dominican Republic (1984-1993)

Jeffrey Poyo
(Inter-American Development Bank)

Enterprise and Cooperative Development Department
International Labour Office Geneva

Enterprise and Cooperative Development Department
Poverty-oriented Banking

Working papers

NE 1	1994	D. Gentil & al.	Banquiers ambulants et opération 71 au Togo et au Bénin
NE 2	1994	B. Balkenhol and E.H. Gueye	Tontines and the banking system - Is there a case for building linkages?
NE 3	1995	Douato A. Soedjede	Mécanismes de collecte de l'épargne et de financement de l'entrepreneuriat informel et formel par les banquiers ambulants au Togo
NE 4	1994	M.A. Adechoubou and S.N. Tomety	Les banquiers ambulants au Bénin
NE 5	1994	B. Hane and M.L. Gaye	Les pratiques du marché parallèle du crédit au Sénégal - Leçons pour le système bancaire
NE 6	1994	I. Ba	PME et institutions financières islamiques
NE 7	1994	B. Balkenhol and Ch. Lecointre	Pratiques bancaires dans les opérations de crédit avec les petites et moyennes entreprises en Afrique de l'Ouest
NE 8	1994	I.F. Camara	Structures mutualistes d'épargne et de crédit dans l'Union Monétaire Ouest-Africaine (UMOA)
NE 9	1995	B. Wesselink	Monitoring guidelines for semi-formal financial institutions active in small enterprise finance
NE 10	1995	J. Poyo	Expansion of rural financial services: The development of a community-based rural credit union network in the Dominican Republic (1984-1993)

Table of contents

Foreword

This working paper is a reprint of a report prepared by Jeffrey Poyo[1] in 1994 which summarizes the findings of a USAID/OSU project to strengthen credit unions in rural areas in the Dominican Republic.

The reported findings are relevant to the debate on sustainable micro-finance mechanisms, for a number of reasons:

in most rural areas, credit unions are still the only source of deposit and credit services, apart from the informal financial market; from the point of view of financial sector development with an equity objective, credit unions therefore deserve to be closely examined;

credit unions can achieve financial self-sufficiency at the primary level over a 5-7 year span, and at the second tier level also, but over a longer period of time; this confirms observations of financial membership organisations in ILO projects in West Africa (PA-SMEC), Madagascar (CECAM), Haiti (Caisses Populaires) and Central America (Bancomunales);

under certain conditions, the mere emphasis on domestic resource mobilization in credit unions will improve management control by members and thus contribute to efficiency; to achieve this objective, technical assistance and training may suffice; in fact, external credit lines may have on balance more detrimental effects;

support and donor agencies need to take a long-term look at institutional development in this field.

Poyo's paper is an interesting illustration of what can be achieved to stimulate growth and efficiency in financial self-help organizations, without resorting to subsidized credit or targeted refinancing schemes. It is for this reason that it will be made available to a larger public through a forthcoming ILO publication about financial cooperatives as conduits for external credit lines.

B. Balkenhol

I. Introduction

Between 1983 and 1992 the United States Agency for International Development (USAID) financed two projects designed to strengthen institutions that provide financial services to the rural population in the Dominican Republic.[2] One of the most innovative components of these projects was the strengthening of rural credit unions.[3] Although USAID, as well as other international donor organizations have supported the development of credit unions in the Dominican Republic over the past twenty years, ironically the supply-leading nature of this support had consistently undermined their financial viability.[4] The strategy employed under the Rural Financial Services Project has been the complete antithesis of these past efforts.

The single most important characteristic of this project has been the sole reliance upon domestic deposit mobilization as the source of funding. This strategy achieved very significant results with respect to institutional development and growth because of the emphasis on local control over funding and business development strategies. Their improved understanding and reliance upon market principles and complete integration into the domestic financial system served to promote greater operational efficiency and constrain excessive risk-taking.

The participating credit unions were provided with specialized technical assistance and training in the transfer of appropriate banking technology. Their operating policies and procedures were redesigned in order to improve the quality of their services, and with it their profitability. Re-pricing of credit services was instituted to more adequately reflect the cost of domestic savings mobilization, increased operational costs, credit risks and opportunity cost of their member's shares. A complete reform of their institutional and financial culture was effected through the technical assistance and training provided under this project.

The underlying objective guiding the strategy employed was to develop a system of self-sustaining, financially viable, integrated network of credit unions supplying the needs for financial services of the local populations in rural communities. Contrary to the general perception, these institutions are not geared primarily towards consumer finance, but service the diverse needs for loans and deposit services of all sectors of the local economy (agriculture, commercial traders, small-scale industry and services). In most of these communities credit unions are the only source of financial services for the small and micro-entrepreneurs, outside of local money lender, pawn shops and limited trade credits.

One of the most important obstacles to be overcome by these institutions in their effort to become viable financial intermediaries was the negative public image they had developed as a result of two decades of paternalistic, supply leading external credit projects. Since their inception they were promoted as conduits for a variety of subsidized credit programs which debilitated their role as financial intermediaries, undermining the confidence of the local population. Their lack of growth and profitability in the provision of financial services led them to diversify into non-financial activities in the early 1980's - with similar results. More recently, the unstable macroeconomic environment and financial crisis confronting the banking system introduced additional challenges for their institutional survival.

Motivated by the poor results of past subsidized and targeted rural credit programs, international donor and as credit institutions had withdrawn support from credit unions generally. Because of their limited market share in aggregate financial flows and isolation from the banking regulatory structure, financial reform programs implemented throughout the Region have generally ignored these intermediaries. The experience in the Dominican

Republic is important because it has demonstrated that: 1) there is a large unsatisfied demand for deposit credit services in the rural communities; 2) that CUs can mobilize these resources thus deepening local financial intermediation, and becoming viable and effective financial institutions in the process.

Their small size and institutional incentive structure inherent in their ownership structure makes CUs somewhat fragile institutions. However, the recent development of the rural credit unions in the Dominican Republic can develop into effective financial intermediaries, as long as institutional incentives as well as pricing structure are reformed and deposit mobilization is aggressively pursued as their primary source of funding.

The following Section of this paper will outline a brief history of credit union system in the Dominican Republic. The recent macroeconomic developments will be reviewed in Section III. The next will outline the general evolution of the financial markets in the Dominican Republic, and the role of these institutions in these markets will be explored in Section V. The strategy employed for institutional strengthening of rural credit unions will be presented in Section VI. In view of the importance of political economy and institutional incentives inherent in their ownership structure, these issues will be discussed in Section VII. The financial performance of the credit unions that participated in the institutional strengthening project will be reviewed in Section VIII. The second tier association created by the credit unions is described in the following Section, while the regulatory structure is analyzed in Section X. Finally, the major conclusions of this study will be drawn together in the last Section.

II. Credit union development in the Dominican Republic

The development of credit unions in Latin America was the result of three principal forces: the European immigrants that brought their ideas of mutual financial institutions from Europe; the Catholic Church; and the Alliance for Progress.[5] The immigrations of the nineteenth century towards the Southern Cone (Argentina, Brazil, Uruguay and Chile), brought the development of mutual self-help societies designed to fulfill their needs for financial services. The vast majority of these institutions were created by the urban working class to provide financing for working capital and consumption loans for the smal urban trading sector. In most cases they serviced primarily the urban population, except in Uruguay where an extensive network of rural savings and loan institutions developed in the likeness of the Raiffaisen tradition in Germany.

The second most important force in the development of the system of credit unions in Latin America was the Catholic Church. During the 1950's the Catholic Church began to actively promote the development of credit unions as a response to the void of formal financial institutions serving the needs of the middle and low income populations, and the dependence of this segment of society on informal money lenders. Without any doubt, the Church was the most important source of support for the development of credit unions in the Dominican Republic.[6] During the decades of the 1960s and 1970s, the Alliance for Progress (later the United States Agency for International Development) further supported the expansion of the credit unions throughout Latin America.

The first credit unions in the Dominican Republic were formed towards the end of the 1940s through the efforts of Canadian religious organizations. At the end of this decade a national federation of credit unions (FEDOCOOP) was established with the participation of eight credit unions. During its first few years, the Federation's objective was the expansion in the number of credit unions throughout the country, receiving financial assistance for this from the Catholic Church as well as the Dominican Republic.

The Federation was able to secure external donations to support the organization of credit unions throughout the country, and as a result the number of affiliated institutions grew rapidly during the following decade. Because of a serious rift which developed between the Catholic Church and the Government in 1959, the federation and affiliated credit unions confronted serious repression, resulting in an important decline in their services and de facto liquidation of many. After the death of the dictator Trujillo in 1963, the Federation was reorganized with the support of the Alliance for Progress, and technical assistance was provided for the writing of a Cooperative Law (Law 127), as well as the law which created the State Institute for Credit and Cooperative Development (IDECOOP). A large number of different types of cooperatives as well as second level federations were created and subsequently integrated in a national organization (National Confederation of Dominican Cooperatives - CODOCOOP).

The period between 1973 and 1981 proved to be critical in the growth of the credit union system, as the general manager of the Federation sat on the Board of Directors of the Consejo Latinoamericano de Cooperativas de Ahorro y Crédito (COLAC), based in Panama. During the decade of the 1970's, operational subsidies for the Federation supported the promotion of credit unions, throughout the countryside. Promises of access to subsidized external loans allowed the Federation to rapidly expand the number of these institutions once again. According to official FEDOCOOP documents, towards the end of this decade there were a total of 116 credit unions affiliated with approximately 37,000 members. Of these, 96 credit unions were classified as active, however, only 25 had full time managers.[7]

Rising delinquency which affected the external loan program imposed severe financial strain upon the credit union system. Though a major hurricane in 1979 affected their ability to recover some of their agricultural production loans that year, their ubiquitous loan delinquency problems suggests more deep seated problem. These externally funded subsidized credit programs suffered from two serious design flaws which in turn led to their failure. The first was that neither the Federation nor its member credit unions had received the necessary technical assistance in order to successfully service the agricultural sector of the economy.[8] More importantly however was that the institutional design of the credit union system as a whole suffered from a severe problem of moral hazard, as the second tier financial intermediary (FEDOCOOP) was owned by the credit unions themselves. It is not surprising that a "borrower-dominated" institution, such as the Federation, would quickly encounter severe loan delinquency problems.[9] Delinquency on the part of member credit unions rapidly eroded the Federation's ability to honor its obligations with COLAC.

The growth of the credit unions during the 1970's was externally induced through access to external sources of subsidized credit, however once this flow dried up, credit union members began to withdraw their investment in these institutions. By the beginning of the 1980's, the Federation was financially bankrupt as were the majority of the credit unions, and only the acquiescence on the part of COLAC has allowed this institution to continue to operate. As the 1970's came to a close the period of rapid credit union growth ended, and the credit unions entered the 1980's devoid of any institutional identity. The poor quality of its financial services no longer fulfilled the needs of its membership, and their non-financial services were generally unprofitable. At every level of the credit union system, the only clearly stated objective was to mobilize external donations and subsidized credit in order to transfer these subsidies to their membership.

III. Macroeconomic environment

The 1980's was a period of severe macroeconomic instability as well as deep structural adjustments in the productive structure of the economy of the Dominican Republic. Between 1980 and 1984 the balance of payments was under severe strain because of the decline of its terms of trade, and the external shocks to the economy (rising oil prices and interest rates). The balance of payments deficit increased from US$ 118 million in 1980 to US$ 373 million in 1983. With the declining net capital inflows, the Central Bank financed the current account deficits in an attempt to maintain an increasingly overvalued exchange rate, leading to a serious deterioration of its net foreign exchange reserves. Between 1980 and 1982 the consolidated public sector deficit averaged about 5.7 percent of GDP and, because of the lack of external resources, was increasingly being financed by the domestic banking system. A reflection of this tendency was that between 1980 and 1984 the proportion of domestic credit absorbed by the public sector rose from 25 to 36 percent. Repression of the financial markets increased dramatically during this period. Growth in real GDP declined from 6 percent in 1980 to 3 percent in 1984.

By 1983-84, the government began taking some actions to control the fiscal imbalance and the deficit declined during these years. In an attempt to reduce the losses of public utilities, the price of public services were adjusted and the increasingly over-valued exchange rate forced the Central Bank to ration access to foreign exchange, shifting "non-essential" imports to the parallel foreign exchange market. At the beginning of 1985 the government carried out the unification of the exchange rate, and severely restrained fiscal and monetary expansion. In April the Dominican Republic entered into a Stand-by agreement with the International Monetary Fund. Real GDP growth in 1984 and 1985 fell to .3 and -2.6 percent respectively. Domestic inflation during these two years increased dramatically from an average of only 7 percent per annum between 1980-83 to 27.1 and 37.6 respectively.

By 1986, the economy was showing signs of recovery, in part because the new government which came to power that year embarked on an aggressive plan of public investments. As a direct result of the massive expansion in public investment spending, real GDP expanded at a rate of 3.2 and 9.1 percent during 1986 and 1987. The economy rapidly overheated as the consolidated fiscal deficit once again grew to over 6.0 percent of GDP, financed primarily by Central Bank credit. The expansionary fiscal and monetary policies led to a rapid growth in the balance of payments deficit and domestic prices. Domestic inflation, which had been controlled once again with the introduction of a stabilization program, grew from 9.7 percent in 1986 to 44.0 and 45.4 percent in the following two years. The exchange rate which had remained stable since 1984 at about 3.1 pesos to the US dollar, rapidly devalued to 6.1 by the end of 1988.

The operating deficits of the autonomous public enterprise sector rose rapidly as inflation in its costs structure clashed with aggressive price controls imposed by government decree. The banking system was relied upon to finance these operating deficits as the Central Government continued enabated on its massive public investment drive. After almost having lost the general elections in 1990, the Government embarked once again upon an aggressive macroeconomic stabilization program.

Beginning in 1990 the government spending on infrastructure investment was cut back and in August of that year a wider set of measures were taken to reduce the public sector deficit. Large increases in the prices of petroleum products, flour, and sugar were designed to reduce the operating deficit of the decentralized public enterprises charged with marketing these basic consumer goods. Although the growth in the money supply was drastically constrained, the readjustment of prices caused the domestic inflation to peak at over 100 percent for the year. After having raised interest rates throughout the period, finally in January of 1991 all regulatory imposed ceilings were removed. In addition, the Central Bank began using open market operations in order to reduce liquidity in the financial markets. During 1990 and 1991, the economy remained in recession, as inflation and pressure on the exchange rate abated. The rise in the consumer price index has averaged approximately 5 percent a year between 1992 and 1993. After a period of exchange rate instability between 1983 and 1990, the last three years the Dominican peso has remained stable at about 12.70 to the dollar.

Over the last twelve years, the Dominican economy had been beset by very severe macroeconomic instability and a significant realignment of the economic structure away from the reliance on the export of its traditional products. As the sugar industry declined, tourism, free zones and production of fruits and vegetable for export to the US market, began to take its place. By the end of 1992 the macroeconomic environment had been stabilized. Tourism has taken over as the single most important source of foreign exchange, and the economy appears to be poised for a period of growth and stability.

IV. Financial markets

Historically, the financial markets in the Dominican Republic have been dominated by commercial banks. However, starting in the second half of the 1970s the Government promoted the creation of specialized banking institutions designed to fill the void in medium and long term finance.[10] The development of these institutions was dependent upon retailing long term, highly subsidized lines of credit from a second tier banking window in the Central Bank, as well as very generous fiscal incentives. Existing private commercial banking institutions sought these specialized bank charters in order to take advantage of the fiscal incentives and privileged access to highly subsidized external lines of credit.

Throughout the economic crisis of the 1980's described above, the banking system was operating under a severely repressive regulatory regime. The adjustment of the regulated price structure imposed by the Central Bank, lagged the general deterioration of prive and exchange rate stability and the banks were confronted by growing excess demand for loans and savings disintermediation. The severe credit rationing imposed led to the elimination of the most costly and risky borrowers from their loan portfolios. Credit rationing fell disproportionately upon smaller borrowers in the interior of the country, and many medium and small clients who had achieved access to the banks in the past were beginning to be rationed out of the system. As the demand for credit grew in response to inflationary pressures and declining real interest rates, the supply of savings in the formal banking system declined as Dominican savers began to search for higher returns in order to protect the real value of their savings. This combination led to the development of a parallel market of non-regulated finance companies.

Table 1: Macroeconomic Indicators for the Dominican Republic (1984-1993)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Real GDP (Average Annual Growth)	.3	-2.6	3.2	9.1	.5	4.1	-5.1	-.9	7.8	3.0
Consumer prices	27.1	37.6	9.7	16.0	44.4	45.4	59.5	53.9	4.6	4.7
Real wages	1.5	-2.1	7.0	-2.3	4.0	-11.0	-4.6	6.0	15.0	5.0
Exchange rate (DR:US)	1.0	3.1	2.9	3.8	6.1	6.3	8.5	12.7	12.8	12.7
Real effective exchange rate (Index 1980 = 100)	140.9	128.8	137.7	164.9	196.8	157.7	152.8	142.8	142.0	137.0
Domestic credit (% of GDP)	32.5	24.5	26.9	27.9	20.9	22.3	17.6	10.9	13.2	15.3
Public sector	16.7	11.6	12.0	9.1	5.5	6.0	4.0	0.9	0.4	-0.6
Private sector	15.8	12.9	14.9	18.7	15.4	16.3	13.6	10.0	12.8	15.9
Current account balance (millions US)	-163.4	-107.6	-183.4	-364.1	-18.9	-198.6	-8.7	-58.0	-392.7	-354.8
Trade balance	-389.0	-547.4	-629.6	-880.2	-718.3	-1039.4	-1058.3	-1070.5	-1612.0	-1585.0
Exports of goods (FOB)	868.1	738.5	722.1	711.3	889.7	924.4	734.5	658.3	566.1	530.0
Imports of goods (FOB)	1257.1	1285.9	1351.7	1591.5	1608.0	1963.8	1792.8	1728.8	2178.1	2115.0
Service balance	-39.4	83.5	160.1	185.5	345.8	456.4	679.0	626.0	787.5	830.2
Unrequited transfers	265.0	356.3	286.1	330.6	353.6	384.4	370.6	386.5	431.8	400.0
Capital account balance	230.8	-5.4	145.2	-31.6	90.1	384.7	120.7	111.7	31.4	509.8
Changes in reserves (- increase)	-97.1	-42.7	-44.1	146.8	-110.1	2.0	-7.9	-341.5	-26.2	-155.0

Informal finance has always played an important role in the provision of credit services to the low income population in the Dominican Republic. Some well-known examples are: pawn shops, SANES (rotating savings and credit associations), money lenders, input suppliers and commercial intermediaries. However, during the 1980's the relative importance of informal financial structures appears to have grown as a result of declining real incomes and financial repression and disintermediation of the regulated banking system. In the rural sector informal finance has played an even more important role because of the lack of a branch network. During the 1980's access to credit from formal financial intermediaries in the rural areas became even more difficult, as the regulatory repression led to severe credit rationing which had a disproportionate impact upon rural markets. In addition, the agricultural development bank's loanable funds were severely constrained as a result of severe loan delinquency problems and restrictions in its access to sources of external credit.[11]

The interest rate margins between deposit and loan rates widened as the banks used different schemes to circumvent the interest ceilings. Non-regulated finance companies began to appear fulfilling the needs of the medium and small borrowers that had been rationed out of the regulated banking system. Forced by the growing disintermediation and currency substitution the banks began to subvert the price controls on deposits. The most important finance groups began to open their own finance companies in order to effectively compete for deposits. A study conducted in 1985 showed that there were in excess of 600 independent non-regulated finance companies operating in the two largest cities of the Dominican Republic.[12] The transparency in the pricing structure within the domestic financial markets was lost, as effective rates diverged significantly from official rate ceilings.

The number of regulated financial institutions also grew rapidly during this period. Between 1980 and 1989, the number of commercial banks increased from 8 to 23, private development banks grew from 2 to 36, mortgage banks from 0 to 16, and savings and loan associations grew from 11 to 20. The lack of evolution of the regulatory and legal structure in response to the growing macroeconomic instability and structural changes in the Dominican economy created very severe distortions within the financial markets including incentives for participation in the banking system. This led to a serious over-investment of scarce resources in the financial system, because of the fragmented institutional structure.

With the large devaluations in the mid 1980's, which partially corrected a highly overvalued exchange rate, the tourist industry began to flourish. However, one of the major bottlenecks facing businessmen interested in participating in this new growth sector was the lack of medium or long term finance and an organized capital market. Many businessmen whose experience had been limited to the real sector of the economy requested and obtained the authorization to operate commercial banks.

Many of the new commercial banks began opening branch offices in the interior of the country, motivated by the extreme competition for deposits in the cities of Santo Domingo and Santiago. Although this appeared to be one of the important benefits of greater competition in the financial markets, these banks were funnelling the savings mobilized into tourist projects owned by the major stockholders of the banks themselves. Ignoring the conflicts of interest, if this transfer of savings from the rural economy to other sectors had resulted from an evaluation of the relative investment opportunities in each sector, then it would have clearly contributed to greater economic efficiency. However, alternative investments in the agricultural sector in the same region were rarely evaluated. For many of these new commercial banks, the incentives for the aggressive expansion of deposit mobilization in the interior of the country was driven more by the desire to fund the economic group's own projects, rather than the simple expansion of banking services.

The over-investment in the financial sector came to a crashing halt in 1988 with the failure of the first non-regulated finance companies. This failure spread quickly to others and eventually began to undermine the stability of the formal banking system. In November of 1990, the Banking Superintendency was forced to take over three of the newest private commercial banks. Because of the inability on the part of depositors to discern the risk characteristics among the private banks, and the lack of action on the part of the Central Bank, rumors and partial runs by depositors began to undermine the financial stability of some of the most respected financial institutions. This climate of instability clearly benefitted the foreign owned and public sector owned banks as the depositors perceived that these institutions had an effective guarantee by large international banking institutions and the government.

The lack of evolution of the regulatory framework, in response to the dramatic macroeconomic instability during the 1980's introduced important distortions in financial prices as well as in the incentives for participation in this market. Faced with the financial crisis which was starting to affect the viability of regulated banking institutions, beginning in 1991, the Central Bank embarked on a financial reform program in an attempt to reduce the instability in the financial markets and regain depositor confidence. The stated objectives of the financial reform was to reduce the number of financial institutions through the elimination of institutional specialization and strengthen prudential regulations and supervision by the Banking Superintendency. However, market forces once again over took policy makers as the financial crisis led to a perceptible shift in depositor's preferences towards greater security at the expense of potential returns, forcing the closure of many (regulated and non-regulated) financial intermediaries. In addition to the non-regulated finance companies that had to close their doors because of insolvency, many decided to close voluntarily as their financial viability has been undermined by the lack of confidence on the part of the depositing public, and the elimination of interest rate restrictions imposed on regulated banking institutions.[13] The financial reform program has been progressing quite slowly and with relative uncertainty.

V. Role of rural credit unions in financial markets

One of the most salient characteristics of the financial markets in the Dominican Republic during the 1970's and 1980's has been its extreme degree of institutional specialization and market fragmentation. In Santo Domingo and Santiago there exists an intense competition among a large number of financial intermediaries utilizing the most modern banking technologies available (ATM machines and home banking, for example). However, a few miles from these major cities, in secondary towns, not even the most basic banking services could be found. Traditionally, only the Agricultural Development Bank and the Reserve Bank (State owned commercial bank) have had an important presence in the smaller towns in the interior of the country.

The primary function of the financial system is the evaluation of risk, in the transformation of savings into investment. The effectiveness with which this intermediation takes place has a direct impact upon the direction and efficiency of investment and therefore upon the rate, and distribution of economic growth in the economy as a whole. The operating policies and principles of each of the institutions in the market establish the "rules of the game" under which this transformation will take place.

Private banking institutions attempt to maximize return on their capital, within the constraints imposed by banking regulations, their fiduciary responsibility towards depositors, and the level of competition in the market place. Intermediaries with other ownership structures, however, such as state owned banks as well as mutual type organizations may have very different institutional objectives.[14] Recent developments in the Dominican Republic underscore how government regulation of these markets often times unintentionally distort these "rules" not only undermining the efficiency of financial intermediation, but placing at risk the basic fiduciary responsibility of participating institutions.

The most important input in the process of financial intermediation is information. Financial transactions are relatively complex, because they trade cash today for future promises of repayment, and thus are carried out within a context of uncertainty. Formal banking institutions that are designed to operate in large urban centers, with a customer base that can offer detailed financial information, and real collateral in the form of urban real estate, are ill equipped to service smaller rural markets in which financial transactions and contracts are more personalized, and detailed information about market transactions is generally unavailable. The limited population density, and perceived inability to mobilize savings have represented important obstacles for their expansion into rural communities. As a result, there has been a large, unsatisfied demand for financial services in the rural milieu.[15]

Due to the lack of regulated banking institutions in many rural communities, informal financial credit mechanisms have developed to fill this void. The demand for credit is serviced by local money lenders, pawn shops, ROSCAs (Rotating Savings and Credit Associations), and other informal financial transactions, whereas savings flows are generally directly invested in physical assets, maintained in the form of currency hoards, or are transferred out of the local economy in the form of deposits in the formal banking system in distant towns and cities.

Informal sources of credit provide an extremely important function satisfying short-term liquidity requirements for emergency purposes, while the general lack of low cost depository service in the rural communities has led to an over-investment in physical assets, as a store of value.[16] Their privileged access to information within a limited geographic area, alows the money lender to service the low income population in an efficient manner. This information is the primary source of their competitive advantage. For example, one of the most common forms of informal finance is for input suppliers or intermediaries who purchase agricultural production, to supply credit to their clients. The information they possess about the productive capacity of their clientele, and their relationship with inter-linked transactions, gives them a clear advantage in evaluating their credit worthiness.

However, interest rates in the informal market are relatively high because of greater costs and risks associated with servicing the low income population, in addition to inefficiencies in the distribution of the costs of risk-bearing. Due to the small size of their portfolio and the use of their own capital, the entire costs of risk-bearing is concentrated in the hands of one individual - the money lender. Because of their inability to share the costs of risk-bearing over a wider pool of individuals, risk aversion leads them to charge more for the risk they assume. The same limited coverage which provides an advantage with respect to information, limits their ability to generate economies of scale, or share the costs of risk-bearing.

Furthermore, the inability to mobilize deposits does not allow for the exploitation of all potential benefits of financial intermediation in the local economy. The lack of efficient mechanisms for the transformation of savings into investment, especially severe in the rural milieu, serves to depress growth in the local economy. Under these conditions investments can only be financed with internally generated savings reinforcing the existing distribution of income, which because of historical reasons is highly concentrated. The lack of effective mechanisms for financial intermediation compound existing obstacles for productive investment that derive from the uncertainty created by the external shocks to which the agricultural sector is prone.

The lack of access to financial services on the part of the middle and low income population, especially acute in the rural communities, has created the conditions for the development of mutual based rotating savings and credit schemes (ROSCAs). In their initial stages credit unions are a type of ROSCA which, because of informational advantages and volunteer labor, are able to operate profitably with a very limited volume, penetrating thin markets which would be prohibitively expensive for any formal financial intermediary. Unlike the ROSCAs, the credit unions are legally incorporated financial institutions regulated by a specific law. This institutional structure facilitates their growth beyond the informal club stage and develop into full service financial intermediaries.

VI. Institutional strengthening of rural credit unions

A. Background

In response to a request from the government of the Dominican Republic for a re-capitalization of the Agricultural Development Bank, in the early 1980's USAID contracted the services of Ohio State University to study the problems of agricultural credit. In direct response to the recommendations of this study, a very innovative technical assistance project was designed, which objective was to reform government policies that negatively impacted upon these markets as well as to strengthen those financial intermediaries operating in the rural milieu. The institutional strengthening component was targeted to the Agricultural Development Bank as well as the network of rural credit unions.

The strategy used to support the rural economy over the past twenty years had been based on the provision of highly subsidized and targeted external credit through various institutional channels. These policies were predicated on the assumption that domestic savings could not be generated as a result of extreme poverty in the rural economy, and that low productivity in this sector required subsidized rates of interest on loans. The detrimental effect of twenty years of these policies on the financial viability of the intermediaries throughout the Region has been well documented in the specialized literature.

Between 1983 and 1986, USAID funded a project entitled the "Rural Savings Mobilization Project", whose major objective was to transform twenty years of accepted policy in the area of rural financial markets on the part of major government officials, academics, banking officials, through research on these topics as well as the implementation of pilot efforts in rural savings mobilization. The implementing institution chosen was the Central Bank, as one of the objectives of this project was to influence policy makers at the highest levels with respect to the need for reform of the regulatory framework which guided the development of the financial markets.

Through this project, for the first time, the Agricultural Development Bank (ADB) was able to diversify its funding sources by offering domestic deposit services to the general public. By the end of the project in 1987, the ADB had mobilized over US$ 4.2 million dollars in savings, from over 100,000 depositors. Also, four rural credit unions were selected to receive intensive technical assistance and training in the transfer of basic banking technology in order to revitalize their financial services. The three that remained in the program by the end of this project had tripled the volume of savings mobilized in 4 years to US$ 1.4 million.

In fact, despite initial skepticism on the part of most observers, the project was highly successful, leading to a one year extension, and the eventual design of a follow-on project. The demand for savings services by the general public proved to be much stronger than had been anticipated, and had an enormous impact on the financial administration practices and risk management on the part of the participating financial intermediaries. The success of this initial effort led to the design of "The Rural Financial Services Project", implemented between 1988 and 1992. The major objective of this project was to expand the transfer of financial technology which had been tested with the original four credit unions. In addition, support was provided to the Agricultural Development Bank in order to strengthen its pilot savings mobilization efforts, as well as to the Central Bank for financial market policy discussions and reform.

USAID had budgeted US$ 1.7 million to contract external technical assistance to carry out this new project. In addition, local currency in the amount of US$ 1.0 was allocated to cover the local expenses for a total of US$ 2.7 million. Over the 4.5 years of implementation, total expenditures amounted to US$ 1.7.[17] It is estimated that under US$ 1.0 million was spent on technical assistance for the credit unions, while the balance was spent on the ADB and other project expenses not related to credit union development. The US$ 1.0 million spent on the credit unions allowed for the revitalization of 12 additional institutions, expansion of services to an additional 17,000 credit union members, the mobilization of domestic savings in the amount of over US$ 5.0 million (for a total of US$ 10.0 million by the end of 1993), and the training of dozens of credit union members, directors and employees. Given the complete stagnation and lack of financial viability of these intermediaries when it began, the results obtained are directly attributable to the project. Although the assistance to the ADB was less intense, by the end of 1992 this institution's savings deposits had grown to almost US$ 28 million, serving over 150,000 depositors.

B. Market-based development

Although the credit union system in the Dominican Republic is one of the oldest in Latin America, its development had been severely undermined by the highly paternalistic philosophy promoted by the Catholic Church, and reinforced through the infusion of externally subsidized credit from international donor and credit organizations. The philosophical foundation of the USAID projects was the antithesis of the typical assistance programs they had received in the past. Under this project the credit unions were neither provided with a direct financial subsidy to cover operational expenses, nor with external credit - subsidized or otherwise.[18] The participating institutions received free technical assistance in financial intermediation technology and training, but were expected to fund their financial services entirely from domestic mobilization, in direct competition with other financial intermediaries.

The technical assistance and training programs concentrated upon transmitting an understanding of the operation and logic of the domestic financial markets, and the application of these principles in the administration of their institutions. These organizations had operated since their inception under a highly paternalistic philosophical construct in which their main objective was to mobilize external grants and subsidized loans for distribution to their membership. The notion that these institutions should compete for deposits with formal financial intermediaries as the primary source of their funding, paying risk-adjusted market rates of interest, was considered by many to be in conflict with their traditional operating philosophy. The primary objective of this project was to transform the entire financial and institutional culture of these intermediaries.

The major challenge facing this project was to convince policy makers of these mutuals that the welfare of their membership could best be served by improving and deepening financial services, and that this could only be achieved through the strict application of market-based operating principles. The success of the pilot project with three credit unions between 1983 and 1987 served to reinforce the message that the development of their credit unions could be based primarily upon domestic deposit mobilization, and that in the long run this strategy would provide for greater institutional stability.

C. Technical assistance and training

The major input provided by this project was specialized technical assistance and training in management of financial intermediaries. By the end of the 1970's through the first half of the 1980's, virtually all open membership, community-based credit unions in the Dominican Republic had entered into a period of stagnation and institutional decline, as external sources of credit dried up. As the quality of financial services offered suffered, membership in these organizations shrank, and loan delinquency rose dramatically. The majority of the credit unions selected for participation, did not have full-time employees, organized accounting systems, and generally managed only limited cash transactions out of their offices.

Most of the credit unions had received some external loans from the National Federation throughout the 1970's, but their inability to repay their debts caused severe financial distress on the entire system. Because of their internal incentive structure, most members had joined attracted by promotions of highly subsidized external credit, and withdrew their support when external funding dried up. Although the institutions selected to participate in this project had been established during the 1960's and 1970's, most were completely inactive and provided no financial services of any significance.[19]

Under this project, credit unions entered into a contract with the Central Bank (implementing agency for the project) to receive technical assistance and training. The credit unions began with 3 or 4 full-time employees: manager, cashier, accountant and credit officer, who were in turn trained by the project technicians. In addition to the technical assistance provided on the job, members of the board of directors and all employees of these credit unions participated in an ambitious training program which consisted of short courses in financial administration, credit analysis, loan portfolio administration, cashier training, marketing and entrepreneurship. Short seminars covering topics of macroeconomic instability and its impact on financial administration of their credit unions, as well as price setting were also provided.

A disproportionate amount of time and effort of the technical assistance team was dedicated to analyzing and explaining the logic and importance of establishing appropriate pricing policies. Though intuitively obvious, it is important to recognize that more than twenty years of accumulated institutional experience correlated the welfare of their membership exclusively with subsidized rates of interest on loans. The exultation of volunteerism, limited return on their membership's capital and the vilification of the local money lenders conditioned their raison-d'être articulated in the cooperative philosophy promoted by their leadership. Although the project stressed the primary objective found in the traditional cooperative philosophy of service to their membership, it proposed to achieve this with the complete reversal of the majority of the principles promoted in the philosophy outlined above. The notion that credit unions would charge interest on their loans which were above regulated commercial banking institutions was considered heresy by the vast majority of the leaders. However, despite dire predictions of membership revolt, the participating credit unions experienced rapid membership growth as the population was attracted not by subsidized interest rates but by the efficiency of the financial services provided.

D. Deposit mobilization

The credit unions had traditionally funded their loan portfolios with share accounts and external loans. According to the law which regulates credit unions[20], member shares represent risk capital, although a ceiling of 5 per cent per annum is imposed on dividends. Their inability to competitively price this instrument, and their relative illiquid nature, transformed them into compensating deposits for loans. Those credit unions with access to external credit were able to attract a rapid growth in their membership and share balances. Before the implementation of the Rural Savings Mobilization project in 1983, a few credit unions had timidly experimented with deposit mobilization, but none had offered these services at competitive rates.

The Cooperative Law, which regulates the establishment and operation of financial service cooperatives, indicates that the objectives of the credit unions are to promote savings and credit services to the low income population. However, in practice the potential demand for deposit services by these households has generally been underestimated and consequently minimized. The design of the subsidized credit programs in the 60's and 70's never considered any role for the mobilization of domestic savings. More recently, the fashionable microenterprise programs of the 1980's and 1990's have at times included components of forced savings, though few programs can be considered to be seriously contributing to the mobilization of domestic savings.

Deposit services are viewed as a type of "merit good", which must be encouraged despite resistance on the part of the public. The notion that the low-income population must be "educated" to increase their demand for these services is quite common. Alternatively, credit services are regarded as a basic necessity of life, akin to health services or housing. This dichotomy is due in part to the generalized belief that low-income households could not utilize deposit services if offered, because they do not have any excess of income above immediate consumption. The importance of access to efficient (low transactions costs), secure and remunerative savings services for the low income and especially the rural population have generally been minimized. The access to deposit services is not only an efficient way of diversifying their risks, but can be an efficient instrument for liquidity management generally unavailable in the rural setting.

One of the central ideas permeating the technical assistance provided under this project was to erase the notion that saving was a type of "merit good" and focus attention upon its essential characteristics as a "service". The institutional growth and ultimate financial viability was directly correlated with their success in domestic savings mobilization. Although success with deposit mobilization was not a sufficient condition for institutional viability, it was undoubtedly a necessary one. Credit union directors and employees had to fully understand the need for deposit services among the different segments of the local population and design appropriate instruments to fulfill these needs in order to attract new members and financial resources. A large amount of time was dedicated to analyzing the various features of savings services which made them either attractive or not. However, competing with banking institutions that had greater experience, resources (human and financial) with which to promote their services, and solid institutional images seemed to be unsurmountable odds.

One of the most important elements of the focus upon domestic deposit mobilization was the attraction of new members whose main interest in the institution were deposit services.[21] In any financial institution whose funding depends primarily upon deposit from the public, net savers are anywhere from three to five times more numerous than the number of net borrowers.[22] However, credit unions in the Dominican Republic had never offered passbook savings accounts or time deposits, and furthermore the pricing and redemption policies on their sahre accounts made it relatively unattractive as a deposit instrument. As a result, the only reason to join one of these financial intermediaries was the expectation of obtaining a subsidized loan which may have been confused with a donation (considering the source of funds). It was expected that the introduction of net-savers into the institution would provide greater stability in their funding base, in addition to improving risk administration.

Great attention was paid to liquidity management during the training because of its importance in ensuring financial solvency. In the past the credit unions were constantly facing liquidity problems because of inadequate policies and procedures in this regard. Although the credit unions were not subject to any official reserve requirements, those participating in this project maintained at all times a self-imposed reserve requirement of 20 per cent of all deposits and share balances. These reserves were maintained in the formal banking system and in cash at the credit unions. Although this level may have appeared high, the macroeconomic instability, banking crisis and the lack of a lender of last resort made conservative cash management a necessity. In some instances during project implementation, these cash reserves proved to be invaluable. Table 2 presents the aggregate savings mobilized by the credit unions that participated in the Rural Financial Services Project. Between the end of 1984 and 1993, the resources mobilized through the use of different financial instruments grew from US$ 573,000 to US$ 10.0 million which represents a multiple of 17 times over a nine year period.

E. Credit services

The credit policies developed within the credit union system throughout Latin America were designed to be simple in their application and based upon solidarity guarantees. Credit union members were permitted to borrow up to a multiple of their share balances, collateralized by pledging other member's shares. As the loan was repaid, their shares became available to serve as collateral for another member's loan. Collateralization with real assets was not emphasized because the entire balance of the loan was guaranteed by the borrower's and other member's shares. Credit screening did not take place at the time of the loan application, but upon acceptance for membership. The evaluation was informal and depended exclusively upon personal knowledge of the potential members by the Board of Directors. The credit union operated as a rotating mutual guarantee scheme in which credit risks were controlled through the evaluation of the application for membership, and collateralized of each other's shares.[23]

Table 2: Dominican Republic: Rural Credit Unions
Deposit mobilization December 31 (000)

		Total savings mobilization	
Year	Number of CUs	Dominican Pesos (DR$)	US$
1984	3	1,766	573
1985	3	2,829	953
1986	3	3,967	1,292
1987	3	6,895	1,413
1988	3	11,728	1,828
1989	3	16,872	2,036
1990	8	28,900	2,140
1991	12	47,800	3,760
1992	15	85,800	6,800
1993	15	128,383	10,030

In order for this rotating credit scheme to work, incentives for participation in the credit union need to be balanced so that some members would be willing to remain net-savers, while pledging their shares for others to borrow. However, the correlation of the credit union's raison-d'être with subsidized interest on loans within the credit union philosophy[24] and its reinforcement with the flow of subsidized external credit, severely distorted the incentives for member participation. As interest rates were not used as an active policy variable in the administration of these institutions, rising domestic inflation throughout the region caused real rates to turn highly negative. Increasingly, the only incentive to join a credit union was the expectation of obtaining a highly subsidized loan. As these institutions became "borrower-dominated", severe moral hazard problems in the management of risk undermined the financial sustainability.

As the cost of remaining a net-saver rose, the excess demand for credit forced the credit union to impose strict rationing. Although a rise in the nominal interest rate was unacceptable, restrictions impose on the loan/share ratio effectively increasing the price of credit. In some cases, the rationing was so severe that the credit union would only lend up to the balance in the members' share account. Other rationing variables used for example were: number of years as a member of the organization, or some definition of need. Under this set of institutional incentives, the only way the credit union could attend to the demand for credit was through some external source of credit. As external sources of finance began to dry up towards the end of the 1970's, the incentives for membership participation in the credit unions vanished and these institutions simply stagnated. The overwhelming majority of the credit unions in the Rural Financial Services Project had reached this point in their credit rationing process at the time they were incorporated into the project.

The project proposed to release the severe credit rationing by once again attracting net-savers through competitively priced deposit services. Not only would the credit unions have to provide attractive deposit services (prices and transactions costs), but more importantly, they had to regain the public's confidence in the credit union as a secure place to deposit their savings and obtain a loan. Loans would need to be priced in accordance with the market interest rates paid for domestic savings, operational costs and risks inherent in their loan services, rather than administrative fiat as had been the case since the mid 1940's.

Credit evaluation was separated from membership decisions, since it was expected that not all members would qualify to borrow from the institution, or would be attracted primarily by credit services. The availability of deposit services with low transactions costs, that paid a risk-adjusted market rate of interest, indeed proved to be a powerful incentive for membership in these institutions. Borrowing members were required to maintain a compensating deposit (generally in shares) in an amount equal to 10 per cent of the loan value, however the loan amount approved depended on their ability to pay.[25] As the majority of their members were self-employed (small or microentrepreneurs), credit union employees were trained to evaluate repayment capacity based upon the household economy as a whole - business and family related income and expenditure cash flows.

Credit services provided by these institutions improved markedly as a result of the implementation of this project. Term structures ranged from 3 to 24 months and all sectors of the economy were serviced. Although sectoral demand for credit at each institution differed depending upon the productive structure of the local economy, on average about 25 per cent of their annual loan disbursements were channelled into agricultural production and cattle ranching. An additional 45 per cent was channelled towards the small trading/commercial sector. The remaining 30 per cent went for personal type consumption loans (education, weddings, housing improvements, debt consolidation, etc.). In most cases, more than 50 per cent of their portfolios are dedicated to servicing the small and microenterprise sectors in the local economy.

Credit analysis within these organizations has improved significantly as a result of the technical assistance program. Towards the end of 1993, seven of the credit unions maintained loan delinquency ratios below 10 per cent; six had ratios between 10-17 per cent, while two had ratios between 20-25 per cent.[26] These ratios are not a very good indication of the portfolio at risk, however because they do not take into consideration the balance not yet due of those loans with delinquent payments, the age of the delinquent payments, collateral available, etc. These delinquency ratios represent inefficiencies in the loan administration systems which need to be further strengthened. However, in a detailed study conducted over a four year period of the loan delinquency problems encountered in one of the largest credit unions, it was determined that despite recurrent delinquency ratios of between 10-15 per cent, loan losses as a proportion of annual disbursements averaged between 2.5-3.0 per cent.[27] Although the experience with respect to loan delinquency and losses has improved dramatically, information systems and credit administration need to be improved in order to help reduce the potential loan losses, as well as inefficiencies which derive from late repayments on the part of their borrowers. Credit administration needs to be improved in order to sustain and further improve their institutional credibility with the public at large, as well as with the regulatory authorities.

Credit unions have been servicing the small and microenterprise sector since their inception. However, as described in the sections above, inappropriate pricing policies, adverse institutional incentives and their paternalistic philosophy contributed to seriously undermine the quality of their services, as well as their financial viability. Their poor performance led to the withdrawal of support by the international donor and lending institutions. The void which was created by the institutional stagnation of the credit union system throughout much of the region was filled by the microenterprise credit programs initiated in the mid-1980's and channelled through non-governmental organizations (NGOs). Because they were not mutual based organizations, the board of directors and managers were entirely independent of the client group they were servicing. This allowed for complete independence in the design and application of credit and pricing policies. However, their financial dependence on external donor and lending organizations has made self-sufficiency difficult to obtain. The experience with microenterprise credit programs has underlined the importance of intensive individual loan administration and appropriate personnel incentives. The credit unions have begun to apply some of these incentives in their loan administration policies.

F. Pricing strategies

One of the major achievements of the technical assistance provided was to radically reform the thinking about the role of interest rates in the financial markets and the importance an appropriate policy plays in the mobilization of domestic savings, and therefore on the financial viability of these organizations. The subject of interest rates in the Dominican Republic has always been a highly charged political and moral issue. Because of the overwhelming influence of the Catholic Church in the development of the credit unions in the Dominican Republic, the entire raison-d'être of these organizations was the destruction of the "evil" money lenders. Despite the fact that the credit unions had separated from the Church in the 1960's, most of the principal leaders of these organizations had these philosophical beliefs deeply ingrained.

As a result, until the advent of the Rural Savings Mobilization Project in 1983, pricing of credit union services at market levels was not only not considered a policy option, but its suggestion bordered on heresy. Initially, the credit unions were very skeptical once they learned about this project and many refused to participate in the initial pilot efforts primarily because of their resistance to a reform of their interest rate policies and their skepticism regarding their ability to mobilize savings deposits from their membership. As a result of the fact that these institutions had never used interest rates as a policy variable, the changes required were quite dramatic.

Throughout the period of project implementation, the unstable macroeconomic environment, together with the financial crisis, resulted in highly variable market interest rates. Growing inflationary expectations between 1983 and 1990 caused domestic interest rates to quadruple in nominal terms, with a short respite in 1985-86 during the short lived stabilization program. The successful stabilization program which began in the second half of 1990 began to have a positive impact on market interest rates towards the second half of 1991 as liquidity in the banking system rose and market interest rates were halved. Continued price stability during 1992 and 1993 has led to further declines in the interest rate structure. Throughout this period, the credit unions had to maintain a very dynamic interest rate policy in order to remain competitive with the rest of the intermediaries in the financial system.

The major goal of most financial intermediaries during this highly unstable period was simple survival as the volatile interest rate structures played havoc with their financial margins. In a conscious effort to limit their exposure, the credit unions maintained strict control over the gap in their term structures limiting their loan portfolio to short-term lending. The project played a critical role in helping the credit unions maintain an appropriate pricing strategy given the very volatile financial markets. For the first time in their history, the credit unions in the Dominican Republic were learning to actively manage their organizations based on market principles rather than passively waiting for external donations, and this learning process was taking place under the most difficult macroeconomic environment.

The pricing experience among the credit unions in the program was quite diverse, owing primarily to the degree of competition they faced from other financial intermediaries. In some cases, where they were essentially monopoly providers of financial services, price elasticities were relatively low and as a result they were unconstrained in establishing their pricing policies. However, in the case of larger credit unions that confronted competition primarily from the commercial banking institutions, they followed the pricing strategy of these formal financial intermediaries.

In general, deposit rates were set somewhat above those offered in the regulated banking institution in an attempt to compensate for the greater perceived risk on the part of depositors. Loan rates were also set above those charged by the commercial banks except in those cases in which competition on the part of other financial institutions threatened to attract their largest clients. Although credit union membership was derived primarily from low income segments of the population, the success in deposit mobilization was in part the result of attracting a segment of the local small businessmen whose access to the banking system had been restricted during the 1980's. These individuals that had access to the banks during the 1970's were attracted to the credit unions because of the possibility of obtaining competitively priced deposit and credit services but also because of their ability to participate in the decision making in these institutions. This group of entrepreneurs were those targeted by the commercial banking institutions as liquidity in the banks began to increase dramatically during the latter half of 1991 and beginning of 1992. In order to retain this segment of their membership, the credit unions were forced to meet the commercial banking systems lower interest rates for credit services.

VII. Political economy and ownership structure

A. Membership composition

The first credit unions formed in the rural communities in the Dominican Republic were promoted by the Catholic Church and initially organized around their parishioners. Their raison-d'être was to "liberate" their members from local money lender and small commercial traders, who represented their only source of credit services.[28] As a result, the philosophical foundations of the credit unions were permeated with moral judgements and vocal hostility towards this segment of the local entrepreneurial class. School teachers and other government employees formed the bulk of credit union membership in their initial stages. Until the advent of external agricultural credit programs in the 1970's, participation on the part of small farmers was limited because of important social barriers, restrictive financial policies, and the lack of any significant outreach to this segment of the local population.

The domination of these institutions by salaried government employees turned out to be an important obstacle in their subsequent development, because both the entrepreneurial talents and financial resources of the most important segment of the local business class were excluded. The domination on the part of public sector employees also led to the over emphasis on the philosophical concepts, as opposed to the more practical business concepts and practices of financial intermediation. Those rural credit unions that had more fully integrated the local entrepreneurial class into their membership, were generally most successful in avoiding complete financial stagnation during the 1980's.

B. External credit vs. internal savings

In their initial stages, the credit unions functioned as informal savings and credit clubs in which regular weekly meetings were held in order to collect share deposits and provide loans. During this stage in their development, they served as a form of mutual insurance scheme which served as an important source of liquidity in case of a personal emergency, a service which represented a very limited alternative to local money lenders.[29] Their small size, voluntary administration, personalized contracts and social pressures, insured that these limited financial services were relatively efficient. As their legal and organizational framework developed, including standardized by-laws and internal operating policies and procedures, their operations became more formalized. This opened the possibilities for institutional growing beyond the club stage into formal financial intermediaries. However, along with the benefits of legal formalization and growth, greater agency problems developed with the separation of ownership and control.

The national federation began as a training center for the promotion of credit unions, however during the 1970's their role was to change drastically as access to subsidized external credit from the Confederation of Latin American Credit Unions (COLAC) became available. The potential of developing into a second tier financial intermediary for the credit union system opened the possibilities to become financially self-sustaining,[30] and as a result intermediation services began to dominate all others.

However, the provision of subsidized external credit through the Federation severely distorted the incentives for credit union participation. Positions on the Board of Directors of the Federation became very attractive as control over external credit flows provided significant political influence among the credit union system. The transformation of the Federation into a credit granting institution tended to undermine its democratic nature, as its income stream became independent of the institutions it was supposed to represent. The Federation became a highly borrower-dominated institution and the result was serious problems of moral hazard in the administration of credit risk.

In the short run, the subsidized external credit served as a catalyst in the growth of the credit union system, while at the same time undermining its long term financial viability, because of its substitution effect with respect to domestic savings mobilization. The original concept of the credit union as a mutual organization, in which members pooled their savings in order to provide credit services, was turned on its head as the system was used primarily as a lona disbursement window for international lending and donor organizations. membership participation in the credit unions was distorted as the only reason for joining a credit union was to gain access to subsidized credit. As mutually based institutions these organizations became dominated by their borrowers, leading to serious problems of excessive risk-taking, creating serious loan recovery problems.

In their initial stages, the credit unions operate as savings and credit clubs and therefore enjoy the same comparative advantages of the informal money lender. However, with growth in membership, the depth of their information about each member and the informal constraints or social pressures are reduced, undermining this comparative advantage. Growth generates the necessary economies of scale allowing them to upgrade their administrative structure and financial technology. However, at the same time it undermines their inherent comparative advantage with respect to information. As these organizations grow beyond the club stage, the natural loss of information and break down of informal mechanisms for the enforcement of contracts must be compensated with improved risk screening and analysis as well as greater reliance upon appropriate formal contracts enforceable in the legal system. The external credit programs in the 1970's channelled through the Federation failed in part because they promoted rapid growth without the required technological change.

The overall impact of these externally targeted credit programs had disastrous results in practically all credit unions throughout Latin America, and the Dominican Republic was no exception. The chain reaction caused by their inability to repay their loans to the Federation and the Federation to COLAC, led to the long period of financial and economic stagnation and decline of the credit union system. The catalyst for growth had been the flows of externally subsidized credit, and the raison-d'être of the national federations and international confederations had been to distribute these funds. Without access to subsidized credit, the entire structure lost its identity. The process of financial decline of these financial structures was greatly accelerated as a result of additional decapitalization caused by the growing macroeconomic instability during the 1980's.

C. Mutual ownership structure and agency problems

Goods and services can be provided through many different organizational forms of ownership: sole proprietor, partnerships, mutuals, or corporate structure. Without the support of public sector subsidies:

> "...the organizational structure that survives in any particular activity is the one that delivers the product demanded by customers at the lowest price while covering costs."[31]

The separation of ownership from control as the organizational form is transformed from sole proprietorship to a mutual or corporate type structure, however introduces potentially serious agency problems, and the survival of different organizations structures depends on the control of these agency costs. According to Fama and Jensen:

> "Agency problems arise because contracts are not costlessly written and enforced. Agency costs include the costs of structuring, monitoring and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits."[32]

In a developed market economy, competition in the capital markets and in the market for managers limits the opportunistic behavior on the part of management, limiting the agency problems in the case of the corporate structure. However, because mutuals are not managed by their owners and professional managers are not constrained by a "competitive market for residual claims (stock market) ... Therefore, economic outcomes should involve relatively extensive shirking and opportunistic behavior by management."[33] Despite this apparent competitive disadvantage, in the financial services industry particularly, the mutual form of organization co-exists with the open corporate structure without any observable tendency for one of these to dominate.

In a financial mutual, the owners of the organization are at the same time the clients and they can withdraw their investment in the firm upon demand. The ability to withdraw their investments upon demand represents an effective control mechanism which constrains the resources under management's control representing a low cost form of "partial takeover or liquidation" of the organization (Fama and Jensen, 1983). However, this control mechanism is only effective in the case of an organization whose investments can be liquidated at a low cost, and are not firm specific as in the case of the assets of financial service organizations.

Although the membership of a financial mutual depend upon a board of directors for administrative oversight, their role is less important than in the case of an open corporation because of the very effective diffuse control mechanism inherent in the ability to withdraw their investment upon demand. According to Fama and Jensen:

> "The role of the board, especially in the less complex mutuals, is largely limited to monitoring agency problems against which redemption of residual claims offers little protection, for example fraud or outright theft of assets by internal agents."[34]

The experience of the credit union system in the Dominican Republic as well as in other countries throughout the region lends empirical support to this observation. As discussed above, the original philosophical basis inherent in the institutional design, as well as the financial incentives which reinforced the distorted incentive for membership participation, introduced very serious moral hazard problems which ultimately led to serious delinquency problems. The almost complete stagnation of these firms towards the end of the 1970's was the result of delinquency ratios approaching 100 per cent which illustrated the diffuse control mechanism referred by Fama and Jensen.

The credit policy of the traditional credit unions promoted throughout the 60's and 70's offered an almost automatic access (once accepted as a member) to a loan up to 3 times the balance in their share account. The only incentive for depositing shares into the credit union was in fact to leverage their deposits with external resources. The share accounts were to serve as a compensating deposit for the loan and were nominally not withdrawable upon demand. As the moral hazard problems which created the initial loan delinquency in the loan portfolios began to erode the member's expectations with respect to their ability to leverage their share deposits in the credit union, they began to "liquidate" their investments through additional loan delinquency.

The by-laws of the credit unions purposely imposed significant transactions costs on the withdrawal of shares, in an effort to afford greater stability to this source of funding. However, a low-cost alternative available to the membership was to request a loan against their share deposits and simply not repay. In fact the astronomical delinquency rates observed in most credit unions towards the end of the 1970's and early 1980's were not an indication of inappropriate credit policies or excessively risky clientele, but the result of the effective liquidation of the these organizations on the part of their owners. An analysis of their delinquent portfolio, carried out during the diagnostic phase of the project, found that the vast majority of the "delinquent" loans had off-setting share balances. The diffuse control mechanism described by Fama and Jensen was in fact practiced in these mutual organizations in the late 1970's.

D. Reform of contractual relations

The basic role of the credit union administration is to manage the financial contracts on both sides of their balance sheets. In this sense, the firm can be viewed simply as a nexus of contracts, in which the directors establish individual policies and conditions, and the employees are charged with their execution on a day-to-day basis. In addition to those, which define the basis of their financial transactions, implicit and explicit contracts define the role of directors and employees. The reform of contractual conditions governing their financial transactions, discussed above, was at the core of the technical assistance provided through this project. In addition, however, important reforms were also introduced into the agency relationships with the credit union board of directors and employees.

In the initial stages of development of the credit unions, the Board of Directors play a central role in the day-to-day administration of the firm. The volunteer nature of their administration is the primary reason these intermediaries can operate in very thin markets, which could not sustain the operations of formal banking institutions. Despite their limited technical expertise, the Board's access to preferential information about their membership, and informal nature of their contracts (personalized) serve to limit their risk exposure. Their small size, however, makes them more vulnerable to stochastic disturbances which affect the local economy in which they operate. Growth in the number of members, increasingly sophistication of financial contracts, and direct competition by regulated banking institutions, increasingly undermines any initial advantage thus requiring substantial investments in professional management and automated information systems in order to remain viable.

As the process of professionalization of credit union management proceeds, the Board of Directors must increasingly restrict their role to the design of policies and operating procedures. This redefinition of the Board's role within the credit union is a difficult transition, especially in a cultural environment in which the centralization of decision-making and micro-management is the norm rather than the exception. This transition was supported with workshops and seminars conducted by the Project for credit union directors.

The introduction of result-based financial compensation of credit union employees represented a revolutionary concept among institutions that had been managed for years by voluntary directors. The project confronted serious resistance on the part of the Board of Directors of almost all participating credit unions to the introduction of performance-based compensation, ostensibly because of the "non-profit" nature of these organizations and a tradition of "volunteerism". In addition, payment of salaries that were competitive with other financial intermediaries meant that in most cases credit union employees would earn more than the directors, many of whom were employed in the public sector (i.e. teachers in public schools). The dichotomy between institutional incentives and those required in contractual relationship with their employees in order to assure a highly motivated and efficient workforce plague all types of non-profit institutions throughout the world. By the end of project implementation, many credit unions had introduced the payment of bonuses based on the profitability of their operations. However, much more remains to be accomplished in this area as financial performance can be significantly improved through the greater use of these types of performance-based contracts.

VIII. Financial performance

During the implementation of the Rural Financial Services Project 1988-92, a total of 15 credit unions signed technical assistance contracts with the Central Bank and received the technical assistance and training package from the project. Nine institutions entered the program during 1990, three of which had participated in the earlier "Rural Savings Mobilization Project" (San José, Santa Lucía and Vallejuelo). Six more were incorporated during 1991. Three of the institutions were created with assistance from the project while the other twelve had been established in the 1960's and 70's. With only one exception (San José), virtually all had ceased to provide financial services, their efforts were almost completely directed towards the search for external donations to fund non-financial services and investments. Their membership had effectively withdrawn by becoming delinquent on their "automatic" loans. Only San José had a performing loan portfolio which allowed it to maintain full-time employees. In effect, all except San José began their financial operations in 1990 through the assistance of the project.

Since most of these institutions did not have any earning assets to begin with, it took them between 18 and 24 months to reach their break even points. The project did not provide any credit resources for on-lending to their membership, and as a result their development depended upon their success with deposit mobilization. However, most were saddled with a negative public image because of the poor quality of the services they had provided in the past. Of the six institutions that were integrated in 1991, three were established with the direct assistance from the project (Neyba, Maimón and El Progreso). In general, these new institutions were able to grow at a much more rapid pace because they did not have to contend with a negative public image.

The tables in the Annex present monthly financial ratios, as well as the monthly averages for the entire year. The ten institutions included are the first to have entered into the program (prior to 1992). Four of those not included began their operations in 1992, and therefore insufficient time has elapsed to alow any meaningful evaluation of their operations. The final institution not included has participated from the beginning, but has been unable to develop its financial services on a self-sustaining basis and has had to diversify into non-financial services in order to remain in operation. In large measure their difficulties are related to the extremely low income level of the town in which it operates.

These statistics present a very clear picture of the extremely fragile situation from which they began, as well as the dramatic reversal experienced as a result of the assistance provided by the project. The project did not provide budgetary support or donations to these organizations, and their start-up costs were financed with their member's share contributions. The most important obstacles confronting these intermediaries in their financial recovery has been the unstable macroeconomic environment, crisis affecting the financial system, the lack of a clear institutional identity as a financial intermediary and their poor image inherited from the past.

However, as the statistics demonstrate, these institutions have been very successful in their progress towards becoming self-sustaining and effective financial intermediaries. By the end of 1993, virtually all were well on their way to becoming profitable financial intermediaries. Although their absolute levels of profitability were still low, their progress over the last two to three years has been noteworthy. As the economy has continued to stabilize throughout 1993 and 1994, their growth rates and profitability have improved in tandem.

Their progress has been due to a large extent to a significantly improved pricing strategy of their financial services. They were able to increase their financial margins throughout the period thus improving their profitability. The smaller credit unions in the more remote areas of the country are able to maintain a relatively large margin, while the margin is much smaller for those that operate in the larger towns in which significant competition exists from commercial banking institutions.

Liquidity ratios have remained high, with its consequent impact on profitability as a result of deliberate policies promoted by the project. Since these institutions did not have access to any lender of last resort, the repercussion of becoming illiquid would have been catastrophic. A minimum voluntary reserve equal to 20 per cent of their deposits and shares was instituted. The recent creation of a central liquidity facility in the second tier association will help to reduce this financial burden as they will have access to an important source of liquidity in case of need. These institutions have been very careful to maintain a relatively large proportion of their assets in income generating investments (loan portfolio and financial investments), as is further confirmed by their limited investment in fixed assets.

Although significant improvements can be observed in the levels of institutional capital, it is evident that they continue to be inadequate. It is important to note that, unlike commercial banking institutions, their member's risk capital is not included in the measure of institutional capital. The only source of capital accumulation are retained earnings or donations, and since most have only recently reached their break-even point, it is not surprising that their capital ratios would be insufficient. No project resources have been used to capitalize these institutions through donations and, as a result, their ability to reach acceptable capital ratios will take some time. However, despite their low capitalization, virtually all institutions are profitable and have demonstrated surprising progress over the last three years. When the net worth is taken into consideration (institutional capital plus member's shares), their financial outlook improves dramatically.

The financial health of these credit unions has improved significantly as a result of the implementation of the Rural Financial Services Project. The prudent financial management practices first introduced to the credit unions through this project continue to be pursued through the technical assistance of the Credit Union Association which has taken its place after the conclusion of the project. If these practices are maintained, it is to be expected that their financial situation will continue to become stronger over the years. These institutions participated in the project in an extremely adverse environment, and with the implementation of very conservative financial management practices were not able to successfully navigate through the financial crisis which led to the demise of much larger and sophisticated banking institutions, but were able to grow and develop as complete and self-sufficient financial intermediaries. Throughout this process, the only significant subsidy received was non-financial, in the form of training and technical assistance. However, some important areas for improvement remain. Among these, the most important are: loan administration, management information systems and personnel management.

Table 3: Credit Union Affiliated to AIRAC
Average monthly financial ratios - 1992

Profitability		San José	Santa Lucía	Momón Bueno	Candelaria	Progreso Fronterizo	Neyba	Maimón	Cootralcoa	Sabaneta Novillo	El Progreso
1.	Monthly profits/average shares	2.75	2.04%	6.67	1.27	2.30	12.23	3.27	3.12	4.29%	2.77%
2.	Monthly profits/average assets	.41	.21	.32	.22	.26	.94	.51	.47	.29%	.35%
3.	Monthly profits/monthly income	19.72	-1.01	9.30	7.96	9.42	26.96	11.22	12.76%	9.72%	8.68%
4.	Monthly income/average assets	1.94	2.39	2.70	2.42	2.53	3.31	3.11	2.96%	2.55%	3.28%
5.	Average total assets/average shares	6.78	8.70	21.55	5.84	8.85	12.95	5.73	6.88	16.74	6.89
6.	Fixed assets/total assets	4.79	11.59	3.67	2.80	7.02	9.60	5.58	2.95%	4.41%	4.33%
	Prices and financial margins										
7.	Return on average loan portfolio	2.71	3.89	4.14	3.68	3.99	4.38	5.59	5.89%	3.66%	4.99%
8.	Interest paid on deposits	1.46	1.29	1.32	1.31	1.50	1.41	1.20	.95%	1.46%	2.10%
9.	Interest paid on interest bearing liabilities	1.37	1.42	1.22	1.30	1.39	1.26	.97	1.09%	1.48%	1.52%
10.	Interest received - Interest paid (DR$)	189,769	107,146	22,404	30,828	21,332	40,057	21,573	42,752	26,005	37,033
11.	Financial margin	.47	2.03	1.81	1.75	2.52	2.55	3.86	4.43%	1.36%	2.74%
12.	Interest spread	1.34	2.46	2.92	2.38	2.60	3.12	4.62	4.80%	2.18%	3.47%
13.	Operating expenses/Av. total assets	.50	1.19	1.12	1.13	1.41	1.11	1.76	1.84%	.92%	1.70%
14.	Operating expenses/Av. earning assets	.59	1.93	1.57	1.55	2.26	1.53	3.40	3.62%	1.20%	2.43%
	Liquidity										
15.	Liquid assets/(deposits + shares)	46.08	33.13	30.31	29.13	35.19	17.96	39.98	43.98%	25.39%	28.84%
16.	Liquid assets/(liabilities + shares)	43.77	31.43	27.17	28.33	31.40	15.51	22.40	42.95%	24.36%	31.69%
17.	Deposits/(deposits + shares)	82.80	85.99	95.04	81.90	82.39	91.34	79.62	79.67%	93.74%	91.93%
18.	Loan portfolio/(deposits + shares)	62.34	62.85	65.26	69.05	93.68	81.42	63.04	67.66%	67.06%	70.08%
19.	Loan portfolio/(liabilities + shares)	60.26	59.27	39.39	67.26	83.54	70.44	53.20	66.04%	64.47%	65.24%
20.	Earning assets/total assets	84.94	61.92	72.07	74.47	62.76	74.03	55.38	51.79%	77.46%	69.85%
	Capital adequacy										
21.	Institutional capital/total assets	8.54	3.69	-5.44	.70	18.27	-2.61	-6.04	19.96%	-.04%	2.42%
22.	Institutional capital/loan portfolio	16.18	7.36	-9.09	1.00	30.87	-3.89	-12.76	40.57%	-.19%	3.92%
23.	Net worth/total assets	23.19	15.11	-.79	17.62	29.62	5.43	11.66	34.81%	5.90%	17.16%
24.	Net worth/loan portfolio	44.16	30.17	1.41	27.44	49.72	7.49	20.92	70.69%	9.24%	27.51%

IX. Second tier cooperative organizations

The concept of institutional integration among credit unions in a second level organization or federation has been one of the basic conceptual building blocks of the credit union system since its inception. The relatively small size and autonomous organizational structure leads to an atomistic system of unit financial intermediaries that face important competitive disadvantages vis-à-vis larger banking institutions. Geographic concentration of risks, lack of economies of scale in the purchase of inputs, training, computerized information systems, lack of effective lobbying mechanisms and access to market information, all reinforce the importance of a second tier institution.

The creation and support of national second tier institutions represented one of the most important institutional vehicles which facilitated the development of the credit union network throughout the Dominican Republic during the 50's and 60's. The national federation was a relatively efficient institutional vehicle for channelling external technical assistance. However, this structure also proved to be a very attractive conduit through which the bilateral and multi-lateral donor and lending institutions could channel subsidized credit, effectively targeting an unprecedented number of low-income, rural households. The provision of financial services rapidly became the raison-d'être of the credit union federation, as it held out the prospect of a rapid progress towards institutional self-sufficiency, limiting its budgetary dependence upon member credit unions.

The monopolistic access to highly subsidized credit lines channelled through the federation seriously undermined the democratic control of the credit union financial system, as the political power became concentration within the federation itself. This financial structure was fraught with very perverse institutional incentives which accentuated serious agency problems, ultimately leading to its demise. Unfortunately, the failure to recognize the very serious designs flaws of this institutional structure has led the international donor community to invest increasingly scarce foreign assistance resources in an attempt to rescue moribund second level institutions in other countries in the Region.

The project design recognized the need for a second tier institution in order to continue to provide all types of non-financial services to the member credit unions once external support for the project terminated. The insolvency of the existing national federation and its determination to continue to operate as a financial intermediary led to the conclusion that a new second tier institution, specialized in the provision of non-financial services and financed through budgetary contributions and service income, became a necessity. Unlike practically all traditional credit union federations throughout Latin America, the second level institution was specifically prohibited from conducting financial intermediation services for member credit unions, because of the very severe conflicts of interest and moral hazard problems this implied.[35]

The financial crisis in the regulated banking system during the period of project implementation imposed very serious risks to the financial solvency of participating credit unions. In addition to the obvious risks of a run on deposits as the crisis of confidence spilled over into the credit unions, the liquid reserves of these intermediaries were invested primarily in domestic banking institutions.[36] The credit unions had difficulties, as did most depositors, identifying the risks inherent in any particular bank - until it was too late. The financial experts employed by the project, who later were hired by the credit union Association, had extensive contacts within the regulatory and banking institutions as a result of their previous employment in the private commercial banking institutions and banking superintendency. The project was very effective at avoiding losses on the part of the participating credit unions in a rapidly contracting regulated financial system.

During the second half of 1991 and throughout 1992, liquidity in the banking system increased dramatically as loan demand declined and deposit mobilization grew rapidly as a result of a decline in the growth of GDP and highly positive real rates of interest. In some credit unions the rapid growth in deposits required a dramatic increase in their investment portfolio in the domestic banking system. This was particularly true of those credit unions located in towns in which a sizable proportion of the population received remittances from abroad. The majority of the credit unions, however, faced a significant excess demand for loans as the strengthening of their services filled an important void in the provision of financial intermediation services. As interest rates in the banking system began to decline in 1992, inter-lending among the various credit unions was becoming more commonplace. The credit union Association began to play an important role as a broker, providing financial information and an assessment of the risk characteristics of the various credit unions that were requesting financing from others.

The financial structure of the credit union Association is quite unique, since its budget is funded almost entirely from the sale of non-financial services to member credit unions. Each credit union pays a fixed monthly cuota related to the size of their institution (total assets). These payments were instituted towards the end of 1991, although these resources were not required to cover operational expenses as the Association did not have any full-time employees until the conclusion of the project in August 1992. Because up to that point all technical assistance and training was completely subsidized by the project, it was intended to introduce the discipline of monthly contributions, and create a limited fund to pay for some start-up costs. The participating credit unions have been contributing for almost two years on a regular basis, which is a clear demonstration of the value placed upon the services they receive.

It was projected that with the income generated from monthly cuotas, charges for training seminars, technical assistance, the interest income derived from the Rural Financial Services Project[37], the Association would reach its break even by the end of 1993. The credit union Association is currently selling its services to non-member institutions such as NGOs, financial and non-financial cooperatives.

The Association has also established a central liquidity facility which serves as a type of mutual fund in order that the smaller credit unions could improve the return on their liquid reserves invested in the banking system. The fund is managed by an Investment Committee which is an independent governing body from the Association's Board of Directors. The positions on the Investment Committee are automatically assigned to the three largest institutional investors in the Fund. Although it is expected that these funds will remain invested in liquid instruments in the domestic banking system, there are provisions for loans to participating credit unions in order to cover short-term liquidity needs. However, because the decision to make loans to credit unions is controlled by the "net-depositor", most of the moral hazard problems of the past will be avoided.

AIRAC has maintained a very close working relationship with the cooperative regulatory agency (IDECOOP), providing limited support and information. Likewise, it has signed technical assistance agreements with a second tier, microenterprise credit fund (FONDOMICRO) to provide assistance to NGOs and credit unions. In addition to the technical assistance and training, AIRAC has played a vital role in improving the financial stability of its member credit unions through the continual supervision of the credit union operations and the collection and analysis of monthly statistical information. Throughout the years the technicians of AIRAC have provided the Board of Directors of each of the credit unions with external supervision which the directors have come to value highly because it represents an additional source of information with which to evaluate the performance of their employees. Because of the weaknesses inherent in the regulatory and supervisory structure which controls the credit unions system, the Association has filled a very important void.

Table 4: Asociación de Instituciones Rurales de Ahorro y Crédito (AIRAC) Comparative balance sheets, 1992-1993 - December 31st (US dollars)

	1992	1993	Change
Cash on hand and banks	14,356	1,858	(12,498)
Accounts receivables	4,422	15,249	10,827
Loan portfolio	0	65,393	65,393
Interest receivable	2,022	3,535	1,513
Inventory	1,423	883	(540)
Financial investments	214,630	449,285	234,655
Fixed assets net	4,225	4,775	551
Other assets	2,881	8,923	6,042
Total assets	243,958	549,900	305,942
Accounts payable	4,467	7,198	2,732
Funds in administration	190,748	401,890	211,142
Liabilities	195,214	409,088	213,874
Donated capital	33,228	120,716	87,488
Budget reserve	16,630	15,515	(1,114)
Profit and loss	(1,114)	4,581	5,695
Net worth	48,743	140,812	92,069
Liabilities + net worth	243,958	549,900	305,942

Table 5: Asociación de Instituciones Rurales de Ahorro y Crédito (AIRAC) Comparative income and expense statements, 1992-1993 (US dollars)

Interest on loans	159	22,101	21,942
Interest on investments	13,425	28,103	14,678
Interest on deposits	2,709	39,456	36,748
Fees for service	9,440	15,242	5,802
Monthly budgetary contributions	16,976	29,218	12,241
Other income	159	14,751	14,592
Sale of assets	0	9,843	9,843
Total income	42,868	158,714	115,846
Operating expenses	31,435	99,258	67,823
Interest paid	12,369	54,677	42,308
Commissions paid	179	198	19
Total expenses	43,982	154,133	110,151
Profit and losses	(1,114)	4,581	5,695

X. Regulation and prudential supervision

The credit unions are mutual-based financial institutions, that are legally incorporated under the Dominican Cooperative Law NE 127. This law regulates all types of enterprises that are organized as cooperatives, independent of the specific sectors in which they operate. The most common types of cooperatives in the Dominican Republic include transportation (taxi and buses), supermarkets, pharmacies, agricultural production and savings and loan (credit unions).[38] As this piece of legislation was designed to regulate enterprises involved in such diverse areas as finance and agricultural production, per force, its prudential norms are extremely general in nature.

Although this law may be sufficient to regulate the activities of production or consumer cooperatives, it is insufficient to regulate financial intermediation. For example, minimum capital requirements are established at US$ 250, while no limits are imposed on loan portfolio concentration. The law does not provide for reserve requirements, or limitations on investments in fixed assets or other non-financial assets. The law provides virtually no operating standards which these intermediaries could use as a guide.

The Law 31 which establishes the Instituto de Desarrollo y Crédito Cooperativo (IDECOOP) as a semi-autonomous public sector institution charged with the supervision of all organizations incorporated under the Cooperative Law. As its name suggests, historically IDECOOP has been more concerned with the promotion of cooperatives, educational, promotional activities and credit than with prudential supervision. Its Board of Directors is composed of public sector officials and leaders elected by the cooperatives themselves. This composition of the Board has introduced very serious moral hazard problems in the administration of credit resources, and as a result of severe delinquency in its loan portfolio, its lending operations have virtually ceased. The structure of its Board of Directors introduces very serious conflicts of interest and, as a result, it cannot carry out its mandate. Its entire operating budget is provided by the Central Government, and its funding is inadequate to carry out its mandate.

In the case of the credit unions, the lack of an appropriate regulatory structure and prudential supervision is critical since they are legally authorized to mobilize savings deposits from the public. In response to this regulatory and supervisory vacuum, the Rural Financial Services Program took on some of these functions. The fact that the project operated out of the Finance Department of the Central Bank provided the necessary institutional credibility. In addition, the Central Bank entered into an inter-institutional agreement with IDECOOP, in which budgetary and technical support were provided to the Institute to strengthen its regulatory functions. However, this Institute neither has the mandate nor the technical know-how to carry out an appropriate supervisory function.

In essence the credit unions in the Dominican Republic, as in most other countries throughout the Region, are not subject to any effective government oversight. Before the project terminated in 1992, an effort was made with the officials of the Central Bank and IDECOOP in order to improve the regulatory oversight of the credit unions. However, because of the overwhelming problems confronting the Central Bank with regard to the regulation and prudential supervision of the formal banking system, and given the relatively small role played by the credit unions within the financial markets, the authorities declined to consider this request.

As a result, AIRAC has been strengthening its oversight of the member credit unions. The Association has become an important source of information regarding the financial health of the participating credit unions, and their continued affiliation to this organization is made dependent upon the fulfillment of minimum standards of performance. Although this is not the optimal situation, it provides an important technical guide for those credit unions that are interested in prudential financial management, but which lack the technical expertise to set the required parameters. This system of self-regulation has proved to be somewhat effective as the credit unions have been able to continue to grow and become more strengthened despite the severe macroeconomic instability and crisis which has engulfed the financial markets since 1989.

The oversight on the part of the Association's technical specialists provides the Boards of Directors of all the credit unions an independent source of additional oversight of their operations. However, AIRAC lacks any legal authority to impose cease and desist orders, or to replace a particular Board of Directors of an institution deemed to be placing the members savings at risk. This situation is somewhat ameliorated by the close working relationship which exists between IDECOOP and AIRAC, which in the past has led to the administrative intervention of a credit union, whose Board of Directors had been shown to be corrupt. However, both the Cooperative Law and the institutional arrangements for the prudential supervision require urgent reforms in order to obtain an appropriate regulatory and supervisory structure. Continued contact of AIRAC with the banking authorities within the Central Bank and Banking Superintendency will undoubtedly be very important in achieving this outcome.

XI. Conclusions

The net economic benefits generated by the institutional strengthening program of the rural credit union network in the Dominican Republic between 1984 and 1992 have been substantial. The investment of approximately US$ 1.25 million over a nine-year period by USAID has led to the creation/strengthening of 15 rural credit unions, serving over 25,000 members, the training of dozens of directors and employees, the mobilization of over US$ 10 million dollars in domestic savings. Through the provision of specialized technical assistance rather than outright credit, these resources have been leveraged by a factor of 8. Perhaps most importantly, this project has served to create an institutional structure which for all practical purposes did not exist, and most probably would not have developed without its assistance. These intermediaries are financially self-sustaining and the flow of economic benefits will continue into the forseeable future.

The deepening of financial services in these 15 communities has served to reduce the transfer of domestic savings from the rural to the urban economy. This "damming" effect has significantly expanded the supply of loanable funds at the local level, lowering the local rate of interest on capital, promoting greater productive investment and with it the growth in income and employment opportunities. Because these institutions are community-based organizations, they have greatly expanded access on the part of the small and microentrepreneurs to financial services, improving the distribution of income in the rural areas.

From a purely technical standpoint, the credit unions still present operational weaknesses which require continued support. However, because the project was successful in creating the institutional and in training the technical specialists, they continue to have access to these services two years after the external support was withdrawn. AIRAC is practically self-sufficient after only two years of operation, and has continued to gain the confidence of its member institutions, evidenced by their willingness to cover the expenses of this second tier institution. Despite the very limited investment of external resources, this project has succeeded in developing a sustainable institutional structure. Despite the initial skepticism, because of disbelief that the rural population in the Dominican Republic had any financial capacity to save, but also because of the extreme weakness and past failures of the credit unions as financial intermediaries, the persistent support over a nine-year period was critical to achieving success.

The most important achievement, however, has been the demonstration of the power of local collective action when organized in an effective manner with a clear goal and strategy for its implementation. The extreme degree of concentration of power throughout Dominican history has created an environment of dependence upon the actions of the public sector. This project successfully mobilized the local community towards the creation of those institutional structures required to provide basic financial services of which most rural communities are devoid. With limited external technical assistance these organizations were able to organize the available human and financial capital to provide financial services in their communities, without any support from the government. This project has had an important demonstration effect through the empowerment of local community organizations, that for years looked towards external donors to provide the needed resources for investment.

Statistical annex

Notes

1. Jeffrey Poyo is a micro-enterprise specialist with the Inter-American Development Bank (IDB). Prior to his employment with IDB, Mr. Poyo was a senior research specialist at Ohio State University where he was directly responsible for the management of the project described here. The report is reproduced here with the kind permission of the author.

2. The two projects were the Rural Savings Mobilization Project, 1983-1987 and the Rural Financial Services Project 1988-1992.

3. Credit unions are considered to be "rural" as long as they were located outside the capital city of Santo Domingo, and Santiago.

4. In addition to USAID, the Inter-American Foundation and the Inter-American Development Bank (through the apex organization COLAC) were the two most active organizations supporting credit unions in the Dominican Republic.

5. This section draws from: Rabines, Manuel R. et. al., "The Colac System: Its Evolution and Future Projections", Panorama of the System of Savings and Loan Cooperatives in Latin America, Latin American Confederation of Savings and Loan Cooperatives - COLAC, Panama, 1981.

6. For a discussion of these topics see: Gary McEoin, *Agent for Change*, Orbis Books, Maryknoll, New York, 1973 and Pablo Steele, *Who are the Owners of Latin America?*, Interamerican Cooperative Institute, Panama, 1973.

7. "Dominican Federation of Credit Unions, Inc.: 30 Years", FEDOCOOP, Santo Domingo, Dominican Republic, 1979, p. 28.

8. For an analysis of the institutional development, and credit administration technology, see: Jeffrey Poyo, Nelson Aguilera Alfred and Claudio Gonzalez-Vega, "Information Structures, Transactions Costs and the Comparative Advantage of Rural Credit Unions", Department of Agricultural Economics and Rural Sociology, The Ohio State University, January 1992.

9. The lack of risk analysis, documentation and loan administration procedures is not surprising in a mutual institution in which the incentives for participation are to gain access to concesionary loan funds. These problems are not only present in mutual type institutions, but can also be found in stock-owned financial institutions.

10. During this period the Government promoted the creation of private development banks and mortgage banks in order to increase the supply of long term finance to fund productive investments and housing.

11. Serious delinquency problems led to restrictions in its access to multilateral and bilateral sources of credit. In addition, the economic stabilization program implemented by the government likewise led to the closure of access to credit flows from the Central Bank.

12. See: Zinser, James et.al., *Non-regulated Financial Markets*, Center for Monetary and Banking Studies, Santo Domingo, Dominican Republic, 1986.

13. A stock exchange has recently been inaugurated which over time will place additional competitive pressure upon the banking system.

14. The degree to which these financial intermediaries can diverge from a profit maximizing behavior depends on the degree of competition in the market place. For an analysis of the political economy of the public sector development banks and rural credit unions, see: Jeffrey Poyo, "Agency Relationships, The Agricultural Development Bank, and Rural Credit Unions in the Dominican Republic", Dept. of Agricultural Economics and Rural Sociology, the Ohio State University, Columbus, 1990.

15. Evidence of this unsatisfied demand was demonstrated with the very rapid growth in the volume of

deposits mobilized, demand for credit, and the number of clients attracted to both the Agricultural Development Bank and rural credit unions that had participated in the USAID projects. The agricultural development bank mobilized over 150,000 individual savings accounts and 15 credit unions were able to reach over 20,000 new members over the same period. It is especially noteworthy that the rural population was willing to deposit their savings into credit unions during a period of general economic and financial instability in view of their image problems.

16. Because of the limited investment required and the well-developed market, which insures their relative liquidity, the rural households in the Dominican Republic have historicaly invested their liquid reserves in pigs.

17. Of the total US$ 2.7 million, US$ 500,000 for external technical assistance was not spent, and because of the rapid rate of devaluation over the period of implementation, the dollar value of the local currency fell to only US$ 527,000. Total expenditures for this project amounted to approximately US$ 1.7 million.

18. Very small, medium term "administrative" loans were provided to some of the credit unions in order to assist with the purchase of office equipment and to improve their physical appearance of their offices generally.

19. The one institution, which was an exception to this rule, was San José de las Matas. Unlike the other institutions this credit union had never received any external loans from the Federation, and was the only one to experiment with the mobilization of time deposits. It was without a doubt the most successful credit union in the country.

20. Ley de Asociaciones Cooperativas, number 127.

21. The credit unions are proscribed from carrying out financial transactions with non-members.

22. Though most clients participate on both sides of the balance sheet, their net position at any point in time may characterize them as net-savers or net-borrowers.

23. For a discussion of this see: Jeffrey Poyo, Nelson Aguilera and Claudio Gonzalez-Vega, "Information Structures, Transactions Costs and the Comparative Advantage of Rural Credit Unions", Dept. of Agricultural Economics and Rural Sociology, the Ohio State University, January 1992.

24. The emphasis upon subsidized interest on loans was a very important tennet of Catholic theology, which as indicated had a very important role in the initial promotion of the credit union system throughout most of Latin America.

25. Reformed credit policies did establish absolute maximums per member depending on the size of the credit union because of implications for loan portfolio concentration and risk diversification. In their initial stages of development these ceilings remained low, because funding depended exclusively on deposit mobilization. These policies have at times served as a constraint on growth as large businessmen tended not to join in the initial stages because the credit union could not satisfy their demand for credit.

26. These ratios represent only the delinquent payments as a proportion of the aggregate loan portfolio.

27. Poyo, Aguilera and Gonzalez-Vega, ...

28. Small store owners generally provided salaried employees with the ability to buy on credit during the month, or cashed government checks for a commission. These businessmen provided an important intermediation function by allowing them to smooth their spending and payment patterns, or avoiding greater transactions costs in going to the bank to cash checks. Likewise, money lenders generally provided services to a segment of society which had no other alternative source of credit.

29. For a discussion of their institutional evolution, see: Jeffrey Poyo, et. al., "Information Structures, Transactions Costs and the Comparative Advantage of Rural Credit Unions", Department of

Agricultural Economics and Rural Sociology, the Ohio State University, Columbus, January 1992.

30. All promotional and training activities had been subsidized by external donor agencies up to this point.

31. Eugene F. Fama and Michael C. Jensen, "Agency Problems and Residual Claims", Journal of Law and Economics, Vol. XXVI (June 1983), p. 327.

32. Ibid., p. 327.

33. Eggertson., p. 141.

34. Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control", Journal of Law and Economics, Vol. XXVI (June 1983), p. 318.

35. It is interesting to note that these conflicts of interest and moral hazard problems were identified early in the development of the credit union systems in the United States, and the financial intermediation roles were separated from the Leagues.

36. The investment policies of the individual credit unions emphasized security over return prohibiting any deposits or investments in non-regulated financial institutions, who generally offered higher rates on deposits.

37. The project had a loan portfolio of approximately US$ 170,000 managed through a commercial banking institution. Long term loans of approximately US$ 15,000 were provided at market rates of interest to a few credit unions to purchase office equipment, office furniture and to partially cover the operating expenses of those institutions that did not have the minimum operation conditions to begin mobilizing deposits from their members. These funds were not used to fund their loan portfolios. The credit union Association is currently using the repayments of these loans to finance the purchase of computer hardware and software by member credit unions.

38. Although most of the savings and loan cooperatives have changed their charter in order to become multi-service cooperatives as explained above.