# Agricultural Development Banks
## Close Them or Reform Them?

Agricultural development banks were established to extend credit and other financial services to customers not considered creditworthy by commercial banks. Although frequently unprofitable, they can play an important role in the fight against rural poverty. Should these banks be closed or are they worth revamping?

*Hans Dieter Seibel*

AS THE 1990s drew to a close, the world's leaders resolved to overcome mass poverty and undernourishment in the new millennium and to eliminate government subsidies and protection, as well as repressive financial policies. They acknowledged the need to replace dysfunctional and otherwise distortional economic policies and to emphasize equitable, sustainable, and viable financial institutions. The international financial institutions took steps to reduce or, in some cases, forgive the debts of the poorest countries and acknowledged some of the shortcomings of structural adjustment. They have shown that, where alternatives exist, they will support those national organizations and financial services that reflect their key concerns—including sustainability of operations, ability to deliver, stakeholder participation, and profitability.

### Banks' outreach growth declines

In such a climate, what is the future of agricultural development banks, which are frequently unprofitable and increasingly seen as the white elephants of development finance? Agricultural development banks were established 20–30 years ago to extend financial services, mainly credit at subsidized interest rates, to customers not considered creditworthy by commercial banks. They are largely state owned and funded by governments and international donor agencies. In general, agricultural development banks have focused on providing credit rather than on accepting deposits, a practice that has undermined their self-reliance as well as their viability.

Given the high cost of administering large numbers of small loans, the banks have tended to provide bigger loans to better-off farmers. Because farming is a seasonal occupation, agricultural lending institutions experience the boom and bust of cash flows, with loan requirements drastically increasing during the sowing season. In addition, an emphasis on providing loans strictly for agricultural activities, mainly crop production, as opposed to providing credit for other kinds of rural income-generating activities has limited the potential of agricultural development banks to serve a wider clientele. Such preferential credit programs have tended to curtail rather than expand their outreach to small farmers and other customers in rural areas.

Because they are government owned, agricultural development banks have frequently been subject to repressive financial measures, such as controlled exchange and interest rates, as well as to political expediencies and vested interests. Interest rate regulation has prevented them from covering their costs and has restricted the access of the poor to financial services. These banks have also remained largely unsupervised, and their de facto exemption from prudential banking regulations and from effective monitoring and supervision of their activities has brought many of them close to insolvency. Interestingly, these constraints have applied to institutions operating in both centrally planned and free-market economies.

With a few laudable exceptions, primarily in Asia, agricultural development banks have also suffered from the reluctance of both public and private sector interests to implement policies and reforms that recognize that the poor are bankable—that they can save, invest, and repay loans. To develop their agricultural activities and microenterprises, prepare for emergencies, and provide for the future, the poor need access to a range of microfinance services, in particular savings-deposit facilities, credit, and insurance.

It is not surprising that agricultural development banks have often become unsustainable. In at least two regions—Africa and Latin America—a number of them have been closed down. Among those remaining, many are technically bankrupt but continue to limp along, unable to attract substantial new funding. They also lack the managerial wherewithal to diversify and enhance customer services—for example, by enabling women farmers and other traditionally disadvantaged groups to both save and borrow.

## Successful reform stories

Reform—which requires operational autonomy and freedom from political interference—entails setting up an appropriate legal and regulatory framework with prudential norms and effective internal control and external supervision. Two agricultural development banks that reformed successfully are the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand and Bank Rakyat Indonesia (BRI).

In October 1998, BAAC, with 4.8 million clients representing some 86 percent of all farm households in the country, came under the supervision of the Bank of Thailand for the first time in its 34-year history. It is now subject to prudential regulation, such as capital-adequacy requirements and loan-loss provisioning. More stringent rules and performance standards may be painful in the short term but will help BAAC in its struggle for financial viability and self-sustainability in the longer term.

BAAC's reforms were actually staggered over more than thirty years. In the beginning, the bank depended almost exclusively on capital from the government for operating funds. Allocations often arrived late, and the inflow of funds was difficult to synchronize with farmers' seasonal credit needs. The result was a chronic funding shortage. Loan-recovery rates dropped to as low as 51 percent in the early 1970s and, by 1974, administrative costs had risen to more than 8 percent, threatening BAAC's financial viability.

### International Fund for Agricultural Development

The fate of agricultural development banks is especially critical to the work of the International Fund for Agricultural Development (IFAD), an international financial institution and specialized agency of the United Nations. Established in 1977, IFAD has a unique mandate to combat hunger and poverty in low-income regions. As part of its mandate, IFAD has traditionally provided loans to farmers and farmers' groups through agricultural development banks and other rural financial institutions.

A sustained impact is crucially important. Thus, IFAD has also explored ways of providing credit through other institutions, among them financial cooperatives and, for example, in West Africa, local institutions that build on ancient indigenous traditions. At the same time, IFAD is among those leading the debate on how to reform existing formal sector institutions, such as agricultural development banks.

With about one-fourth of its portfolio dedicated to rural finance activities, IFAD is currently preparing guidelines to address the main difficulties that have beset rural financial institutions, including agricultural development banks. The guidelines focus on improving access by the rural poor—as users and user-owners—to sustainable financial institutions that mobilize their own resources, cover their costs from their operating income, and finance their expanding outreach from their profits. IFAD mobilizes resources and knowledge through a strategic, complementary, and dynamic coalition of clients, governments, financial and development institutions, nongovernmental organizations, and the private sector.

The bulk of IFAD's resources are made available to low-income countries on highly concessional terms, repayable over 40 years, including a grace period of 10 years and a yearly service charge of 0.75 percent. Between its establishment in 1977, and 1999, IFAD provided nearly $7 billion in loans and grants for 550 projects with a total cost of $19.3 billion in 115 countries.

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In 1975, the Bank of Thailand adopted an agricultural credit policy stipulating that commercial banks would initially have to lend 5 percent—and 20 percent subsequently—of their portfolios to the agricultural sector. Under this policy, the banks could either lend the amount directly to farmers or deposit with BAAC any portion of the quota that they could not disburse directly. This policy marked a turning point in BAAC's operations, and the increasing availability of commercial bank deposits made up for the BAAC's shortage of funds. Other measures were also taken, including shifting from wholesale lending through agricultural cooperatives, to retail lending to individual farmers organized into joint-liability groups. By 1987, BAAC had formed about

100,000 joint-liability groups involving 1.5 million members, compared with 821 agricultural cooperatives.

Between 1988 and 1996, the Bank of Thailand eliminated interest rate ceilings on the fixed deposits of commercial banks and eventually liberalized all interest rates. Restrictions were removed on the opening of branches, and commercial banks were allowed to offer a wide range of financial products in rural areas. By 1998, BAAC had increased the number of its branches to 535 from 82. While commercial banks were expanding their lending portfolios and reducing their deposits, BAAC was increasing its outreach and savings mobilization to the point where rural deposits became its main source of funds. Moreover, following Thailand's financial and economic crisis in 1997, BAAC was seen as a safer haven than its commercial competitors and received significant inflows of deposits.

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BRI's experience shows what can be achieved under deregulation. Since 1984, BRI has been a major provider of microfinance, mobilizing microsavings and offering small and micro loans to individuals and groups at the village level. By 1989, BRI was able to fully finance its village lending activities from locally mobilized savings. Since then, the growth of savings has outpaced that of loans, testifying to a strong demand by the rural poor for deposit services. By 1999, its 3,700 rural subbranches had 2.5 million active borrowers and some 20 million savings accounts. Among the three leading rural financial institutions in Indonesia, BRI accounts for 78 percent of savings account deposits and 52.2 percent of all loan accounts.

By implementing sound policies, including a massive staff retraining program, this formerly frail government-owned agricultural development bank made its microfinancing unit a tremendous success. Part of this success stems from the bank's recognition of the need to reach out to the rural poor as well as to wealthier clients. BRI benefited from interest rate deregulation and a management initiative to commercialize operations by transforming its subbranches into self-sustaining profit centers. For example, it offered its staff profit-sharing incentives. The bank covers its costs from the interest rate margin and finances expansion from its profits; its long-term loss ratio is only 2.1 percent.

Even during the recent Asian banking crisis, BRI's microbanking unit remained profitable: it was the only profitable entity among the government-owned banks. At the peak of the crisis in June–August 1998, the demand for credit stagnated because of a general lack of confidence in the market. At the same time, however, BRI attracted 1.29 million new savers, leading to increases in the volume of savings deposits in both nominal and real terms.

## Preconditions for reform

The experiences of BAAC and BRI suggest that reforming the agricultural development banks may be feasible and that their financial performance and outreach can be greatly improved, but only if certain preconditions exist to facilitate their rehabilitation. Among these, a favorable financial sector climate, an effective demand for rural financial services, and a real commitment to profitability and sustainability of operations are essential.

Despite the difficulties that have beset agricultural development banks in most parts of the world, they have continued to provide important financial services through their branch networks. In regions where these banks have been closed, their market share has generally not been filled by other financial institutions. In addition, after several decades of operation, these banks have accumulated valuable customer information that would be expensive and time-consuming to replicate.

Any financial institution following sound practices can become sustainable and combine outreach and viability. But generally, institutions built on principles of self-reliance and private ownership have better prospects. To maximize their outreach, institutions must be financially sustainable: they must be able to cover all their costs, mobilize their own resources, protect their funds against erosion from inflation and nonrepayment of loans, and make a profit to finance their expansion.

Clearly, the political will either to close loss-making institutions or to implement effective reforms is essential. A consensus is needed among development and financial institutions, including the World Bank, regional development banks, and the International Fund for Agricultural Development (IFAD) (see box), together with the IMF and bilateral donors. Governments also need to be pressured to implement reforms with implications for their own fiscal and prudential regulatory and supervisory policies.

In the 1990s, a political consensus emerged, through a variety of international forums, in favor of promoting sustainable forms of rural banking, including credit, savings schemes, and other financial services, for poor women and men. The recent financial crisis in Asia has also highlighted the need for closer scrutiny and regulation of financial organizations, including agricultural development banks and microfinance institutions.

## Reform goals

The essence of agricultural development bank reform would be to transform these banks into viable and sustainable providers of financial services to a wide-ranging rural clientele (see table). In many cases, reform would mean financial and

## Framework for reform

**Overall objective**

Transform agricultural development banks into viable and sustainable providers of financial services to all segments of the rural population, incuding the poor

**Key results to be achieved**

- The political will to reform or close banks
- Adequate reform strategies (for example, privatization)
- An effective planning process
- Operational autonomy and freedom from political interference
- An appropriate legal and regulatory framework with prudential norms
- Financial restructuring
- Organizational restructuring
- Human resource development, including staff retraining
- Effective delivery system (decentralized network of branches as profit centers)
- Demand-driven deposit, credit, and other financial products
- Financial sustainability
- Effective internal control and external supervision

organizational restructuring, staff retraining, and human resource development. It could also entail cleaning up a bank's portfolio of bad debts, which may require consolidating loss-making state-owned enterprises. Such enterprises are among the major customers of agricultural development banks. As with commercial credit institutions, agricultural development banks should concentrate on demand-driven financial products tailored to the actual needs of rural customers, with a particular emphasis on the very poor, who in many developing countries form the majority of the population. For this reason, effective outreach implies the establishment of a decentralized network of branches that work as profit centers.

The challenge is to find a way for all the stakeholders—donor institutions, governments, and the rural community—to work together for reform. Institutions like IFAD, with a long history of assisting the rural financial sector, will continue to work in this area to improve financial institutions' viability and outreach to the poor with demand-driven financial services. Innovation should not necessarily imply establishment of new organizations when it might be more cost effective, although at times politically more sensitive, to reform existing ones. F&D