DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK
MULTILATERAL INVESTMENT FUND

DOMINICAN REPUBLIC

IMPROVING REMITTANCE DISTRIBUTION CHANNELS IN SUPPORT OF THE MICROENTERPRISE SECTOR IN THE DOMINICAN REPUBLIC

(TC-02-12-00-8)

DONORS MEMORANDUM

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Abbreviations

IDB	Inter-American Development Bank
IIC	Inter-American Investment Corporation
LIBOR	London Interbank Offered Rate
MIF	Multilateral Investment Fund
POS	point of sale
SEIF	Small Enterprise Investment Fund of the MIF

ABSTRACT

Remittances are a crucial source of capital for the Latin American and Caribbean region, exceeding 10% of GDP in some countries. The positive impact of remittances on the region's development and growth, however, continues to be undermined by market inefficiencies. Combining competition with technology will help to reduce the costs of transferring remittances, which should produce a drop in fees and, by extension, an increase in the amounts received by beneficiaries. Of the portion of remittances that recipients state is used for consumption and housing expenses, an estimated 20% to 30% actually goes toward financing microenterprise activities. Furthermore, lower-cost transfers coupled with financial services that offer added value for the client would become a key motivating factor for: (i) low-and-medium-income economic units to join the formal banking system; and (ii) formal financial institutions to cover this unserved segment (downsizing).

The project will implement new technologies to develop alternatives to the channels traditionally used for receiving, controlling, and distributing remittances traditionally used in the Dominican Republic and the United States. The MIF will finance, on market terms, the necessary organizational and technological adjustments for Grupo BHD to gradually replace those channels with others that are more efficient and less costly. This will open the way for large-scale expansion of its remittance transfer services (first stage) and financial services (second stage) to the target population, in addition to increasing financing for Dominican microenterprises and their capital development.

The US$2.5 million loan, at competitive market rates, will be granted to Grupo BHD, a holding company of businesses devoted principally to banking, tourism, and real estate development; established in 1972, Grupo BHD´s core business unit. The Grupo BHD units involved in receiving, transferring, and distributing remittances are:

(i) Remittances Dominicanas, S.A., a financial intermediary incorporated in and dedicated to the distribution of remittances in the Dominican Republic

(ii) BHD Corp., a financial intermediary incorporated in the United States and dedicated to the receipt of remittances in the United States and Puerto Rico

(iii) Banco BHD, a financial intermediary incorporated in the Dominican Republic that provides support and deepening—in addition to clearing services—for the remittance activities of Remittances Dominicanas and BHD Corp.

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(TC-02-12-00-8)

EXECUTIVE SUMMARY

Executing agency:	Grupo BHD
Project number:	TC-02-12-00-8
Beneficiaries:	The microfinance sector and low-to-medium-income economic units in the Dominican Republic
Objectives:	General objectives: i. Facilitate access to capital in the Dominican microfinance sector ii. Benefit recipients of remittances by enhancing the end value of such payments through a reduction in transfer commissions iii. Involve the traditional formal financial sector in providing financial services to low-and-medium-income economic units iv. Enhance the impact of remittances on the economy's internal savings and on channeling such savings to productive sectors Specific objectives: i. Create competition with a view to reducing the intermediation commissions inherent in current remittance distribution mechanisms through the implementation of new technologies ii. Promote capitalization of the microfinance sector by enhancing the end value received by remittance recipients iii. Encourage remittance recipients and small commercial establishments that distribute remittances to participate in the formal banking system iv. Develop and implement new technologies to attract, transfer, control, and receive remittances

Financing: A loan in the amount of up to US$2.5 million, to be disbursed in a single tranche

Execution timetable: Up to five years, including a grace period of up to two years.

Environmental and social review: The Committee on Environment and Social Impact (CESI) approved the project at its 23 January 2003 meeting.

Description: The project falls within the framework of the MIF´s core activity of serving the microenterprise sector, as defined in the 28 July 2000 report of the Working Group on the MIF Strategy (document MIF/GN-56) and especially within the Action Plan of the MIF cluster of projects on remittances as a development tool (document MIF/GN-73). A loan will be made to a local financial institution that is establishing and expanding services for microenterprises and small businesses, with the innovation of establishing links between remittances and the formal financial system in support of the local microenterprise sector. That sector will increase its capitalization thanks to lower commissions on remittance transfers—as a result of the incorporation of new technologies for more efficient capture, control, and distribution of flows—and to access to new financial products and services.

Remittances are a crucial source of capital for the Latin American and Caribbean region, exceeding 10% of GDP in some countries. The positive impact of remittances on the region's development and growth, however, continues to be undermined by market inefficiencies. Combining competition with technology will help to reduce the costs of transferring remittances, which should produce a drop in fees and, by extension, an increase in the amounts received by beneficiaries. Of the portion of remittances that recipients state is used for consumption and housing expenses, an estimated 20% to 30% actually goes toward financing microenterprise activities. Furthermore, lower-cost transfers coupled with financial services that offer added value for the client would become a key motivating factor for: (i) low-and-medium-income economic units to join the formal banking system; and (ii) formal financial institutions to cover this unserved segment (downsizing).

The loan, at competitive market rates, will be granted to Grupo BHD, a holding company of businesses devoted principally to banking, tourism, and real estate development; established in 1972, Grupo BHD´s core business unit (72% of its assets) is Banco BHD. The group's shareholder structure is very varied, comprising 62 local investors. The Grupo BHD units involved in receiving, transferring, and distributing remittances are:

i. Remittances Dominicanas, S.A., a financial intermediary incorporated in and dedicated to the distribution of remittances in the Dominican Republic
ii. BHD Corp., a financial intermediary incorporated in the United States and dedicated to the receipt of remittances in the United States and Puerto Rico
iii. Banco BHD, a financial intermediary incorporated in the Dominican Republic that provides support and deepening—in addition to clearing services—for the remittance activities of Remittances Dominicanas and BHD Corp.

The project will implement new technologies to develop alternatives to the channels traditionally used for receiving and distributing remittances. The MIF will finance, on market terms, the necessary organizational and technological adjustments for Grupo BHD to gradually replace those channels with others that are more efficient and less costly. This will open the way for large-scale expansion of its remittance transfer services (first stage) and financial services (second stage).

Risks:

Country risk. Given the macroeconomic fragility of the Dominican Republic, new crises could have a negative impact on Grupo BHD. **Mitigating factor**. The group is a holding company that is well diversified both sectorally (e.g., finance, tourism and real estate) and geographically (e.g., domestic and international presence). Thanks to the international makeup and commitment of its investors to its financial activities, Grupo BHD has a solid shareholder structure that contributes to its strength. Furthermore, its management team possesses many years of experience in similar, difficult scenarios.

Systemic risk. Many of the factors that affect liquidity management at financial institutions lie beyond Grupo BHD´s control. **Consideration**. The main Grupo BHD unit that would be affected is Banco BHD, which has a sound shareholder structure, a very competent management team with considerable experience in similar situations, and it currently enjoys a healthy situation. Under the project, Grupo BHD would also seek to expand its remittance business and thus diversify its sources of deposits.

Credit risk. If the group's financial situation worsened considerably, the MIF could sustain losses. **Mitigating factor**. The MIF would be lending to an institution established, capitalized, and managed by a group of local investors who have obtained excellent results thus far. The MIF resources would represent a very low percentage of the group's liabilities. In the event of significant deterioration, an unsatisfactory audit or failure of the group to honor any other credit commitment, the loan would be accelerated. The MIF will constantly monitor the institution to ensure compliance with the loan conditions as well as progress in that area.

Credit deviation risk. Grupo BHD could channel the proceeds from this loan to other of its units or to activities other than those indicated in the project. **Mitigating factor**. The group's obligation to channel the loan proceeds to this project will be established in the contract. Non-acceleration of the loan will hinge on the institution's achievement of specific social-impact targets set by the MIF. Grupo BHD is fully aware that one of its main competitive advantages vis-à-vis other financial institutions lies in working with and building links between remittances and the microenterprises and small businesses of the Dominican Republic. The loan will be on competitive market terms in order to prevent the resources from being used to replace liabilities.

Exceptions to Bank policy: None.

I. ELIGIBILITY FOR MIF FUNDING

1.1 The Dominican Republic was declared eligible to receive financing from the MIF on 12 September 1994 by the Donors Committee. The project received the no objection of the Dominican government on 25 November 2002.

1.2 The MIF´s Policy and Operations Committee found the operation to be eligible[1] to receive MIF financing under the Small Enterprise Investment Fund (SEIF) inasmuch as it involves a loan to a national financial institution that is establishing and expanding services for microenterprises and small businesses; the committee highlighted the innovative nature of the project in establishing linkages between remittances and the formal financial system in support of the local microenterprise sector. The project falls within the framework of the MIF´s core activity of serving the microenterprise sector, as defined in the 28 July 2000 report of the Working Group on the MIF Strategy (document MIF/GN-56) and especially within the Action Plan of the MIF cluster of projects on remittances as a development tool (document MIF/GN-73).

1.3 This project is highly innovative and accordingly holds great potential in terms of demonstration and replicability, since it will assist a formal financial institution in adopting new technologies that will enable it to serve smaller-sized economic units; it will do so by setting up a more efficient network to attract, control, and distribute remittances that will provide greater added value to remittance recipients in the Dominican Republic. This will also support greater capitalization of local microenterprises[2] and greater deepening of the formal financial system.

1.4 This is the first time that the MIF would support, through reimbursable funding provided on competitive market terms, the implementation of a new technological system to attract, transmit, control, and distribute remittances, producing a reduction in commission fees. The increased efficiency and the development of new related financial services will help to improve the margins of all financial institutions involved, yielding profits and ensuring the project's sustainability in the long term.

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[1] Pursuant to the Agreement Establishing the Multilateral Investment Fund.

[2] Recipients say they use 97% of the amount of remittances for consumption and housing expenditures; an estimated 20% to 30% of that amount is actually used to finance microenterprise activities.

II. BACKGROUND

A. The macroeconomic setting and financial system of the Dominican Republic[3]

2.1 During the 1990s, the Dominican Republic experienced strong economic expansion. GDP growth was steady throughout the decade, averaging 5.7% per annum, and was compatible with price and exchange rate stability. Even so, this growth did not translate into a sufficient level of development, measured in terms of the creation of new jobs and revenue for broad sectors of the population.

2.2 The combination of macroeconomic weakness and the vulnerability of the financial system poses a risk to the economy that this growth may cease. The threats to stability arise mainly from fuel prices, cumulative disequilibria, and tension between fiscal and monetary policy, and have resulted in: (i) high domestic interest rates, despite economic stability and low rates abroad; (ii) central bank intervention in the financial market, where it sets the interest rate floor as marginal borrower; (iii) mounting quasi-fiscal deficits, reflecting the growing gap between the return on the central bank's assets and the cost of its liabilities; (iv) domestic price trends during the first two months of the year indicating that, for the second year in a row, 2003 could close with double-digit inflation; and (v) recourse to monetary control.

2.3 Since the last quarter of 2002, the monetary authorities have been pursuing a tight policy aimed at absorbing the impact of devaluations in the peso. They recently extended to 15 April the ceiling imposed on the lending and investment portfolios of commercial banks and other financial intermediation institutions. This means that loans may not be granted in excess of the amounts in effect at the time of approval of the first restriction on 8 December 2002.

2.4 Underlying the apparent robustness of the system are a series of structural weaknesses, including a low level of financial deepening and high intermediation spreads, that create a risk of insolvency for the financial sector and of instability and inequity for the productive sectors.

B. Remittances and microfinance in the Dominican Republic

2.5 In 2002, *remittances*[4] to Latin America and the Caribbean—coming mainly from the United States, Japan, and Europe—totaled US$32 billion and were thus a crucial source of capital for the region. This amount outstripped the normal flow of official external aid for the entire region and was equivalent to roughly all foreign direct investment in the region and, in some cases, equaled or exceeded revenue

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3 José Juan Gomes Lorenzo. IDB. *Dominican Republic. Economic Situation and Outlook*. October 2002.

4 MIF/IDB Press Release. *Remittances to Latin America and the Caribbean reached US$32 billion in 2002, IDB´s Multilateral Investment Fund says.* 27 February 2003.

generated by the main exports, equivalent to 10% or more of the GDP of five countries. Estimates are that the volume of remittances will continue to grow over the coming years.

2.6 The positive impact of remittances on the region's development and growth, however, continues to be undermined by market inefficiencies, the lack of monitoring and information, and weak financial mechanisms. These high costs, the highest in the world,[5] are the result of the inefficiency of the current systems, where only a fraction of transfers are made through formal financial institutions, which tend to charge lower fees to their clients than traditional wire transfer companies. The combination of competition and technology will help to reduce the costs of transferring remittances and should lead to a reduction in fees and, accordingly, an increase in the amounts received by beneficiaries. As more people gain access to banks and credit unions, the use of electronic services to transfer money will take on greater relevance. Less costly transmission of remittances coupled with value-added services for the client will be a key motivating factor for the unbanked to join the formal banking system.

2.7 Remittances sent by Dominican immigrants residing in the United States and Europe constitute one of the Dominican Republic's main sources of foreign exchange. Based on data of the central bank and the MIF,[6] foreign exchange flows from remittances occupied third place among imports, close behind the tourism sector and the export-processing zones. In 2002, remittances totaled US$2.11 billion, equivalent to roughly 10% of GDP. The volume of foreign exchange received in the form of remittances grew at an average annual rate of 14% during the period 1995-2001 and 16.9% in 2002. It is expected to continue growing by 7% per annum over the next five years. An estimated 1.5 million Dominicans live in the United States and some 150,000 in Europe.

2.8 The country's **microfinance**[7] sector has experienced visible growth in recent years as a result of overall growth in the economy and market opening. Microenterprise constitutes one of the most active sectors of the economy given its potential to create and expand job opportunities (39.6% of total employment), its contribution to GDP (estimated at 31%[8]), and its strategic role in poverty reduction, considering that it accounts for 29% of the economically active population, estimated at over 3.5 million persons.[9] Furthermore, microenterprise fosters the development of

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[5] MIF. *Sending Money Home: An International Comparison of Remittance Markets*. February 2003.

[6] MIF. *Sending Money Home: An International Comparison of Remittance Markets*. February 2003.

[7] Marina Ortiz. FondoMicro, Inc. *Microempresas, Globalización y Servicios Financieros en la República Dominicana*.

[8] Glenn D. Westley and Brian Branch. *Safe Money. Development of effective credit unions in Latin America*. 2000.

[9] Consejo Hondureño de la Empresa Privada. *La Economía Informal en Centroamérica, Panamá y República Dominicana*.

entrepreneurial skills and helps to broaden marketing opportunities and, for the most part, use of local raw materials.

2.9 A common feature of Dominican microenterprises is the level of capital invested by owners to launch and maintain their businesses, which is calculated at less than US$1,000 per year. Such low capitalization limits the possibilities for them to adopt modern production technologies, forces them to work on a small scale, and makes them very vulnerable to family emergencies and economic vagaries. To counteract this limitation, microenterprises focus on intensive use of labor, which is their main resource. Low capitalization is partly offset by operators´ ingenuity and motivation in the face of limited access to alternative sources of financing.

2.10 One of the most evident obstacles to microenterprises is their access to the formal financing market. Few microenterprises and small business have been able to meet their financing needs through formal credit institutions. Accordingly, the delivery of adequate financial services to this sector is a key element for development of these economic units. Such financial services include both savings products (savings accounts and certificates of deposit) and credit products (loans in general—business, personal, housing—, credit cards, credit lines, etc.). Few businesses have gained access to formal credit, either through banks and finance companies (4.5%) or microfinance programs and institutions, which are promoted mainly by non-governmental organizations (4.3%). Informal financing arrangements, such as family members and friends, are usually the basic option for operators to obtain funds, although the prevailing socioeconomic situation is resulting in a growing role for remittances from family members living abroad.

C. MIF financial support strategy for microfinance institutions and remittance transfers

2.11 The MIF is supporting **microfinance institutions** in Latin America and the Caribbean through various financial instruments and vehicles:

(i) Direct operations. The MIF makes equity investments and long-term loans to support the establishment or growth of recently created microfinance institutions, with the MIF playing the role of anchor investor, allowing the founding partners to leverage considerably their resources, e.g., Financiera Calpia (El Salvador), Bangente (Venezuela), and Banco de la Pequeña Empresa (Dominican Republic).

(ii) The MIF also broadens financing options through a number of various arrangements, such as term credit to Fundaciones de la Mujer in Colombia and to Banco Multicredit in Panama. Other financing arrangements used by the MIF include subordinated and/or convertible loans and the underwriting of bond issues in local capital markets of microfinance institutions, e.g., DFL/CML in Trinidad and Tobago.

(iii) Operations with established bank intermediaries interested in pursuing a strategy of deepening (or "downscaling") whereby they incorporate into their clientele a market segment different from the one targeted by the traditional corporate banking sector or private banks, with the positive repercussions this has for productivity and economic growth. The financing proposed herein for Grupo BHD falls in this category.

(iv) The MIF also acts as promoting partner for various funds specializing in channeling capital and debt to microfinance institutions, e.g., Profund, AIM, and LACIF.

(v) Line of activity to strengthen microfinance institutions. This initiative seeks to build institutional capacity by developing such areas as information systems, financial management, monitoring and supervision, and accounting and loan procedures.

(vi) The MIF supports legal and regulatory reforms to enhance development opportunities for microenterprises, with the objective of creating market conditions similar to those of larger businesses for microenterprise development. As a complement, projects in this area also seek to build the supervisory capacity of banking authorities.

2.12 The Action Plan of the MIF project cluster on remittances as a development tool[10] is designed to "increase the amount of resources received from the flow of remittances… and to improve the development impact of these funds". These two objectives must be present in all projects supported with MIF funds, including investment operations (loans and equity and quasi-equity investments). The action plan also establishes that, pursuant to the recommendations of the working group's report, the projects to be included in this cluster must be innovative and serve to introduce new mechanisms for the transfer and use of remittances. The projects must assist both the private and public sectors in developing appropriate mechanisms to enhance the development impact of remittances and increase the revenue earned by individuals who receive such remittances. Specifically, this will entail promoting safer and more efficient vehicles for the transfer of remittances, and developing local banking systems that provide multiple financial services to the population not yet in the banking system.

2.13 Projects under the remittance cluster must pursue the following objectives:

(i) Reduce the cost of transferring remittances

(ii) Gradually improve the ease of and access to remittance transfers

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[10] MIF. Remittances as a development tool (document MIF/GN-73). December 2001.

(iii) Mobilize and channel immigrant savings through greater participation of formal financial institutions in the process

(iv) Channel immigrant capital towards productive investments

2.14 The objectives of individual projects supported by MIF investments and related to remittances must also be consistent with the policies set forth for lending under the MIF´s Small Enterprise Investment Fund (SEIF). Such resources may only be channeled to non-governmental organizations or local financial intermediaries that are creating or expanding services to microenterprises and small businesses, or are providing credit to or investing in microenterprises and small businesses. Furthermore, beneficiaries of MIF investment operations must be organizations that: (i) are financially sustainable; (ii) leverage third-party resources; (iii) benefit from the additionality of the resources provided; (iv) provide a demonstration effect; and (v) make it possible to establish adequate supervision mechanisms.

III. THE BORROWER

A. Institutional analysis

3.1 The loan will be granted to Grupo BHD, a holding company of businesses engaged mainly in banking and insurance activities; established in 1972, the group's core business unit (72% of its assets) is Banco BHD. Its shareholder structure is very varied, comprising 62 local investors. The Grupo BHD units involved in receiving, transferring, and distributing remittances are:

(i) Remittances Dominicanas, S.A., a financial intermediary incorporated in the Dominican Republic and dedicated to the distribution of remittances in the Dominican Republic

(ii) BHD Corp., a financial intermediary incorporated in the United States and dedicated to the receipt of in the United States and Puerto Rico

(iii) Banco BHD, a financial intermediary incorporated in the Dominican Republic that provides support and deepening—in addition to clearing services—for the remittance activities of Remittances Dominicanas and BHD Corp.

3.2 The loan would be granted to Grupo BHD because:

(i) it presents a much more attractive risk profile for the MIF than Remittances Dominicanas, S.A.;[11]

[11] In this regard, the financial structuring of the operation is similar to that of Dynamic Finance Limited in Trinidad and Tobago. (document MIF/AT-411).

(ii) it is the holding company that combines the three units of the group involved in the receipt, control, transfer, and distribution of remittances; and

(iii) it averts the potential risks posed by related party transactions that are customary between parent companies and their subsidiaries.

3.3 Remittances Dominicanas, S.A. is currently one of the main companies that receive and distribute remittances in the Dominican Republic. Sixty-two percent of its capital is owned by Grupo BHD. It was founded in 1998 to complement and add value to the remittance transfer services of BHD Corp. in the United States. One of the strengths of Remittances Dominicanas is its ideal position to comply with the recently passed measures against money-laundering and the financing of terrorist groups,[12] which include fraudulent transfers. Since it is part of Grupo BHD, the entire transfer process is monitored, from receipt of the remittance from the sender to its delivery to the beneficiary. In addition, the fact that Banco Popular of Puerto Rico,[13] a formal, regulated financial institution of the United States, is a shareholder of Banco BHD means that stricter controls are required. Remittances Dominicanas effected 834,000 transfers in 2002 for a total of US$198 million; the average transfer was US$224.

3.4 BHD Corp. was established in 1983 to serve the Dominican community of New York City by offering information and representation of banking services. In 1993, BHD Corp. obtained a license as money transmitter from the Banking Department of the State of New York, becoming the first Dominican company to obtain that license and to participate formally in the remittance transfer market from the United States to the Dominican Republic. At present, BHD Corp. is licensed to operate in the states having the highest concentration of Dominican immigrants; it has nine offices of its own, located in New York, New Jersey, Rhode Island, Massachusetts, and Puerto Rico, and over 400 authorized agents. BHD Corp. currently possesses 12% of the market of remittances from the United States to the Dominican Republic, and has a medium-term objective of attaining 20%.[14] BHD Corp. is owned by Grupo BHD (80%) and Banco Sabadell (20%).[15]

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[12] USA Patriot Act of the 2001: "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism". Title III – International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. http://www.immigration.gov/graphics/lawsregs/patriot.pdf. According to the Asociación Dominicana de Remesadoras de Divisas, in over five years no cases have been registered among its members (which include BHD Corp.) of attempts to effect fraudulent transfers, money laundering or other crimes.

[13] Banco Popular is Puerto Rico´s largest bank and, in terms of assets, one of the top 40 banks of the United States.

[14] In comparison, Western Union has 30%.

[15] Spain´s fourth largest banking group, currently made up of Banco Sabadell, Banco Asturias, Sabadell Banca Privada, and ActivoBank, the Banco Herrero and Solbank brands, and several subsidiary and part-owned companies.

3.5 The main component of Grupo BHD is Banco BHD, the fourth largest bank in the Dominican Republic following its recent merger with Banco Fiduciario. The rating assigned by Fitch (national long-term A+; international long-term BB- stable) is supported by a solid market position and adequate levels of capitalization and return, coupled with all the benefits provided by its diversified shareholder structure and the cooperation provided by Banco Sabadell of Spain (20% of its capital stock) and Banco Popular of Puerto Rico (18% of its capital stock). Banco BHD is looking to expand its share in the consumer and retail markets. With the proposed loan, the MIF would be strengthening its focus on low- and medium-income economic units normally underserved by the traditional commercial banking community (thereby expanding the market coverage). Banco BHD has made a show of such intent through its equity interest, together with the MIF, in the establishment of Banco de la Pequeña Empresa[16] in 1996. Since then, Banco BHD has participated actively as minority shareholder in the governance of the institution.

B. Financial analysis

3.6 Grupo BHD is a corporation organized in the Dominican Republic that serves as the parent company for a group of Dominican businesses active in the sectors of finance, tourism, real estate development, and remittances. At 31 December 2002, Grupo BHD had assets valued at US$1.4 billion, liabilities valued at US$1.2 billion, shareholder equity of US$151 million, net earnings of US$19.5 million, retained earnings of US$25 million, and dividends for US$21 million (of which only US$500,000 was paid in cash, with the rest reinvested in stock of the group).

3.7 Grupo BHD´s main area of business is financial activity, which accounts for 85% of its assets and 89% of its liabilities. In order of importance, its other activities are tourism promotion (Coratur, S.A.), with 7% of its assets, and real estate promotion (Promotora BHD, S.A. and Inmobiliaria BHD, S.A.), with 7% of its assets. BHD Corp., which is the Grupo BHD unit that handles remittance transfers, represents 0.45% of the group's assets. Grupo BHD´s net worth decreased last year to US$151 million, owing to the negative impact of appreciation of the United States dollar (US$1 = RD$16.97 at 31 December 2001 versus US$1 = RD$20.75 at 31 December 2002); in local currency terms, however, it increased.

3.8 Grupo BHD´s performance is closely linked to the activities of its main unit, Banco BHD, which represents 72% of the group's total assets and, accordingly, its performance essentially determines the results of Grupo BHD. The most important recent development affecting Banco BHD was its merger with Banco Fiduciario in early 2001. As a result of the merger, Banco BHD became the fourth largest bank in

[16] MIF/AT-85.

the Dominican Republic with 11% of the national market, measured in terms of assets, loans, and deposits. The merger increased BHD´s assets by 64.3%, allowing it to continue to pursue a growth strategy that targets retail banking. Deposits and securities held by the public have been the main source of funding for the institution, supplemented by interbank financing and the capital base of Banco BHD. The bank's liquidity ratios are satisfactory (17.3% of its assets are in liquid funds or equivalent) although there has been some deterioration recently. That notwithstanding, Banco BHD enjoys access to significant credit lines from Banco Sabadell and Banco Popular.

3.9 The merger affected Grupo BHD negatively by deteriorating the quality of its portfolio and triggering a slight decrease in the ratios of return on assets (from 1.6% to 1.4%) and on equity (from 14.6% to 12.9%). Even after provisions were doubled in 2002 (from US$8 million to US$17 million), the ratio of bad-loan provisions to past-due portfolio worsened, rising to a level of 94%. That notwithstanding, Grupo BHD has obtained a favorable open equity exposure ratio[17] of 0.018. This performance is also the result of the change in methodology for calculating the past-due portfolio in September 2002 to bring it into line with international standards. Even so, the ratios for provisions and portfolio quality of Banco BHD, and by extension of Grupo BHD, are better than those of the system.[18] Linked credits account for 7.8% of Banco BHD´s overall portfolio.

Grupo BHD – Summary financial history (US$ millions)

	2002	**2001**	**2000**
Total assets	1,404	1,460	1,276
Available funds and short-term investments	342	329	298
Net portfolio	803	837	702
Total liabilities	1,196	1,239	1,113
Deposits	202	228	223
Outstanding securities	759	751	590
Credit from banks and other institutions	216	229	276
Equity	151	162	138
Financial revenue, net	76	67	40
Provisions for at-risk assets	(17)	(8)	(11)
Net operating profit	132	116	75
Operating expenses, depreciation and amortization	95	81	52
Final profit	20	24	19

17 Open equity exposure: past-due portfolio minus provisions / equity.

18 Fitch Ratings. Banco BHD. November 2002.

Key financial parameters

	2002	2001	2000
Equity/ total assets	10.8%	11.1%	10.8%
Return on assets	1.4%	1.6%	1.5%
Return on equity	12.9%	14.6%	13.6%
Bad-loan provisions / past-due portfolio	94%	119.3%	302.4%
Liquid assets + investments / total deposits + outstanding securities	35.5%	33.6%	36.7%
Net financial margin (net earnings / gross financial revenue)	11.3%	14.7%	19.5%
Income / expenditures ratio	1.585	1.577	1.583

2002 Financial information
(US$ thousands)

	Remittances Dominicanas, SA	BHD Corp.
Total assets	2,349.8	8,842.9
Total liabilities	1,662.5	7,465.1
Net worth	687.3	1,377.8
Revenue	2,341	8,116.2
Expenditures	2,111	8,406.8
Net profit	173	(308.6)

3.10 Remittances Dominicanas S.A. and BHD Corp. present a financial situation that, although back on a sound footing, is somewhat more delicate owing to their size (US$2.3 million and US$8.8 million respectively) and their short economic history. Since they are consolidated businesses within Grupo BHD, they enjoy the backing and financial security of the group as well as access to the services and products of Banco BHD. At the same time, however, they are subject to the strategic priorities of the group. The losses posted by BHD Corp. are the result of foreign-exchange losses and the process of expansion.

Remittance activity

	1999	2000	2001	2002
Remittances received in the Dominican Republic (US$ millions)	1,722	1,789	2,150	2,167
Received by Remittances Dominicanas (US$ millions)	114	154	229	198
Market share of Remittances Dominicanas, S.A.	6.6%	8.6%	10.7%	9.1%
Number of transfers through Remittances Dominicana, S.A.	614,000	896,000	935,000	884,000
Average amount of remittance sent (US$)	186.0	196.0	245.0	224.0

IV. THE OPERATION

A. Objectives and components of the project

4.1 General objectives:

(i) Facilitate access to capital in the Dominican microfinance sector.

(ii) Benefit recipients of remittances by enhancing the end value of such payments through a reduction in transfer commissions.

(iii) Involve the traditional formal financial sector in providing financial services to low-and-medium-income economic units.

(iv) Enhance the impact of remittances on the economy's internal savings and on channeling such savings to productive sectors.

4.2 Specific objectives:

(i) Create competition with a view to reducing the intermediation commissions inherent in current remittance distribution mechanisms through the implementation of new technologies

(ii) Promote capitalization of the microfinance sector by enhancing the end value received by remittance recipients

(iii) Encourage remittance recipients and small commercial establishments that distribute remittances to participate in the formal banking system

(iv) Develop and implement new technologies to attract, transfer, control, and receive remittances

4.3 Components of the project. The transfer of international remittances involves three separate activities:

(i) Receipt of the remittance in the country of origin. This is effected by a remittance agent that can be either an internationally known company (e.g., Western Union) or a company with specific national ties (e.g., BHD Corp., Quisqueyana). These agents usually have offices in places having large concentrations of immigrants and, in the United States, are licensed by the banking department of each state. In many instances, the agents operate through subagents (stores, beauty parlors, etc.) that receive the remittance in cash together with the delivery instructions, which they convey to the remittance agent. The client then makes an international telephone call to notify family members of the remittance. In the case of the Dominican Republic, the average cost of a remittance comes to roughly 9% of the amount sent. At present, 71% (of that 9%) goes to commissions paid to subagents.[19]

(ii) Transfer to the beneficiary country. The transfer agent has a contract with a firm that delivers the remittances in the beneficiary country. This firm can be related to the transfer agent or totally independent. Once the agent has received the delivery instructions from the sender, notification is sent electronically to the local distributors who then deliver the funds.

(iii) Delivery of the remittance to the end beneficiary. Given the unavailability of modern technologies, remittance delivery firms in the Dominican Republic work through two distribution channels to deliver funds to the end beneficiary: (i) a network of offices made up of distribution offices or delivery subagents located around the country; these offices offer direct delivery of the remittance to the beneficiary; and (ii) courier services. Such arrangements entail a high degree of risk, logistical complexity and, as a result, high costs. The main risks in the distribution and delivery of remittances that will be mitigated by this project are: (i) robbery and/or assault when remittance is left with agent or picked up by beneficiary; (ii) insolvency of subagents; and (iii) robbery and/or assault of couriers and offices.

4.4 The project will develop, through the implementation of innovative technologies, alternatives to the distribution channels traditionally used to deliver remittances. The MIF will finance, on market terms, the necessary organizational and technological adjustments for Grupo BHD to gradually replace the traditional receipt and delivery channels with others that are more efficient and less costly. This will enable it to significantly expand its remittance transfer services (first stage) and financial services (second stage).[20] It will also increase the level of participation in the formal banking system—with all the positive repercussions that will bring—of Dominicans who are not served by the local financial system.

4.5 Clients who do not wish to continue receiving remittances at home will have the following options:

(i) Network of affiliated commercial establishments using the point-of-sale (POS) technology. This arrangement entails the affiliation of a large number of small businesses in the services sector that, given their

[19] Commissions paid to send a remittance are broken down thus: 71% for the subagent, 20% for the remitting agent, and 9% for the distributing firm.

[20] Manuel Orozco. *Enabling environments? Facing a spontaneous or incubating stage*. January 2002. This correlation between remittances and participation in the formal banking system was shown to be viable and successful in the experiment undertaken by the San José de las Matas credit union (Dominican Republic).

intrinsic features, could become ideal distributors of remittances, e.g., supermarkets, pharmacies, corner grocery stores, and gasoline stations. The POS technology works much like the veriphones used to authorize debit- and credit-card transactions. After receiving the usual phone call from the family member sending the remittance, the beneficiary goes to the most convenient commercial establishment and enters the code provided by the sender. The POS system then communicates with the central servers and receives authorization for the affiliated business to pay out the funds. At the same time, the server orders a credit to the checking account of the POS establishment in the amount delivered to the beneficiary plus a commission paid to the establishment for providing this service.

(ii) Banco BHD network. Under this option, clients would use the network of 56 branch offices and 108 automatic teller machines as the distribution channel. This would allow Remittances Dominicanas to downsize part of its network of offices. Risks associated with delivery would also be reduced, since the bank offices have better security arrangements. For Banco BHD, the increase in traffic at its branches would provide an opportunity for cross sales of other mass-market products, such as savings accounts. In this regard, Banco BHD would play a key role in promoting the inclusion of these clients (recipients of remittances) in the formal banking system.

(iii) Distribution of "rural" remittances through community development institutions and cooperatives. The physical presence and prestige of these institutions in their communities makes them an ideal distributor, while enabling them to generate additional revenue from distribution services that would also ultimately benefit the community. Delivery through these institutions would also be handled through the POS electronic system.

4.6 Unlike other initiatives, the Grupo BHD arrangement does not require that the recipient of the remittance be affiliated with Banco BHD. Although this would be highly desirable since it would mean an increase in access to formal financial services, it is hoped that such access would be secured by convincing users of the advantages and value added of being affiliated. This would guarantee universal access by all Dominicans to an efficient remittance distribution system.

4.7 Grupo BHD´s strategy is based on the premise, according to recent studies,[21] that many users of remittance transfer services are skeptical of banks and other financial institutions. Their opinions are often based on impressions more so than on first-hand experience since the majority of them (and their families) do not participate in

[21] MIF. *Sending Money Home: An International Comparison of Remittance Markets*. February 2003.

the formal banking system. Accordingly, the interaction that financial institutions are able to establish with this underserved population will determine the project's success or failure. Furthermore, it has been shown that users are willing to adopt innovative technologies based on the convenience, security and reliability that such technologies provide both to senders in the United States and to recipients in the Dominican Republic.

4.8 The MIF loan proceeds would be used to cover expenditures incurred. The total cost of the project is US$6,475,000 (the MIF would provide 39% of the resources needed by Grupo BHD to execute the project):

(i)	Installation of dedicated premises (30 sites in the USA)	US$1,500,000
(ii)	Installation of server connections at affiliated businesses (USA; 100 connections)	US$1,500,000
(iii)	Customization of technological platform (USA)	US$ 500,000
(iv)	Software (Dominican Republic)	US$ 165,000
(v)	Advertising and promotion (USA and Dom.Rep.)	US$ 700,000
(vi)	Legal expenses (USA)	US$ 200,000
(vii)	Working capital (USA and Dom.Rep.)	US$1,560,000
(viii)	Financial consulting services	US$ 50,000
(ix)	POS machines[22] (510 units in Dom.Rep.)	US$ 300,000
		US$6,475,000

4.9 The project will only be successful for Grupo BHD if it is able to bring fees down while also achieving the objectives of: (i) broadening access for clients in the United States and the Dominican Republic; (ii) offering excellent service and rapid delivery based on modern technology; and (iii) tapping the advantages and added value that banking services could bring to this sector. The management of Grupo BHD is aware that it cannot maintain a competitive advantage based solely on lower prices, since competitors would eventually lower their prices as well. The BHD network will need to develop qualities of reliability and efficiency in order to capture and keep new clients.

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22 The investment will be made in a gradual fashion over the period 2003-2005. To create an impact and build credibility in the new channels, the management feels that the project should begin by installing 270 POS units (53% of the total) during the first year.

4.10 The rationale for MIF support of this project lies in the potential benefit for the Dominican Republic's microfinance sector. By reducing the intermediation costs of sending remittances and thus increasing the amount that beneficiaries receive, the capital formation of microenterprises would benefit, since 20% to 30% of the capital invested in microenterprises is financed through remittances.[23] In a country where access to credit is limited, remittances are the best alternative means of access to capital for microentrepreneurs who have someone who can send them money from abroad. In this regard, there are strong indications that support economically rational behavior in decision-making on the use of remittances[24] by beneficiary microentrepreneurs.

4.11 Additionally, the project will foster the development of new products with a view to moving from manual remittance processing to technologies that provide low cost to users and, at the same time, create a value chain that will improve the quality of life by facilitating access to such financial services as life and health insurance, coverage of funeral expenses, home savings plans, college fund plans, and debit and credit cards. The benefits will accrue both to Dominican emigrants and to the recipients of remittances.[25]

4.12 As a secondary consideration, the proposed mechanism also implies the affiliation of a large number of small businesses in the services sector that—given their intrinsic characteristics of: (i) handling large amounts of cash, (ii) high volume of clients, and (iii) supplying basic goods and/or services (food, medicine, etc.)—would be ideal distributors of remittances, e.g., supermarkets, pharmacies, corner grocery stores, and gasoline stations. These businesses, aside from generating additional revenue from the distribution of remittances, would benefit from becoming part of the formal banking system and from the additional client traffic created by distributing remittances.

4.13 Grupo BHD is negotiating a series of contracts with rural credit unions that will become distributors of remittances in rural areas in exchange for special discounts. The project calls for installing the new technological platforms in these credit unions. The first pilots will be run with the La Vega Real and La Candelaria credit unions. Three significant benefits will be obtained: (i) socially disadvantaged areas will begin to receive services; (ii) rural credit unions will be strengthened in order

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[23] Christopher Woodruff and Rene Zenteno. *Remittances and Microenterprises in Mexico*. August 2001.

[24] **Shivani Puri and Tineke Ritzema. International Labour Organization.** *Migrant Worker Remittances, Micro-finance and the Informal Economy: Prospects and Issues*. 1999.

[25] Leonides Buencamino and Sergei Gorbunov. *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*. November 2002.

to offer a broader range of financial services to a broader community;[26] and (iii) the emigrant community will be better served.

4.14 The project is expected to have the following impact on the fees that users pay to send remittances:

Proposed fees

	Current fee (US$)	As a % of amount sent	Proposed fee (US$)	As a % of amount sent
Amount sent	245.00	100%	245.00	100%
Commission	17.30	7%	7.30	3%
Exchange spread	5.50	2%	5.50	2%
Total commission	22.80	9%	12.80	5%
			Change in fee	-44%

4.15 In other words, the capital of Dominican microenterprises would increase between US$11 million and US$16.5 million over the space of five years, thanks to lower commissions on the over 5.5 million remittances that would be received and distributed by Grupo BHD. This figure does not include the increase in capital resulting from reinvestment of earnings generated by this increased access to capital, nor does it reflect the multiplier effect of 3:1 of remittances in the local economy.[27]

B. Financial terms and conditions of the operation

(i) Borrower: Grupo BHD, S.A.

(ii) Amount: up to US$2.5 million, in a single disbursement[28]

(iii) Period: up to five years, including a grace period of not more than two years

(iv) Amortization period: equal semiannual payments to begin after the second year from the date of the first disbursement

(v) Interest rate: variable, equivalent to the six-month LIBOR rate + 4.5% per annum, payable semiannually

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[26] An analysis is under way to see if rural credit unions can market the products of Banco BHD, which are difficult for such small credit unions to develop, while gaining access to financial services, e.g., portfolio securitization or mortgages through Banco BHD.

[27] MIF. *"Sending Money Home: An International Comparison of Remittance Markets*. February 2003.

[28] The loan will be disbursed in a single tranche, since the most important investments of the project will be made during the initial stages. As a condition precedent to the first disbursement, BHD Corp. and Remittances Dominicanas S.A. are to show that they possess the necessary licenses and permits.

(vi) Front-end fee: 0.5% of the principal

(vii) Past-due fee: 6% per annum payable on the amount of principal due, calculated on the basis of a 360-day year

(viii) Advance-prepayment fee: 3% of the amount paid in advance multiplied by the ratio of the number of months until maturity to the contractual maturity in months

(ix) Surety: general guarantee of the institution

(x) Financial clauses: the MIF may accelerate the loan or require that guarantees be established in the event of:

a. significant deterioration of the financial situation of Grupo BHD or its principal subsidiaries as measured by the following ratios of Banco BHD:

- loan portfolio provision / past-due loans ≥ 90%
- past-due loans / gross loan portfolio ≤ 8%
- net loan portfolio / (deposits + securities + financings) ≥ 70%
- equity / total assets ≥ 9%

b. a share retention agreement

c. an unsatisfactory audit of Grupo BHD or Banco BHD

d. failure to comply with regulations or supervisory agencies of remittance agencies and financial institutions in the United States and Dominican Republic (including the Patriot Act)

e. financial cross-default

f. failure to meet the project's social objectives as measured by the supervision indicators

(xi) Use of proceeds: The loan proceeds will be used to finance part of the expenses to be incurred in upgrading and developing new technological channels to receive and distribute remittances to the Dominican Republic

(xii) Supervision: Comfort letter on supervision of Banco BHD

4.16 The interest rate takes into account the prevailing market conditions and is aimed at preventing situations of lending at subsidized rates or rates that are so burdensome as to make it impossible for Grupo BHD to execute the project. The key parameters used in determining the interest rate were: (i) as the minimum price, recent IDB loans to the Dominican Republic; (ii) U.S. dollar interest rates for commercial bank borrowings as published by the central bank; (iii) lending rates for similar operations of multilateral and private institutions; and (iv) the pricing guidelines of the Inter-American Investment Corporation. It was determined that a variable rate of six-month LIBOR plus 4.5%, plus a front-end fee of 0.5%, would be within those guidelines.

4.17 **Supervision indicators**. To prevent the loan from being accelerated, evidence is to be provided that Remittances Dominicanas, S.A. and BHD Corp have complied with the following parameters:

(i) The fee charged per remittance is to drop from the current average level of 9% to 5%[29] before 2007

(ii) Grupo BHD is to show that it has incurred at least US$3 million in counterpart expenses

(iii) Remittances Dominicanas S.A. is to have installed at least 200 POS units before 31 December 2004 and 400 by 31 December 2007

4.18 To ensure monitoring of the operation, the MIF may, at its sole discretion, subcontract supervision of the project to a third party.[30] Grupo BHD undertakes to cooperate in good faith with such party, providing all information requested and affording access to the necessary persons and institutions.

4.19 **Expected outcomes**. The following tangible outcomes are expected from this project:

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[29] It is hoped that this objective will be achieved during the first year of the project, although prevailing macroeconomic conditions are creating uncertainty as to the viability of that time frame.

[30] The MIF has already strengthened supervision of a portion of its microfinance portfolio by hiring Omtrix, S.A., a Costa Rican firm specializing in investment in microfinance institutions.

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Number of remittances distributed by Remittances Dominicana S.A.	923	1,015	1,127	1,206	1,266	5,537
Capital distributed by Remittances Dominicanas S.A.	229,827	252,735	280,623	300,299	315,234	1,378,718
Increase in the remittance amount received as a result of lower commission	9,193	10,109	11,225	12,012	12,609	55,148
Multiplier effect in the Dominican economy as a result of the 4% decrease in the fee (3:1)	27,579	30,327	33,675	36,036	37,827	165,444
Increase in capitalization of Dominican microenterprises (calculated average of 25%)	2,298	2,527	2,806	3,003	3,152	13,786

Figures in thousands.
Figures in U.S. dollars.

4.20 The nonfinancial outcomes expected from this project are:

(i) development, in five years, of alternative channels for remittance distribution,[31] with the main vehicles being: (i) POS (mainly businesses, pharmacies and gasoline stations): 45%; (ii) rural credit unions: 15%; (iii) Banco BHD network: 20%; and (iv) courier services: 5%.

(ii) creation of a network of strategic partnerships with rural credit unions and other formal financial intermediaries that provide access to the underprivileged social strata (deepening) to formal banking products and services.

C. Environmental considerations

4.21 The Committee on Environment and Social Impact examined and approved the project at its 24 January 2003 meeting. No recommendations were made, inasmuch as the planned activities do not directly affect microcredit clients or the environment.

[31] Remittances Dominicanas, S.A., currently distributes 97% of its remittances by courier, 2.5% through its own network of offices, and only 0.5% through the commercial network of Banco BHD.

V. RISKS AND MITIGATING FACTORS

5.1 **Country risk**. Given the macroeconomic fragility of the Dominican Republic, new crises could have a negative impact on Grupo BHD. **Mitigating factor**. The group is a holding company that is well diversified both sectorally (e.g., finance, tourism and real estate) and geographically (e.g., domestic and international presence). Thanks to the international makeup and commitment of its investors to its financial activities, Grupo BHD has a solid shareholder structure that contributes to its strength. Furthermore, its management team possesses many years of experience in similar, difficult scenarios.

5.2 **Systemic risk**. Many of the factors that affect liquidity management at financial institutions lie beyond Grupo BHD´s control. **Consideration**. The main Grupo BHD unit that would be affected is Banco BHD, which has a sound shareholder structure, a very competent management team with considerable experience in similar situations, and it currently enjoys a healthy situation. Under the project, Grupo BHD would also seek to expand its remittance business and thus diversify its sources of deposits.

5.3 **Credit risk**. If the group's financial situation worsened considerably, the MIF could sustain losses. **Mitigating factor**. The MIF would be lending to an institution established, capitalized, and managed by a group of local investors who have obtained excellent results thus far. The MIF resources would represent a very low percentage of the group's liabilities. In the event of significant deterioration, an unsatisfactory audit or failure of the group to honor any other credit commitment, the loan would be accelerated. The MIF will constantly monitor the institution to ensure compliance with the loan conditions as well as progress in that area.

5.4 **Credit deviation risk**. Grupo BHD could channel the proceeds from this loan to other of its units or to activities other than those indicated in the project. **Mitigating factor**. The group's obligation to channel the loan proceeds to this project will be established in the contract. Non-acceleration of the loan will hinge on the institution's achievement of specific social-impact targets set by the MIF. Grupo BHD is fully aware that one of its main competitive advantages vis-à-vis other financial institutions lies in working with and building links between remittances and the microenterprises and small businesses of the Dominican Republic. The loan will be on competitive market terms in order to prevent the resources from being used to replace liabilities.

VI. EXCEPTIONS TO BANK POLICIES

6.1 None.