Agricultural banks: Ignore them, close them or reform them?

During the 1960s, state agricultural banks that offered subsidized targeted credit were considered to be a major tool for modernization in developing countries. When the experiment failed, donors such as the World Bank and the German Ministry of Economic Cooperation, acting through KfW Development Bank, phased out their support around 1980. Since then, various other types of rural financial institutions have emerged in many countries. What are the prospects for agricultural banks in a market-led financial system? Should they be closed, reformed or simply ignored?

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State agricultural banks in developing countries have their roots back in the nineteenth century. For example, Syrian and Jordanian agricultural banks can be traced back to the Ottoman Bank of Myra, established in Damascus in 1888, while the origins of Bank Rakyat Indonesia date back to 1895. Almost all the agricultural banks that are still in operation today have gone through major crises.

The era of modernization and capital transfer

The golden age for agricultural banks was during the 1950s to 1970s. It began with the unprecedented success of the development banks, which had been established to finance the reconstruction of destroyed Europe – in particular the World Bank in 1944 and the German Kreditanstalt für Wiederaufbau (KfW) in 1948. They widened their sphere of activity when underdeveloped countries became independent. The proposed paradigm for the new developing countries was that modernization could be achieved through capital transfer based on the model of the Marshall Plan and the German economic miracle. National development banks were established to channel loans. Half of all agricultural banks in a UN Food and Agriculture Organization (FAO) database emerged during this initial period (http://www.fao.org/ag/ags/agsm/Banks/index.htm).

From a sectoral perspective, agricultural banks were an instrument of ministries of agriculture to increase agricultural production, which in turn was to help financing the industrial sector. Since the 1970s, an additional objective has been poverty reduction through individual or group loans to smallholders.

The modernization theory and its hypotheses

Developing countries lacked the expertise for the effective planning of agricultural finance. Experts from international organizations provided this expertise. In the framework of an intended total modernization of economy and society, they introduced modern financial institutions. Indigenous financial institutions based on self-help, as part of the traditional social system, had no place in this concept. Similarly, farmers without formal education lacked the expertise to make intelligent production decisions. This expertise was

The Thai agricultural bank BAAC survived the general wave of closures and, despite various restrictions, is going from strength to strength.

Photo: Seibel

provided by the comprehensive manuals that came with targeted credit. Farmers produced what was subsidized. If the loans arrived too late, they were diverted and used to purchase consumer goods.
Banks did not have a delivery network. Agricultural cooperative societies stepped in and channelled subsidized loans alongside seeds and fertilizer, but not without a share of the proceeds going to their boards.
The smallholders were too poor to save. The agricultural banks therefore distributed loans without offering any savings products. Since farmers were unable to deposit their savings with the bank after the harvest, they had to rely on loans year after year.

The disastrous experience of the agricultural banks has led to a paradigm shift: smallholders, microentrepreneurs and women are well capable of saving, taking out loans, and repaying them despite high interest rates.

Agriculture was not productive enough to bear the full cost of capital, and interest was therefore subsidized. Excess demand meant loans had to be rationed. Everyone profited from this system: the bigger farmers, because they had access to funds on favourable terms; bank staff, because they were able to supplement their meagre incomes with under-the-table payments; civil servants and politicians, because they themselves were able to obtain loans, or use cheap loans to buy political favours from their electorate. In their effort to increase production the banks created staff incentive schemes based on the volume of loan disbursement. Thus it was neither in the interests of the bank staff nor the farmers that loans be repaid; many agricultural banks did not even operate an information system to supervise and control credits. Meanwhile, the mountain of external debt continued to rise.
Supported by donors, instructed by experts and steered by interest groups, this system of agricultural credit proved its long-term stability in many countries. Since loans to sovereign countries were typically issued for 40 years, and since the countries themselves guaranteed the repayments, with the banks acting merely as implementing bodies for the state outside the control of bank supervision, international donors were slow in checking up on their optimistic expectations for the impact of the loans. The macroeconomic reckoning finally came in the 1990s and, for the poorest countries, was settled through debt relief.

From agricultural credit to rural finance

The failure of the agricultural banks did not remain hidden from view. The outcome of assessments during the 1970s, initiated by USAID's 1973 Spring Review of Small-Farmer Credit, is reflected succinctly in the title of a publication: Undermining Rural Development with Cheap Credit (D.W. Adams, D.H. Graham & J.D. von Pischke, Boulder Colorado 1984). The World Bank, USAID and Germany stopped supporting agricultural banks at the beginning of the 1980s. Yet, under disbursement pressure, regional development banks and specialist multilateral institutions have maintained their partnership with agricultural banks, without their owners, among them the German government, monitoring the impact of their support: whether it has made some of the poor richer, but the countries poorer.
Overall, the disastrous record of the agricultural banks made it necessary to revise the initial hypotheses, resulting in a paradigm shift: smallholders, micro-entrepreneurs, women and the landless are capable of saving. They are able to take out loans for a variety of purposes and repay them, despite interest rates much higher than those charged by agricultural banks. They possess local knowledge and make sensible production decisions. Like the rural economy as a whole, their household economies are diversified and generally comprise many different economic activities.
Our perspective on financial institutions has widened, and the terminology has been updated: traditional organizations in the 1960s, self-help groups and credit NGOs in the 1970s, informal financial institutions and microcredit institutions since the 1980s, microfinance institutions (MFIs) as local financial intermediaries since 1990, and, since around 2004, inclusive financial institutions. Under appropriate legal conditions, autonomous, self-reliant rural financial institutions can evolve, or be upgraded from informal and semi-formal into formal institutions, even without external initiatives or capital injections. These institutions may be in private, municipal, non-profit, cooperative or public ownership. Many of them, such as local rural banks in Indonesia, Nigeria and The Philippines, and savings and credit cooperatives in Vietnam, are – under increasingly effective supervision – independent of donors. An increasing number are economically sustainable and finance their growth through profits; those that are not profitable are closed by financial authorities, or, following controversial discussions about the alleged outreach vs. sustainability dilemma, are either forced by their donors to increase their efficiency or see their support removed.
From a development policy perspective, the poverty hypothesis (poor in savings, investment ideas and institutions) and the resulting strategy of subsidized targeted credit by development banks have led to a gigantic misallocation of production factors and the distortion of rural financial markets. This has now been replaced by the strategic hypothesis of a differentiated sector of viable and sus-

You will know them by their loans

Rajwa is 50 years old, a widow with five children. She lives in the Karak region of Jordan. She received a loan equivalent to US$ 3 000 from the agricultural bank at an interest rate of 7 percent, to be repaid in eight annual instalments. She bought 20 sheep and equipment to produce cheese and butter. Unfortunately, she discovered that there was no market for her products, because every family produces its own cheese and butter. With a loan of US$ 300 for eight months, she could have bought milk and equipment and could have tested her entrepreneurial abilities without too great a risk. However, because of high transaction costs and low interest rates dictated by the government, the bank does not provide small short-term loans. Rajwa would now like to buy a sewing machine for US$ 170, but the bank loan with inappropriate terms has ruined her and rendered her unbankable.
Khuland from Manshiya, also in Karak, is 30 years old and married with six children. As a member of a support group, she received a loan from a local NGO of US$ 210 for a period of six months at an interest rate of ten percent, and opened a shop in her house. After this, she received two further short-term loans of US$ 280 and US$ 350 and expanded her product range. As a reliable client, she has now received an individual loan of US$ 3 000 over 30 months and rents her own shop. Her business is growing and she makes all her interest payments on time.

tainable rural financial institutions as part of the respective national financial system (H.D. Seibel: *Financial Systems Development and Microfinance*. Schriftenreihe der GTZ Nr. 258, Eschborn 1996; H.D. Seibel: *What Matters in Rural and Microfinance*, WP 2005-1, www.uni-koeln.de/ew-fak/aef/working_papers.htm). The new outlook is expressed in a growing number of rural and microfinance policy papers (such as AsDB, *Microfinance Development Strategy, 2000*; BMZ, *Sectoral Policy Paper on Financial System Development*, 1994, 2004; CGAP, *Microfinance Consensus Guidelines*, 2003; CGAP, *Building Inclusive Financial Systems*, 2004; IFAD, *Rural Finance Policy*, 2000). A vision for the future may be gained from a look backwards at the history of rural and microfinance in Europe since the 18th century, now largely integrated into the formal financial sector (H.D. Seibel: *History Matters in Microfinance*. Small Enterprise Development 14/2, 2003:10-12).

Three options for agricultural banks

Do state agricultural banks still fit into the world of financial system development? Should they be closed because they devour public funds whilst simultaneously impeding the expansion of local financial institutions? Or should they be left to their own devices, while we concentrate on microfinance institutions (MFIs) instead? There is something to be said for this approach, as is illustrated in the not atypical example in the box on page 31. Alternatively, are there opportunities to extend the reforms in microfinance to agricultural banks? In many cases, these questions are obsolete: in Latin America many agricultural banks have been privatized; in Africa many have been closed, and others are insolvent. Far-reaching reforms are found in some Asian countries. For an individual agricultural bank, three strategies are possible: ignore it, close it or reform it. The decision rests more with governments than it does with banks themselves. In the 1980s and 1990s, large donors ignored the agricultural banks. Since about 2000, the banks have been back in focus following the initiatives by multilateral and bilateral donors such as IFAD, CGAP, FAO and GTZ (H.D. Seibel: *Agricultural development banks: close them or reform them?* Finance & Development, International Monetary Fund, June 2000: 45-48).

Ignoring these banks is the most expensive strategy. Faced with political pressure or a lack of alternatives, many governments see themselves forced to keep their agricultural banks alive. In countries with scarce resources, the closure of these banks is almost always preceded by a longer period of ignoring them. In 1999, the state cooperative bank in Uganda was closed; its problems had been ignored rather than resolved. The Centenary Rural Development Bank took over a number of branches and solved the problems. The Cooperative Bank of Kenya has been showing signs of serious problems for years, but despite this, the World Bank is cooperating with it, pointing to problems, but not pushing for them to be solved. As in Uganda, ignoring the problems will lead to the closure of the bank.

Nabard, an agricultural apex bank in India, has facilitated and refinanced bank linkages of 1.6 million savings-based self-help groups with 24 million members; 90 percent of them are women.

Photo: Seibel

The determination of governments to set up agricultural banks appears unshaken. Of the 75 agricultural banks in the FAO database, 37 percent were first established in the 1980s and 1990s. Even more pronounced is the political will to keep agricultural banks alive. This fact cannot be ignored. In many cases, these banks have a branch infrastructure which none of the parties wishes to abandon and a client base that has no alternatives in the short term. Is keeping agricultural banks alive a purely political decision with no objective justification?

Reforming agricultural banks

In the 1970s the Food and Agriculture Organization (FAO) of the United Nations initiated the establishment of Regional Agricultural Credit Associations (RACAs): Afraca for Africa, Apraca for Asia-Pacific and Nenaraca for the Near East and North Africa. In recent years, RACAs helped member institutions to carry out studies and promoted an exchange of experiences. The impetus for this came from reforms, some of which with spectacular results, both in countries with market economies and with more restrictive policy environments. A few examples are provided below (cf. H.D. Seibel, T. Giehler & S. Karduck, *Reforming Agricultural Banks*, 2005, http://ww.gtz.de/de/dokumente/en-Reforming-Agricultural-Banks.pdf).

Bank Rakyat Indonesia (BRI), a big-bang reformer. The reform of BRI has its roots in the deregulation of interest rates in 1983. However, that only affected the division of the bank through which subsidized agricultural loans have been channelled to 700 000 farmers, and which, with repayment rates at around 50 percent, was experiencing particularly heavy losses. This division is now called the Microbanking Division (MBD). Major factors influencing the liberalization were an oil crisis, Stanford-educated financial policy experts and the Harvard Institute for International Development (HIID). In 1984, with the help of HIID, the then 3 000 (now 4 185) sub-district units were turned into profit centres with individual performance incentives. They were equipped with two attractive financial products: the savings product SIMEDES that paid an interest rate of 11.5 percent, plus 1.5 percent for a lottery component, and the flexible credit product KUPEDES, which offered loans that were not tied to a particular purpose and ranged from US$ 35 to US$ 5 800, with monthly repayment rates at a level of four times the previous interest rate, the equivalent of 44 percent per annum (against an inflation rate below ten percent). If all

Photo: Seibel

At the end of 2003 the Microbanking Division of the Indonesian agricultural bank BRI held savings deposits of more than US$ 3.53 billion.

repayments were on time, a quarter of the interest was refunded. This resulted in a repayment rate of 95 percent and reduced the loss ratio to less than 2 percent.
Within six years, the BRI unit desa system became probably the most successful model for the reform of agricultural banks. By the end of 2003, MBD had 29.9 million savings accounts with US$ 3.53 billion in deposits and 3.1 million loan accounts with a portfolio of US$ 1.68 billion. Return on assets was 5.7 percent. Since the mid-1990s, it has produced annual profits of over US$ 100 million and generated annual excess liquidity of US$ one to two billion. However, there is an urgent need for new financial products with which to invest these funds in the rural economy, lest they be siphoned off to the urban economy. Without the profits generated by MBD, BRI would have probably been liquidated during the 1997/98 financial crisis (H.D. Seibel: *The Microbanking Division of Bank Rakyat Indonesia: A Flagship of Rural Microfinance in Asia*. In: M. Harper & S. Arora, eds., Small Customers, Big Market: Commercial Banks in Micro-Finance. ITDG Publications, Rugby, 2005).

BAAC in Thailand: Gradual reforms under restrictive conditions. To this day, the Bank for Agriculture and Agricultural Cooperatives is subject to interest rate restrictions at around 12 percent per annum. It has survived thanks to gradual reforms and substantially increased efficiency. Reforms proceeded in several stages. Between 1966 and 1974, BAAC created a system of group loans for cooperatives and individual loans for farmers in loan guarantee groups. Between 1975 and 1987, it expanded its agricultural loan business through state-decreed loan quotas from commercial banks and at the same time dismantled the loss-making cooperative loans. From 1988 to 1996, with increasing liberalization of interest rates, the foundations were laid for self-reliance by means of savings mobilization, and for sustainability thanks to improved loan repayment and productivity. The 1997 financial crisis highlighted the danger inherent in foreign financing: BAAC lost almost half of its capital. It has since been subject to regulation by the central bank.
By decision of parliament, BAAC is now able to diversify its portfolio. The Bank provides loans to 92 percent of farm households, as well as savings and loan services to growing numbers of rural people. The number of savings accounts is 9.6 million, and there are 5.2 million borrowers. The loan portfolio is fully covered by savings. It meets its costs, despite considerable interest and moratorium restrictions (under 'Thaksinomics') (M.L. Haberberger, L. Wajananawat & N. Kuasakui: *Bank for Agriculture and Agricultural Co-operatives, Thailand*. In: The Challenge of Sustainable Outreach. GTZ, Eschborn, 2003: 249-288).

NABARD in India: Reform of outreach to low-income groups. The National Bank for Agriculture and Rural Development in India was founded in 1982 as an apex bank for three banking networks comprising 150,000 rural units. They comprised commercial banks which are now generally profit-making; regional rural banks, which have been in a process of reform for ten years and 80 percent of which are now profitable; and cooperative banks, the reform of which is currently being planned with help from Germany. In response to encouragement from Apraca, as well as from German Technical Cooperation (GTZ). NABARD runs a revolutionary programme to reach target groups through the rural banks. The programme has been operated as a pilot project during 1992-96 and implemented since on a national level. Facilitated by governmental and non-governmental organizations, self-help groups, particularly from the lowest segments of society, mobilize savings, lend them to members and are then refinanced by 36 000 bank branches. Since 1996, 1.6 million self-help groups (SHGs) with 24 million members (90 percent of whom are women), comprising 120 million family members, gained access to bank credit. SHG banking in India has now become the rural microfinance programme with the strongest growth in any developing country.
Despite low interest rates fluctuating between 10 and 13 percent, SHG banking is a lucrative financial product for banks thanks to high repayment rates and the externalization of social mobilization costs. On-lending rates to members are determined by the SHGs themselves. With net margins of twelve percent on average and continuing savings contributions from their members, they mobilize their own funds to a significant extent and, with the consent of the central bank expressed in a circular letter, act as autonomous informal financial intermediaries. Members benefit most, and at minimal transaction costs: they gain in self-confidence, local participation, entrepreneurial activity and additional income (WP 2001-3, 2002-7, 2004-2, http://www.uni-koeln.de/ew-fak/aef/working_papers.htm).

The political will for reform

The list of positive examples could be continued. It includes the Banque Nationale Agricole in Tunisia, which, by moving into the urban savings and credit markets, was also able to expand its rural portfolio and make profit. Another example is Bank Keshavarzi in Iran, which disburses loans to 1.5 million loan customers every year and increasingly finances them through savings; confronted with interest rate restrictions, it now moves into wholesale banking. An example on the fringes of the public agricultural banks is the Centenary Rural Development Bank already mentioned above. This bank, owned by the Catholic Church in Uganda, was reformed with the assistance of the Sparkassenstiftung für Internationale Kooperation (Savings Banks Foundation for International Cooperation) and IPC GmbH of Frankfurt, and now runs a highly successful banking business with small and micro rural clients (H.D. Seibel, CRDB, Uganda: *A Flagship of Rural Bank Reform in Africa*. Small Enterprise Development 14/3, 2003:35-46).
There is a multitude of successful reform measures and models. The crucial factor is the political will for reform and the determination to persist through crises and against opposition by vested interests. Bank supervision authorities have an important role to play. Donors can also contribute to reform, for example by strengthening the supervisory authorities and the RACAs' exposure and dialogue programmes.